

Summary of 2013

Revenue & Education Investment Proposal

Representative Reuven Carlyle,

Chair, House Finance Committee

Chair Carlyle's Revenue & Education Investment Proposal for 2013-15 Biennium	
<u>Close and Narrow Tax Exemptions and Special Rates</u>	2013-15 Estimated Impact (\$ in millions)
Repeal preferential B&O rate: Travel agents & tour operators. <i>Created to help agents compete with airlines in 1975, when flight bookings generated 75% of agents' revenue (no longer true); no other state provides this.</i>	\$14.6
Repeal preferential B&O rate: Insurance agents. <i>Other similar agent/sub-agent industries receive no preference.</i>	\$46.1
Repeal preferential B&O rate: Resellers of prescription drugs. <i>Designed to encourage in-state operations, but out-of-state operators can get this, so purpose undermined.</i>	\$29.0
Repeal preferential B&O rate: Stevedoring. <i>JLARC says no aid to port competitiveness; Citizen Commission says terminate; no other state provides this.</i>	\$27.7
Narrow: B&O and sales tax exemptions for import commerce. <i>Based on now-outdated court finding; favors foreign producers and importers over in-state producers and their distributors.</i>	\$24.1
Repeal exemption: Sales tax on bottled water. <i>2003 exemption to comply with nationwide Streamlined Sales Tax deal, since changed to allow tax.</i>	\$51.5
Repeal exemption: Sales tax for non-residents. <i>Favors non-residents over residents; auto sales would remain exempt; no other state provides such a broad exemption.</i>	\$63.7
Repeal exemption: Sales tax on janitorial services. <i>Other cleaning services subject to tax; Citizen Commission says terminate.</i>	\$36.2
Repeal exemption: Public utility tax on interstate transport, in-state portion. <i>Favors out-of-state products over in-state; original legal basis since overturned; 45 other states tax this.</i>	\$63.2
Repeal exemption: Extracted fuel. <i>1949 exemption for timber/wood industries; oil refineries (in state since 1950s) now exploit this; now only in WA, AL.</i>	\$40.8
Repeal: Handling losses fuel-tax deduction. <i>1930s exemption outmoded by process improvements; across-the-board deduction, not actually quantified; JLARC, Citizen Commission both say terminate.</i>	\$5.2
Narrow: High-tech R&D B&O credit. <i>JLARC says costs more than gain from job creation, and no link to R&D effort.</i>	\$23.2
Repeal exemption: High-tech R&D sales & use tax exemption. <i>JLARC says costs more than gain from job creation, and no link to R&D effort.</i>	\$55.5
<u>Tax Fairness for Communications Services and Estates</u>	2013-15 Estimated Impact (\$ in millions)
Communications services parity: Repeal sales tax exemption for residential landline telephone service, other tax parity changes (SHB 1971). <i>1983 exemption outmoded by new technology; unfair to cell-phone users; industry in agreement on repeal.</i>	\$109.9
Estate tax clarification & parity: Tax estates equally w/o regard to marital status (HB 1920). <i>Unfair exemption for estates of married couples only; product of courts, not Legislature; counter to 2006 statewide vote for fair estate tax.</i>	\$160.3
<u>Maintain Current Revenues</u>	2013-15 Estimated Impact (\$ in millions)
Extend 0.3% B&O surcharge. <i>Tax on doctors, lawyers, architects and others increased in 2010; prime support for schools.</i>	\$534.0
Extend & lower Beer tax. <i>Tax on large brewers increased in 2010; little effect on sales; proposal would lower tax, move closer to pre-2010 large/micro tax treatment.</i>	\$58.7
TOTAL	\$1,343.7

All estimates assume a July 1, 2013 effective date with 11 months of collections for FY 2014

Repeal Special B&O Rates & Exemptions

About 40 industries receive a preferential rate on their business and occupation (B&O) tax rate, paying sometimes far less than similar businesses. Many others pay no B&O tax thanks to exemptions.

This proposal repeals four such preferential rates and one exemption that are either ineffective, no longer justified, or simply a special exemption that we can no longer afford over paying to educate our children. Specifically, it:

- Repeals a 0.275% rate for travel agents and tour operators.
- Repeals a 0.484% rate for insurance agents.
- Repeals a 0.138% rate for resellers of prescription drugs.
- Repeals a 0.275% rate for stevedoring.
- Narrows an exemption from B&O tax for the sale of taxable goods in import commerce.

Travel Agents & Tour Operators

This preferential rate was created in 1975 when travel agents operated under a very different business model, relying on airplane ticket bookings for 75% of their income. The travel industry has changed dramatically in recent years, and the original objectives for this special rate – fair tax treatment between travel agents and interstate air carriers – no longer apply.

Out-of-state companies currently are taking advantage of this rate and JLARC found in its review that no other states offer comparable exemptions for travel agents and tour operators. The Citizens' Commission noted "there is no apparent compelling reason any longer for preferential tax treatment" through this rate and recommended it be terminated.

Insurance Producers, Title Insurance Agents and Surplus Line Brokers

A preferential rate of 1.1% for these businesses was created in 1983; it was further reduced twice, finally to the current rate of 0.484% in 1998. Other professional businesses with agent/sub-agent models (stock brokerages, real estate firms) do not get a similar preferential rate. When creating the rate, the Legislature provided no economic or competitive justification for the lower tax rate and in its comments, the Citizens' Commission stated "no evidence was provided for why a lower tax rate relative to similar agent/sub-agent relationship in other industries is appropriate."

Resellers of Prescription Drugs

This preferential rate applies to businesses that warehouse and resell prescription drugs to retailers, hospitals, clinics and other health care providers. It was created in 1998 to attract out-of-state drug companies to build warehouses in Washington. Drug companies without in-state warehouses have been able to take advantage of this rate, undermining the purpose for which the preferential rate was created. This rate is less than 30% the standard B&O tax rates paid by in-state businesses warehousing and selling other products.

Stevedoring

This preferential rate was created in 1979 after a Supreme Court decision upheld the taxation stevedoring and similar business activities. Stevedoring is labor, service, or transportation activities where cargo is loaded or unloaded to or from vessels or barges involved in waterborne interstate and foreign commerce.

This lower tax rate appears to have been intended to help the competitiveness of Washington's ports; however, JLARC found no material evidence to suggest it has had any role in doing so. No other states offer a similar tax exemption and the Citizens' Commission recommended in its review "that the Legislature stop supporting these industries financially by terminating the preferential tax rates."

Import Commerce

This exemption allows importers to pay no B&O tax or collect sales tax on their sales of taxable goods, primarily wholesale activities. It originally was put in agency tax rules due to a now-outdated interpretation of the Commerce Clause and later placed in statute in 2007. This proposal would close the tax exemption for imports with the exception of aerospace components.

This exemption gives importers an unfair advantage over in-state manufacturers and wholesalers, who would pay taxes on the sale of the same goods. Example: the sale of a piece of construction equipment purchased from a Washington-based company would be subject to B&O tax; the sale of the same construction equipment manufactured in China then purchased through the Washington distributor of the Chinese company would not be subject to the B&O tax.

Repeal Sales Tax Exemptions

There are literally hundreds of exemptions from Washington's sales & use tax, even as it provides the biggest source of tax revenue for education and other valuable programs at the state level. Many of these exemptions serve real benefits, like the sales tax exemption on food. Others are harder to defend, especially as we face tough decisions about how to fund our schools.

This proposal repeals three such sales tax exemptions. Specifically, it:

- Repeals a sales tax exemption for bottled water.
- Repeals a sales tax exemption for nonresidents.
- Repeals a sales tax exemption for janitorial services.

Sales Tax on Bottled Water

Sales of bottled water were always subject to sales tax before January 1, 2004, in anticipation of Washington joining the Streamlined Sales and Use Tax Agreement. That agreement now allows for member states to tax bottled water sales separately. Use of bottled water is a discretionary purchase and contributes negatively to the environment – most aren't recycled and end up in our waste streams, costing local governments. This proposal would allow for refunds for taxes on sales of prescribed bottled water and sales to persons lacking readily available potable water.

Sales Tax on Nonresidents

Nonresidents from states with no sales tax or a sales tax rate of less than 3% are exempted from paying Washington's sales tax on the purchase of goods. This exemption was created in the 1960s, and originally required nonresidents to purchase a permit in order to utilize the exemption. This exemption provides a direct tax benefit to nonresidents over Washington residents.

In fact, Washington residents pay income taxes if working in Oregon, whose residents claim most of this benefit. Independent studies and by DOR found that merchandise selection is the biggest factor in determining where people shop – King County, a non-border county, has the second most nonresident purchases. Sales of motor vehicles, the biggest impact for border counties, would remain exempt under this proposal.

Sales Tax on Janitorial Services

Janitorial services (cleaning and caretaking of the interior of buildings) were exempted from retail sales tax when the tax was created in 1935. As a result, businesses providing janitorial services are taxed at the Service B&O tax rate rather than the Retail B&O tax rate.

Other specialized cleaning services are subject to retail sales tax, with those businesses paying the Retail B&O tax rate and many other states now collect sales tax on these same services. Janitorial services are discretionary for households and not integral to the operations of businesses serviced. The Citizens' Commission recommended this exemption be terminated.

Repeal Transportation & Oil-Related Tax Exemptions

There are numerous exemptions in Washington's tax code based on outdated court interpretations or outmoded technologies and business practices. While these exemptions may have been justified when first enacted, they deserve extra scrutiny now when we face hard choices about funding our education system.

This proposal repeals three such tax exemptions related to fuel production and distribution, and transportation. Specifically, it:

- Repeals a use tax exemption for extracted fuel.
- Repeals a public utility tax deduction for instate portions of interstate transportation.
- Repeals a fuel tax deduction for handling losses.

Use Tax on Extracted Fuel

This tax exemption was created for the timber and wood products industry in 1949 to allow them to use a by-product called hog fuel in the milling and manufacturing process. The first oil refinery opened in Washington in the 1950s, and the state's five oil refineries now account for 98% of the value of this exemption. Fuel used in the manufacturing process by other industries in Washington is generally taxed and only one other state, Alabama, provides a similar tax exemption for fuel created in the petroleum refining process.

Public Utility Tax on Instate Portions of Interstate Transportation

This exemption was created in 1935 because of the U.S. Supreme Court's interpretation at the time of the Commerce Clause's application to interstate business activities. It allows for a deduction from the Public Utility Tax for interstate carriers on instate portion of transporting goods and passengers from other states.

This tax deduction exempts the transportation of goods from other states from taxes that apply to transporting goods produced in Washington within the state, disadvantaging our Washington goods produced for sale in state. The original legal basis for granting the exemption has long since been overturned by the U.S. Supreme Court and 45 other states and the District of Columbia tax this activity in some manner.

Handling Losses Fuel Tax Deduction

Fuel suppliers and distributors get an across-the-board deduction from motor vehicle fuel taxes for "handling losses" during the loading and transport of gasoline. The deduction was created in the 1930s, when handling and transportation of fuel was very different than today.

Fuel handling standards today are much stricter, so we are giving a tax exemption on losses that likely don't occur. We should incentivize better environmental practices, not subsidize gasoline spillage and vapor emissions. JLARC and Citizens' Commission both recommended this exemption be terminated.

Narrow & Repeal High Technology Business Exemptions

JLARC's tax preference review process has provided invaluable information for certain exemptions by examining closely the total economic benefit generated and allowing us to contrast that with the investment of the state's dollars. In 2012, JLARC reviewed the two preferences below and could find no clear evidence that the state's investments were directly generating new jobs in this sector.

B&O Tax Credit and Sales & Use Tax Deferral on High Tech Research & Development

These two preferences allow high technology businesses to receive a credit for spending on qualifying research and development and a deferral on sales and use taxes on purchases for facilities, machinery and equipment used in qualifying research and development. This proposal would repeal the sales and use tax deferral and narrow the B&O tax credit to apply only to firms with less than \$10 million in annual business income.

JLARC's review of these exemptions found that the costs to taxpayers per new job exceeded the economic benefit created by those same jobs. The review also could not identify new spending on research and development at high tech firms that was directly attributable to these tax breaks.

Tax Fairness for Communications Services & the Estate Tax

Communications Services Tax Fairness – HB 1971

A sales tax exemption for local residential phone service was created in 1983 after the break-up of “Ma Bell.” As new technologies have been developed, the exemption has applied to fewer and fewer phone customers. This proposal eliminates an unfair disparity between taxation of residential phone service customers based purely on the technology being used and has been negotiated and supported by the communications industry. It helps local communities by ensuring the dollars for E-911 are collected more fairly and it provides support for rural phone carriers to help them serve communities that would otherwise be underserved.

Bracken Decision Tax Fairness – HB 1920

The *Bracken* court decision in October 2012 created inequitable tax treatment for estate taxes between married couples and single individuals. Without legislative action, the result will be significant revenue losses to our Education Legacy Trust Account due to allowing married couples to significantly reduce their Washington estate tax liability.

Under the court’s decision, single and divorced individuals’ estates over \$2 million would clearly be subject to estate taxes, but married couples’ estates would have a large exemption. Fixing this is a matter of fairness and honoring the intent of the legislature and voters when Washington’s estate tax was created.

Maintain Current Revenues

Extend B&O Tax Rate on Services

The 1.5% Service B&O tax rate paid by doctors, lawyers, architects and others was increased by 0.3% in 2010. Continuing this tax rate will provide more than \$500 million for our schools in the next two years.

Lower & Extend Beer Tax Rate

The tax rate for beer from large breweries was increased from \$8.08 per barrel to \$23.58 per barrel by adding a 50 cents per gallon surtax in 2010. This proposal would extend the per gallon surtax at a lower rate of 25 cents per gallon instead of 50 cents and add a 15 cent per gallon surtax for microbreweries.

This proposal would lower taxes on most beer below the current rate, but still raise \$58 million for our schools. Taxes would go up by just 14 cents per six-pack for large breweries and just over 8 cents per six-pack for small breweries. This proposal would return the differential between tax rates for large and small breweries to the same level as prior to 2010.

Sales of beer by large brewers by volume actually decreased less during the fiscal year this surtax was imposed than during the previous fiscal year. Under this proposal, Washington’s state tax on beer will go from 7th highest among states to 10th highest for most beer and from 38th to 22nd for microbrews.

Summary of Proposals

As a final note, this proposal recognizes that the McCleary decision must change our frame of thinking about our tax system. We can no longer continue with business as usual on tax exemptions. The funds raised through this proposal will be dedicated to spending on education and higher education for our new economy – we must remember that doing so is our first and highest priority.

It also provides a contrast with the Senate Republican budget, which makes the choice to continue down the same path as before. That path resulted in \$3.6 billion in costs for new exemptions created since 1995 – money that could be used to fund our obligation to McCleary this biennium more than twice over.

