

PRELIMINARY REPORT:  
2019 TAX PREFERENCE PERFORMANCE  
REVIEWS

# Financial Institutions' Income from Certain Airplane Loans

## LEGISLATIVE AUDITOR'S CONCLUSION:

The preference provides targeted financial relief to two airlines headquartered in Washington. The Legislature should add a performance statement to clearly state the public policy objective.

*Updated August 20, 2019*

## Preference provides B&O tax deduction to out-of-state financial institutions when they make loans to Washington-based commercial airlines

The Legislature enacted this preference in 2010. The preference provides a business and occupation (B&O) tax deduction to out-of-state financial institutions when they make loans to commercial airlines headquartered in Washington. The loans must be secured by commercial airplanes. Out-of-state lenders do not pay B&O tax on income they earn from interest and fees on these loans.

### Estimated Biennial Beneficiary Savings

\$2.1 Million - \$3.4 Million

### Tax Types

Business and Occupation Tax  
RCW 82.04.43391  
Applicable Statutes

The preference was included as part of broader legislation that extended the B&O tax to service businesses that were not physically present in Washington. The tax applied to businesses that met minimum thresholds for receipts from Washington. As a result, some out-of-state lenders became subject to B&O tax. The preference exempts out-of-state lenders from owing B&O tax on income from airplane loans they make to Washington-based commercial airlines.

The preference does not have an expiration date.

## Preference achieves inferred public policy objective

The Legislature did not state a public policy objective when the preference passed in 2010. JLARC staff infer an objective based on information provided by the Department of Revenue and the airlines impacted.

Objective (Inferred)	Results
Provide targeted financial relief to commercial airlines headquartered in Washington by exempting out-of-state lenders from owing B&O tax on their loan income. The airlines typically pay these taxes as part of their loan agreements with the financial institutions.	<b>Met.</b> The preference is providing targeted financial relief to two commercial airlines headquartered in Washington. Alaska Airlines and Horizon Air Industries have both benefited to date.

## Recommendations

### Legislative Auditor's Recommendation: Clarify the intent and duration

The Legislature should clarify the intent and duration of the tax preference. If the preference is intended to provide targeted financial relief to Washington-based airlines, the Legislature should add a performance statement and determine whether the relief is meant to be permanent or time-limited.

More information is available on the Recommendations Tab.

### Commissioners' Recommendation

Available October 2019.

*This report was updated on July 19, 2019 to revise beneficiary savings as a result of new legislation, and on August 20, 2019, to clarify the preference's beneficiaries.*

## REVIEW DETAILS

### 1. Preference achieves inferred objective

**Preference provides targeted financial relief to Washington-based airlines by exempting out-of-state lenders from owing B&O tax on airplane loans they provide**

#### **JLARC staff infer public policy objective**

The Legislature did not state a public policy objective when it passed this preference. The preference passed before the Legislature's requirement to provide a performance statement for each preference. Although the underlying bill was heavily debated in the Legislature, the section establishing this tax preference was never discussed in the public record.

Based on information obtained from the airlines impacted by the preference and the Department of Revenue, JLARC staff infer the preference was intended to provide targeted financial relief to airlines headquartered in Washington.

#### **Washington-based airlines benefit when out-of-state lenders are not taxed on income they earn from airplane loans**

The preference provides a business and occupation (B&O) tax deduction to out-of-state lenders on income they earn from airplane loans made to Washington-based airlines.

Airline representatives indicate that their loan contracts with lenders require them to reimburse the financial institutions for any additional costs, including state taxes, that may occur during the life of the loan. Because out-of-state lenders are exempt from B&O tax on airplane loans, this cost is not passed on to the Washington-based airlines receiving the loans.

The preference applies to lenders located outside of Washington. Financial institutions with locations in Washington continue to owe B&O tax on the income they earn from airplane loans. Out-of-state lenders may receive advantageous tax treatment compared to in-state lenders.

## Preference included in 2010 legislation that changed tax rules for service businesses

The preference was included in broader legislation that changed how B&O tax was applied to certain income earned by service businesses, including financial institutions.

Until 2010, financial businesses with Washington customers were generally not subject to B&O tax if the business had no physical presence in the state.

In 2010, the Legislature extended the B&O tax to service businesses that are not physically present in Washington. The tax applied to businesses that met minimum thresholds for property, payroll, and receipts from Washington. As a result, some out-of-state lenders became subject to B&O tax. However, this preference exempts out-of-state lenders from owing B&O tax on airplane loans they make to Washington-based commercial airlines.

## Preference has no expiration date

The preference took effect June 1, 2010, and has no expiration date.

## 2. Two airlines and 32 lenders benefit

### Two airlines headquartered in Washington and approximately 32 out-of-state financial institutions benefit from the preference

Tax preferences have **direct beneficiaries** (entities whose state tax liabilities are directly affected) and may have **indirect beneficiaries** (entities that may receive benefits from the preference, but are not the primary recipient of the benefit). Because JLARC staff infer this preference was primarily intended to benefit the indirect beneficiary, the indirect beneficiary is discussed first.

### Indirect beneficiaries: Washington-based Alaska Airlines and Horizon Air Industries

The indirect beneficiaries of this preference are Alaska Airlines and Horizon Air Industries, the only commercial airlines headquartered in Washington that have benefited to date. Alaska Airlines and Horizon Air Industries are subsidiaries of Alaska Air Group.

Alaska Air Group representatives state that the terms of their loan agreements require them to reimburse the lenders for any additional costs, including state taxes, that may occur during the

life of the loan. Because of this preference, the out-of-state lenders do not owe business and occupation (B&O) tax on their loan income, and no additional tax is passed on to the two airlines.

Other industries may use similar contract agreements that pass on taxes and other costs to their customers. JLARC staff did not investigate the contract terms of other industries, which involve private legal agreements between numerous parties and across multiple business sectors.

## **Direct beneficiaries: Out-of-state lenders**

In addition to the two Washington-based airlines, approximately 32 financial institutions located outside of Washington directly benefited from this tax preference in 2018. These businesses were exempt from B&O tax on income they earned from loans made to Alaska Airlines and Horizon Air Industries.

Without this preference, these businesses would be subject to B&O tax if they met minimum thresholds for property, payroll, or receipts from Washington.

### **3. Estimated biennial savings: \$2.1 million - 3.4 million**

#### **Estimated direct revenue impact ranges between \$2.1 million and \$3.4 million in 2021-23 Biennium**

JLARC staff estimate the direct beneficiary savings for out-of-state lenders in Fiscal Year 2018 was \$857,000. The estimated beneficiary savings for the 2021-23 biennium is between \$2.1 million and \$3.4 million.

The estimated beneficiary savings increase in future years due to a 20% surcharge added to the service activities business and occupation (B&O) tax rate and another B&O tax increase that applies to specified financial institutions. Both increases take effect January 1, 2020.

**Exhibit 3.1: Estimated direct beneficiary savings from B&O tax deduction**

Biennium	Fiscal Year	Estimated Income Earned by Out-of-State Lenders from Loans to WA-Based Airline Company	Range for Estimated Direct Beneficiary Savings
2017-19 7/1/17-6/30/19	2018	\$57,100,000	\$857,000
	2019	\$57,100,000	\$857,000
2019-21 7/1/19 - 6/30/21	2020	\$57,100,000	\$942,000 - \$1,285,000
	2021	\$57,100,000	\$1,028,000 - \$1,713,000
2021-23 7/1/21-6/30/23	2022	\$57,100,000	\$1,028,000 - \$1,713,000
	2023	\$57,100,000	\$1,028,000 - \$1,713,000
	2021-23 Biennium	\$114,200,000	\$2,056,000 - \$3,426,000

Source: JLARC staff analysis and calculations based on detail provided by Alaska Air Group.

As noted in this report, the B&O taxes owed by out-of-state lenders would typically be passed on to the airlines. Because of this preference, both the out-of-state lenders and the Washington-based airlines receive benefits. Alaska Air Group's annual adjusted net income for 2018 was \$554 million, compared to \$791 million in 2017.

**4. Applicable statutes**

**RCW 82.04.43391, RCW 82.04.080(2)**

**Business and Occupation Tax**

**RCW 82.04.43391**

**Deductions - Commercial aircraft loan interest and fees**

(1) In computing tax there may be deducted from the measure of tax interest and fees on loans secured by commercial aircraft primarily used to provide routine air service and owned by:

- (a) An air carrier as defined in RCW 82.42.010, which is primarily engaged in the business of providing passenger air service;
- (b) An affiliate of such air carrier; or

(c) A parent entity for which such air carrier is an affiliate.

(2) The deduction authorized under this section is not available to any person who is physically present in this state as determined under RCW 82.04.067(6).

(3) For purposes of this section, the following definitions apply:

(a) "Affiliate" means a person is "affiliated," as defined in RCW 82.04.645, with another person; and

(b) "Commercial aircraft" means a commercial airplane as defined in RCW 82.32.550.

### RCW 82.04.080(2)

(1) "Gross income of the business" means the value proceeding or accruing by reason of the transaction of the business engaged in and includes gross proceeds of sales, compensation for the rendition of services, gains realized from trading in stocks, bonds, or other evidences of indebtedness, interest, discount, rents, royalties, fees, commissions, dividends, and other emoluments however designated, all without any deduction on account of the cost of tangible property sold, the cost of materials used, labor costs, interest, discount, delivery costs, taxes, or any other expense whatsoever paid or accrued and without any deduction on account of losses.

(2) Financial institutions must determine gains realized from trading in stocks, bonds, and other evidences of indebtedness on a net annualized basis. For purposes of this subsection, a financial institution means a person within the scope of the rule adopted by the department under the authority of RCW 82.04.460(2).

## RECOMMENDATIONS & RESPONSES

### Legislative Auditor's Recommendation

#### Legislative Auditor's Recommendation: Clarify the intent and duration

**The Legislature should clarify the intent and duration of this preference.**

If the preference is intended to provide targeted financial relief to Washington-based airlines, the Legislature should add a performance statement and determine whether the relief is meant to be permanent or time-limited.

**Legislation Required:** Yes

**Fiscal Impact:** Depends on legislative action.

## RECOMMENDATIONS & RESPONSES

### Letter from Commission Chair

Available October 2019.

## RECOMMENDATIONS & RESPONSES

### Commissioners' Recommendation

Available October 2019.

## RECOMMENDATIONS & RESPONSES

### Agency Response

If applicable, available October 2019.

#### Washington Joint Legislative Audit and Review Committee

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