

# Joint Legislative Audit and Review Committee (JLARC)



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## SENATORS

Randi Becker  
 John Braun, *Vice Chair*  
 Annette Cleveland  
 David Frockt  
 Janéa Holmquist Newbry  
 Jeanne Kohl-Welles, *Secretary*  
 Mark Mullet  
 Ann Rivers

## REPRESENTATIVES

Cathy Dahlquist, *Assistant Secretary*  
 Tami Green  
 Kathy Haigh, *Chair*  
 Ed Orcutt  
 Gerry Pollet  
 Derek Stanford  
 J.T. Wilcox  
 Hans Zeiger

July 16, 2014

## JOINT LEGISLATIVE AUDIT AND REVIEW COMMITTEE REGULAR COMMITTEE MEETING MINUTES

### COMMITTEE BUSINESS

- Representative Kathy Haigh, JLARC Chair, called the meeting to order at 10:00 a.m.
- *A motion was made to approve the minutes from the April 23, 2014, JLARC meeting. Motion was seconded and carried unanimously.*
- Legislative Auditor Keenan Konopaski reported to the Committee on the successful review of the office by a committee of peers from other legislative audit offices. The GAO “Yellow Book” standards require the office to undergo a peer review every three years. The Legislative Auditor noted that the peer reviewers held discussions with each of the members of the JLARC Executive Committee. The peer review report is posted on the JLARC website.
- The Legislative Auditor introduced new staff member Jack Brumbaugh, the legislative intern who is helping the tax team with next year’s tax preference reviews. He will be at JLARC for the summer.

### REPORTS, PRESENTATIONS, DISCUSSIONS

#### **Implementation of State Auditor’s Office (SAO) I-900 Recommendations to the Legislature—Status Report**

Steven Meyeroff from the JLARC staff presented the annual status report. The report covers the status of the Legislature’s action on recommendations made to it by SAO between 2010 and 2013.

Representative Haigh noted the status report shows that the Legislature does respond to the recommendations.

#### **2014 Tax Preference Performance Reviews—Preliminary Report**

John Woolley, Mary Welsh, and Dana Lynn from the JLARC staff presented the preliminary report for this year’s tax preference reviews. JLARC staff reviewed 24 preferences in 2014. All tax preference performance audits place an emphasis on whether the preference has met its public policy objectives. The report includes Legislative Auditor recommendations to review and clarify 20 preferences, to continue three preferences, and to terminate one preference.

#### Package of Aerospace Preferences

Representative Wilcox commented that a unit cost comparison among states, rather than the total amount of tax preference provided, would be helpful when assessing the cost of doing business in Washington relative to other

states. Staff identified factors that make it difficult to make such comparisons, including the different tax structures of other states such as income tax states with apportionment factors and the ability for some other states to provide cash awards, which Washington is unable to offer.

Representative Pollet asked about the finding in the report that the goal has been met, despite the fact that all 787 jobs are not in Washington and asked if there is information about the cost per job actually created and about the impact on total state revenues. Staff clarified that, in the original package of preferences, the Legislature's stated goal was to continue an aerospace presence in Washington, explaining that the Legislature did not establish a target level of jobs, nor did it specifically mention 787 jobs. Staff concluded there is evidence of the goal being met because the relative share of Washington aerospace employment is higher than the national average and does not decline over the study period.

Representative Pollet commented that this approach focuses on the text of the legislation rather than the context of the larger debate, which was about 787 jobs. Staff explained that, at the time, the Legislature did not know whether they would be adding 787 jobs and did not make that a condition of the tax preference.

Representative Pollet asked whether the analysis considers the net revenue change for the state, for example, whether more revenue was produced as a result of the indirect benefits. Staff answered that the tax effects, both positive and negative, are contained in the model results.

Representative Orcutt reviewed the assumptions of Scenario 3, which is the scenario where Boeing sites the 787 in Washington but does not add jobs, instead staffing the 787 line with workers already in Washington working on lines being phased out. He noted that this scenario assumes that these workers are not leaving the state and wondered how the analysis calculated a net job loss. Staff explained it was not possible to establish a causal relationship between the tax preferences and the creation of jobs. Instead, they analyzed the scenarios that legislators faced in 2003 when making their decision to enact the preferences. Staff explained further that the assumptions in the three scenarios were the inputs into the model, and that the model then generated the estimates of the economic effects.

Senator Kohl-Welles asked about a provision in the 2013 aerospace legislation that says Boeing would lose the preferential rate if it sites the final or wing assembly of the 777X in another state. Staff confirmed that the preferential rate for the 777X would not apply if any final assembly or wing assembly is moved out of state.

Representative Dahlquist asked how information on employee numbers reported in the economic analysis takes into account part-time workers and contract workers. Staff explained that the REMI model relies on employment numbers submitted by each state to the federal Department of Labor and that these numbers include both full-time and part-time workers. Staff added that the information reported by Washington aerospace companies to the state Department of Revenue on their annual surveys shows that most of the beneficiary employees are full-time employees and that the contractors would be reported by their employers.

Representative Dahlquist asked if the job projections presented to the Legislature when it considered the 2013 legislation included the 4,300 employees who just received lay-off notices. Staff answered that they do not have information about those projections. Staff clarified that those lay-offs are not included in these model runs because the model was developed before the 2013 legislation.

Senator Frockt asked if South Carolina's aerospace tax preferences include a specific head-count for jobs to be created or maintained in that state in order to receive the preference. Staff replied they would research that question. Senator Frockt asked if it is correct that Washington does not have such a requirement: staff confirmed that he is correct.

Senator Frockt referenced a study by Community Attributes that came out right before the last special session and asked how the methodology used in that study compares to the REMI analysis used in the JLARC study. Staff

answered that the studies use different approaches, explaining Community Attributes did an economic impact study of the aerospace industry. In contrast, the JLARC study is an economic analysis of the tax preferences. Staff added that the JLARC study also includes effects related to the government sector, which is not part of the Community Attributes study.

Representative Stanford noted that the analysis of the three scenarios looks at a 20-year timeframe beginning in 2003, and asked if we have a sense about how the projections compare with actual numbers we are seeing today. Staff answered that the scenarios are all hypothetical and assume that everything else in the economy remained constant. While the aerospace sector has increased employment since the preferences were enacted, staff cannot determine whether the increase is attributable to the preferences.

Representative Wilcox commented that he was glad the scenario analysis includes a downside since sometimes the discussions only include the upside. He asked if the reviews of most preferences consider the downside attributable to inaction and if staff ever assigns probabilities to the different scenarios. Staff answered that they did not assign probabilities and explained this is the first time staff had a model that enables them to conduct this scenario analysis.

#### Commercial Airplane Part Place of Sale

Representative Pollet asked why we do not know the cost of this exemption. Staff answered that an out-of-state manufacturer that is exempt from the B&O tax and has no other tax obligation in Washington would not have to report at all, and that an out-of-state manufacturer that did have to report would not be required to report the amount of the exemption. Representative Pollet asked if this meant that, if a bill were to close the exemption, we would not have a fiscal note to estimate the revenue. Staff answered that this would be up to the Department of Revenue. Staff said that the Department sometimes uses national data and other means to arrive at an estimate but that there are no actuals to use.

Representative Orcutt asked who would be paying the tax if the preference were removed. Staff answered that the B&O tax would be paid by the out-of-state parts manufacturer. Representative Orcutt asked how the Department of Revenue would have jurisdiction over a manufacturer that is located out-of-state and manufacturing the part there. Staff said the key is how statute defines the place of sale and that other out-of-state manufacturers of goods that are delivered in Washington pay Washington B&O tax.

#### Certified Aircraft Repair Firms

Senator Rivers asked for clarification about the beneficiaries of the preference and the requirement that the repair stations be federally certified. Staff clarified that there are repair stations that are federally certified but that do not work on commercial airplanes, instead working on private airplanes. Staff explained that such firms would not be eligible for the preference.

Senator Rivers asked how many people the beneficiaries employ. Staff answered that beneficiaries reported 2,241 employees in 2009 and 2,893 employees in 2012.

#### Aircraft Part Prototypes

Representative Dahlquist asked if there is additional information about the two companies that supported the original legislation, for example, do they not qualify for the preference because they make more than \$20 million per year? Staff answered that they talked with people at both of the companies and confirmed that they are not taking the preference and explained that taxpayer information about revenues is confidential.

Representative Orcutt asked why there is a recommendation to terminate the preference just because no firm is using it right now. He added that a firm might benefit from the preference in the future. Staff answered that the evaluations are generally a look back to see if a preference has been meeting its public policy objective and that there

is no evidence of the preference doing so. Representative Orcutt asked if there is any cost to the state if the preference stayed on the books. Staff answered there is no cost if the preference is not used.

#### Fresh Food Processors

Representative Pollet observed there did not seem to be a similar exemption package for these food processors in other states. Staff noted the difficulty of making comparisons with other states for B&O preferences because of the unique nature of the B&O tax, adding that there are some preferences for food processors in other states.

Representative Pollet noted the report says only 18 percent of fruit and vegetable firms created new jobs. Staff indicated these figures come from the Department of Revenue's annual survey and that new job creation was fairly low, noting that the fruit and vegetable food processing jobs had remained fairly static while there was an increase in the use of the preference by wineries.

Representative Haigh asked if this preference was related to legislation from several years earlier when the Legislature considered the pending closure of an asparagus processing plant. Staff indicated that the closure of that plant and others was part of the discussion related to the 2005 bill that created the exemption for fruit and vegetable processors.

Representative Wilcox noted that the reason these products are called agricultural commodities is because they are extremely price sensitive and move to the areas where costs are lowest. He added that the products are undifferentiated and cannot charge a premium due to differences in taxes. He noted that a number of the fresh products that are sold in Washington are processed across the river in Portland.

#### International Investment Management Services

Representative Wilcox said he assumes that the business model is one of high volume and low margins and that the original concern was Washington being a B&O tax state rather than a state with a net income tax that takes into account the high volume/low margin nature of the business. He asked how the change to the direct nexus model impacted the disadvantage that businesses in Washington might have compared to a net income tax state. Staff answered that the change has impacted the income that the businesses pay tax on in Washington. Prior to the change, Washington service businesses generally paid Washington taxes on all of their out-of-state income, so the preferential rate provided them with a decreased rate that made them better able to compete with businesses in other states or localities. Staff explained further that the 2010 nexus changes decreased the income to which that preferential rate applied, noting that these two factors in conjunction may have a different outcome than what the Legislature originally intended. Staff noted the Legislature did not state their objective for the preference was to mitigate the difference between a gross receipts tax and net income tax. If this had been a stated objective, JLARC staff would have reviewed that information.

Representative Wilcox asked about the number of states that have adopted economic nexus standards. Staff answered that over half of the states have adopted the standards. Staff explained that, when Washington adopted its economic nexus rules, it did so in a way that was intended to treat multi-state tax revenue more consistently across the states. Staff confirmed for Representative Wilcox that this meant similarity in measuring taxable revenue and not necessarily similarity in the amount of taxes collected by each state.

#### Electricity Sales by Non-Light & Power (L&P) Businesses

Senator Becker asked if a co-op that sells electricity to customers is a non-L&P business. Staff responded that generally co-ops are L&P businesses, generating and distributing electricity and paying public utility tax, explaining that the non-L&P businesses are different from this. The Legislative Auditor added that the non-L&P businesses usually do not own the electricity infrastructure.

Senator Rivers noted a company in her district produced electricity as a by-product that the company then sells. She asked if such a company would be a non-L&P business. Staff suggested that such a business would probably also fall under the definition of an L&P business because the business is generating electricity. Staff provided an example of irrigation districts and ports that can be L&P businesses because they generate electricity when conducting their activities.

Senator Frockt asked for clarification about whether any electricity sales are subject to the sales tax and not paying public utility tax. Staff responded that electricity sales are exempt from sales tax and subject to public utility tax under a different preference discussed in the 2014 reviews.

Senator Frockt asked why we do not know if energy brokering activities are taking place in Washington. Staff answered that this service is exempt from B&O tax reporting so there is no data. Staff added that industry representatives interviewed for the study reported that electricity marketing is taking place in the state. Staff also noted the industry representatives reported that electricity brokering had previously taken place but that it is uncertain if it takes place now because of the lack of reporting: The service previously provided by Enron is an example of electricity brokering.

Overall

Representative Haigh reminded the Committee that today’s presentation was the preliminary report. The Chair noted that the meeting on September 19<sup>th</sup> of the Citizen Commission for Performance Measurement of Tax Preferences offers the chance for public testimony. The Chair noted that the Committee’s review of the final report, including the Commission’s comments, is scheduled for the December 10<sup>th</sup> JLARC meeting.

With no further business before the Committee, the Chair adjourned the meeting.

ATTENDANCE

JLARC Members Present: Senators Randi Becker, John Braun, David Frockt, Jeanne Kohl-Welles, and Ann Rivers; Representatives Cathy Dahlquist, Tami Green, Kathy Haigh, Ed Orcutt, Gerry Pollet, Derek Stanford, J.T. Wilcox, and Hans Zeiger.

JLARC Staff Present: Keenan Konopaski, Legislative Auditor; John Woolley, Deputy Legislative Auditor; Linda Byers, Peter Heineccius, Dana Lynn, Steven Meyeroff, Mary Welsh, Eric Whitaker, Marilyn Richter, Matt Stoutenburg, Ashley Elliott, and Jack Brumbaugh.

ADJOURNMENT

The meeting was adjourned at 11:55 am.

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CHAIR

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VICE CHAIR