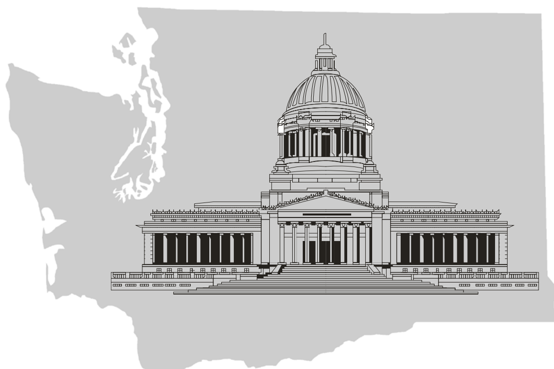
State of Washington
Joint Legislative Audit & Review Committee (JLARC)



# 2009 Full Tax Preference Performance Reviews

## Report 09-11

January 5, 2010

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***Joint Legislative Audit and Review Committee***

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## Audit Authority

The Joint Legislative Audit and Review Committee (JLARC) works to make state government operations more efficient and effective. The Committee is comprised of an equal number of House members and Senators, Democrats and Republicans.

JLARC's non-partisan staff auditors, under the direction of the Legislative Auditor, conduct performance audits, program evaluations, sunset reviews, and other analyses assigned by the Legislature and the Committee.

The statutory authority for JLARC, established in Chapter 44.28 RCW, requires the Legislative Auditor to ensure that JLARC studies are conducted in accordance with Generally Accepted Government Auditing Standards, as applicable to the scope of the audit. This study was conducted in accordance with those applicable standards. Those standards require auditors to plan and perform audits to obtain sufficient, appropriate evidence to provide a reasonable basis for findings and conclusions based on the audit objectives. The evidence obtained for this JLARC report provides a reasonable basis for the enclosed findings and conclusions, and any exceptions to the application of audit standards have been explicitly disclosed in the body of this report.

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**Committee Approval**

On January 5, 2010, this report was approved for distribution by the Joint Legislative Audit and Review Committee.

**2009 Full Tax Preference Performance Reviews**

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**January 5, 2010**

STATE OF WASHINGTON

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# REPORT SUMMARY

## What Is a Tax Preference?

Tax preferences are exemptions, exclusions, or deductions from the base of a state tax; a credit against a state tax; a deferral of a state tax; or a preferential state tax rate. Washington has more than 580 tax preferences.

## Why a JLARC Review of Tax Preferences?

### *Legislature Creates a Process to Review Tax Preferences*

In 2006, the Legislature expressly stated that periodic reviews of tax preferences are needed to determine if their continued existence or modification serves the public interest. The Legislature enacted Engrossed House Bill 1069 to provide for an orderly process for the review of tax preferences. The legislation assigns specific roles in the process to two different entities. The Legislature assigns the job of scheduling tax preferences, holding public hearings, and commenting on the reviews to the Citizen Commission for Performance Measurement of Tax Preferences. The Legislature assigns responsibility for conducting the reviews to the staff of the Joint Legislative Audit and Review Committee (JLARC).

### *Citizen Commission Sets the Schedule*

EHB 1069 directs the Citizen Commission for Performance Measurement of Tax Preferences to develop a schedule to accomplish a review of tax preferences at least once every ten years. The legislation directs the Commission to omit certain tax preferences from the schedule such as those required by constitutional law.

The Legislature also directs the Commission to consider two additional factors in developing its schedule. First, the Commission is to schedule tax preferences for review in the order in which the preferences were enacted into law, except that the Commission must schedule tax preferences that have a statutory expiration date before the preference expires. This means that Washington's longest-standing tax preferences are evaluated first.

The Commission has identified three categories of review, based on each tax preference's estimated biennial fiscal impact:

1. Full reviews (over $10 million)
2. Expedited reviews (between $2 million and $10 million)
3. Expedited light reviews ($2 million or less)

However, at their discretion, the Commission may elect to subject a tax preference with a fiscal impact of $2 million or less to the expedited review process.

In September 2008, the Commission adopted its third ten-year schedule for the tax preference reviews. The schedule for 2009 includes a total of 25 tax preferences under the business and occupation tax, public utility tax, sales tax, use tax, aircraft excise tax, and the insurance premiums tax. Of these 25 tax preferences, the law required 12 tax preferences to have a full review process, which are included in this report.

### *JLARC Staff Conduct the Tax Preference Reviews*

JLARC's assignment from EHB 1069 is to conduct the reviews of tax preferences according to the schedule developed by the Commission and consistent with the guidelines set forth in statute. This report presents JLARC's reviews of the 12 tax preferences scheduled by the Commission for full review. Thirteen expedited tax preference reviews are included in a separate report.

## JLARC's Approach to the Tax Preference Reviews

Consistent with the Scope and Objectives for conducting the full tax preference reviews, JLARC has evaluated the answers to a set of ten questions for each tax preference:

- **Public Policy Objectives:**

1. What are the public policy objectives that provide a justification for the tax preference? Is there any documentation on the purpose or intent of the tax preference? (RCW 43.136.055(b))
2. What evidence exists to show that the tax preference has contributed to the achievement of any of these public policy objectives? (RCW 43.136.055(c))
3. To what extent will continuation of the tax preference contribute to these public policy objectives? (RCW 43.136.055(d))
4. If the public policy objectives are not being fulfilled, what is the feasibility of modifying the tax preference for adjustment of the tax benefits? (RCW 43.136.055(g))

- **Beneficiaries:**

5. Who are the entities whose state tax liabilities are directly affected by the tax preference? (RCW 43.136.055(a))
6. To what extent is the tax preference providing unintended benefits to entities other than those the Legislature intended? (RCW 43.136.055(e))

- **Revenue and Economic Impacts:**

7. What are the past and future tax revenue and economic impacts of the tax preference to the taxpayer and to the government if it is continued? (This includes an analysis of the general effects of the tax preference on the overall state economy, including the effects on consumption and expenditures of persons and businesses within the state.) (RCW 43.136.055(h))

8. If the tax preference were to be terminated, what would be the negative effects on the taxpayers who currently benefit from the tax preference and the extent to which the resulting higher taxes would have an effect on employment and the economy? (RCW 43.136.055(f))
9. If the tax preference were to be terminated, what would be the effect on the distribution of liability for payment of state taxes? (RCW 43.136.055(i))

### *Other States:*

10. Do other states have a similar tax preference and what potential public policy benefits might be gained by incorporating a corresponding provision in Washington? (RCW 43.136.055(j))

## Methodology

JLARC staff analyzed the following evidence in conducting these full reviews: 1) legal and public policy history of the tax preferences; 2) beneficiaries of the tax preferences; 3) government data pertaining to the utilization of these tax preferences and other relevant data; 4) economic and revenue impact of the tax preferences; and 5) other states' laws to identify any similar tax preferences.

Staff placed particular emphasis on the legislative history of the tax preferences, researching the original enactments as well as any subsequent amendments. Staff reviewed state Supreme Court, lower court, or Board of Tax Appeals decisions relevant to each tax preference. JLARC staff conducted extensive research on other state practices using the Commerce Clearing House database of state laws and regulations.

Staff interviewed the agencies that administer the tax preferences (primarily the Department of Revenue and the Department of Transportation). These parties provided data on the value and usage of the tax preference and the beneficiaries. JLARC staff also obtained data from other state and federal agencies to which the beneficiaries are required to report. In a few cases, beneficiaries and other agencies provided additional information.

It is not within the purview of these reviews to resolve or draw definitive conclusions regarding any legal issues discussed within the reviews.

## Summary of the Results from JLARC's Reviews

The table beginning on page 5 provides a summary of the recommendations from JLARC's analysis of the tax preferences scheduled for full review in 2009. JLARC provides analysis of tax preferences scheduled for expedited review in 2009 in an additional volume. Of the 12 tax preferences included in this volume, this report recommends that the Legislature continue 11 tax preferences as they are. The full report raises issues for the Legislature's consideration for one of the current tax preferences.

## Organization of This Report

This report includes 12 separate chapters. Each chapter consists of a review of one or more tax preferences. There are three chapters (Motor Fuel and Special Fuel, Newspapers, and Tuition and Fees) which contain an evaluation of multiple related tax preferences. The chapter on cash discounts includes the deductions from B&O tax, sales and use taxes, and public utility tax.

Each chapter begins with a summary of the findings and recommendations from JLARC's analysis of the tax preferences. Then, each chapter provides additional detail, including additional information supporting the answers to the questions outlined in the law. Appendices provide the Scope and Objectives, agency and Tax Commission comments, and the text of current law for each preference.

## 2009 Full Reviews

| Year Enacted | # of Claimants in 2008 ($ amount) | JLARC Recommendation | Comments by Citizen Commission for Performance Measurement of Tax Preferences | Related Legislation as of 2009 |
|---|---|---|---|---|
| **JLARC recommendation: Legislature should continue the tax preference** | | | | |
| Motor Vehicle and Special Fuel/ 82.08.0255(1)(d); 82.12.0256(2)(d) | | | | |
| 1935 | 5 million ($709 million) | Continue | Endorses without comment | Unknown until after 2010 session |
| Joint Utility Services/ 82.16.050(3) | | | | |
| 1935 | 551 ($9.7 million) | Continue | Endorses without comment | Unknown until after 2010 session |
| Tuition and Fees/ 82.04.4282(5); 82.04.4332 | | | | |
| 1935 | 557 ($18 million) | Continue | Does not endorse and comments as follows: The Commission recommends that the Legislature clarify the intended public policy purpose of the Tuition and Fees Deductions from B&O tax and define more precisely the term "education institution" for purposes of determining which institutions are entitled to the B&O tax deduction.<br><br>Commissioner Stephen Miller voted in agreement with the Commission and submitted the following minority report: Any loss of private school opportunities due to the elimination of this tax preference can be made up for with growth in public school attendance, so there is no net loss of education in Washington State. As there is no public benefit to the preference, I encourage the Legislature to consider eliminating the preference entirely. | Unknown until after 2010 session |
| Cash Discounts/ 82.04.4283; 82.08.010; 82.16.050(4) | | | | |
| 1935 | 10,000 ($46 million) | Continue | Endorses without comment | Unknown until after 2010 session |

## 2009 Full Reviews

| Year Enacted | # of Claimants in 2008 ($ amount) | JLARC Recommendation | Comments by Citizen Commission for Performance Measurement of Tax Preferences | Related Legislation as of 2009 |
|---|---|---|---|---|
| Investments by Nonfinancial Firms/ 82.04.4281 | | | | |
| 1935 | Unknown ($310 million) | Continue | Endorses with comments: The Legislature should consider whether investment income should be taxed by some means other than the B&O gross receipts tax. | Unknown until after 2010 session |
| Income of Employees/ 82.04.360 | | | | |
| 1935 | 3.2 million ($2.3 billion) | Continue | Endorses without comment | Unknown until after 2010 session |
| Motor Fuel Taxes/ 82.04.4285 | | | | |
| 1935 | 2,400 ($23.2 million) | Continue | Endorses without comment | Unknown until after 2010 session |
| Casual Sales/ 82.08.0251 | | | | |
| 1935 | Unknown ($25.6 million) | Continue | Endorses without comment | Unknown until after 2010 session |
| Janitorial Services/ 82.04.050(2)(d) | | | | |
| 1935 | Unknown ($33 million) | Continue | The Commission does not endorse the JLARC recommendation, and recommends the State Legislature terminate this preference. | Unknown until after 2010 session |
| Feed and Seed/ 82.04.050(9) | | | | |
| 1935 | 40,000 ($57 million) | Continue | Endorses without comment | Unknown until after 2010 session |

| 2009 Full Reviews | | | | |
|---|---|---|---|---|
| **Year Enacted** | **# of Claimants in 2008 ($ amount)** | **JLARC Recommendation** | **Comments by Citizen Commission for Performance Measurement of Tax Preferences** | **Related Legislation as of 2009** |
| General Aviation/ 82.48.110 | | | | |
| 1949 | 5,900 ($10.8 million) | Continue | Endorses with comments: The Commission endorses the recommendation because it meets the Legislature's objective of avoiding double taxation; however, the Legislature should consider whether the current excise fees should be raised and whether the level of these excise fees should more closely correspond to the Legislature's apparent original intent of approximately one percent of value. | Unknown until after 2010 session |
| **JLARC recommendation: Legislature should re-examine or clarify the intent of the tax preference** | | | | |
| Newspapers/ 82.08.0253; 82.12.0345 | | | | |
| 1935 | 2.3 million ($9.5 million) | The Legislature should clarify the current intent of the retail sales and use tax exemptions for newspapers, because a number of circumstances have changed since the original tax preference enactment.<br><br>The Department of Revenue should update its administrative rule for newspapers to reflect current law, because the administrative rule uses a content-based definition. | Endorses without comment | Unknown until after 2010 session |

# MOTOR VEHICLE AND SPECIAL FUEL EXEMPTIONS FROM SALES AND USE TAXES – SUMMARY

## Current Law

Current law provides exemptions from retail sales and use taxes for motor vehicle fuel (principally gasoline) and special fuels (principally diesel). Retail sales and use taxes do not apply to motor vehicle or special fuel if the motor vehicle fuel or special fuel tax is paid. On the other hand, retail sales and use taxes are generally owed if motor vehicle fuel or special fuel taxes are not applicable or are refunded.

See page A3-1 in Appendix 3 for the current statute, RCW 82.08.0255(1)(d) and RCW 82.12.0256(2)(d).

## Legal History and Public Policy Objectives

1921 The Legislature first adopted a tax on motor vehicle fuel. At this time, special fuels were subject to the motor vehicle fuel tax.

1932 The federal government first imposed a tax on motor vehicle fuel.

1935 The Legislature faced a significant revenue shortfall as it convened in 1935. To raise additional revenue, lawmakers passed the Revenue Act of 1935. As part of the 1935 act, the Legislature created the retail sales tax. The original retail sales tax applied to retail sales of tangible personal property. The 1935 legislation included specific exemptions from these new taxes, including an exemption from the retail sales tax for motor vehicle and special fuel subject to the motor vehicle fuel tax.

1941 Sales of fuel subject to the motor vehicle fuel tax were exempted from the use tax.

1971 The Legislature separated special fuel taxes and motor vehicle fuel taxes into different statutory chapters.

1980 The Legislature specifically provided that sales of special fuels subject to the specific special fuels statutes were exempt from sales and use taxes.

Generally, the retail sales and use taxes apply to the sales or use of all tangible personal property and selected services. In the case of motor vehicle and special fuel, the Legislature made an exception and chose not to apply the retail sales and use taxes if the motor vehicle or special fuel tax had been imposed. Instead, they chose to tax fuel only under the motor vehicle fuel and special fuel taxes to avoid double taxation.

## Beneficiaries

Individuals and businesses that purchase motor vehicle fuel for use on the public highways are the beneficiaries of these tax exemptions. In 2008, there were an estimated 5 million licensed drivers in Washington.

## Revenue and Economic Impacts

- Purchasers of motor vehicle and special fuel saved $969 million from the exemptions in Fiscal Year 2008. Of this amount, $709 million is state retail sales tax, and $260 million is local retail sales taxes. These figures assume that state and federal fuel taxes are included in the selling price. If the state and federal motor vehicle fuels are excluded from the price of fuel subject to the retail sales tax, the taxpayer savings are $812 million – $594 million in state taxes and $218 million in local taxes.
- The economic impacts of imposing the retail sales tax to the sale of motor vehicle fuel and special fuel are of two types:
    1) The impact that an increase in price of motor vehicle fuel will have on the fuel industry and the economy as a whole; and
    2) The impact that an increase in price will have on consumers.

## Other States

There are 45 states and the District of Columbia that impose sales and use taxes. Of these, 40 exempt motor fuel from their sales and use taxes. Four of the five states that do impose sales and use taxes apply the taxes before other state motor fuel taxes.

## Recommendation

**The Legislature should continue the sales and use tax exemptions for motor fuel and special fuel. The sales and use tax exemptions for motor fuel and special fuel are achieving the objective of avoiding double taxation of fuel.**

| | |
|---|---|
| **Legislation Required:** | No. |
| **Fiscal Impact:** | None – No change in status quo. |

# MOTOR VEHICLE AND SPECIAL FUEL SALES TAX EXEMPTIONS – REPORT DETAIL

## Current Law

Current law provides exemptions from retail sales and use taxes for motor vehicle fuel (principally gasoline) and special fuels (principally diesel). Retail sales and use taxes do not apply to motor vehicle or special fuel if the motor vehicle fuel or special fuel tax is paid. On the other hand, retail sales and use taxes are generally owed if motor vehicle fuel or special fuel taxes are not applicable or are refunded.

See page A3-1 in Appendix 3 for the current statute, RCW 82.08.0255(1)(d) and RCW 82.12.0256(2)(d).

## Legal History

1921 The Legislature first adopted a tax on motor vehicle fuel (gasoline). At this time, special fuels (principally diesel fuel) are subject the motor vehicle fuel tax.

1932 The federal government first imposed a tax on motor vehicle fuel.

1935 The Legislature faced a significant revenue shortfall as it convened in 1935. To raise necessary revenue, lawmakers passed the Revenue Act of 1935. As part of the 1935 act, the Legislature created the retail sales tax and companion use tax. The original retail sales tax targeted retail sales of tangible personal property. The use tax targeted the use of items in the state. The 1935 legislation included specific exemptions from these new taxes, including an exemption for motor vehicle and special fuel subject to the motor vehicle fuel tax.

1941 Sales of fuel subject to the motor vehicle fuel tax were exempted from the use tax.

1971 The Legislature separated special fuel taxes and motor vehicle fuel taxes into different statutory chapters.

1980 The Legislature specifically provided that sales of special fuels subject to the specific special fuels statutes were exempt from sales and use taxes.

## Other Relevant Background

### *Motor Vehicle and Special Fuel Taxes*

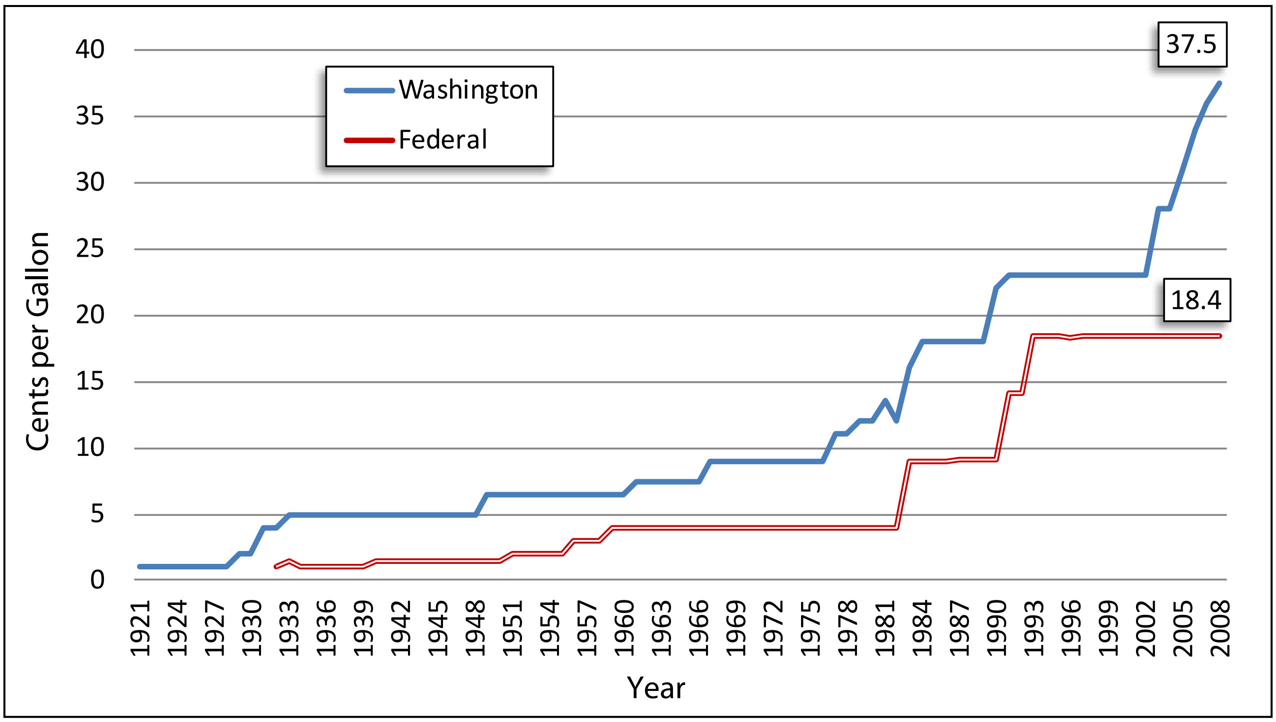
Commonly called the gas tax, the motor vehicle fuel and special fuel taxes are, in fact, two taxes:

- The motor vehicle fuel tax applies to each gallon of motor vehicle fuel removed from a "terminal rack" (the point where the fuel from a refinery or pipeline is delivered into tanker trucks for distribution to a retailer or bulk consumer). Motor vehicle fuel includes gasoline and other inflammable gas or liquids that are used to propel motor vehicles or boats. It does not include special fuels such as diesel and propane. The 2009 state tax on motor vehicle fuel is 37.5 cents per gallon. The federal tax is 18.4 cents per gallon.

- The special fuel tax applies to each gallon of special fuel removed from a terminal rack. The principal type of special fuel is diesel, but also includes natural gas, propane, and butane. The 2009 state tax on special fuel is 37.5 cents per gallon. The federal tax on diesel fuel is 24.4 cent per gallon.

The Legislature imposed the motor vehicle fuel tax in 1921 with a rate of 1 cent per gallon. The federal government followed with an additional tax of 1 cent per gallon in 1932. The growth in federal gas tax rates parallel the growth in Washington's rates until 2003 when the Legislature increased the state tax rate by 5 cents and again by 9.5 cents in 2005 to fund highway projects. (See Exhibit 1.)

Exhibit 1 – Washington and Federal Gas Tax Rates Grow Similarly Until 2003




Source: Comparative State and Local Taxes, Department of Revenue, 2008; The Tax Foundation.

## *18th Amendment to the State Constitution*

Since the first motor vehicle fuel tax in 1921, the Legislature dedicated the proceeds from the tax to the Motor Vehicle Fund. This fund was dedicated to, among other things, paving and general road construction of the state primary highways.

The voters adopted the 18th amendment to the state's Constitution in 1944. This amendment put the dedication of the motor vehicle fuel tax revenues for highway purposes into the state's Constitution:

> *… all excise taxes collected by the State of Washington on the sale, distribution or use of motor vehicle fuel … shall be paid into the state treasury and placed in a special fund to be used exclusively for highway purposes.*

> …(provided) *that this section shall not be construed to include revenue from general or special taxes or excises not levied primarily for highway purposes*

While the first part of the amendment provides that all excise taxes on motor vehicle fuel are to be used exclusively for highway purposes, there is an exception to this requirement. The proviso does not preclude a general tax on motor vehicle fuel, such as a retail sales tax. The tax proceeds on fuel from such a general tax do not need to be used for highway purposes.

### *Blue Ribbon Commission on Transportation*

The most recent discussion of extending the sales tax to gasoline came from the Blue Ribbon Commission on Transportation. The Legislature and the Governor formed the Blue Ribbon Commission on Transportation in 1998 to assess the local, regional, and state transportation system; to ensure that current and future funding is spent wisely; to make the system more accountable and predictable; and to prepare a 20-year plan for funding and investing in the transportation system.

In 2000, the Commission made 18 recommendations to the Governor and the Legislature. The Commission recommended the adoption of a package of new revenues to fund a comprehensive set of investments, which it believed, taken together with recommended efficiency measures and reforms, would ensure a 20-year program of preserving, optimizing, and extending the state's transportation system.

Included in the new revenue package was a proposal to add a new sales tax to motor vehicle fuels. The Commission proposed that this sales tax on gas be imposed on the wholesale commodity price of the fuel, up to a set cap. It recommended that proceeds would be dedicated to all transportation purposes (as opposed to highway purposes only). The tax would not be imposed on top of the existing motor vehicle fuel taxes and would be collected at the terminal rack, like other motor vehicle fuel taxes.

Instead of imposing a sales tax on gas for the first time in history, the Legislature chose to increase the gas tax to fund transportation projects. The Legislature increased rates by 5 cents effective July 1, 2003. In 2005, it raised rates by 9.5 cents phased in over the next four years.

## Public Policy Objectives

### *What are the public policy objectives that provide a justification for the tax preference? Is there any documentation on the purpose or intent of the tax preference?*

Generally, the retail sales and use taxes apply to the sales or use of all tangible personal property. In the case of motor vehicle fuel, the Legislature made an exception and chose not to apply the retail sales and use taxes unless the motor vehicle fuel tax had not been imposed on the fuel.

The original draft of the 1935 Revenue Act developed by the House Committee on Revenue and Taxation applied the retail sales tax to the sale of motor vehicle fuel. The price was to exclude the amount of fuel tax imposed by the state or the federal governments. Later, as the proposal proceeded towards passage in the House of Representatives, the chairman of the committee offered a floor amendment to provide an outright exemption from the retail sales tax for sales of motor fuel subject to the state's fuel tax. This amendment passed leaving fuel taxable under the same gallonage tax in place since 1921.

The Legislature commonly avoids taxing a transaction under two separate tax schemes. Business activities subject to the business and occupation tax are not subject to the public utility tax and vice versa. Insurance income is taxable under the insurance premiums tax and not the business and occupation tax. Likewise, the Legislature chose to increase the gas tax rate rather than add another layer of taxation by imposing the retail sales tax as well. It also may have wanted to keep the tax system simple – a dual gas tax would impose one rate based on gallonage and another based on the retail selling price.

### *What evidence exists to show that the tax preference has contributed to the achievement of any of these public policy objectives?*

The public policy objective of avoiding double taxation is being achieved. In 2003 and in 2005, the Legislature chose to impose significantly higher fuel taxes rather than accept the recommendation of the Blue Ribbon Commission on Transportation to impose a sales tax.

### *To what extent will continuation of the tax preference contribute to these public policy objectives?*

The public policy objective is being achieved.

### *If the public policy objectives are not being fulfilled, what is the feasibility of modifying the tax preference for adjustment of the tax benefits?*

The public policy objective is being achieved.

## Beneficiaries

### *Who are the entities whose state tax liabilities are directly affected by the tax preference?*

Individuals and businesses that purchase motor vehicle fuel for use on the public highways are the beneficiaries of these tax exemptions. In 2008, there were an estimated 5 million licensed drivers in Washington.

### *To what extent is the tax preference providing unintended benefits to entities other than those the Legislature intended?*

There do not appear to be any unintended beneficiaries from exempting fuel subject to the motor vehicle fuel and special fuel taxes from the retail sales and use taxes. If the fuel taxes are paid, then sales or use tax is not owed. If the fuel taxes are not due, or if they have been refunded, then the retail sales and use taxes are owed. The use tax is collected by the Department of Licensing when motor vehicle fuel tax refunds are provided.

## Revenue and Economic Impacts

### *What are the past and future tax revenue and economic impacts of the tax preference to the taxpayer and to the government if it is continued?*

The revenue impact of imposing the retail sales on gasoline depends on several factors: the volume of fuel sold, the price of motor vehicle fuel, and whether the Legislature includes the state and federal motor vehicle fuel taxes in the price, or not. If the state and federal motor vehicle fuel taxes are included in the price of the fuel subject to the retail sales tax, purchasers of fuel saved $969 million in Fiscal Year 2008. Of this amount, $709 million is the estimated state retail sales tax, and $260 million is the estimated local retail sales tax savings. If the state and federal motor vehicle fuels are excluded from the price of fuel subject to the retail sales tax, the taxpayer savings are $812 million – $594 million in state taxes and $218 million in local taxes.

Exhibit 2 – Taxpayer Savings Resulting from Exempting Motor Vehicle from the Retail Sales and Use Taxes (Dollars in Millions)

| | Include Motor Vehicle Taxes In Taxable Price | | | Exclude Motor Vehicle Taxes From Taxable Price | | |
|---|---|---|---|---|---|---|
| **Fiscal Year** | **State** | **Local** | **Total** | **State** | **Local** | **Total** |
| 2006 | $557 | $204 | $761 | $452 | $166 | $618 |
| 2007 | $605 | $222 | $827 | $494 | $181 | $674 |
| 2008 | $709 | $260 | $969 | $594 | $218 | $812 |
| 2009 | $564 | $207 | $771 | $450 | $165 | $614 |
| 2010 | $480 | $176 | $656 | $359 | $132 | $491 |
| 2011 | $590 | $216 | $806 | $466 | $171 | $637 |

Source: JLARC analysis using March 2009 Transportation Revenue Forecast.

Note: Figures for fiscal years 2009 to 2011 are estimates.

From year-to-year there is a wide fluctuation in the amount of fuel purchases primarily due to the wide fluctuations in the price of motor fuel. The amount of taxpayer savings peaks in 2008 at $969 million (if the taxable price includes the motor vehicle fuel taxes) and reaches a low point in 2010 at $656 million. The retail price of gasoline is forecasted to go from $3.34 per gallon in Washington in 2008 to $2.31 per gallon in 2010, a price drop of 31 percent.

Exhibit 3 – Washington Retail Fuel Price Per Gallon, State and Federal Motor Vehicle Fuel Taxes Included

| Fiscal Year | Gasoline | Diesel |
|---|---|---|
| 2006 | $2.64 | $2.92 |
| 2007 | $2.88 | $3.03 |
| 2008 | $3.34 | $3.76 |
| 2009 | $2.75 | $3.05 |
| 2010 | $2.31 | $2.03 |
| 2011 | $2.75 | $2.58 |

Source: March 2009 Transportation Revenue Forecast, retail prices for all grades, all services.

Note: Figures for fiscal years 2009 to 2011 are estimates.

Gasoline sales are forecast to grow slowly from 2.7 billion gallons in 2008 to 2.9 billion gallons in 2011. Diesel sales reached a peak in 2008 at 777 million gallons, are forecast to decline to 668 million gallons in 2009, and are forecast to grow slowly to 711 million gallons in 2011.

## *If the tax preference were to be terminated, what would be the negative effects on the taxpayers who currently benefit from the tax preference and the extent to which the resulting higher taxes would have an effect on employment and the economy?*

Imposing a tax on the selling price of motor fuel at the sales tax rate would increase the price of fuel to the customer. The current state and local sales tax rate is 8.9 percent on average (the combination of the state's 6.5 percent sales tax and the average local sales tax rate of 2.4 percent). Steep fuel price increases over the past several years had little impact on consumption of fuel. During the fuel price increases from 2002 to 2008, consumption of fuel remained relatively steady.

Gasoline prices increased from 2002 to 2008 by an average of 16 percent per year. However, per capita fuel consumption declined from 549 gallons per person to 528 gallons, a decline of 0.6 percent per year. Many factors other than price are involved in determining fuel consumption. However, the fact that consumers purchased almost the same amount of fuel during the period that prices rose significantly suggests that taxes can be passed on to consumers.

Higher fuel prices did not appear to negatively impact the fuel industry. During the same 2002 to 2008 period, wages paid to refinery workers in Washington increased from $73,000 per year to $117,000. The median household income in Washington also grew, but at 3 percent per year. (See Exhibit 4.)

Exhibit 4 – Trends in Selected Washington Economic Indicators, 2002 to 2008

| Economic Indicator | FY 2002 | FY 2008 | Average Annual Change |
|---|---|---|---|
| Average Gasoline Price | $1.37 | $3.34 | 16.0% |
| Gross Fuel Consumption (billion gallons) | 3.317 | 3.481 | 0.8% |
| Per Capita Fuel Consumption (gallons) | 549 | 528 | (0.6%) |
| Average Wages Refinery Employees | $72,922 | $117,034 | 8.2% |
| Household Median Income | $50,003 | $60,010 | 3.1% |

Sources: Transportation Revenue Forecast, Washington Department of Employment Security, and the Office of Financial Management.

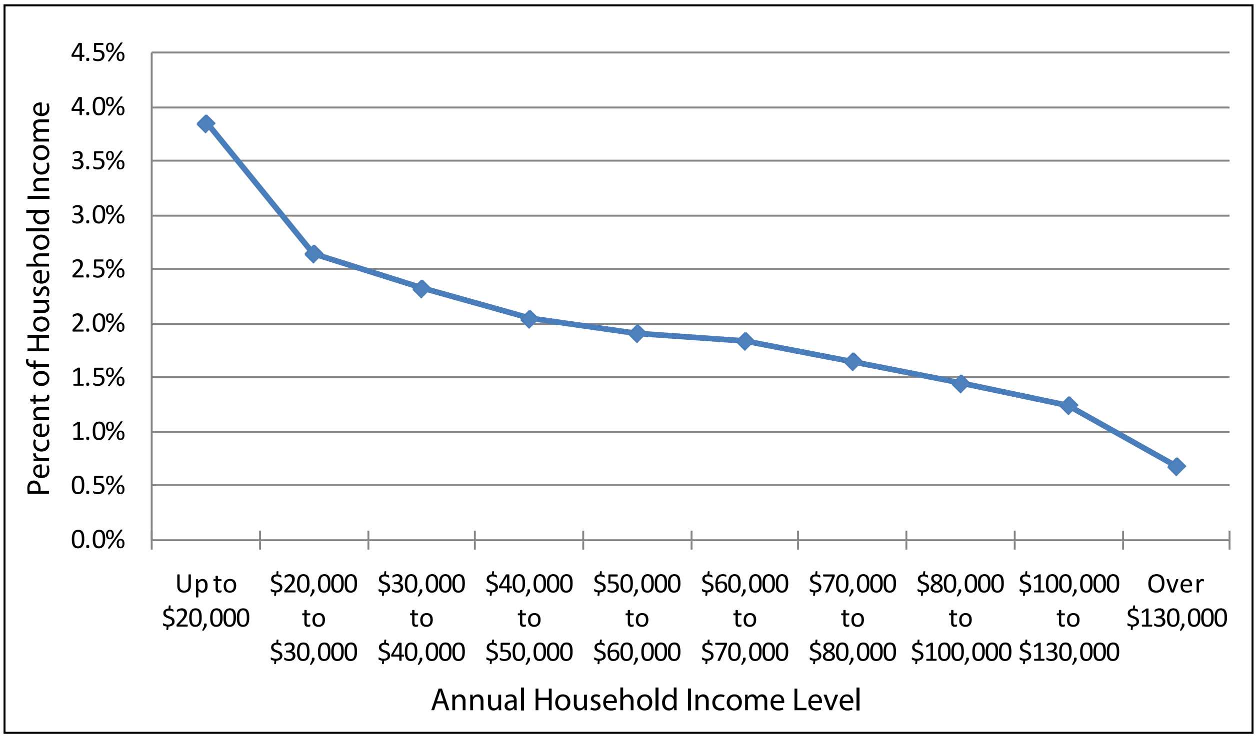
U.S. refinery utilization fell from 91 percent of capacity in 2002 to 88 percent of capacity in 2008. However, this may have been more a result of crude oil supply constraints that led to price increases, rather than a fall-off in the demand for gasoline.

## *If the tax preference were to be terminated, what would be the effect on the distribution of liability for payment of state taxes?*

The incidence of imposing the retail sales tax on the sale of motor vehicle fuel would be on consumers – both business consumers of motor vehicle fuel and households. Seventy percent of motor vehicle fuel purchases are made by households; 29 percent of purchases are made by businesses, and 1 percent is made by government. While taxes would go up for everyone, a sales tax on motor vehicle and special fuel would result in a slight shift in taxes from business to households.

An increase in the price of fuel would impact lower income households more than higher income households. Households at the lowest income level spend 10 percent of their income on gasoline, while households at the highest income level spend 2.3 percent of their income on gasoline. (See Exhibit 5.)

Exhibit 5 – Lower Income Households Spend a Greater Portion of Income on Gasoline than Do Higher Income Households




Source: 2007 Consumer Expenditure Survey, Bureau of Labor Statistics.

## Other States

### *Do other states have a similar tax preference and what potential public policy benefits might be gained by incorporating a corresponding provision in Washington?*

There are 45 states and the District of Columbia that impose a sales tax. Of these, 40 exempt motor fuel from the sales tax. Those states where motor fuel is taxable by a sales tax include: California, Georgia, Illinois, Indiana, and Michigan. In West Virginia, the state applies what is referred to as a sales tax, but the rate is applied on the wholesale price of motor fuel, rather than the retail price.

Taxes applied to motor fuel vary by state. All states apply a motor fuel tax in addition to the federal tax; both are collected on a per unit basis or cents per gallon. Of those states applying a sales tax to motor fuel, four apply the sales tax to the taxable amount before state motor fuel taxes are considered. In contrast, California's sales tax is applied after federal and state taxes are included.

## Recommendation

**The Legislature should continue the sales and use tax exemptions for motor fuel and special fuel. The sales tax and use tax exemptions for motor fuel and special fuel are achieving the objective of avoiding double taxation of fuel.**

**Legislation Required:** No.

**Fiscal Impact:** None – No change in status quo.

# JOINT UTILITY SERVICES DEDUCTION FROM PUBLIC UTILITY TAX – SUMMARY

## Current Law

The public utility tax is based on gross income from the operation of utilities and public service companies. These companies provide services in the area of energy, water, communications, and transportation. Current law provides a deduction for amounts paid by one utility or public service company to another for services jointly furnished by both. Consequently, if a customer pays Company A for a service (e.g., hauling some freight) but that company hired Company B to do some of the work, Company A takes a deduction from its income for the amount it paid Company B and Company B pays the tax on this amount.

See page A3-1 in Appendix 3 for the current statute, RCW 82.16.050(3).

## Legal History and Public Policy Objectives

1933 The Legislature faced a revenue shortfall as it convened in January 1933. In response, lawmakers adopted a temporary tax imposed on the privilege of engaging in business activities. The new tax applied to a wide range of business activities, including utility and public service businesses.

In the 1933 legislation, intermediary sales of utility services from one provider to another prior to sale to the final consumer were not to be subject to tax. The 1933 act provided that taxpayers (the utility and public service companies) could deduct from gross income amounts derived from the sale of services for resale to another company taxable under the same classification.

1935 To address a continuing revenue shortfall, the Legislature passed the Revenue Act of 1935. As part of the act, the Legislature created a separate public utility tax. The utility and public service business activities previously taxed under the 1933 act were included in the new public utility tax. The 1935 Legislature continued the same design for the public utility tax and again provided a deduction for amounts paid by one utility or public service company to another for services jointly furnished by both.

The essential deduction language in the current law has not changed since 1935.

The public policy objective for this deduction is to retain the public utility tax as a single-turnover tax, imposing the tax only once on each service.

## Beneficiaries

The entities directly affected by the deduction for jointly provided utility services are the utilities and public service companies that provide the services. In Fiscal Year 2008, 551 businesses reported this deduction to the Department of Revenue.

## Revenue and Economic Impacts

In Fiscal Year 2008, utilities and public service companies saved $9.7 million by not doubly paying public utility tax on income earned from jointly provided utility services. These companies paid $349 million to other utility and public service companies for services jointly provided to customers. The future expected taxpayer savings are $10 million annually.

The likely impact of terminating this tax preference would be an increase in charges to businesses and household consumers of jointly provided utility and public services. This impact would occur to the extent that the businesses could or would be allowed to pass on the higher costs to consumers. If the businesses could not pass on the costs, the next result would likely be lower wages paid to employees or lower profits to the businesses. Given the relatively small size of the tax preference, terminating the tax preference would not have any significant impact on employment in the statewide economy.

## Other States

Most states have exemptions similar to Washington's public utility tax deduction for jointly furnished services. JLARC found that 45 states and the District of Columbia impose a sales tax which is the most comparable tax to Washington's public utility tax. Most of these jurisdictions exempt at least some services that would be taxable under Washington's public utility tax.

## Recommendation

**The Legislature should continue the public utility tax deduction for income paid to another utility or public service company for jointly provided services. The deduction is achieving the objective of imposing the tax only once on each service.**

**Legislation Required:** No.

**Fiscal Impact:** None – No change from status quo.

# JOINT UTILITY SERVICES DEDUCTION FROM PUBLIC UTILITY TAX – REPORT DETAIL

## Current Law

The public utility tax is based on gross income from the operation of utilities and public service companies. These companies provide services in the area of energy, water, communications, and transportation. Current law provides a deduction for amounts paid by one utility or public service company to another for services jointly furnished by both. Consequently, if a customer pays Company A for a service (e.g., hauling some freight) but that company hired Company B to do some of the work, Company A takes a deduction from its income for the amount it paid Company B and Company B pays the tax on this amount.

See page A3-1 in Appendix 3 for the current statute, RCW 82.16.050(3).

## Legal History

1933 The Legislature faced a revenue shortfall as it convened in January 1933. In response, the Legislature adopted a temporary business activities tax imposed on the privilege of engaging in business activities. The tax was to be in place from August 1933 through July 1935. The tax applied to a wide range of businesses including public service and utility businesses. Public service and utility businesses included light and power companies, telephone and telegraph companies, water companies (except irrigation companies), steam and street railways, and highway transportation companies. Multiplying the "value of products," "gross proceeds of sales," or "gross income of the business" by the statutorily established rates determined the amount of the tax.

As opposed to what became the business and occupation tax in 1935, the tax on public service and utility activities in the 1933 legislation did not pyramid (taxing gross income from successive sales of the same item or service). The 1933 legislation made it clear that intermediary sales of utility commodities and services from one provider to another prior to sale to the final consumer were not to be subject to tax. This allowed taxpayers (the utility and public service companies) to deduct from their gross incomes the amount derived from the sale of services to another company taxable under the same classification. Under the 1933 legislation, public utilities and services were to be taxed only once, on the final sale to the consumer.

1935 The Legislature continued to face a significant revenue shortfall as it convened in 1935. To raise additional revenue, the Legislature passed the Revenue Act of 1935. As part of the act, the Legislature created a separate public utility tax. The public service and utility businesses previously taxed under the 1933 business activities tax fell under the new public utility tax. The 1935 Legislature continued the structure of the 1933 act, and it continued to eliminate pyramiding of the public utility tax, imposing the tax only once on each service.

## Other Relevant Background – Turnover Taxation

The business and occupation tax is considered a "multiple-turnover" tax because tax is imposed at every stage of the production and distribution chain. The public utility tax and the retail sales tax are considered "single-turnover" taxes because they tax the final sale to the end user. In 1929, the National Industrial Conference Board published a book on sales or "turnover" taxation that provided detail on turnover taxes and their application worldwide.[1]

While the State Tax Commission characterized the 1933 temporary business activities tax as a multiple-turnover tax, the tax had aspects of both multiple-turnover and single-turnover. The portions of the 1933 act that became the business and occupation tax were a multiple-turnover tax. The portions of the 1933 act that became the public utility tax had aspects of a single-turnover tax. As passed by the Legislature, the tax on utility and public services was a retail sales tax; however, with the Governor's veto of a section directing that the tax be passed onto to the consumer, the public utility tax became a tax on producers. Intermediary sales of a service to businesses in the same industry were not taxed.

The 1929 Conference Board publication discussed the economic and social aspects of each type of turnover tax, as well as administrative and legal issues. A 1930 report of the Washington Tax Investigation Commission referred policymakers to the discussion of "sales taxes" in the Conference Board book. The drafters of the 1933 and 1935 tax legislation would have been familiar with the pros and cons of the various taxes as they attempted to construct a tax system for Washington that met the State Supreme Court's approval.

## Public Policy Objectives

### *What are the public policy objectives that provide a justification for the tax preference? Is there any documentation on the purpose or intent of the tax preference?*

The public policy objective for this deduction is to structure the public utility tax as a single-turnover tax, imposing the tax only once on each service.

The Legislature had the option in 1933 and 1935 of taxing public utilities and services by a "multiple-turnover" or a "single-turnover" tax. It chose a single-turnover tax system. By definition, a necessary piece to such a tax system is that intermediate sales are not taxed.

The tax on public services and utilities falls within the classification of a "single-turnover tax." In what eventually became the public utility tax, the Legislature in 1933 essentially designed a retail sales tax on public utilities and services. With the Governor's veto of a section of the legislation directing that the tax be passed onto the consumer, the public utility tax became a tax on producers.

It is clear from the 1933 legislation that intermediary sales of utility commodities and services from one provider to another prior to sale to the final consumer were not to be subject to tax. The 1933 act provided that taxpayers (the utility and public service companies) could deduct from gross

[1] "General Sales or Turnover Taxation," National Industrial Conference Board, New York, 1929.

income amounts derived from the sale of services to another company taxable under the same classification. The 1935 Legislature continued the same design for the public utility tax.[2]

### *What evidence exists to show that the tax preference has contributed to the achievement of any of these public policy objectives?*

To accomplish the public policy objective of a single-turnover tax, a deduction needs to be provided for payments made to another public service firm for services jointly provided by both firms so that the tax is imposed only once on each good or service. This deduction accomplishes this objective.

### *To what extent will continuation of the tax preference contribute to these public policy objectives?*

If the public policy objective is to continue the public utility tax as a single-turnover, then the income deduction for payments made to another utility or public service firm for services jointly provided by both firms needs to be continued.

### *If the public policy objectives are not being fulfilled, what is the feasibility of modifying the tax preference for adjustment of the tax benefits?*

The public policy objective is being fulfilled.

## Beneficiaries

### *Who are the entities whose state tax liabilities are directly affected by the tax preference?*

The entities directly affected by the deduction for jointly provided utility services are the utility and public service businesses that provide the services. In Fiscal Year 2008, 551 businesses reported this deduction to the Department of Revenue, as shown in Exhibit 6.

[2] JLARC reviewed "Sales of commodities for resale by water and gas utilities" in 2008 ("2008 Expedited Tax Preference Performance Reviews, Report 09-4, January 7, 2009, JLARC); and "Sales of electric power resold" is scheduled for review in 2014.

Exhibit 6 – Business Firms Deducting Amounts Paid to Another for Services Jointly Provided

| Business Activity | Number of Firms Reporting Jointly Provided Services (FY 2008) |
|---|---|
| Motor Transportation | 392 |
| Urban Transportation | 91 |
| Sewer Collection | 33 |
| Water Distribution | 19 |
| Power | 7 |
| Gas | 1 |
| Other Public Service Business | 8 |
| **Total** | **551** |

Source: Department of Revenue.

### *To what extent is the tax preference providing unintended benefits to entities other than those the Legislature intended?*

No unintended benefits are apparent.

## Revenue and Economic Impacts

### *What are the past and future tax revenue and economic impacts of the tax preference to the taxpayer and to the government if it is continued?*

In Fiscal Year 2008, utility and public service companies saved $9.7 million by not doubly paying public utility tax on income earned from jointly provided utility services. These companies paid $349 million to other utility and public service companies for services jointly provided to customers. The future expected taxpayer savings are $10 million annually.

Exhibit 7 – Tax Savings From Income Deductions for Jointly Provided Services (Dollars in Millions)

| Fiscal Year | Deducted Income | Taxpayer Savings |
|---|---|---|
| 2006 | $348 | $9.7 |
| 2007 | $326 | $9.2 |
| 2008 | $349 | $9.7 |
| 2009 | $350 | $10.0 |
| 2010 | $350 | $10.0 |
| 2011 | $350 | $10.0 |

Source: Department of Revenue.

Note: Figures for fiscal years 2009 to 2011 are estimates.

The bulk of the income deductions and taxpayer savings are concentrated in two types of utilities: motor transportation and sewer collection. As shown in Exhibit 8, in Fiscal Year 2008, motor transportation services accounted for 49 percent of the income deducted and 34 percent of the tax savings. The sewer collection firms accounted for 45 percent of the income deductions and 63 percent of the tax savings.

Exhibit 8 – Income Deductions and Tax Savings by Type of Public Service
(FY 2008, Dollars In Millions)

| Business Activity | Deducted Income | Share of Total | Taxpayer Savings | Share of Total |
|---|---|---|---|---|
| Motor Transportation | $169 | 49% | $3.3 | 34% |
| Sewer Collection | $157 | 45% | $6.1 | 63% |
| Urban Transportation | $14 | 4% | $0.1 | 1% |
| Power | $4 | 1% | $0.2 | 2% |
| Other Public Service, inc. Water Distribution and Gas | $3 | 1% | $0.1 | 1% |
| **Total** | **$349** | **100%** | **$9.7** | **100%** |

Source: Department of Revenue.

Note: Figures for fiscal years 2009 to 2011 are estimates.

With regards to motor transportation, the deduction occurs when a trucking or log hauling company contracts with another trucking company to do a portion of a job. With sewer collection, the deduction occurs when a city, such as Seattle or Olympia, charges its residents for sewer collection and then contracts with another entity for the actual work.

Employment in the industries containing the businesses that provide joint utility and public services totaled almost $90,000 in 2007. These industries paid wages of $4 billion for an average wage of $45,000 per employee. As with the number of firms using the income deduction, most of the employment is found in the transportation services sectors of trucking, warehousing, courier, and messenger services.

Exhibit 9 – Employment and Wages in Utility and Public Service Sectors, 2007

| Industry Sector | Employment | Total Wages | Average Annual Wages |
|---|---|---|---|
| Trucking/Warehousing | 44,973 | $1,961,964,489 | $43,625 |
| Couriers and Messengers | 10,510 | $388,838,901 | $36,997 |
| Electric Power Generation & Distribution | 6,035 | $452,642,774 | $75,003 |
| Water Supply | 3,940 | $194,931,186 | $49,475 |
| Sewerage Treatment | 802 | $47,326,780 | $59,011 |
| All Other (estimated) | 23,442 | $996,106,610 | $42,493 |
| **Total** | **89,702** | **$4,041,810,740** | **$45,058** |

Source: Employment Security Department with estimates by JLARC.

### *If the tax preference were to be terminated, what would be the negative effects on the taxpayers who currently benefit from the tax preference and the extent to which the resulting higher taxes would have an effect on employment and the economy?*

If this tax preference were to be terminated, there are two sectors of public utility taxpayers that would bear the brunt of the impact: motor transportation services and sewerage collection services. The likely impact of terminating the income deduction for public services that are jointly provided would be an increase in the charges to the business and household consumers of these services. This impact would occur to the extent that the businesses could or would be allowed to pass on to consumers the higher costs. If the businesses could not pass on the costs, the next result would likely be lower wages paid to employees or lower profits to the businesses.

Given the relatively small size of the tax preference, terminating the tax preference would not have any significant impact on employment in the statewide economy.

### *If the tax preference were to be terminated, what would be the effect on the distribution of liability for payment of state taxes?*

Terminating this tax preference that allows utility and public services that are jointly provided to be taxed only once would result in increased tax revenues of $10 million per year, unless the trucking firms and sewer collection utilities changed their operating or billing practices (e.g., rather than a city billing its residents for sewer service, the entity actually providing the service could directly bill the city's residents and avoid double-taxation). This is about 2.5 percent of the $400 million per year raised by the public utility tax.

## Other States

### *Do other states have a similar tax preference and what potential public policy benefits might be gained by incorporating a corresponding provision in Washington?*

Most states have exemptions similar to Washington's public utility tax deduction for jointly furnished services. JLARC found 45 states and the District of Columbia impose a sales tax which is the most comparable tax to Washington's public utility tax. Most of these jurisdictions exempt at least some services that would be taxable under Washington's public utility tax.

## Recommendation

**The Legislature should continue the public utility tax deduction for income paid to another utility or public service company for jointly provided services. The deduction is achieving the objective of imposing the tax only once on each service.**

| | |
|---|---|
| **Legislation Required:** | No. |
| **Fiscal Impact:** | None – No change from status quo. |

# TUITION AND FEES DEDUCTIONS FROM B&O TAX – SUMMARY

## Current Law

A qualified private educational institution may deduct the payment it receives for tuition and fees when calculating gross income for taxation under the business and occupation (B&O) tax. This tax preference has been in place since the creation of the B&O tax in 1935. A separate statute (RCW 82.04.170) and an administrative rule (WAC 458-20-167) define the term "tuition fees." The definition includes instructional costs, library, laboratory, health service, and other special fees as well as room and board charges to student and faculty of an "educational institution." Over time, the Legislature has changed and clarified what constitutes an "educational institution."

See pages A3-2 and A3-3 in Appendix 3 for the current law, RCW 82.04.4282 and RCW 82.04.4332.

## Legal History and Public Policy Objectives

1933 The Legislature faced a revenue shortfall as it convened in January 1933. In response, lawmakers adopted a temporary tax imposed on the privilege of engaging in business activities. The tax was to be in place from August 1933 through July 1935. The new tax applied to a wide range of business activities including manufacturing, wholesaling, retailing, and utilities. Religious, scientific, educational, benevolent and other corporations or societies not organized for profit or financial gain were exempted from the business activities tax.

1935 The Legislature continued to face a significant revenue shortfall as it convened in 1935. To raise additional revenue, the Legislature passed the Revenue Act of 1935. As part of the 1935 act, the Legislature created the business and occupation tax. The law applied to "persons" engaged in taxable business activities. "Persons" included nonprofit as well as for-profit organizations.

The Legislature provided a deduction for "tuition fees" from the new tax for both private and nonprofit qualified educational institutions. "Tuition fees" included instructional fees, library, laboratory, health service and other special fees as well as room and board charges to students and faculty.

1937 The Legislature added a proviso that the term "educational institution" meant only those institutions created or generally accredited as such by the state that offer a program of "a general academic nature" but "specialty schools, business colleges, other trade schools, or similar institutions do not qualify."

1943 The Legislature enlarged the definition of "educational institution" to include not-for-profit institutions that are "privately endowed under a deed of trust to offer instruction in trade, industry, and agriculture."

1965 The Legislature amended the deduction to also apply to privately operated kindergartens.

1985 The Legislature expanded the definition of "educational institution" to include certain degree-granting institutions accredited by accrediting organizations recognized by the United States Secretary of Education.

1993 The Legislature amended the definition statute twice during this session to reach the current version. Foreign degree-granting institutions were added as qualifying private educational institutions. The Legislature also included educational programs co-sponsored by a nonprofit organization and an educational institution if the educational institution grants college credit for course work completed through the program.

The basic public policy objective for allowing tuition and fees to be deducted from gross income and not subject to the B&O tax appears to be to encourage general education activities. The public policy objective for the 1993 change to exempt approved branch campuses of foreign degree-granting institutions from the B&O tax is to facilitate the establishment and operation of such branch campuses in Washington.

## Beneficiaries

The direct beneficiaries from allowing tuition and fees received by private educational institutions to be deducted for B&O tax purposes include the following private educational institutions:

- Nonpublic schools, including parochial or independent schools, which have been approved by the Washington State Board of Education;
- Degree-granting private higher education institutions, both nonprofit and for-profit, accredited by an accrediting association recognized by the U.S. Secretary of Education, and offering a general education program;[3]
- Private nonprofit institutions that offer instruction in trade, industry, and agriculture and are privately endowed under a deed of trust;
- Programs that an educational institution cosponsors with a nonprofit organization, provided that the educational institution grants college credit for course work successfully completed through the education program;
- Nonprofit branch campuses of foreign degree-granting institutions; and
- Privately operated kindergartens.

[3] As a policy, the institution must grant degrees and be accredited by an accrediting association approved by the U.S. Department of Education. The U.S. Department of Education has approved many accrediting associations (18 regional and national accrediting agencies and 43 specialized accrediting agencies), many of which accredit institutions that do not provide a general education, but rather accredit institutions that provide a specific type of career or technical education in a specified field. No review was made to determine if the institutions using the income deduction were providing a general education as opposed to a vocational or technical education.

Public K-12 schools and public four-year institutions are not included in this list of beneficiaries. Public K-12 schools are not included in this estimate because they generally do not charge tuition. The public higher education institutions are not included as they are not subject to the B&O tax (RCW 82.04.030, WAC 458-20-189(3)(b)). Room charges at the private colleges are also not included because the B&O tax may not be imposed on rent for accommodations.

## Revenue and Economic Impacts

- The taxpayer savings resulting from not imposing the B&O tax on tuition and fees received by private educational institutions is nearly $18 million per year. This estimate includes 530 private K-12 schools approved by the State Board of Education and 27 institutions of higher education. Of these higher education institutions, 17 are nonprofit and ten are for-profit.
- The amount of additional educational activity that takes place in Washington because of the B&O tax deduction for tuition and fees earned by private educational institutions is not known. The measure of the economic impact of the B&O tax preference is the extent to which the deduction promotes education that otherwise would not occur, were it not for the deduction.

## Other States

All 46 states and the District of Columbia with corporate income taxes exempt nonprofit private educational institutions.

## Recommendation

**The Legislature should continue the B&O tax deduction for tuition and fees earned by private educational institutions. The deduction is achieving the objective of encouraging general education activities.**

**Legislation Required:** None.

**Fiscal Impact:** None – No change in status quo.

# TUITION AND FEES DEDUCTIONS FROM B&O TAX – REPORT DETAIL

## Current Law

A qualified private educational institution may deduct the payment it receives for tuition and fees when calculating gross income for taxation under the business and occupation (B&O) tax. This tax preference has been in place since the creation of the B&O tax in 1935. A separate statute (RCW 82.04.170) and an administrative rule (WAC 458-20-167) define the term "tuition fees." The definition includes instructional costs, library, laboratory, health service, and other special fees as well as room and board charges to student and faculty of an "educational institution." Over time, the Legislature has changed and clarified what constitutes an "educational institution."

See page A3-2 and A3-3 in Appendix 3 for the current law, RCW 82.04.4282 and RCW 82.04.4332.

## Legal History

1933 The Legislature faced a revenue shortfall as it convened in January 1933. In response, lawmakers adopted a temporary tax imposed on the privilege of engaging in business activities. The tax was to be in place from August 1933 through July 1935. The new tax applied to a wide range of business activities including manufacturing, wholesaling, retailing, and utilities. Religious, scientific, educational, benevolent and other corporations or societies not organized for profit or financial gain were exempted from the business activities tax.

1935 The Legislature continued to face a significant revenue shortfall as it convened in 1935. To raise additional revenue, the Legislature passed the Revenue Act of 1935. As part of the 1935 act, the Legislature created the business and occupation tax. The law applied to "persons" engaged in taxable business activities. "Persons" included nonprofit as well as for-profit organizations.

The Legislature provided a deduction for "tuition fees" from the new tax for both private and nonprofit qualified educational institutions. "Tuition fees" included instructional fees, library, laboratory, health service and other special fees as well as room and board charges to students and faculty.

1937 The Legislature added a proviso that the term "educational institution" meant only those institutions created or generally accredited as such by the state that offer a program of "a general academic nature" but "specialty schools, business colleges, other trade schools, or similar institutions do not qualify."

1943 The Legislature enlarged the definition of "educational institution" to include not-for- profit institutions that are "privately endowed under a deed of trust to offer instruction in trade, industry, and agriculture."

1965 The Legislature amended the deduction to also apply to privately operated kindergartens.

1985 The Legislature expanded the definition of "educational institution" to include certain degree-granting institutions accredited by accrediting organizations recognized by the United States Secretary of Education.

1993 The Legislature amended the definition statute twice during this session to reach the current version. Foreign degree-granting institutions were added as qualifying private educational institutions. The Legislature also included educational programs co-sponsored by a nonprofit organization and an educational institution if the educational institution grants college credit for course work completed through the program.

The primary interpretive issue arising from this deduction is whether a particular taxpayer qualifies as an "educational institution" within the meaning of the statutes. As noted above, the Legislature has changed that definition over time. The Department of Revenue has addressed two main issues relating to the definition: 1) the meaning of "generally accredited" and 2) whether a particular program is of "a general academic nature."

In regard to the first issue, the Board of Tax Appeals concluded that a private school not accredited by the state but on a list of schools approved by the State Board of Education was entitled to the deduction.[4] Similarly, the Department allowed the deduction to a Bible college which was accredited by a private organization that reviewed religious schools.[5]

As for the "general academic nature" of the program, the Board of Tax Appeals found that the nursing program at a private hospital was of a sufficiently general nature because the program was accredited and credits from the program were accepted at some traditional four year institutions.[6] On the other hand, the Department denied the deduction to a radiology school at a private hospital, finding that it was a specialty school rather than one of a general nature.[7]

## *Tax Status of Schools and Colleges*

The income deduction for tuition and fees is not restricted to nonprofit private educational institutions. K-12 schools approved by the State Board of Education are exempt from the B&O tax on tuition and fees, whether or not the school is a nonprofit organization. To be eligible for a B&O tax deduction, a college must be accredited, offer an educational program of a general academic program and may be either a nonprofit or a for-profit organization. Specialty schools, business colleges, and trade schools are not eligible for a B&O tax deduction, except for nonprofit schools which are privately endowed to offer a program in trade, industry, and agriculture. Exhibit 10 provides a summary of the B&O tax deductions for schools and colleges.

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[4] Skinner v. Revenue, BTA Docket No. 42848 (1994).

[5] In re Determination No. 87-297, 4 WTD 75 (1987).

[6] Deaconess Hospital v. Revenue, BTA Docket No. 79-26 (1980).

[7] In re Determination No. 01-015, 23 WTD 121 (2004).

Exhibit 10 – B&O Tax Status for Schools and Colleges: The Income Deduction for Tuition and Fees is Not Restricted to Nonprofit Private Educational Institutions

| | School or College Type | B&O Tax Status |
|---|---|---|
| Nonprofit | K-12, SBE approved | Exempt |
| | K-12, did not seek SBE approval | Taxable |
| | College, general academic program | Exempt |
| | Trade school | Taxable (unless privately endowed to offer a program in trade, industry, and agriculture) |
| For-Profit | K-12, SBE approved | Exempt |
| | K-12, did not seek SBE approval | Taxable |
| | College, general academic program | Exempt |
| | Trade school | Taxable |

Source: WAC 458-20-167 and WAC 458-16-270.

Note: SBE Stands for State Board of Education.

## Public Policy Objectives

### *What are the public policy objectives that provide a justification for the tax preference? Is there any documentation on the purpose or intent of the tax preference?*

**Encourage the provision of general education in Washington:** The public policy objective for allowing tuition and fees to be deducted from gross income and not subject to the B&O tax appears to be to encourage general education activities. In 1933, the Legislature exempted nonprofit educational corporations from the business activities tax. Subsequently, in 1935, the Legislature changed the form of the tax preference from an exemption for nonprofit educational organizations to a deduction for certain kinds of income (e.g., tuition and fees) for either nonprofit or for-profit organizations.

There are two primary legal theories for providing tax exemptions to nonprofit organizations:

- Tax-base definition: The base-defining theory states that charitable activity does not rise to the level of a taxable activity. Nonprofit organizations have no excess funds with which to pay taxes.
- Subsidy theory: The state grants a tax exemption because the work of the nonprofit organization lessens the burden on government.

In 1933, with enactment of the temporary business activities tax, the Legislature granted an exemption to a class of organizations: nonprofit educational, scientific, religious, benevolent or other corporations. The exemption did not apply to any corporation organized for profit or to which any part of the income would benefit any private stockholder or individual.

In 1935, with the Revenue Act, the Legislature changed the form of the tax preference from the type of organization that is eligible (nonprofit or for-profit) to the type of income (initiation fees, dues, contributions, donations, tuition and fees, and endowment funds). Tuition and fees were fees charged by private educational institutions. By rule the State Tax Commission defined "educational institution" to include any institution that is accredited and offers students an educational program of a general academic nature. A business college, dancing school, music school, or any trade or specialty school did not fit the definition of an "educational institution."

The purpose of 1933 tax exemption for nonprofit educational corporations may have been to define the tax base or provide a subsidy. In 1935, however, it appears the Legislature wanted to encourage the activity of providing a general education without regard to the nonprofit or for-profit status of the educational institution involved.

**Facilitate the establishment of foreign degree-granting institutions in Washington:** The public policy objective for the tuition and fees deduction for approved branch campuses of foreign degree-granting institutions from the B&O tax is to facilitate the establishment and operation of such branch campuses in Washington. In the legislation providing for, among other things, the B&O tax deduction for branch campuses of nonprofit foreign degree-granting institutions, the Legislature stated a policy to facilitate the establishment and operation of such branch campuses. The Legislature found that:

- It is important to the economic future of the state to promote international awareness and understanding;
- The state's economy and economic well-being depends heavily on foreign trade and international exchange;
- Policies should be implemented to encourage universities and colleges domiciled in foreign countries to establish branch campuses in Washington; and
- It is important to those foreign colleges and universities that their status as authorized foreign degree-granting institutions be recognized by the state.

## *What evidence exists to show that the tax preference has contributed to the achievement of any of these public policy objectives?*

**Encourage general education:** Private educational institutions, both publically and privately operated, exist in Washington. The publically operated K-12 and higher education institutions likely are not affected by this tax preference. The extent to which this tax preference contributes to the activities of the privately operated schools and colleges is not known.

**Facilitate the establishment of foreign degree-granting branch campuses:** At the time the Legislature enacted the 1993 legislation, there was only one branch campus of a foreign degree-granting institution in Washington. In 2009, there are two.

## *To what extent will continuation of the tax preference contribute to these public policy objectives?*

**Encourage general education:** Continuation of this tax preference should have little effect on the operations of the publicly operated K-12 and higher education institutions. The extent to which this tax preference promotes general education by privately-owned schools and colleges in this state is not known.

**Facilitate the establishment of foreign degree-granting branch campuses:** It is not clear if this tax preference has contributed to the establishment of foreign degree-granting branch campuses in Washington. Of the two campuses now in Washington, one was established prior to the enactment of the deduction.

### *If the public policy objectives are not being fulfilled, what is the feasibility of modifying the tax preference for adjustment of the tax benefits?*

**Encourage general education:** To some extent the public policy purpose of promoting general education is being fulfilled by exempting tuition and fees from the B&O tax.

**Facilitate the establishment of foreign degree-granting branch campuses:** It is unknown what the two foreign branch campuses might do if the tax preference were to be terminated.

## Beneficiaries

### *Who are the entities whose state tax liabilities are directly affected by the tax preference?*

The direct beneficiaries from allowing tuition and fees received by private educational institutions to be deducted for B&O tax purposes include the following private educational institutions:

- Nonpublic schools, including parochial or independent schools, which have been approved by the Washington State Board of Education;
- Degree-granting private higher education institutions, both nonprofit and for-profit, accredited by an accrediting association recognized U.S. Secretary of Education, and offering a general education program;[8]
- Private nonprofit institutions that offer instruction in trade, industry, and agriculture and are privately endowed under a deed of trust;
- Programs that an educational institution cosponsors with a nonprofit organization, provided that the educational institution grants college credit for course work successfully completed through the education program;
- Nonprofit branch campuses of foreign degree-granting institutions; and
- Privately operated kindergartens.

Public K-12 schools are not included in this estimate because they generally do not charge tuition.

### *To what extent is the tax preference providing unintended benefits to entities other than those the Legislature intended?*

No unintended beneficiaries are apparent.

[8] As a policy, the institution must grant degrees and be accredited by an accrediting association approved by the U.S. Department of Education. The U.S. Department of Education has approved many accrediting associations (18 regional and national accrediting agencies and 43 specialized accrediting agencies), many of which accredit institutions that do not provide a general education, but rather accredit institutions that provide a specific type of career or technical education in a specified field. No review was made whether the institutions utilizing the income deduction were providing a general education as opposed to a vocational or technical education.

## Revenue and Economic Impacts

### *What are the past and future tax revenue and economic impacts of the tax preference to the taxpayer and to the government if it is continued?*

The taxpayer savings resulting from not imposing the B&O tax on tuition and fees earned by private educational institutions is $18 million per year. This estimate includes 530 private K-12 schools approved by the State Board of Education and 27 institutions of higher education. Of these higher education institutions, 17 are nonprofit and ten are for-profit. The common schools are not included in this estimate because they do not charge tuition. The public higher education institutions are not included as they are not subject to the B&O tax. Room charges at the private colleges are also not included because the B&O tax may not be imposed on rent for accommodations.

Exhibit 11 – Taxpayer Savings from Exempting Tuition from B&O Tax
(Dollars in Millions)

| Fiscal Year | Private K-12 | Private Higher Education | Total |
|---|---|---|---|
| 2006 | $7.2 | $9.1 | $16.3 |
| 2007 | $7.4 | $9.7 | $17.1 |
| 2008 | $7.6 | $10.4 | $18.0 |
| 2009 | $7.9 | $11.0 | $18.9 |
| 2010 | $8.1 | $11.6 | $19.7 |
| 2011 | $8.3 | $12.2 | $20.5 |

Source: JLARC analysis of data from the Department of Revenue and the National Center for Education Statistics.

Note: Figures for fiscal years 2009 to 2011 are estimates.

The amount of additional educational activity that takes place in Washington because of the B&O tax deduction for tuition and fees earned by private educational institutions is not known. The measure of the economic impact of the B&O tax preference is the extent to which the deduction promotes education that otherwise would not occur, were it not for the deduction. In general, the economic impacts of education are of two types:

1) **The impact of students receiving an education (investment in human capital) and the long-term improvement in the state's economy of having a better educated workforce and citizenry.** To the extent that graduates remain in Washington, it provides a productivity boost to the state. There are increased lifetime earnings associated with a better educated workforce. For every one percent increase in workers with a Bachelor's degree in a state there is an associated $800 increase in the state's median per capita income. At any given age a person with an Associate's degree earns between 15 to 28 percent more than someone with only a high school diploma. Someone with a Bachelor's degree earns from 67 to 82 percent more. Between the ages of 45 to 54 the average earnings of someone with a

Bachelor's degree working full-time is over $74,000. This is $32,000 more than the average income of someone who only graduated from high school.[9]

2) **The impact of bringing new dollars into the Washington economy.** This is accomplished by bringing into Washington nonresident students who would not otherwise come to this state. These nonresident students spend money on tuition, room and board, as well as other items. This impact is similar to the impact of tourism. Several private colleges have the majority of their entering class coming from outside of Washington. The overall average for out-of-state freshmen at all the private nonprofit colleges that report to the Department of Education is 46 percent. Applying the share of out-of-state freshmen students to the overall enrollments at these colleges result in 16,000 nonresident students. The listed undergraduate tuition at these colleges ranges from $8,000 to $33,000 per year. Nearly $230 million per year in tuition income can be attributed to nonresident students in Washington's private nonprofit colleges. In addition these students need to purchase room and board and other items. Expenditures on room and board, books, transportation, entertainment, and other items come to approximately $160 million per year.[10]

## *If the tax preference were to be terminated, what would be the negative effects on the taxpayers who currently benefit from the tax preference and the extent to which the resulting higher taxes would have an effect on employment and the economy?*

If the Legislature terminated the B&O tax preference deduction for tuition and fees received by private educational institutions, the costs of operations for these institutions would increase. The private institutions would need to either increase tuition or reduce costs by cutting wages or services. At the K-12 level, this could cause a shift of some students from private schools to public schools. As the students shifted, expenditures for education would shift from the private sector to the public sector.

For postsecondary education, higher tuition costs might have to be paid by in-state and out-of-state households. For in-state households, the overall impact on the economy would be mostly netted out as there would be a reduction in consumption by households (either households of students paying increased tuition, or households of employees receiving lower wages) and there would be an increase in expenditures by the state government. To the extent that the B&O tax was passed forward onto the tuition paid by nonresident students, there would be a gain to the state.

[9] "The Social and External Benefits of Education," Theo Eicher, UW Economic Policy Research Center, 2006.

[10] Ibid.

### *If the tax preference were to be terminated, what would be the effect on the distribution of liability for payment of state taxes?*

Termination of the tax preference could result in higher tuition and fees. Increasing the cost of education would have a relatively larger impact on both lower income households and higher income households. The U.S. Bureau of Labor Statistics conducts a survey of household expenditures by income level. Students generally fall in the lower income level, and higher income households have less access to need-based financial aid.

Exhibit 12 – Lower and Higher Income Households Pay More of Their Income on Education


Source: U.S. Bureau of Labor Statistics, Consumer Expenditure Survey, 2007.

## Other States

### *Do other states have a similar tax preference and what potential public policy benefits might be gained by incorporating a corresponding provision in Washington?*

No other state relies on a gross receipts tax that is as broad as Washington's B&O tax. For this reason, the most valid comparison is a comparison based on other states' income taxes. JLARC found 45 states and the District of Columbia exempt non-profit private educational institutions from their corporate income tax.

## Recommendation

**The Legislature should continue the B&O tax deduction for tuition and fees earned by private educational institutions. The deduction is achieving the objective of encouraging general education activities.**

**Legislation Required:** None.

**Fiscal Impact:** None – No change in status quo.

# CASH DISCOUNTS DEDUCTION FROM B&O, SALES AND USE, AND PUBLIC UTILITY TAXES – SUMMARY

## Current Law

Sellers may deduct cash and trade discounts taken by the purchaser in determining the sellers' amount of tax liability under the business and occupation tax, the public utility tax, and the retail sales tax. The deductions are allowed for cash discounts, trade discounts, in-store coupons taken at the cash register, and other reductions in the price taken by the purchaser. Manufacturers' and distributors' rebates are not allowed a deduction. Likewise, credits, discounts and allowances, taken by the seller for services to the manufacturer or wholesaler such as advertising allowances and "make-ready" services are not deductible.

See page A3-3 in Appendix 3 for the current statutes, RCW 82.04.4283, RCW 82.08.010 and RCW 82.16.050(4).

## Legal History and Public Policy Objective

The 1933 temporary business activities tax defined gross income of a business to mean "the value proceeding or accruing from the sale … and all receipts actually received." In 1935, the Legislature established an explicit deduction for cash discounts for the business and occupation tax, the public utility tax, and the retail sales tax.

There has been no statutory change to the deductions for over seven decades. Over the years, the Department of Revenue has issued rules and advisories more narrowly defining discounts to exclude third party transactions when the seller performs services for consideration in return for the discount. The Legislature amended the definition of the "selling price" in 2007 to conform to the national Streamlined Sales and Use Tax Agreement, but the amendment merely codified existing interpretation and current practice.

The public policy objective for this deduction is to recognize that sellers should not be taxed on income they did not actually receive from purchasers.

## Beneficiaries

About 10,000 firms take a deduction for cash and trade discounts for about $3 billion annually. The deduction is taken mostly by wholesalers, retailers and health care service businesses. Wholesalers typically take the deduction for volume discounts. Retailers generally take the deduction for in-store coupons or discounts taken by the purchaser at the time of sale. Health care services take a deduction for the difference between the invoice price for providing services to patients and the amount reimbursed by Medicaid, Medicare, and private insurers.

## Revenue and Economic Impacts

Businesses that take the deduction have reduced their taxes about $46 million per year. Repealing the tax deduction would not result in this amount of increased revenues, however. Taxpayers would likely alter their method of reporting the tax. For example, taxpayers could file an amended return when they receive the actual payment.

## Other States

There are 45 states and the District of Columbia that have corporate net income taxes. Corporate net income taxes include only those payments that are actually received as income and, therefore, do not include any amount not received such as a cash discount.

## Recommendation

**The Legislature should continue the deduction for cash and trade discounts from the business and occupation tax, the public utility tax, and the retail sales tax. The tax preference is achieving the objective of recognizing that sellers should not be taxed on income they did not actually receive from purchasers.**

| | |
|---|---|
| **Legislation Required:** | No. |
| **Fiscal Impact:** | None – No change from status quo. |

# Cash Discounts Deduction from B&O, Sales and Use, and Public Utility Taxes – Report Detail

## Current Law

Sellers may deduct cash and trade discounts taken by the purchaser in determining the amount of the sellers' tax liability under the business and occupation tax, the public utility tax, and the retail sales tax. The deduction is allowed for cash discounts, trade discounts, in-store coupons taken at the cash register, and other reductions in the price taken by the purchaser. Manufacturers' and distributors' rebates are not allowed a deduction. Likewise, credits, discounts, and allowances taken by the seller for services to the manufacturer or wholesaler such as advertising allowances and "make-ready" services are not deductible.

See page A3-3 in Appendix 3 for the current law statutes, RCW 82.04.4283, RCW 82.16.050(4), and RCW 82.08.010.

## Legal History

1933 The Legislature faced a revenue shortfall as it convened in January 1933. In response, lawmakers adopted a temporary tax imposed on the privilege of engaging in business activities. The tax was to be in place from August 1933 through July 1935. The new tax applied to a wide range of business activities including manufacturing, wholesaling, retailing, and utilities. Multiplying the gross income of a business by the statutorily established rates determined the amount of the tax. Rates ranged from 0.2 percent to 3 percent depending on the type of business activity.

The 1933 temporary business activities tax defined gross income of the business to mean value proceeding or accruing from the sale and all receipts "actually received." This effectively provided a deduction for cash discounts.

1935 The Legislature continued to face a significant revenue shortfall as it convened in 1935. To raise necessary revenue, the Legislature passed the Revenue Act of 1935. As part of the 1935 act, the Legislature created the business and occupation tax, the retail sales tax and the public utility tax.

The 1935 act also provided a specific exemption for cash discounts for the business and occupation tax, the public utility tax, and the retail sales tax.

There has been no statutory change to the deduction for over seven decades. Over the years, the Department of Revenue has issued rules and advisories more narrowly defining discounts to exclude third party transactions when the seller performs services for consideration in return for the discount. This consideration can be in the form of allowances, discounts, credits, or rebates to include:

- "Make-ready" services by an equipment dealer for a manufacturer, where the manufacturer typically pays the dealer for the services in the form of a credit to be applied to a future transaction;
- Advertising allowances from wholesalers to retailers; and
- Manufacturers' rebates paid directly to the buyer. For example, a purchaser of an automobile pays full price to the dealer and then is rebated by the manufacturer.

In 2007, the Legislature amended the definition of the "selling price" to conform to the national Streamlined Sales and Use Tax Agreement (SSUTA). The SSUTA language did not change current practice of the Department of Revenue but clarified that consideration received by the seller from third parties cannot be deducted.

## Other Relevant Background

Accounting terminology distinguishes between cash discounts and trade discounts. Cash discounts are amounts deducted from the purchase invoice for prompt payment. Trade discounts are defined as the difference between the list price and the actual price. Statute allows deductions for both cash and trade discounts when the discounts are actually taken by the purchaser as long as the gross amount has been reported on the tax return. Businesses that account for sales on the accrual basis are likely to calculate gross receipts for state tax purposes on the full invoice price and take a deduction for cash and trade discounts. Businesses that account for sales on the cash basis most likely report the actual amount of receipts paid by the purchaser as gross receipts and do not take a deduction. The Department allows both reporting methods.

Hospitals and other health care providers have been instructed by the Department of Revenue to report gross income at standard billing rates and then take a cash discount deduction for adjustments to reflect reduced rates paid by Medicaid, Medicare, and private insurers.

Typically, trade discounts are taken for quantity sales such as two-for-the-price-of-one sales, sales by a wholesaler to another business for volume sales, sales of shop-worn merchandise, or coupons taken at the cash register. At one time, it was common for manufacturers and wholesalers to accept payment in installments and offer discounts for timely payment. Cash discounts for timely payment are not as common as in the past because financing arrangements are now mostly made through financing companies.

## Public Policy Objectives

### *What are the public policy objectives that provide a justification for the tax preference? Is there any documentation on the purpose or intent of the tax preference?*

The public policy objective is to recognize that sellers should not be taxed on income they did not actually receive from purchasers. Conversely, when the discount is offered by a third party that reimburses or provides other consideration to the seller to lower prices or to provide services such as manufacturing rebates, “make-ready” services credits, or advertising allowances, the discount is included in the tax base.

### *What evidence exists to show that the tax preference has contributed to the achievement of any of these public policy objectives?*

By allowing this deduction for cash and trade discounts, the Legislature is recognizing that sellers should not be taxed on income they did not actually receive from purchasers.

### *To what extent will continuation of the tax preference contribute to these public policy objectives?*

The public policy objectives are being filled.

### *If the public policy objectives are not being fulfilled, what is the feasibility of modifying the tax preference for adjustment of the tax benefits?*

The public policy objectives are being filled.

## Beneficiaries

### *Who are the entities whose state tax liabilities are directly affected by the tax preference?*

About 10,000 firms take a deduction for cash and trade discounts for about $3 billion annually. The deduction is taken mostly by wholesalers, retailers and health care service businesses. Wholesalers typically take the deduction for volume discounts. Retailers generally take the deduction for in-store coupons or discounts taken by the purchaser at the time of sale. Health care services take a deduction for the difference between the invoice price for providing services to patients and the amount reimbursed by Medicaid, Medicare, and private insurers.

### *To what extent is the tax preference providing unintended benefits to entities other than those the Legislature intended?*

There are no known unintended beneficiaries.

## Revenue and Economic Impacts

### *What are the past and future tax revenue and economic impacts of the tax preference to the taxpayer and to the government if it is continued?*

Businesses that take the deduction have reduced their taxes about $46 million per year. Repealing the tax deduction would not result in increased revenues, however. The decline in projected savings is due to the economic downturn expected to last until Fiscal Year 2011 (See Exhibit 13).

Exhibit 13 – Deductions for Cash and Trade Discounts ($Millions)

| Fiscal Year | Business & Occupation Tax | Public Utility Tax | Sales & Use Tax | Total |
|---|---|---|---|---|
| 2006 | $19.1 | $0.2 | $24.4 | $43.7 |
| 2007 | $21.0 | $0.4 | $25.7 | $47.1 |
| 2008 | $23.8 | $0.3 | $21.9 | $46.0 |
| 2009 | $22.0 | $0.3 | $19.9 | $42.2 |
| 2010 | $23.1 | $0.3 | $20.1 | $43.5 |
| 2011 | $25.0 | $0.3 | $21.3 | $46.7 |

Source: Department of Revenue tax records.

Note: 2009 - 2011 figures are estimates based on the Economic Revenue Forecast Council, March 2009 forecast.

### *If the tax preference were to be terminated, what would be the negative effects on the taxpayers who currently benefit from the tax preference and the extent to which the resulting higher taxes would have an effect on employment and the economy?*

Repealing the tax deduction would not result in increased revenues. Taxpayers take the deduction for cash discounts as an accounting convenience. Business wholesalers that make sales "on account" typically bill customers and receive payment at a later date. They may choose to report the full invoice price for tax purposes and take a deduction for the difference between the invoice price and actual payment but they are not precluded from reporting tax on a cash basis. Taxpayers could also file an amended return when the payment is made.

## Other States

### *Do other states have a similar tax preference and what potential public policy benefits might be gained by incorporating a corresponding provision in Washington?*

There are 45 states and the District of Columbia that have corporate net income taxes. Corporate net income taxes include only those payments that are actually received as income and, therefore, do not include any amount not received such as a cash discount.

## Recommendation

**The Legislature should continue the deduction for cash and trade discounts from the business and occupation tax, the public utility tax, and the retail sales tax. The tax preference is achieving the objective of recognizing that sellers should not be taxed on income they did not actually receive from purchasers.**

**Legislation Required:** No.

**Fiscal Impact:** None – No change from status quo.

# INVESTMENTS OF NONFINANCIAL FIRMS DEDUCTION FROM B&O TAX – SUMMARY

## Current Law

Statute provides a business and occupation (B&O) tax deduction for interest, dividends, and capital gain income earned by businesses not engaged in banking, loan, or security activities.

See pages A3-3 and A3-4 in Appendix 3 for the current statute, RCW 82.04.4281.

## Legal History and Public Policy Objectives

1933 Lawmakers adopted a temporary tax imposed on the privilege of engaging in business activities, including financial business activities. The tax was to be in place from August 1933 through July 1935.

1934 The Legislature amended the 1933 statute to exempt from the new tax income from investment and endowment funds earned by nonfinancial businesses.

1935 As part of the 1935 Revenue Act, the Legislature created the business and occupation tax, containing the majority of the business activities included in the 1933 act. The Revenue Act also provided a specific deduction from the B&O tax for investment income by nonfinancial businesses. The language of this deduction remained essentially unchanged until 1970.

1937 The Legislature provided a B&O tax deduction for the income of national and state banks, trust companies, mutual savings banks, building and loan, and savings and loan associations.

1970 The Legislature repealed the B&O deduction for national and state banks, mutual savings banks, savings and loan associations and "other financial businesses." The gross income from engaging in financial business became subject to the B&O tax under the service classification of 1.5 percent.

With the repeal of the bank deduction, issues arose over the distinction between nonfinancial business that continued to receive the deduction and financial businesses now subject to the tax. For nonfinancial businesses, issues centered on what types of investments continued to qualify.

- What is a "financial business?" The Washington Supreme Court ruled in 1976 that businesses with the primary purpose of earning income through the use of substantial funds were "financial businesses" and not entitled to the deduction.[11]

[11] Sellen Construction v. Revenue, 87 Wn.2d 878 (1976).

- What types of investments are taxable?" In 1986, the Washington Supreme Court determined that interest on real estate contracts did not qualify for the deduction because the contracts were not incidental investments of surplus funds.[12]

1995 Following these cases, the Department of Revenue announced a two-part inquiry for determining whether a taxpayer was an "other financial business." The Department asked:

1) Does a taxpayer's financial activity have the primary purpose and objective of earning income through a substantial outlay of funds? In making this determination, the Department held that if a taxpayer's financial income was 5 percent or less of its annual income, such income would be considered incidental, and the taxpayer would qualify as a nonfinancial business eligible for the deduction.
2) If the financial income exceeds 5 percent, is the taxpayer's activity comparable to those of banking, loan or security businesses? The Department considered such factors as the source of the income, frequency of investments, volume of investments, percentage of income from investments in relation to the total income of the business, and the relationship of the investment income to the other activities of the business.

2000 The issue of which businesses and activities qualified for the deduction again came before the Washington Supreme Court in 2000. In that case, the court ruled that Simpson Investment Company, a parent holding company for the Simpson lumber companies, was an "other financial business" under the statute, and thus its investment income did not qualify for the deduction.[13]

2001 As a result of the Simpson decision, the Legislature directed the Department to work with affected businesses to agree on a compromise to provide clarity. The Governor directed the Department of Revenue to convene a task force to develop proposed legislation for the 2002 Session.

2002 The Legislature passed the proposed changes eliminating the term "other financial business" and providing a deduction for "amounts derived from investments." The statute, however, specifically provided that this section did not apply to banking businesses, lending businesses, security business, or the extension of credit, revolving credit arrangements, installment sales, and the acceptance of payment over time for goods or services.

The public policy objective for this deduction is to avoid taxing the income from investment of incidental surplus funds of businesses and the savings of individuals. This activity is not engaging in business for the purposes of the B&O tax.

[12] O'Leary v. Revenue, 105 Wn.2d 679 (1986).

[13] Simpson Investment Co. Revenue, 141 Wn.2d 139 (2000).

## Beneficiaries

Both nonfinancial businesses and individuals benefit from the deduction for investment income. Individuals with large investment portfolios could possibly be taxed without the deduction. Individuals with large investment portfolios reported over $20 billion in investment income in Washington in 2005. Washington's share of nonfinancial investment income received by corporations and partnerships was $15 billion in the same year.

## Revenue and Economic Impacts

Nonfinancial businesses and individuals saved an estimated $310 million in B&O tax from the deduction for investment income in Fiscal Year 2008. This was a 50 percent decline from the previous year due to the slowing of the economy. Future taxpayer savings from the deduction for investments are expected to continue to decline and are not expected to recover until 2013.[14] The severe reduction is attributable largely to substantial losses from the sale of capital assets as a result of the recent economic downturn. Capital losses can be carried forward to subsequent tax years to offset capital gains and are predicted to exceed gains for several years after the economy is expected to recover.

## Other States

Washington's B&O tax is unique in that no other state imposes such a broad-based gross receipts tax. The closest comparisons are net income taxes imposed in 45 states and the District of Columbia. Interest, dividends, and capital gains are taxed as part of a net income tax structure with no distinction between financial and nonfinancial businesses. Five states—Nevada, South Dakota, Texas, Wyoming and Washington—lack any form of income tax.

## Recommendation

**The Legislature should continue the deduction for investment income of nonfinancial businesses, because it is meeting the objective of not treating incidental investment as engaging in businesses.**

| | |
|---|---|
| **Legislation Required:** | No. |
| **Fiscal Impact:** | None – No change from status quo. |

[14] Global Insights, March 2009 forecast.

# INVESTMENTS OF NONFINANCIAL FIRMS DEDUCTION FROM B&O TAX – REPORT DETAIL

## Current Law

Statute provides a business and occupation (B&O) tax deduction for interest, dividends, and capital gain income earned by businesses not engaged in banking, loan, or security activities.

See pages A3-3 and A3-4 in Appendix 3 for the current statute, RCW 82.04.4281.

## Legal History

1933 Lawmakers adopted a temporary tax imposed on the privilege of engaging in business activities, including financial business activities. The tax was to be in place from August 1933 through July 1935.

1934 The Legislature amended the 1933 statute to exempt from the new tax income from investment and endowment funds earned by nonfinancial businesses.

1935 As part of the 1935 Revenue Act, the Legislature created the business and occupation tax, containing the majority of the business activities included in the 1933 act. The Revenue Act also provided a specific deduction from the B&O tax for investment income by nonfinancial businesses. The language of this deduction remained essentially unchanged until 1970.

1937 The Legislature provided a B&O tax deduction for the income of national and state banks, trust companies, mutual savings banks, building and loan, and savings and loan associations.

1970 The Legislature repealed the B&O deduction for national and state banks, mutual savings banks, savings and loan associations and "other financial businesses." The gross income from engaging in financial business became subject to the B&O tax under the service classification of 1.5 percent.

With the repeal of the bank deduction, issues arose over the distinction between nonfinancial business that continued to receive the deduction and financial businesses now subject to the tax. For nonfinancial businesses, issues centered on what types of investments continued to qualify.

- What is a "financial business?" The Washington Supreme Court ruled in 1976 that businesses with the primary purpose of earning income through the use of substantial funds were "financial businesses" and not entitled to the deduction.[15]

[15] Sellen Construction v. Revenue, 87 Wn.2d 878 (1976).

- What types of investments are taxable?" In 1986, the Washington Supreme Court determined that interest on real estate contracts did not qualify for the deduction because the contracts were not incidental investments of surplus funds.[16]

1995 Following these cases, the Department of Revenue announced a two-part inquiry for determining whether a taxpayer was an "other financial business." The Department asked:

- Does a taxpayer's financial activity have the primary purpose and objective of earning income through a substantial outlay of funds? In making this determination, the Department held that if a taxpayer's financial income was 5 percent or less of its annual income, such income would be considered incidental, and the taxpayer would qualify as a nonfinancial business eligible for the deduction.
- If the financial income exceeded 5 percent, is the taxpayer's activity comparable to those of banking, loan or security businesses? The Department considered such factors as the source of the income, frequency of investments, volume of investments, percentage of income from investments in relation to the total income of the business, and the relationship of the investment income to the other activities of the business.

2000 The issue of which businesses and activities qualified for the deduction again came before the Washington Supreme Court in 2000. In that case, the court ruled that Simpson Investment Company, a parent holding company for the Simpson lumber companies, was an "other financial business" under the statute, and thus its investment income did not qualify for the deduction.[17]

2001 As a result of the Simpson decision, the Legislature directed the Department to work with affected businesses to agree on a compromise to provide clarity. The Governor directed the Department of Revenue to convene a task force to develop proposed legislation for the 2002 Session.

2002 The Legislature passed the proposed changes eliminating the term "other financial business" and providing a deduction for "amounts derived from investments." The statute, however, specifically provided that this section did not apply to banking businesses, lending businesses, security business, or the extension of credit, revolving credit arrangements, installment sales, and the acceptance of payment over time for goods or services.

[16] O'Leary v. Revenue, 105 Wn.2d 679 (1986).

[17] Simpson Investment Co. Revenue, 141 Wn.2d 139 (2000).

## Public Policy Objectives

### *What are the public policy objectives that provide a justification for the tax preference? Is there any documentation on the purpose or intent of the tax preference?*

The public policy objective is to avoid taxing investment of incidental surplus funds of businesses and the savings of individuals because this activity is not engaging in business for the purpose of B&O taxation.

### *What evidence exists to show that the tax preference has contributed to the achievement of any of these public policy objectives?*

By providing this deduction, the Legislature is accomplishing its objective of not taxing incidental investment as engaging in business.

### *To what extent will continuation of the tax preference contribute to these public policy objectives?*

The public policy objective is being fulfilled.

### *If the public policy objectives are not being fulfilled, what is the feasibility of modifying the tax preference for adjustment of the tax benefits?*

The public policy objective is being fulfilled.

## Beneficiaries

### *Who are the entities whose state tax liabilities are directly affected by the tax preference?*

Both nonfinancial businesses and individuals benefit from the deduction for investment income. Individuals with large investment portfolios could possibly be taxed under the B&O tax were it not for the deduction. Individuals with large investment portfolios reported over $20 billion in investment income in Washington in 2005. Washington's share of nonfinancial investment income received by corporations and partnerships was $15 billion in the same year.

### *To what extent is the tax preference providing unintended benefits to entities other than those the Legislature intended?*

Some confusion arose in 1970 after the Legislature repealed the B&O deduction for banks, savings and loan associations, and "other financial businesses." Major issues revolved around what type of entities qualified as nonfinancial businesses and what constituted a qualifying investment. The 2002 tax law changes eliminated the term "other financial business" and specifically provided that this deduction does not apply to banking businesses, lending businesses, security business, loans or the extension of credit, revolving credit arrangements, installment sales, and the acceptance of payment over time for goods or services. The law applies to all investment income from qualifying business activities. These modifications appeared to clear up the confusion, and there has not been a significant problem with unintended beneficiaries since that time.

## Revenue and Economic Impacts

### *What are the past and future tax revenue and economic impacts of the tax preference to the taxpayer and to the government if it is continued?*

Nonfinancial businesses and individuals saved an estimated $310.1 million in B&O tax from the deduction for investment income in 2008. This is a 50 percent decline from the previous year. Future taxpayer savings from investments are expected to decline by over 50 percent and not expected to recover until 2013.[18] The severe reduction is attributable largely to substantial losses from the sale of capital assets as a result of the recent economic downturn. Capital losses can be carried forward to subsequent tax years to offset capital gains. Carry forward losses are predicted to exceed gains several years after the economy is expected to recover.[19]

Exhibit 14 – Estimate of B&O Tax Savings for Investment Income of Nonfinancial Businesses and High Income Individuals (in $Millions)

| Year | Corporate | Partnership | Individual | Total |
|---|---|---|---|---|
| 2006 | $219.3 | $34.3 | $327.4 | $581.1 |
| 2007 | $238.3 | $36.6 | $347.8 | $622.7 |
| 2008 | $207.3 | $13.9 | $88.9 | $310.1 |
| 2009 | $192.3 | $12.6 | $82.6 | $287.5 |
| 2010 | $188.2 | $12.4 | $80.8 | $281.4 |
| 2011 | $198.2 | $13.3 | $85.0 | $296.4 |

Source: Internal Revenue Service, Statistics of Income, 2005 and Department of Revenue.

Note: All figures are estimates projected forward using Global Insights and Washington Economic and Revenue Council forecasts.

### *If the tax preference were to be terminated, what would be the negative effects on the taxpayers who currently benefit from the tax preference and the extent to which the resulting higher taxes would have an effect on employment and the economy?*

It is unlikely that the full amount of tax savings would be realized if the deduction were repealed because certain businesses could avoid the tax by reducing their presence in Washington.

[18] Global Insights, March 2009 forecast.

[19] National figures for corporations and partnerships are allocated to Washington by the ratio of Washington employees to U.S. employees by sector. Federal individual tax returns are available for Washington residents. Investment income of individuals with less than $200,000 in adjusted gross income is excluded because the average investment income per return is less than the $28,000 minimum reporting threshold for B&O tax purposes.

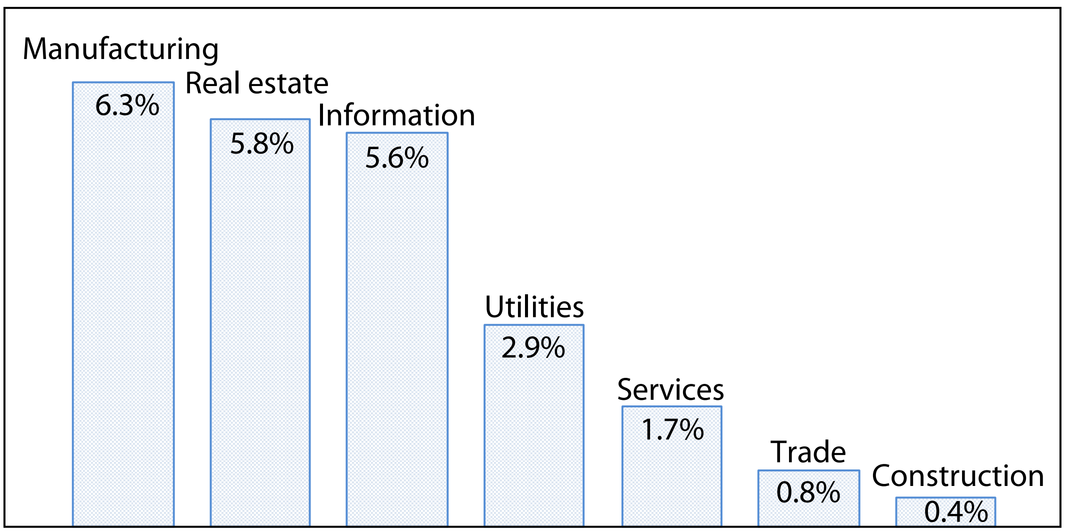
Businesses that operate both in Washington and other states could more easily avoid the tax than business operating solely in Washington or individuals residing in Washington.

For example, a business could form a subsidiary in Nevada, a state with no corporate or personal income tax. The subsidiary could invest surplus funds of the business and pass the earnings back to the Washington parent company in the form of a dividend. Dividends from subsidiaries to parent companies are exempt from the business and occupation tax.

It would be more difficult for individuals to avoid a tax on investment earnings in Washington. They could have to create a domicile in another state without an income tax or a with a low rate income tax to reduce their liability.

Impacts would be felt in nonfinancial industry sectors with a higher percentage of earnings in the form of interests, dividends, and capital gains from investments. According to Exhibit 15 below, manufacturing, real estate, and information sectors earn more from investments than other sectors.

Exhibit 15 – Investment Income as a Percent of Receipts




Source: Internal Revenue Service Corporate Tax Returns, Statistics of Income, 2005.

Employment in the manufacturing and information sectors makes up about 28 percent of all Washington employment. An increase in costs for these sectors would result in either increased prices or reduced employment on the margin. Increased revenues due to the elimination of the deduction would lead to increases in government spending and shift employment to the government sector.

## Other States

### *Do other states have a similar tax preference and what potential public policy benefits might be gained by incorporating a corresponding provision in Washington?*

Washington's B&O tax is unique in that no other state imposes such a broad-based gross receipts tax. The closest comparisons are net income taxes imposed in 45 states and the District of

Columbia. Interest, dividends, and capital gains are taxed as part of a net income tax structure with no distinction between financial and nonfinancial businesses. Five states—Nevada, South Dakota, Texas, Wyoming and Washington—lack any form of income tax.

## Recommendation

**The Legislature should continue the deduction for investment income of nonfinancial businesses, because it is meeting the objective of not treating incidental investment as engaging in businesses.**

| | |
|---|---|
| **Legislation Required:** | No. |
| **Fiscal Impact:** | None – No change from status quo. |

# INCOME OF EMPLOYEES EXEMPTION FROM B&O TAX – SUMMARY

## Current Law

Employees are exempt from paying business and occupation (B&O) tax on their income. However, independent contractors are distinct from employees and do pay B&O tax on their income.

The B&O tax applies broadly to every person for the privilege of engaging in business on the "value of products, gross proceeds of sales, or gross income of the business." Persons can be businesses, individuals, instrumentalities of the United States and political subdivisions of Washington, but not the state of Washington. All exemptions, including the exemption for employee income, are explicitly stated in statute.

See page A3-4 in Appendix 3 for the current statute, RCW 82.04.360.

## Legal History and Public Policy Objective

1933 The Legislature faced a revenue shortfall as it convened in January 1933. In response, lawmakers adopted a temporary tax imposed on the privilege of engaging in business activities.

In September 1933, the Washington State Supreme Court declared the tax to be imposed on commercial activities that properly excluded wage earners. The court concluded that a tax on wages would be "out of harmony and the spirit of the act"[20]

In the 1933 extraordinary session, the Legislature specifically excluded from the business activities tax "persons acting solely in the capacity of employee or servant, receiving a fixed wage or salary [and] … having no interest in the income or the profits." However, the Legislature applied the tax to the income of public officials and state employees who earned more than $200 a month.

1935 The Legislature continued to face a significant revenue shortfall as it convened in 1935. To raise additional revenue, the Legislature passed the Revenue Act of 1935. As part of the act, the Legislature created the B&O tax which contained many of the provisions of the 1933 act. The B&O tax specifically exempted employees from paying this new tax on their wages, as distinguished from independent contractors who owed the tax.

1991 The Legislature included full time insurance agents as employees. In another 1991 change, the Legislature provided that, for purposes of the B&O tax, a "booth renter" is an independent contractor subject to the B&O tax. Booth renters include beauticians, barbers, and manicurists who rent facilities in a salon or shop but who receive no

[20] Stiner v. Yelle,174 Wn. 363 (1933).

compensation from the owner. While the reference to "booth renter" remains in statute, the definition was deleted in 2002.

The major issue arising from the exemption for employee income is distinguishing an "employee" from an "independent contractor." The statute has never defined "employee." In interpreting the statute, the Department of Revenue (DOR) gives primary consideration to the employer's right to control the employee. Other factors DOR uses to determine employee status is whether a person:

- Receives compensation at a fixed rate or a percentage of the business;
- Is not liable for any expenses or debt of the business;
- Is generally entitled to fringe benefits such as paid vacation, sick leave, insurance, and pension benefits;
- Is treated as an employee for federal tax purposes; or
- Is paid a net amount after deductions for employment taxes.

The Legislature never intended to tax the wages of employees as a business activity. It did not consider employees to be engaging in business and never included their compensation in the measure of business income for purposes of the B&O tax.

## Beneficiaries

If Washington employees paid a B&O tax on their income, it would be similar to a personal income tax. The exemption applies to all employees in Washington. In 2008, 3.2 million employees received wage and salary disbursements of $152.8 billion. By far the largest share of wages (31 percent of total) is paid to employees in the service sector. Federal, state, and local government wages are in second place (19 percent).

## Revenue and Economic Impacts

Employees saved an estimated $2.3 billion due to the B&O exemption for employee wages in Fiscal Year 2008. However, it would be unlikely that repealing the exemption would result in revenue gain. Any tax on the income of employees might be viewed as a personal income tax.

## Other States

Forty-one states impose a personal income tax on the wages and salaries of employees. New Hampshire and Tennessee tax the interest and dividend earnings of individuals and not wages and salaries. Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming do not impose a personal income tax.

## Recommendation

**The Legislature should continue to exempt the income of employees from the B&O tax. The exemption is achieving the objective of not treating employee wages as a business activity.**

| | |
|---|---|
| **Legislation Required:** | No. |
| **Fiscal Impact:** | None – No change in status quo. |

# INCOME OF EMPLOYEES EXEMPTION FROM B&O TAX – REPORT DETAIL

## Current Law

Employees are exempt from paying business and occupation (B&O) tax on their income. However, independent contractors are distinct from employees and do pay B&O tax on their income.

The B&O tax applies broadly to every person for the privilege of engaging in business on the "value of products, gross proceeds of sales, or gross income of the business." Persons can be businesses, individuals, instrumentalities of the United States and political subdivisions of Washington, but not the state of Washington. All exemptions, including the exemption for employee income, are explicitly stated in statute.

See page A3-4 in Appendix 3 for the current statute, RCW 82.04.360.

## Legal History

1933 The Legislature faced a revenue shortfall as it convened in January 1933. In response, lawmakers adopted a temporary tax imposed on the privilege of engaging in business activities.

In September 1933, the Washington State Supreme Court declared the tax to be imposed on commercial activities that properly excluded wage earners. The court concluded that a tax on wages would be "out of harmony and the spirit of the act"[21]

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1991 The Legislature included full time insurance agents as employees. In another 1991 change, the Legislature provided that, for purposes of the B&O tax, a "booth renter" is an independent contractor subject to the B&O tax. Booth renters include beauticians, barbers, and manicurists who rent facilities in a salon or shop but who receive no

[21] Stiner v. Yelle, 174 Wn. 363 (1933).

compensation from the owner. While the reference to "booth renter" remains in statute, the definition was deleted in 2002.

The major issue arising from the exemption for employee income is distinguishing an "employee" from an "independent contractor." The statute has never defined "employee." In interpreting the statute, the Department of Revenue (DOR) gives primary consideration to the employer's right to control the employee. Other factors DOR uses to determine employee status is whether a person:

- Receives compensation at a fixed rate or a percentage of the business;
- Is not liable for any expenses or debt of the business;
- Is generally entitled to fringe benefits such as paid vacation, sick leave, insurance, and pension benefits;
- Is treated as an employee for federal tax purposes; or
- Is paid a net amount after deductions for employment taxes.

## Public Policy Objectives

### *What are the public policy objectives that provide a justification for the tax preference? Is there any documentation on the purpose or intent of the tax preference?*

The Legislature never intended to tax the wages of employees as a business activity. It did not consider employees to be engaging in business and never included their compensation in the measure of business income for purposes of the B&O tax.

### *What evidence exists to show that the tax preference has contributed to the achievement of any of these public policy objectives?*

By providing this tax exemption, the Legislature is recognizing that employee income is not intended to be part of the business and occupation tax base.

### *To what extent will continuation of the tax preference contribute to these public policy objectives?*

Continuation of the exemption may be required to ensure that the wages and salaries of employees are excluded from the B&O tax base.

### *If the public policy objectives are not being fulfilled, what is the feasibility of modifying the tax preference for adjustment of the tax benefits?*

The public policy objectives are being fulfilled.

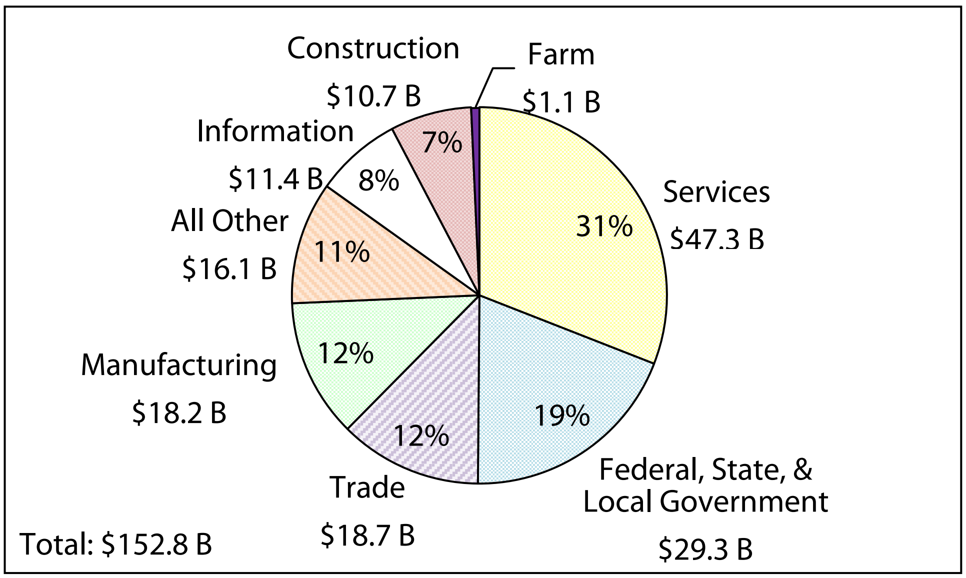
# Beneficiaries

## *Who are the entities whose state tax liabilities are directly affected by the tax preference?*

The exemption applies to all employees in Washington. In 2008, 3.2 million employees received wage and salary disbursements of $152.8 billion. By far the largest share of wages (31 percent of total) is paid to employees in the service sector. Federal, state, and local government wages are in second place (19 percent). (See Exhibit 16.)

Service employees account for such a large share in part because there are more service entities that other firms. Services include professional services such as accounting, legal, engineering; healthcare services; personal services such as beauty and barber shops; and food and accommodation services. Over half of all employers are service firms.[22]

Exhibit 16 – Service Employees Receive 31% of Washington Wage and Salary Disbursements




Source: U.S. Bureau of Economic Analysis, Wage and Salary Disbursements for Washington State, preliminary 2008.

## *To what extent is the tax preference providing unintended benefits to entities other than those the Legislature intended?*

Unintended benefits could occur if an independent contractor receives tax treatment as an "employee." The distinction between "employee" and independent contractor has been the subject of numerous taxpayer appeals. Many of these decisions dealt with insurance agents. The Legislature intended the 1991 amendment to resolve these issues by providing that full-time life insurance agents were to be considered employees and therefore exempt from the B&O tax.

Examples of where taxpayers have been found to be independent contractors and thus subject to the B&O tax include: construction superintendent, personal chef, senior editor of a magazine,

[22] Washington State Employment Security Department, Quarterly Census of Employment & Wages, 2007.

mortgage company broker, optometrist, golf pro, jockey, consulting physician for Group Health, and taxi cab driver. These decisions rested most heavily on the conclusion that the taxpayer was not under the control of another party.

## Revenue and Economic Impacts

### *What are the past and future tax revenue and economic impacts of the tax preference to the taxpayer and to the government if it is continued?*

In Fiscal Year 2008, employees saved an estimated $2.3 billion in tax due to the B&O exemption for employee wages. Due to the broad application of the B&O tax to gross income, employees could possibly be subject to the tax were it not for the exemption.

The estimate of future savings is based on total wage and salary disbursements for Washington from the March 2009 economic forecast of the Economic Revenue and Forecast Council. Farm, non-farm, private and government employment is included under the assumption that all wages and salaries would be subject to the B&O tax. Since employees are providing a service to their employers, the rate is assumed to be 1.5 percent, the tax rate for service activities. (See Exhibit 17.) The relatively small amount of income of insurance sales agents is excluded because this exemption passed separately in 1991 and will be reviewed by the Tax Preference Commission in 2013.

Exhibit 17 – Savings from the Exemption for Employee Wages
(Dollars in Billions)

| Fiscal Year | Employee Savings |
|---|---|
| 2006 | $2.04 |
| 2007 | $2.20 |
| 2008 | $2.28 |
| 2009 | $2.29 |
| 2010 | $2.38 |
| 2011 | $2.53 |

Source: All figures are estimates based on the Economic Revenue and Forecast Council, Washington wage and salary disbursements, March 2009.

### *If the tax preference were to be terminated, what would be the negative effects on the taxpayers who currently benefit from the tax preference and the extent to which the resulting higher taxes would have an effect on employment and the economy?*

If this preference were terminated, it is questionable whether this income would be taxed under the B&O tax. A tax on wages could be perceived as an income tax. Washington has a long history of rejecting an income tax.

Imposing a tax on gross income of employees would add to the household tax burden in Washington State. Households currently directly pay 55 percent of state and local taxes, while businesses pay the remaining 45 percent. Imposing a 1.5 percent tax on the wages and salaries of employees would increase the household share of taxes to 59 percent.[23]

Employers might tend to pay higher wages in order to retain and attract workers to compensate for the tax on wages and salaries. Increasing the cost of labor increases the cost of doing business.

## *If the tax preference were to be terminated, what would be the effect on the distribution of liability for payment of state taxes?*

The service sector would be the hardest hit by the repeal of the exemption for employee wages. Currently, the largest share of private non-farm wages and salary disbursements are made to employees in the services sector. The services sector includes business, professional services, entertainment, and health services.

Services are also the most labor-intensive of industry sectors. Wages and salaries as a percent of gross output range from 32 to 47 percent of gross output in the services sector. The industry average for all sectors is 23 percent. (See Exhibit 18.) If service firms pay higher wages to compensate for a tax on wages, they would likely attempt to pass the higher costs on to their customers in the form of price increases. Increased revenues due to the elimination of the exemption would likely lead to increases in government spending and shift employment to the government sector.

[23] Washington State Tax Alternatives Model, House Finance Committee and Department of Revenue, 2005.

Exhibit 18 – Services Are More Labor-Intensive than Other Sectors

| Sector | Wages and Salaries as a Percent of Gross Output |
|---|---|
| Real estate and rental and leasing | 4% |
| Utilities | 10% |
| Agriculture, forestry, fishing, and hunting | 10% |
| Manufacturing | 15% |
| Information | 15% |
| Transportation and warehousing | 26% |
| Finance and insurance | 26% |
| Accommodation and food services | 29% |
| Construction | 30% |
| Wholesale trade | 30% |
| Retail trade | 31% |
| Services: Arts, entertainment, and recreation | 32% |
| Services: Professional, scientific, and technical | 36% |
| Services: Administrative and waste management | 38% |
| Services: Management of companies and enterprises | 39% |
| Services: Health care and social assistance | 41% |
| Services: Educational | 47% |
| All industry Average | 23% |

Source: U.S. Bureau of Economic Analysis, 'Wages and Salaries As a Percent of Gross Output, 2007.

## Other States

### *Do other states have a similar tax preference and what potential public policy benefits might be gained by incorporating a corresponding provision in Washington?*

If Washington employees paid a B&O tax on their income, it would be similar to a personal income tax. Forty-one states impose a personal income tax on wages and salaries of employees. New Hampshire and Tennessee tax the interest and dividend earnings of individuals and not wages and salaries. Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming do not impose a personal income tax.

## Recommendation

**The Legislature should continue to exempt the income of employees from the B&O tax. The exemption is achieving the objective of not treating employee wages as a business activity.**

**Legislation Required:** No.

**Fiscal Impact:** None – No change in status quo.

# MOTOR FUEL B&O TAX DEDUCTION – SUMMARY

## Current Law

Current law provides a deduction that allows businesses to exclude state and federal motor vehicle fuel excise tax collections from their gross income, for the purposes of the business and occupation (B&O) tax.

See page A3-5 in Appendix 3 for the current statute, RCW 82.04.4285.

## Legal History and Public Policy Objectives

1921 Washington has had a motor vehicle fuel tax since 1921, and the federal government has had a similar tax since 1932.

1933 The Legislature put the temporary business activities tax in place with a specific deduction for the existing motor vehicle fuel taxes.

1935 The Legislature enacted the B&O tax and allowed the deduction for motor fuel taxes contained in the 1933 business activities tax.

The Legislature designed the B&O tax as a tax on gross income associated with business activities. However, the Legislature intended motor vehicle fuel taxes to be paid by the final consumer of motor vehicle fuel and not the supplier, the distributor, or the retailer that sold motor fuel. The public policy objective of this deduction is to acknowledge that motor vehicle fuel taxes are collections owed by the consumer and remitted to the state and federal government and do not provide actual income to a business.

## Beneficiaries

The beneficiaries of the B&O tax preference on motor vehicle fuel excise taxes are the Washington businesses that collect motor fuel taxes. Washington firms that sell motor vehicle fuel and take a deduction for fuel taxes include oil refineries, petroleum bulk station operators, petroleum wholesalers, and retailers of motor vehicle fuel such as gas stations, supermarkets, warehouse clubs, and convenience stores.

## Revenue and Economic Impacts

- Based on a volume of about 3.5 billion gallons of gasoline and diesel fuel sold in Washington in 2008, the deduction for motor vehicle fuel taxes reduced B&O tax collections by about $23 million. While B&O revenues were reduced by this amount, Washington collected nearly $1.3 billion in state fuel taxes during the same period. Federal fuel taxes added nearly $700 million to this amount, for a total of more than $1.9 billion in motor vehicle fuel taxes collected from Washington fuel sales during 2008.

- In 2007, the suppliers (refineries or importers), distributors (who transport fuel), and retailers (who sell fuel) employed 100,730 people and paid nearly $2.8 billion in wages for an average annual wage of $27,429.

## Other States

Delaware and Ohio impose a business gross receipts tax similar to Washington's B&O tax. Michigan imposes a tax on gross receipts less purchases of business inputs. Like Washington, all three of these states exclude motor vehicle fuel excise taxes from their calculation of tax due under their gross receipts tax.

## Recommendation

**The Legislature should continue to allow businesses to exclude state and federal motor vehicle fuel excise tax collections from their gross income for the purposes of the B&O tax. The deduction achieves the objective of acknowledging that motor vehicle fuel tax collections are intended to be paid by the end consumer and do not provide actual income to a business.**

**Legislation Required:** No.

**Fiscal Impact:** None – No change to status quo.

# MOTOR FUEL B&O TAX DEDUCTION – REPORT DETAIL

## Current Law

Current law provides a deduction that allows businesses to exclude state and federal motor vehicle fuel excise tax collections from their gross income, for the purposes of the business and occupation (B&O) tax.

See page A3-5 in Appendix 3 for the current statute, RCW 82.04.4285.

## Legal History

1921 Washington has had a motor vehicle fuel tax since 1921 and the federal government has had a similar tax since 1932.

1933 The Legislature put the temporary business activities tax in place with a specific deduction for the existing motor vehicle fuel taxes.

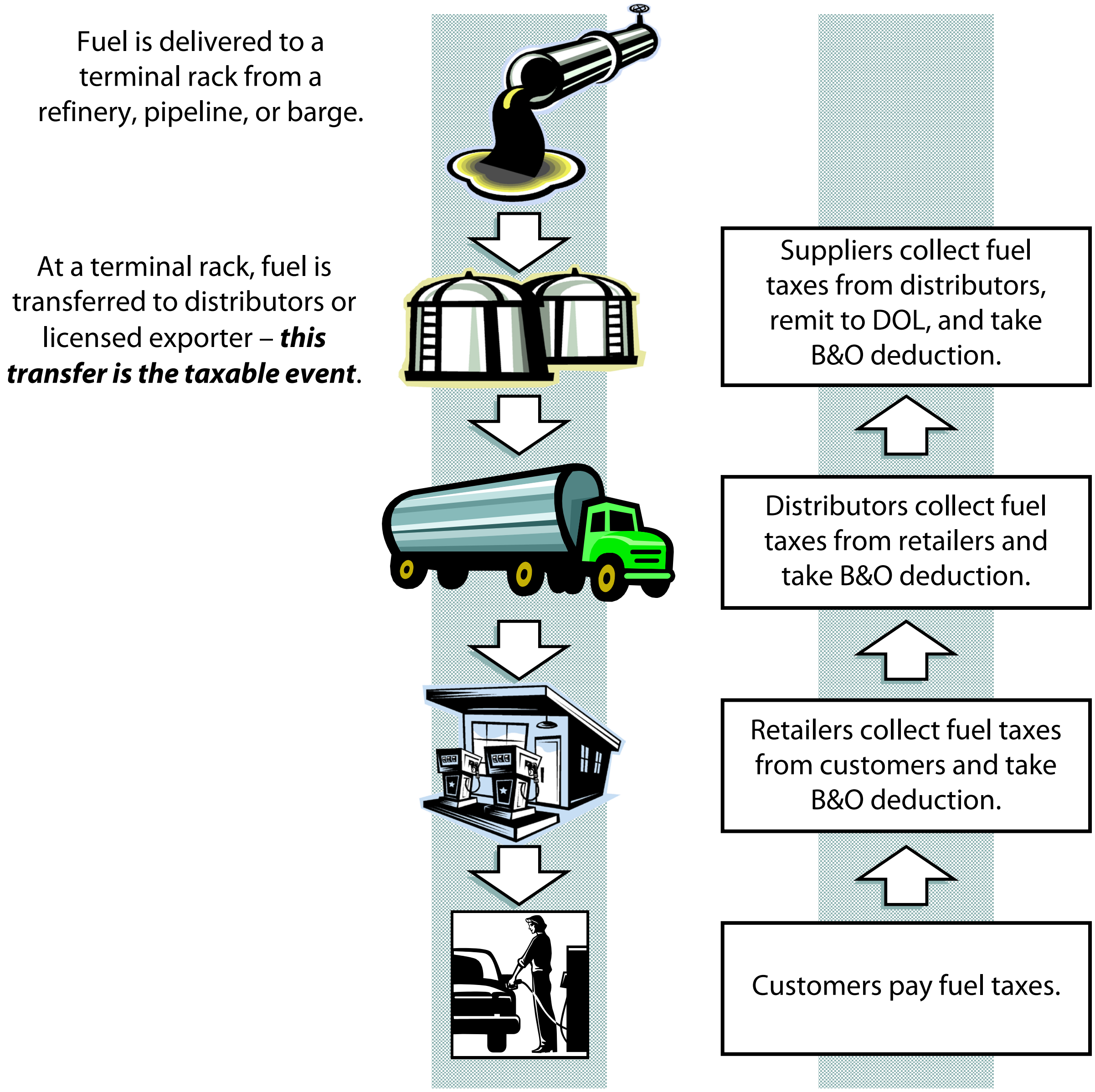
1935 The Legislature enacted the B&O tax and allowed the deduction for motor fuel taxes contained in the 1933 business activities tax.

The current deduction took shape in the 1933 business activities tax when the Legislature specifically allowed a deduction from gross income of the business for the motor vehicle fuel tax collected. The only legislative change since that time was the 1998 insertion of the specific citations for the state and federal taxes referenced in the statute.

## Other Relevant Background

Fuel is delivered to a terminal rack from a refinery, pipeline, or barge. At a terminal rack, fuel is transferred to distributors. This transfer is the taxable event. Fuel tax may also be imposed upon importation, blending or use by an interstate motor carrier if the fuel is purchased in another state. The supplier collects state and federal fuel taxes from the distributor when fuel is transferred from the terminal rack. The supplier then remits the collections to the Department of Licensing and the U.S. Internal Revenue Service and takes a B&O tax deduction for fuel taxes paid. The distributor collects fuel taxes from the retailer and takes a B&O deduction for the taxes paid. Similarly, the retailer collects the fuel tax from the end consumer of motor fuel and takes a B&O deduction. In this manner, even though the terminal rack is the legal point of taxation, the end consumer is ultimately liable for the tax. (See Exhibit 19 on the following page.)

Exhibit 19 – State Law Provides that Consumers are Ultimately Liable for the Fuel Tax




Source: JLARC analysis of tax statutes. Note: Fuel taxes may also be imposed upon importation, blending, or use by a motor carrier operating interstate if the fuel is purchased in another state.

## Public Policy Objectives

### *What are the public policy objectives that provide a justification for the tax preference? Is there any documentation on the purpose or intent of the tax preference?*

The Legislature designed the B&O tax as a tax on gross income associated with business activities. On the other hand, the Legislature intended motor vehicle fuel taxes to be paid by the final consumer of motor vehicle fuel and not the business activity of supplying, distributing, and retailing fuel. The public policy objective of this deduction is to acknowledge that motor vehicle fuel taxes are collections owed by the consumer and remitted to the state and federal government and do not provide actual income to a business.

The B&O tax is to constitute a part of the operating overhead expense, and the tax is not to be construed as a tax on purchasers or customers (see RCW 82.04.500). In contrast, motor vehicle fuel taxes collected by a business on behalf of state or federal governments are not part of the operating overhead of a business. A B&O tax on motor vehicle fuel tax receipts would therefore violate the express legislative intent for both the B&O tax and the motor fuel tax.

The temporary 1933 state Business Activities Tax and the 1935 state Revenue Act which created the B&O tax contained very broad and inclusive definitions of "gross income." Anything the Legislature did not want to tax had to be written as deduction from the definition. The Legislature allowed motor vehicle fuel taxes collected by a business to be deducted. The Washington motor vehicle fuel tax had been in place since 1921, and the federal tax came into being in 1932.

### *What evidence exists to show that the tax preference has contributed to the achievement of any of these public policy objectives?*

Allowing the deduction of state and federal motor vehicle fuel taxes from the calculation of businesses' gross income acknowledges that these tax collections do not provide actual income to the businesses.

### *To what extent will continuation of the tax preference contribute to these public policy objectives?*

If the public policy objective is to acknowledge that businesses do not receive these revenues as part of their income, then a deduction for motor vehicle fuel taxes collected by a business would need to be continued.

### *If the public policy objectives are not being fulfilled, what is the feasibility of modifying the tax preference for adjustment of the tax benefits?*

The public policy is being fulfilled.

## Beneficiaries

### *Who are the entities whose state tax liabilities are directly affected by the tax preference?*

The distribution chain for motor vehicle fuel generally consists of three parts:

- Suppliers (e.g., refineries or importers) who own fuel at "terminal racks;"
- Distributors who remove fuel from terminal racks and transport the fuel to retailers; and
- Retailers who sell fuel to motor vehicle operators.

The motor vehicle fuel tax is remitted to the state and federal governments by fuel suppliers. Suppliers collect the tax from distributors. In turn, distributors may collect the tax from retailers, who may include the tax in the selling price of the motor vehicle fuel. State law places the legal liability for remitting the tax on the supplier. Suppliers, distributors, and retailers are allowed to deduct the fuel taxes they collect and are the beneficiaries of the tax preference. The effect of the deduction is to make the end consumer ultimately liable for the fuel tax.

In 2008, the Department of Licensing licensed 286 entities to supply, import, export, or distribute motor vehicle fuel (primarily gasoline) or special fuel (primarily diesel). An entity may hold more than one license; however, a supplier's license allows an entity to perform any function. These 286 licensees represent the universe of the suppliers and distributors that benefit from the tax preference. In addition, there are about 2,100 gasoline stations in Washington that also benefit from this tax preference.

### *To what extent is the tax preference providing unintended benefits to entities other than those the Legislature intended?*

JLARC's review identified no unintended beneficiaries of this tax preference.

## Revenue and Economic Impacts

### *What are the past and future tax revenue and economic impacts of the tax preference to the taxpayer and to the government if it is continued?*

Based on a volume of about 3.5 billion gallons of gasoline and diesel fuel sold in Washington in 2008, the deduction for motor vehicle fuel tax reduced B&O tax collections by about $23 million. While B&O revenues were reduced by this amount, Washington collected nearly $1.3 billion in state fuel taxes during the same period. Federal fuel taxes added nearly $700 million to this amount, for a total of more than $1.9 billion in motor vehicle fuel taxes collected from Washington consumers during 2008.

Exhibit 20 – Motor Vehicle Fuel Sales, Taxes, and Taxpayer Savings

| Fiscal Year | Gasoline and Diesel Sales (billion gallons) | Fuel Taxes ($millions) | | | Taxpayer Savings ($millions) |
|---|---|---|---|---|---|
| | | State | Federal | Total | |
| 2006 | 3.4 | $1,067 | $677 | $1,744 | $20.9 |
| 2007 | 3.4 | $1,168 | $676 | $1,844 | $22.1 |
| 2008 | 3.5 | $1,253 | $687 | $1,940 | $23.2 |
| 2009 | 3.4 | $1,279 | $671 | $1,950 | $23.3 |
| 2010 | 3.6 | $1,359 | $712 | $2,071 | $24.8 |
| 2011 | 3.6 | $1,351 | $709 | $2,060 | $24.7 |

Source: Gasoline and diesel sales from Transportation Revenue Forecast Council November 2008 Forecast; taxes and taxpayer savings are JLARC calculations.

Note: Figures for fiscal years 2009 to 2011 are estimates.

The types of firms that sell motor vehicle fuel and take a deduction for fuel taxes include oil refineries, petroleum bulk station operators, petroleum wholesalers, and retailers of motor vehicle fuel such as gas stations, supermarkets, warehouse clubs, and convenience stores.

In 2007, petroleum refineries in Washington employed 1,895 workers and paid an average wage of $114,000. The bulk terminals employed 614 people and paid an average of $54,000 in wages. The distributors employed 1,378 workers and paid an average wage of $45,000. Washington gasoline stations (including those with convenience stores) employed nearly 14,000 people and paid an average wage of $17,000. In addition, there are other retailers where motor vehicle fuel may be only a small portion of their total sales. These retailers, as a sector total, employ 83,000 people and pay an average wage of $27,000.

Exhibit 21 – Employment and Wages in Motor Vehicle Fuel Distribution-Related Firms, 2007

| Industry | Employment | Total Wages ($millions) | Average Wages |
|---|---|---|---|
| Petroleum Refineries | 1,895 | $216 | $114,158 |
| Petroleum Bulk Stations & Terminals | 614 | $33 | $53,858 |
| Petroleum Merchant Wholesalers | 1,378 | $62 | $44,801 |
| Gasoline Stations | 13,774 | $238 | $17,243 |
| **Subtotal** | **17,661** | **$549** | **$31,065** |
| Other Retailers* | 83,069 | $2,214 | $26,656 |
| **Grand Total** | **100,730** | **$2,763** | **$27,429** |

Source: Employment Security Department.

*Not all of these retailers sell motor vehicle fuel.

Note: Figures for fiscal years 2009 to 2011 are estimates.

## *If the tax preference were to be terminated, what would be the negative effects on the taxpayers who currently benefit from the tax preference and the extent to which the resulting higher taxes would have an effect on employment and the economy?*

If suppliers, distributors, and retailers were required to pay B&O tax on motor vehicle fuel taxes collected by them and passed up the fuel distribution chain, the amount of tax would be about $70 per 10,000 gallons of motor vehicle fuel. This equates to less than a penny per gallon.

Historically, consumers do not purchase significantly less fuel when prices are high. Consequently, a tax increase can be passed onto consumers without a proportionate loss in sales. Therefore, it is likely that applying the B&O tax to motor fuel tax receipts would result in a price increase to consumers.

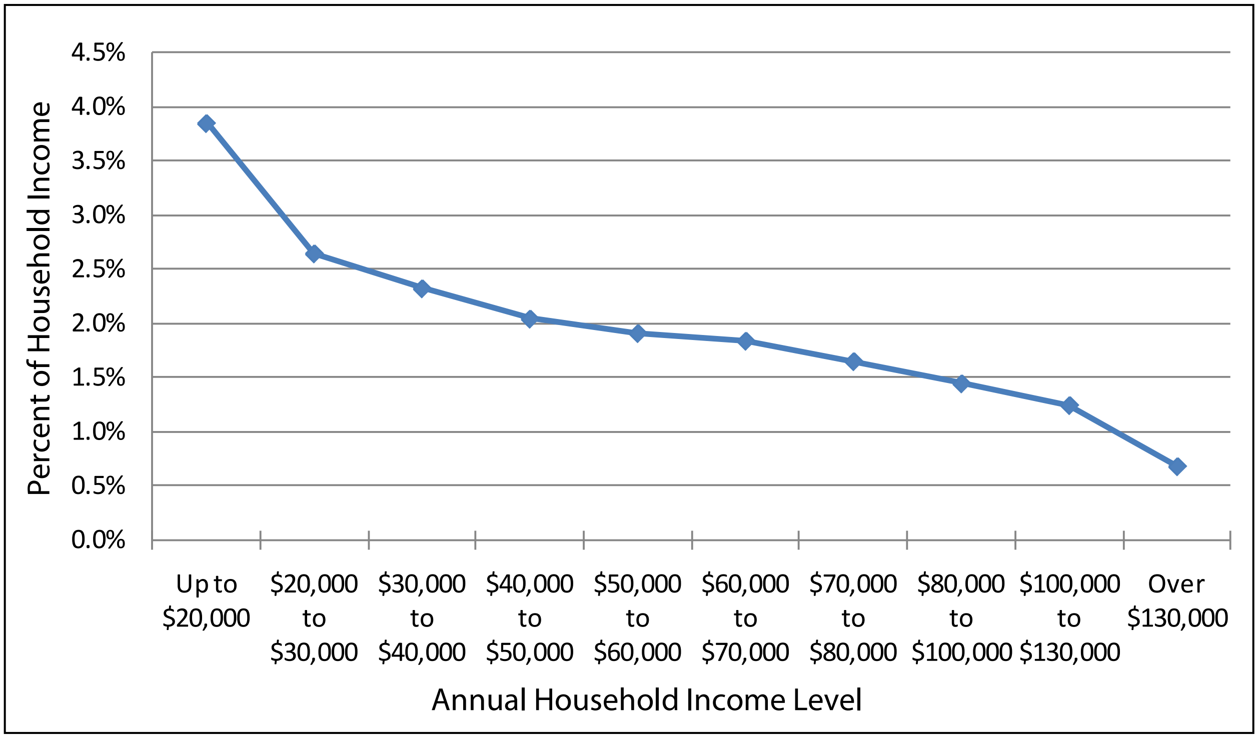
Given that the average price of gasoline in Washington (all grades) has ranged from $1.57 per gallon in December 2003 to $4.36 in July 2008 and back down to $1.88 in December 2008, a penny per gallon increase in the retail price of gasoline would likely go unnoticed.

## *If the tax preference were to be terminated, what would be the effect on the distribution of liability for payment of state taxes?*

To the extent that motor vehicle fuel-related businesses are able to pass the tax onto consumers, the businesses collecting the motor vehicle fuel tax should not be affected. The impact would fall on motor fuel consumers – both business consumers of motor vehicle fuel and households. The current estimate of motor vehicle fuel purchases is that 70 percent are made to households, 29 percent to business, and 1 percent to government.

As shown in Exhibit 22, among households of all income levels, the effect of any increase in the price of motor vehicle fuel would be relatively higher on lower-income households than on higher-income households.

Exhibit 22 – Lower Income Households Spend a Greater Portion of Income on Gasoline than Do Higher Income Households




Source: 2007 Consumer Expenditure Survey, Bureau of Labor Statistics.

## Other States

### *Do other states have a similar tax preference and what potential public policy benefits might be gained by incorporating a corresponding provision in Washington?*

Delaware and Ohio impose a business gross receipts tax similar to Washington's B&O tax. Michigan imposes a tax on gross receipts less purchases of business inputs. Like Washington, all three of these states exclude motor vehicle fuel excise taxes from their calculation of tax due under their gross receipts tax.

## Recommendation

**The Legislature should continue to allow businesses to exclude state and federal motor vehicle fuel excise tax collections from their gross income for the purposes of the B&O tax. The deduction achieves the objective of acknowledging that motor vehicle fuel tax collections are intended to be paid by the end consumer and do not provide actual income to a business.**

| | |
|---|---|
| **Legislation Required:** | No. |
| **Fiscal Impact:** | None – No change to status quo. |

# NEWSPAPERS EXEMPTIONS FROM SALES AND USE TAXES– SUMMARY

## Current Law

Current law provides an exemption from retail sales and use taxes for sales of newspapers via subscription and at newsstands. Statute defines a printed newspaper as a publication issued at regular intervals of at least twice a month, printed on newsprint, and folded loosely without stapling or glue.

See page A3-5 in Appendix 3 for the current statutes, RCW 82.08.0253 and RCW 82.12.0345.

## Legal History and Public Policy Objectives

The Legislature has provided the sales tax exemption for newspaper sales since the creation of the sales tax. What has evolved over time is the definition of a newspaper, changing the exemption's application.

1935 The Legislature faced a significant revenue shortfall as it convened in 1935. To raise additional revenue, the Legislature created the retail sales tax and the companion use tax. The 1935 act exempted newspaper sales from the sales tax. The Tax Commission interpreted that the new sales tax applied to other forms of information delivery such as sales of magazines and periodicals.

1970 The Department of Revenue (DOR) promulgated an administrative rule defining the word "newspaper." Pursuant to this rule, a newspaper's content had to be of "general interest" and not devoted solely to "a specialized field." In administering this rule, the Department frequently had to adjudicate whether the content of a particular publication was of general interest (and thus exempt from sales tax as a newspaper) or was too specialized to qualify (and was thus subject to the tax).

1987 The United States Supreme Court ruled that a definition that distinguishes between publications on the basis of their content violates the freedom of the press provisions of the First Amendment and thus is unconstitutional.[24] Following this decision, definitions of "newspaper" in other states often focused on the format (type of paper and folding) of the publication and publication frequency.

1989 The Department of Revenue issued a "Statement of Policy" indicating it intended to amend its rule defining newspapers to conform to the United States Supreme Court decision. The Statement further provided that the Department's new policy allowed specialized publications, in addition to those of general interest, to qualify as newspapers. However, the Department has not yet amended this rule.

[24] Arkansas Writers' Project, Inc. v. Ragland, 481 U.S. 221 (1987).

1993 Following the Supreme Court's decision, the Legislature adopted a definition of "newspaper" focusing on the format of a publication. To be considered a newspaper under the 1993 definition, a publication had to be issued regularly at least once a week and printed on newsprint in tabloid or broadsheet format folded loosely together without stapling, glue, or any other binding of any kind. The Legislature placed this definition in the chapter of law dealing with the business and occupation (B&O) tax. DOR used this same definition when administering the newspaper sales and use tax exemptions.

1994 The Legislature created a use tax exemption for newspapers. In a separate bill, the Legislature broadened the 1993 definition of "newspaper" to change the publication interval from at least once a week to at least twice a month. With a definition in statute based on format and frequency of publication, the number of DOR administrative reviews of what constitutes a "newspaper" has decreased.

2008 For purposes of B&O taxation, the Legislature adopted a temporary expansion of the definition of a newspaper, adding supplements of the newspaper and electronic versions of printed newspapers. DOR used this amended definition for administering the newspaper sales and use tax exemptions.

2009 As part of a bill addressing digital goods and services, the Legislature amended the language for both the sales and the use tax exemptions for newspapers. The exemptions now expressly apply to sales or use of printed newspapers and newspapers transferred electronically, if the electronic version meets certain qualifications. The electronic version must share content with the printed newspaper, and it must be prominently identified by the same name as the printed newspaper or otherwise indicate that it is a complement to the printed newspaper.

The Legislature also added a specific definition of a "printed newspaper" to the sales tax exemption statute. The definition is similar to the definition of a newspaper established in the B&O chapter in 1994, with the addition of including newspaper supplements.

The Legislature did not specify its public policy objective when it established these sales and use tax exemptions in 1935 and 1994, respectively. Based on court cases and historic administrative practices, reasons for the original establishment in 1935 may have included 1) a desire to avoid "taxation of knowledge" and any infringement of the First Amendment of the Constitution; 2) an expectation of low revenue potential; and 3) a wish to preclude using children as tax collectors. A number of changes have taken place with regard to these potential objectives since that original enactment. Additionally, changing economic conditions have affected the newspaper industry as a whole in more recent years.

## Beneficiaries

The beneficiaries of exempting newspapers from the retail sales and use taxes are the purchasers of newspapers. Based on national statistics, this is currently about 34 percent of the population.

## Revenue and Economic Impacts

By not having to pay retail sales tax on newspapers, consumers are saving about $13 million per year in state and local taxes. Of this amount, $9.5 million is in state taxes, and $3.5 million is in local taxes. A sales tax on newspapers would increase the price for purchasers. This would have only a modest impact on demand because of declining readership in recent years.

## Other States

There are 45 states and the District of Columbia that impose a sales tax. Of these, 31 states exempt newspapers from the sales tax. The tax treatment for online newspapers is affected by federal law and multi-state agreement. Federal law prohibits states from taxing online newspapers at a higher rate than paper versions. A multi-state agreement requires that by 2012, sales taxes for online newspapers among other digital products be separately imposed.

## Recommendations

1) **The Legislature should clarify the current intent of the retail sales and use tax exemptions for newspapers, because a number of circumstances have changed since the original tax preference enactment.**

   **Legislation Required:** Yes, if a change is desired.

   **Fiscal Impact:** $13 million per year in state and local sales taxes, if the exemption is terminated.

2) **The Department of Revenue should update its administrative rule for newspapers to reflect current law, because the administrative rule uses a content-based definition.**

   **Legislation Required:** No.

   **Fiscal Impact:** None.

# NEWSPAPERS EXEMPTIONS FROM SALES AND USE TAXES – REPORT DETAIL

## Current Law

Current law provides an exemption from retail sales and use taxes for sales of newspapers via subscription and at newsstands. Statute defines a printed newspaper as a publication issued at regular intervals of at least twice a month, printed on newsprint, and folded loosely without stapling or glue.

See page A3-5 in Appendix 3 for the current statutes, RCW 82.08.0253 and RCW 82.12.0345.

## Legal History

1935 The Legislature faced a significant revenue shortfall as it convened in 1935. To raise additional revenue, the Legislature created the retail sales tax and the companion use tax. The 1935 act exempted newspaper sales from the sales tax. The Tax Commission interpreted that the new sales tax applied to other forms of information delivery such as sales of magazines and periodicals.

1970 The Department of Revenue promulgated an administrative rule defining the word "newspaper." The 1970 definition was similar to the definition in place in the current DOR rule:

> The word "newspaper" means a publication of general circulation bearing a title, issued regularly at stated intervals of at least once every two weeks, and formed of printed paper sheets without substantial binding. It must be of general interest, containing information of current events. The word does not include publications devoted solely to a specialized field (WAC 458-20-143, last updated 1983).

In administering this rule, the Department frequently had to adjudicate whether the content of a particular publication was of general interest (and thus exempt from sales tax as a newspaper) or was too specialized to qualify (and was thus subject to the tax).

1987 The United State Supreme Court ruled that a definition that distinguishes between publications on the basis of their content violates the freedom of the press provisions of the First Amendment and thus is unconstitutional.[25] Following this decision, definitions of "newspaper" in other states often focused on the format (type of paper and folding) of the publication and publication frequency.

1989 The Department of Revenue issued an advisory stating it intended to amend its rule defining newspapers to conform to the United States Supreme Court decision. The Advisory further provided that the Department's new policy allowed specialized publications, in addition to

[25] Arkansas Writers' Project, Inc. v. Ragland, 481 U.S. 221 (1987).

those of general interest, to qualify as newspapers. However, the Department has not yet amended this rule.

1993 Following the Supreme Court's decision, the Legislature adopted a definition of "newspaper" focusing on the format of a publication. To be considered a newspaper under the 1993 definition, a publication had to be issued regularly at least once a week and printed on newsprint in tabloid or broadsheet format folded loosely together without stapling, glue, or any other binding of any kind. The Legislature placed this definition in the chapter of law dealing with the business and occupation (B&O) tax. DOR used this same definition when administering the newspaper sales and use tax exemptions.

1994 The Legislature created a use tax exemption for newspapers. In a separate bill, the Legislature broadened the 1993 definition of "newspaper" to change the publication interval from at least once a week to at least twice a month. With a definition in statute based on format and frequency of publication, the number of DOR administrative reviews of what constitutes a "newspaper" has decreased.

2008 For purposes of B&O taxation, the Legislature adopted a temporary expansion of the definition of a newspaper, adding supplements of the newspaper and electronic versions of printed newspapers. DOR used this amended definition for administering the newspaper sales and use tax exemptions.

2009 As part of a bill addressing digital goods and services, the Legislature amended the language for both the sales and the use tax exemptions for newspapers. The exemptions now expressly apply to sales or use of printed newspapers and newspapers transferred electronically, if the electronic version meets certain qualifications. The electronic version must share content with the printed newspaper, and it must be prominently identified by the same name as the printed newspaper or otherwise indicate that it is a complement to the printed newspaper.

The Legislature also added a specific definition of a "printed newspaper" to the sales tax exemption statute. The definition is similar to the definition of a newspaper established in the B&O chapter in 1994, with the addition of including newspaper supplements.

## Additional Background Information

The newspaper industry itself has undergone a number of significant changes in recent years:

- **Newspaper circulation and readership is declining** – Nationally, the peak years for newspapers, in terms of circulation, were from the mid-1960s to the early 1990s. Since then, there has been a 20 percent decline in the circulation of both daily and Sunday papers. For daily papers, circulation in 2008 was at the lowest level since 1945. In 1994, 58 percent of Americans said they read a newspaper on a typical day; that percentage declined to 34 percent in 2008.
- **Advertising revenue is declining** – Sales of newspaper advertising have fallen over the last decade. In 2000, newspapers sold nearly $49 billion in advertising via classified ads, retail ads, and national ads. Advertising sales declined to $35 billion in 2008, a decline of nearly 30 percent. Internet competitors are offering a viable substitute for hosting ads.

- **The emergence of digital products** – The advent of the Internet and extensive computer services has created new products for consumers. The distinction between traditionally taxable goods and nontaxable services blurs as more content and services are available electronically. Washington and other states are seeking to address consistent taxation of digital products as part of compliance with the multi-state Streamlined Sales and Use Tax Agreement.
- **Preferential B&O tax treatment** – In 2009, the Legislature lowered the B&O tax rate for the printing and publishing of newspapers, from 0.484 percent to 0.2904 percent of gross income.

## Public Policy Objectives

### *What are the public policy objectives that provide a justification for the tax preference? Is there any documentation on the purpose or intent of the tax preference?*

The Legislature did not specify its public policy objective when it established the original sales tax exemption in 1935. Based on court cases and historic administrative practices, potential public policy objectives include:

- **Avoiding infringement of the First Amendment** – In court challenges newspaper companies argued that taxes on newspapers violate the federal constitution. The First Amendment of the U.S. Constitution provides that "Congress shall make no law . . . abridging the freedom of speech, or of the press . . ." The Court has noted that one of the factors leading to the American Revolution was the imposition by the English Parliament of taxes upon all newspapers.[26] The main purpose of these taxes was to suppress publication of comments and criticisms objectionable to the King. These assessments were commonly characterized as "taxes on knowledge." Since then, newspaper advocates have argued that a tax on newspaper circulation does not promote the First Amendment's underlying policy of encouraging the free flow of information.
- **An expectation of low revenue potential** – In 1935, the Legislature set the initial sales tax rate for most goods at 2 percent of the selling price. The Legislature authorized the State Tax Commission to make tax tokens available to enable buyers to pay the sales tax on transactions of all sizes. The Tax Commission issued tokens in the denomination of one-fifth cent. The tax schedule prepared by the Commission called for zero cents tax on goods costing one to four cents, and one-fifth cent tax on goods costing five to 14 cents.

  In 1935, newspapers generally cost two or five cents per copy. Newspapers selling for two cents would not have been taxed, and newspapers selling for a nickel would have been taxed one tax token (one-fifth cent).
- **Preclude using children as tax collectors** – Other states have asserted that the administrative burdens of collecting the tax outweigh the benefit of the payments.[27] A number of newspaper carriers at the time of original enactment were children. The Legislature may not have wanted

[26] Grosjean v, American Press Co, 297 US 233, 245-46 (1936).

[27] See Hearst Corp. v. Iowa Department of Revenue, 461 NW2d 295, 306 (1990).

to put these children in the role of tax collector. However, in Washington, youth selling magazines or periodicals in the 1930s collected sales tax through the use of tax tokens.

## *What evidence exists to show that the tax preference has contributed to the achievement of any of these public policy objectives?*

A number of changes have taken place with regard to these potential public policy objectives since the original enactment of the sales tax exemption in 1935:

- **Avoiding infringement of the First Amendment** – The U.S. Supreme Court has weighed in on the subject of the First Amendment and taxation of newspapers, clarifying that newspapers can be subjected to common forms of taxation. The Supreme Court has ruled that states are precluded from abridging the freedom of speech or of the press because of the due process clause of the fourteenth amendment.[28] According to the Court, the First Amendment is aimed at any form of previous restraint upon printed publications or their circulation, including restraint by taxation of newspapers and their advertising. The Court, however, has clearly stated that the owners of newspapers are not immune from any of the ordinary forms of taxation for the support of government.[29] Thus, a general tax, such as a sales tax, that is broadly applied to others in addition to newspapers is permissible.[30] Taxes that single out the press, or small numbers of the press such as those with only a certain level of circulation or volume of production, would likely be unconstitutional.[31]
- **An expectation of low potential revenue** – Newspapers no longer cost a nickel or less. Instead, many daily papers cost 50 or 75 cents. Currently, other retail items selling for 50 to 75 cents are taxed. As explained in the revenue impact section of this review, the sales and use tax exemptions are worth some $13 million per year in foregone state and local sale taxes.
- **Preclude using children as tax collectors** – Most newspaper subscribers pay the newspaper companies directly for their subscriptions. Generally, individuals who deliver the papers would no longer be called upon to collect a sales tax.

It is not clear if a new policy purpose exists for these exemptions given the changing industry conditions and the 2009 B&O tax preference enacted for newspapers.

## *To what extent will continuation of the tax preference contribute to these public policy objectives?*

The public policy objective is unclear.

[28] See "Grosjean v. American Press Co.," 297 U.S. 233 (1936) for a full discussion.

[29] Grosjean at p. 250.

[30] See Leathers v.Medlock, 499 U.S. 439 (1991).

[31] Minneapolis Star & Tribune Co. v. Minnesota Comm'r of Revenue, 460 U.S. 575 (1983); "Grosjean v. American Press Co.," 297 U.S. 233 (1936).

### *If the public policy objectives are not being fulfilled, what is the feasibility of modifying the tax preference for adjustment of the tax benefits?*

The public policy objective is unclear.

## Beneficiaries

### *Who are the entities whose state tax liabilities are directly affected by the tax preference?*

The beneficiaries of exempting newspapers from the retail sales and use taxes are the purchasers of newspapers. Based on national statistics, this is currently about 34 percent of the population.

### *To what extent is the tax preference providing unintended benefits to entities other than those the Legislature intended?*

No unintended beneficiaries are apparent.

## Revenue and Economic Impacts

### *What are the past and future tax revenue and economic impacts of the tax preference to the taxpayer and to the government if it is continued?*

By not having to pay retail sales tax on newspapers, consumers are saving about $13 million per year in state and local sales taxes. Of this amount, $9.5 million is in state taxes, and $3.5 million is in local taxes. While newspaper circulation may continue to decline, increases in the price of a newspaper could offset these reductions.

Exhibit 23– Taxpayer Savings (Dollars in Millions)

| Fiscal Year | State Retail Sales/Use Taxes | Local Sales/ Use Taxes | Total Taxes |
|---|---|---|---|
| 2006 | $10.2 | $3.7 | $13.9 |
| 2007 | $10.3 | $3.8 | $14.1 |
| 2008 | $9.5 | $3.5 | $13.0 |
| 2009 | $9.1 | $3.3 | $12.4 |
| 2010 | $9.1 | $3.3 | $12.4 |
| 2011 | $9.1 | $3.3 | $12.4 |

Source: JLARC Analysis of Department of Revenue data.

Note: Figures for fiscal years 2009 to 2011 are estimates.

### *If the tax preference were to be terminated, what would be the negative effects on the taxpayers who currently benefit from the tax preference and the extent to which the resulting higher taxes would have an effect on employment and the economy?*

Imposing the sales tax on purchasers of newspapers would affect taxpayers and the economy in two ways.

1) Purchasers would pay higher taxes, and more revenues would be available to state and local governments to fund public services.
2) Publishers would face reduced demand for newspapers.

**Impact on Purchasers:** Imposing a sales tax on newspapers would shift spending from households to the state and local governments. Consumers would have less to spend on other household purchases. The taxing entities would receive more revenues to provide government services.

**Impact on the Newspaper Industry:** If the retail sales tax were applied to newspapers, consumers would be faced with approximately an 8.9 percent price increase. The daily paper now costing 50 to 75 cents would cost 54 to 82 cents. The increase in price would only modestly impact sales. Newspaper readership has been declining for nearly two decades. This decline will likely continue, with the resulting losses in newspaper income and employment, regardless of the price impact of imposing a retail sales tax.

Washington newspapers' gross business income (income from all sources including subscriptions and advertising), after adjusting for inflation, had been relatively flat at around $1 billion per year through most of this decade and took a sharp decline in 2008. As business income remained flat, newspaper publishers reduced employment. Employment peaked in 1999 and 2000 at 9,700 jobs. Since then the industry has lost over 3,000 jobs to an estimated employment level of 6,600 jobs in 2008. Total wages paid in the industry, after adjusting for inflation, have also been declining from $375 million $250 million in 2008. Average real wages, adjusted for inflation, have declined from $41,000 per year in 2004 to $37,500 in 2008. This occurred during a time when the real average nonfarm annual wage stayed relatively flat at $49,000 to $50,000 per year. Though a sales tax could impact newspaper sales, economic forces other than the retail sales tax are causing changes to the industry.

Exhibit 24 – Income, Employment, and Wages in the Newspaper Publishing Industry

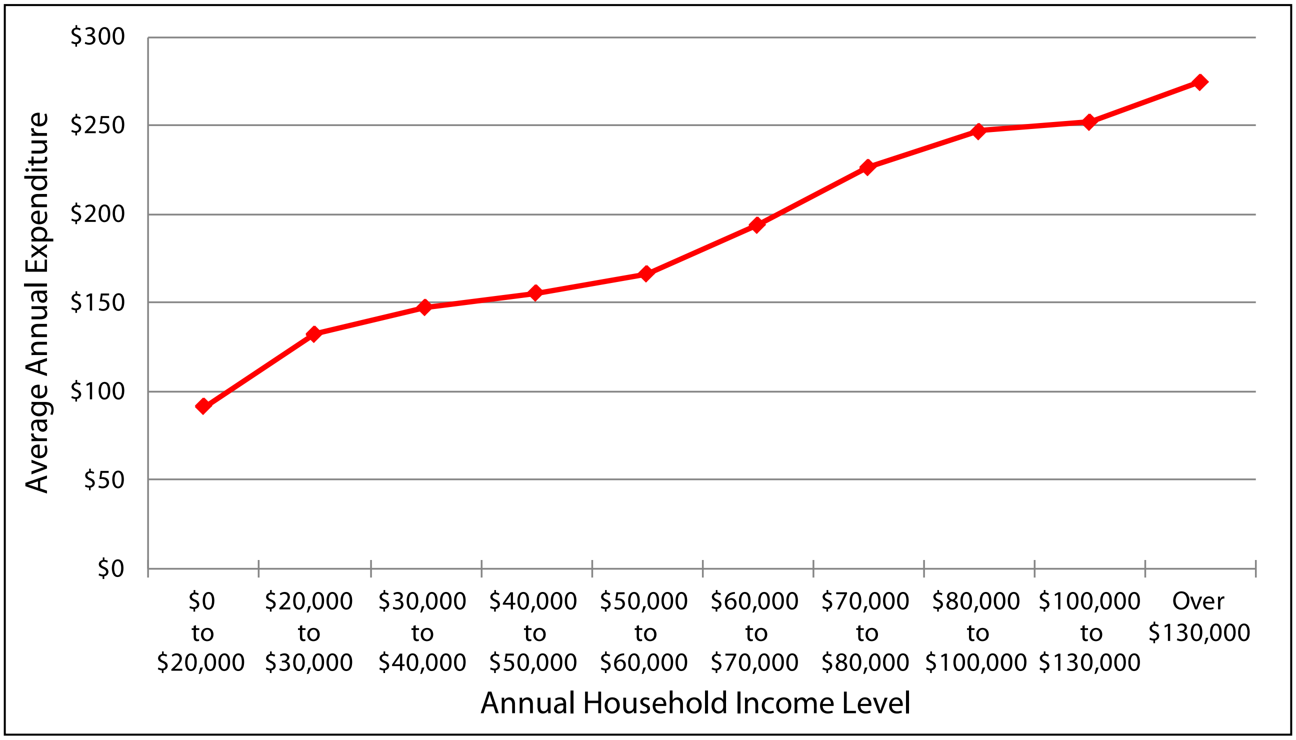
| Calendar Year | Real Gross Business Income (2008 dollars in millions) | Employment | Real Wages (2008 dollars in millions) | Average Real Wages (2008 dollars) |
|---|---|---|---|---|
| 1999 | $1,159 | 9,713 | $375 | $38,642 |
| 2000 | $1,142 | 9,700 | $377 | $38,900 |
| 2001 | $1,020 | 8,206 | $350 | $38,029 |
| 2002 | $991 | 8,849 | $344 | $38,896 |
| 2003 | $987 | 8,727 | $347 | $39,742 |
| 2004 | $1,036 | 7,636 | $313 | $41,035 |
| 2005 | $1,066 | 7,453 | $302 | $40,567 |
| 2006 | $1,082 | 7,259 | $296 | $40,837 |
| 2007 | $1,000 | 7,060 | $295 | $41,813 |
| 2008 est. | $856 | 6,618 | $249 | $37,562 |

Sources: Washington Departments of Revenue and Employment Security.

### *If the tax preference were to be terminated, what would be the effect on the distribution of liability for payment of state taxes?*

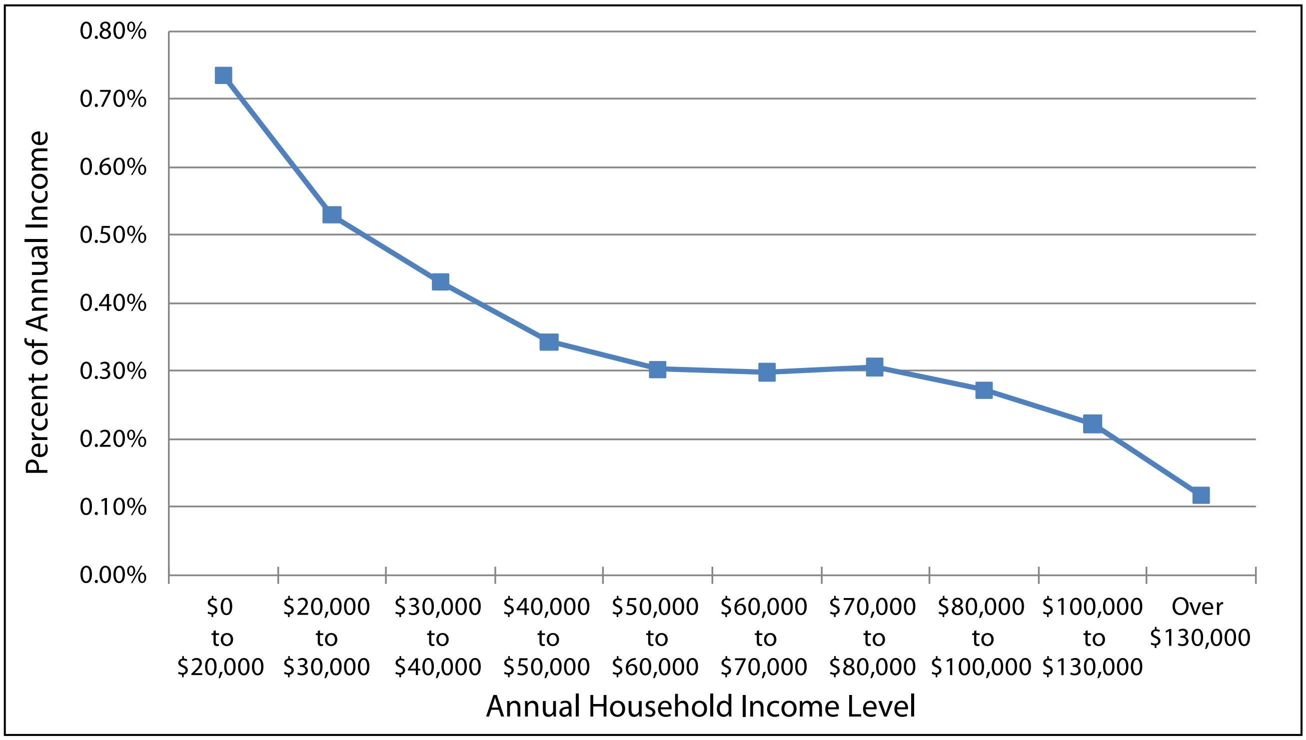
As for most consumer items, lower income households would pay a greater portion of their income in tax than higher income households. Newspaper readership increases with household income. However, lower income households pay a higher percent of their income on newspapers than higher income households. (See Exhibits 25 and 26.)

Exhibit 25 – High Income Households Spend More Money on Newspapers




Source: Department of Revenue using OFM Washington Population Survey and U.S. Department of Labor, Consumer Expenditure Survey, 2005 figures.

Exhibit 26 – Low Income Households Pay a Higher Share of Their Income on Newspapers




Source: Department of Revenue using OFM Washington Population Survey and U.S. Department of Labor, Consumer Expenditure Survey, 2005 figures.

## Other States

### *Do other states have a similar tax preference and what potential public policy benefits might be gained by incorporating a corresponding provision in Washington?*

There are 45 states and the District of Columbia that impose a sales tax. Of these, 31 exempt newspapers from the sales tax. Those states where newspapers are taxable by sales tax include: Alabama, Arizona, California, Florida, Georgia, Hawaii, Idaho, Kansas, Kentucky, Maine, Maryland, Missouri, South Dakota, West Virginia, and the District of Columbia.

The tax treatment for online newspapers is affected by federal law and multi-state agreement, as indicated below:

- Internet Tax Freedom Act (IFTA) - A provision of the federal IFTA says that online products may not be taxed at a higher rate than similar "offline" products. States exempting newspapers from sales and use tax may not impose this tax for online newspapers. States applying the sales and use tax may not impose a higher tax rate for online newspapers than the rate for the paper version.
- Streamlined Sales and Use Tax Agreement (SSUTA) – The SSUTA has defined electronically delivered products (digital products) as not being tangible personal property. As of January 1, 2010, to remain in compliance with the SSUTA, Washington and other SSUTA-member states must stop imposing retail sales tax on the sale of certain

specified digital products as the sale of tangible personal property. As of January 1, 2012, this prohibition is extended to all other digital products, including online newspapers. By these deadlines, sales and use taxes imposed by SSUTA-member states on digital products must be separately imposed from the general imposition of retail sales and use taxes on tangible personal property.

## Recommendations

1) **The Legislature should clarify the current intent of the retail sales and use tax exemptions for newspapers, because a number of circumstances have changed since the original tax preference enactment.**

   **Legislation Required:** Yes, if a change is desired.

   **Fiscal Impact:** $13 million per year in state and local sales taxes, if the exemption is terminated.

2) **The Department of Revenue should update its administrative rule for newspapers to reflect current law, because the administrative rule uses a content-based definition.**

   **Legislation Required:** No.

   **Fiscal Impact:** None.

# CASUAL SALES EXEMPTION FROM RETAIL SALES TAX – SUMMARY

## Current Law

Casual and isolated sales by individuals, such as a person holding a garage sale, are exempt from the retail sales tax. Buyers of such goods or services are required to pay the use tax if the good is used in Washington and sales tax has not been collected. Casual sales of goods and services by persons who are engaged in business activities and required to register with the Department of Revenue are subject to the sales tax.

See page A3-6 in Appendix 3 for the current statute, RCW 82.08.0251.

## Legal History and Public Policy Objectives

1935 The Legislature faced a significant revenue shortfall as it convened in 1935. To raise additional revenue, lawmakers passed the Revenue Act of 1935. As part of the 1935 act, the Legislature created the retail sales tax and a companion use tax. The original retail sales tax was imposed on retail sales of tangible personal property, with no services taxed at that time. The use tax was imposed on the use of items in the state if the good was taxable under the sales tax but no tax had been paid. The 1935 legislation also included specific exemptions from these new taxes, including "casual or isolated sales by a person who is not engaged in the business of selling tangible personal property."

1939 The Legislature disallowed the casual sales exemption for businesses taxable under the business and occupation (B&O) tax and the public utility tax.

1941 The Legislature added services to real property to the sales tax base.

1943 The Legislature expanded the application of the casual sales exemption to the sales of services. In addition, the Legislature exempted casual sales from the conveyance tax, a tax on the sale of real estate, but this tax was later repealed in 1961.

1949 Legislation made the buyer liable for the use tax in the case of a casual sale where the seller did not collect the sales tax.

When enacting the casual sales exemption, the framers of Washington's sales tax considered the high cost of administration and the low expected tax yield of taxing casual sales. Although the potential tax revenues are much greater today because of the growth in small volume online selling, collecting the tax would still pose an undue administrative burden on the Department of Revenue.

## Beneficiaries

The beneficiaries of the casual sales exemption are primarily individuals who purchase used household goods. These purchases take place in garage sales, rummage sales, through online web platforms such as eBay or Craigslist, and from one individual to another. Casual sales are estimated at $400 million in 2008. Purchasers are liable for the use tax, but due to low compliance with this tax they are unintended beneficiaries.

## Revenue and Economic Impacts

Purchasers saved an estimated $25.6 million in state sales tax and $9.4 million in local sales tax in the 2008. Although legally obligated to pay use tax, purchasers rarely comply except for purchases such as motor vehicles that are required to be registered. Terminating the casual sales exemption would not likely result in significant revenues because of the difficulty in requiring occasional sellers to register and pay taxes to the Department of Revenue.

## Other States

There are 45 states and the District of Columbia that impose a sales tax. Of these, 43 exempt casual sales from the sales tax. Eight states exempt casual sales of motor vehicles from the sales tax. Washington and three other states impose the use tax on the casual sales of motor vehicles.

## Recommendation

**The Legislature should continue the exemption for casual and isolated sales. It is achieving the objective of avoiding the administrative burden that would be entailed in collecting the tax.**

| | |
|---|---|
| **Legislation Required:** | No. |
| **Fiscal Impact:** | None – No change from status quo. |

# CASUAL SALES EXEMPTION FROM RETAIL SALES TAX – REPORT DETAIL

## Current Law

Casual and isolated sales by individuals, such as a person holding a garage sale, are exempt from the retail sales tax. Buyers of such goods or services are required to pay the use tax if the good is used in Washington and sales tax has not been collected. Casual sales of goods and services by persons who are engaged in business activities and required to register with the Department of Revenue are subject to the sales tax.

See page A3-6 in Appendix 3 for the current statute, RCW 82.08.0251.

## Legal History

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1939 The Legislature disallowed the casual sales exemption for businesses taxable under the business and occupation (B&O) tax and the public utility tax.

This modification results in different treatment for businesses than for non-businesses. If an entity is taxable under the B&O or public utility tax, it must collect retail sales tax on its casual sales regardless of whether it is in the business of selling such items. For example, if an auto repair shop sells surplus office furniture, it must collect the retail sale tax. A similar sale by an individual of household furniture would be exempt from the retail sales tax although the buyer would be liable for paying the use tax.

1941 The Legislature added services to real property to the sales tax base.

1943 The Legislature expanded the application of the casual sales exemption to the sales of services. In addition, the Legislature exempted casual sales from the conveyance tax, a tax on the sale of real estate, but this tax was later repealed in 1961.

1949 Legislation made the buyer liable for the use tax in the case of a casual sale where the seller did not collect the sales tax.

The exemption has remained substantively the same since 1949.

## Public Policy Objectives

### *What are the public policy objectives that provide a justification for the tax preference? Is there any documentation on the purpose or intent of the tax preference?*

In granting an exemption for casual sales, the framers of Washington's sales tax considered the high cost of administration and the low expected tax yield. Washington enacted its sales tax in 1935 not long after Mississippi became the first state in the nation to impose a general sales tax in 1932. By 1938, 29 states including Washington had imposed a sales tax as a major revenue source, modeling their structures along common lines. Washington followed the sales tax model in place in the 1930s which excluded incidental personal and business sales. States exempted casual sales based on the justification that "the volume of such incidental sales is relatively low and the revenue from them is too small to warrant any thoroughgoing attempt to prevent evasion of the tax on such sales."[32]

### *What evidence exists to show that the tax preference has contributed to the achievement of any of these public policy objectives?*

By providing this exemption, the state is successfully avoiding the administrative burden collecting this tax would entail. The statutory language exists in virtually the same form since 1943 when the exemption was expanded to include services. The subsequent changes to statute have only narrowed and clarified the exemption.

### *To what extent will continuation of the tax preference contribute to these public policy objectives?*

The public policy objective is being fulfilled.

### *If the public policy objectives are not being fulfilled, what is the feasibility of modifying the tax preference for adjustment of the tax benefits?*

The public policy objective is being fulfilled.

## Beneficiaries

### *Who are the entities whose state tax liabilities are directly affected by the tax preference?*

The beneficiaries of the casual sales exemption are primarily individuals who purchase used household goods. They make purchases at garage sales, through online web platforms such as eBay or Craigslist, and from one individual to another. Sales are irregularly scheduled and non-routine. National estimates are available for garage sales and flea markets, and of small volume online sellers. Washington's share of the national sales is $400 million in 2008. (See Exhibit 27.)

The law requires that buyers pay use tax on their purchases if the sales tax has not been paid. However, compliance with use tax is very low. The Department of Revenue in its Compliance Study

[32] General Sales of Turnover Taxation, National Industrial Conference Board, Inc., 1929.

indicates that businesses underreport use tax on their returns by 25.5 percent.[33] Individual purchasers failing to pay use tax are largely undetected unless they voluntarily report. Only 6,000 consumer use tax returns were voluntarily filed with the Department of Revenue compared to the estimated 900,000 Washingtonians who shopped at garage sales and flea markets in Fiscal Year 2008.

Exhibit 27 – Estimate of Casual Sales in Washington (Dollars in Millions)

| Fiscal Year | Garage Sales & Flea Markets | Online Small Volume Sellers (excluding store & auto sales) | Total |
|---|---|---|---|
| 2008 | $37.6 | $356.3 | $393.9 |

Source: America's Research Group, 2009; The Long Tail is Longer than You Think: *The Surprisingly Large Extent of Online Sales by Small Volume Sellers,* Joe Bailey, et al., May 12, 2008; eBay press release, April 2009; Department of Revenue.

## *To what extent is the tax preference providing unintended benefits to entities other than those the Legislature intended?*

Persons who appear to be making casual sales but, in fact, are engaging in business are unintended beneficiaries of the tax exemption. Locating and registering these businesses is an administrative concern for the Department of Revenue particularly for used vehicles sales and online sales.

**Casual Sales of Vehicles:** Businesses are required to collect sales tax on casual sales of motor vehicles. The buyer is not subject to use tax when the vehicle is registered if proof of payment of sales tax is provided. On the other hand, if an individual not required to be licensed with the Department of Revenue sells a vehicle, the buyer is responsible for paying use tax at the time the vehicle is registered.

Problems arise because some businesses regularly sell used vehicles without registering with the Department of Revenue. Persons who sell more than four vehicles a year are required to be registered dealers. These unregistered dealers are known as "curb-stoners" and are routinely pursued by the Attorney General's Office, the Department of Licensing, and the Department of Revenue for tax evasion and consumer fraud.

**Casual Sales Conducted Online:** The growth in online retailing by small volume sellers has also complicated the issue of what constitutes a casual sale. Online marketers like eBay, Google, and Craigslist provide a platform for individuals to sell their products and services. Some of the larger online platforms like Amazon handle the transaction and payment for the seller and remit sales tax to Washington. On other sites, like eBay and Craigslist, the seller handles the transaction and payment. If sellers are making sales on a continuous basis, they are liable for the sales tax, but often fail to collect the tax from their customers.

Businesses that process online payments are required under the federal Housing and Economic Recovery Act of 2008 to report online sales with transactions that exceed $20,000 or 200 transactions each year. States may in the future have help to identify some online continuous sellers due to this new federal reporting requirement.

[33] Department of Revenue Compliance Study, 2008.

## Revenue and Economic Impacts

### *What are the past and future tax revenue and economic impacts of the tax preference to the taxpayer and to the government if it is continued?*

No actual figures on casual sales exist because of the difficulty in identifying and valuing these sales. JLARC's estimate of casual sales is based on national estimates of sales at garage sales, flea markets, and small volume online sellers.

Data on garage sales and flea markets are provided by America's Research Group, a market research firm that surveys shoppers. On average, Americans spent $5.71 at a garage sale or flea market in Fiscal Year 2008. The U.S. Census Bureau conducts monthly surveys of retailers, including online retailers. However, the Census survey excludes small volume online sellers that sell through web platforms such as eBay. Researchers at the University of Maryland estimate that the small sellers sell more than $30 billion in merchandise annually in the U.S. Based on eBay estimates, 19 percent of these online sales are automobiles and 46 percent are online stores that sell at fixed prices and are not casual sellers.[34] This information is combined to derive estimates of casual sales.

JLARC used personal income as the basis to derive Washington's share of the national estimates. Purchasers saved an estimated $25.6 million in state sales tax and $9.4 million in local sales tax in the 2008. The figures may underestimate actual sales because not all types of casual sales are included. It is also possible that some individual sellers may collect sales tax.

Exhibit 28 – Taxpayer Savings from Exemption for Casual and Isolated Sales
(Dollars in Millions)

| Fiscal Year | State Sales Tax | Local Sales Tax |
|---|---|---|
| 2006 | $20.1 | $7.4 |
| 2007 | $24.5 | $9.0 |
| 2008 | $25.6 | $9.4 |
| 2009 | $22.9 | $8.4 |
| 2010 | $23.1 | $8.5 |
| 2011 | $24.5 | $9.0 |

Source: America's Research Group, 2009; The Long Tail is Longer than You Think: *The Surprisingly Large Extent of Online Sales by Small Volume Sellers,* Joe Bailey, et al., May 12, 2008; eBay press release, April 2009.

Note: figures for all years are estimates.

### *If the tax preference were to be terminated, what would be the negative effects on the taxpayers who currently benefit from the tax preference and the extent to which the resulting higher taxes would have an effect on employment and the economy?*

Terminating the casual sales exemption would not likely result in significant revenue increases because of the administrative difficulty in requiring individuals to register and pay taxes to the Department of Revenue.

[34] eBAY Inc. Reports first Quarter 2009 Results, eBAY press release, April 2009.

## Other States

### *Do other states have a similar tax preference and what potential public policy benefits might be gained by incorporating a corresponding provision in Washington?*

There are 45 states and the District of Columbia that impose a sales tax. Of these, 43 exempt casual sales from the sales tax. Those states where casual sales are taxable are Colorado, Oklahoma, and Wyoming.

Some states limit the exemption of casual sales. Five states impose the sales tax on casual sales of a certain number, scope, and character that would otherwise require a seller's permit. A threshold in these states is three or more sales from the seller within a 12-month period. Additionally, four states impose the sales tax on casual sales if the sale price exceeds a specific dollar amount ranging from $600 to $3,000.

Sales tax exemptions for casual sales of motor vehicles are handled differently than other casual sales. Although 20 states exempt casual sales of motor vehicles from the sales tax, 12 of these states apply a separate tax to these sales. In the remaining states, casual sales of motor vehicles are taxable as a sale. Washington and three other states specifically impose a use tax on the buyer when the sales tax has not been collected.

## Recommendation

**The Legislature should continue the exemption for casual and isolated sales. It is achieving the objective of avoiding the administrative burden that would be entailed in collecting the tax.**

**Legislation Required:** No.

**Fiscal Impact:** None – No change from status quo.

# JANITORIAL SERVICES EXEMPTIONS FROM SALES AND USE TAXES – SUMMARY

## Current Law

Retail sales tax does not apply to janitorial services. Businesses that perform services are treated two different ways under Washington tax law. Statute taxes services either as:

1) A retail service – the business pays tax under the business and occupation (B&O) tax retailing classification (at a rate of 0.471 percent) and collects sales tax from its customers; or

2) A non-retail service – the business pays taxes under the B&O tax "service and other" classification (at a rate of 1.5 percent). The customer does not pay the sales tax.

Statute specifically excludes janitorial services from the definition of a retail sale which makes them a non-retail service (category #2 above). Buyers of janitorial services are exempt from paying the retail sales tax on their purchase of these services. Businesses that provide janitorial services must pay the higher business and occupation (B&O) tax rate of 1.5 percent under the "service and other" classification. This review is about the sales tax exemption.

Janitorial services include such activities as cleaning and caretaking of the interior of buildings.

See pages A3-6 through A3-10 in Appendix 3 for the current statute, RCW 82.04.050(2)(d).

## Legal History and Public Policy Objectives

1935 The Legislature faced a significant revenue shortfall as it convened in 1935. To raise additional revenue, the Legislature created the retail sales tax and the B&O tax as part of the 1935 Revenue Act. The original retail sales tax and retailing B&O tax were imposed on the retail sales of tangible personal property only. Services, including janitorial services, were taxed exclusively under the B&O service tax classification.

1939 The Legislature, under pressure to further raise revenues, added repair services performed on personal property to the retail sales tax base, creating a new category of retail services.

1941 The Legislature continued adding to the sales tax base by defining services performed on real property as a retail service.

1943 The Legislature specifically excluded janitorial services from the B&O retailing tax classification which maintained their original tax treatment.

1971 The Legislature more narrowly defined janitorial services as "cleaning and caretaking services ordinarily performed by a commercial janitor service businesses," and listed qualifying and non qualifying services.

The public policy objective of the tax preference was to not tax business inputs. Most states including Washington adopted the sales tax as a major revenue source in the 1930s. States taxed tangible goods and did not tax services. For the most part, states excluded services based on the following public policy considerations:

1) Taxing services would be unproductive because the sale of services made up a small share of the economy compared to the sale of tangible goods.[35]
2) Identifying service transactions and enforcing collection of a sales tax would be administratively difficult because at the time many services were performed by individuals and not businesses.[36]
3) Taxing business inputs would increase business costs and discourage business investment.[37]

Circumstances have changed from those that existed when Washington first exempted janitorial services from the sales tax. Services now represent a much higher share of the economy. Many states are now taxing services demonstrating that administrative difficulties can be overcome. These two public policy objectives are outdated. However, the policy objective of avoiding taxes on business inputs is not outdated.

## Beneficiaries

The beneficiaries of the tax preference are the business and household customers that do not have to pay the sales tax on janitorial services that they purchase.

## Revenue and Economic Impacts

- Business and household customers for janitorial services saved an estimated $33 million in state sales taxes and $15 million in local sales tax in Fiscal Year 2008. This estimate assumes a decline in the purchase of janitorial services due to the economic downturn.
- Janitorial industry employment has grown faster than overall employment – 54 percent growth compared to 37 percent growth for all non-farm employment since 1990. Removing the exemption would likely slow employment growth because customers would tend to purchase fewer janitorial services.

## Other States

There are 45 states and the District of Columbia that impose a retail sales tax. Of these, 29 exempt janitorial services from the sales tax. Those states where janitorial services are taxable under the sales tax include: Arkansas, Connecticut, the District of Columbia, Florida, Hawaii, Iowa, Maryland, Minnesota, Nebraska, New Jersey, New Mexico, New York, Ohio, Pennsylvania, South Dakota, Texas, and West Virginia.

[35] Sales Taxation of Services: 1996 Update, Federation of Tax Administrators, April 1997.
[36] The Distributional Effects of a Sales Tax on Services, National Tax Journal, Siegfried Smith, 1991.
[37] Sales Taxation of Business Inputs, Council on State Taxation, Robert Cline and John Mikesell, 2005.

## Recommendation

**The Legislature should continue exempting janitorial services from sales and use taxes. The janitorial services exemption is achieving the objective of exempting these business inputs from the sales tax.**

**Legislation Required:** No.

**Fiscal Impact:** None – No change in status quo.

# JANITORIAL SERVICES EXEMPTION FROM SALES AND USE TAXES – REPORT DETAIL

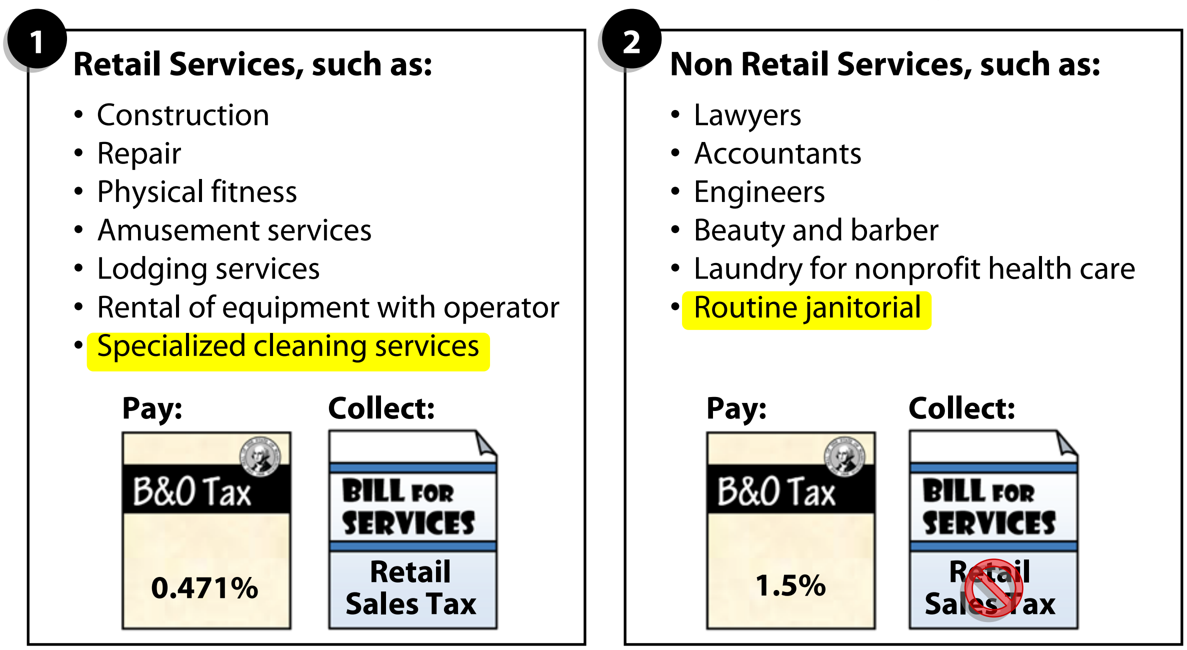
## Current Law

Businesses that perform services are treated two different ways under Washington tax law. Statute taxes services either as:

1) A retail service – the business pays tax under the business and occupation (B&O) tax retailing classification (at a rate of 0.471 percent) and collects sales tax from its customers; or

2) A non-retail service – the business pays taxes under the B&O tax "service and other" classification (at a rate of 1.5 percent). The customer does not pay the sales tax.

Exhibit 29 – Services are Taxed in Two Different Ways




Source: JLARC analysis of tax law.

Statute specifically excludes janitorial services from the definition of a retail sale which makes them a non-retail service (category #2 above). Buyers of janitorial services are exempt from paying the retail sales tax on their purchase of these services. Businesses that provide janitorial services must pay the higher business and occupation (B&O) tax rate of 1.5 percent under the "service and other" classification. This review is about the sales tax exemption.

Janitorial services include such activities as cleaning and caretaking of the interior of buildings. They do not include specialized cleaning services such as cleaning the exterior walls for buildings or cleaning septic tanks.

See pages A3-6 through A3-10 in Appendix 3 for the current statute, RCW 82.04.050(2)(d).

## Legal History

1935 The Legislature faced a significant revenue shortfall as it convened in 1935. To raise additional revenue, the Legislature created the retail sales tax and the B&O tax as part of the 1935 Revenue Act. The original retail sales tax and retailing B&O tax were imposed on the retail sales of tangible personal property only. Services, including janitorial services, were taxed exclusively under the B&O service tax classification.

1939 The Legislature, under pressure to further raise revenues, added repair services performed on personal property to the retail sales tax base, creating a new category of retail services.

1941 The Legislature continued adding to the sales tax base by defining services performed on real property as a retail service.

1943 The Legislature specifically excluded janitorial services from the B&O retailing tax classification which maintained their original tax treatment.

1971 The Legislature more narrowly defined janitorial services as "cleaning and caretaking services ordinarily performed by a commercial janitor service businesses," and listed qualifying and non qualifying services.

Most states including Washington adopted the sales tax as a major revenue source in the 1930s. States taxed tangible goods and did not tax services. For the most part, states excluded services based on the following public policy considerations:

1) Taxing services would be unproductive because the sale of services made up a small share of the economy compared to the sale of tangible goods.[38]
2) Identifying service transactions and enforcing collection of a sales tax would be administratively difficult because at the time many services were performed by individuals and not businesses.[39]
3) Taxing business inputs would increase business costs and discourage business investment.[40]

## Other Relevant Background

Cleaning services are also taxed two different ways. Specialized cleaning services or cleaning of building exteriors are taxed as a retail service. Routine janitorial services are taxed as a non-retail service under the B&O tax service classification (See Exhibit 30)

[38] Sales Taxation of Services: 1996 Update, Federation of Tax Administrators, April 1997.
[39] The Distributional Effects of a Sales Tax on Services, National Tax Journal, Siegfried Smith, 1991.
[40] Sales Taxation of Business Inputs, Council on State Taxation, Robert Cline and John Mikesell, 2005.

Exhibit 30 – Cleaning Services Also Taxable In Two Different Ways

| **Retail Service**<br>**Specialized Cleaning Services** | **Non Retail Service**<br>**Routine Janitorial Services** |
|---|---|
| **Enacted in Statute** | |
| • Cleaning exterior walls of buildings<br>• Cleaning septic tanks<br>• Furnace or septic tank cleaning<br>• Removing snow<br>• Sandblasting | • Washing interior and exterior window surfaces<br>• Cleaning and waxing floors<br>• Cleaning interior walls and woodwork<br>• Cleaning in place of rugs, drapes and upholstery |
| **Adopted in Rule or Advisory** | |
| • Chimney cleaning<br>• Cleaning plant, industrial machinery, fixtures<br>• Special clean up jobs required by construction, fires, floods, etc. | • Dusting<br>• Disposing of trash<br>• Removing snow from pedestrian entryways and sidewalks adjacent to buildings |

Source: JLARC analysis of statutes and administrative rules and advisories.

## Public Policy Objectives

### *What are the public policy objectives that provide a justification for the tax preference? Is there any documentation on the purpose or intent of the tax preference?*

The public policy of the tax preference is to exclude janitorial services as a retail service and exempt customers of janitorial services from the sales tax. In the 1935 Revenue Act the Legislature imposed the retail sales tax on tangible goods only. Over many years as the Legislature sought additional revenues to fund the state's financial needs, it added certain services to the sales tax base. In general, retail services are services performed on real or personal property, lodging, amusement, and select personal services. Few business and professional services have been subjected to the sales tax.

When states began enacting retail sales taxes in the 1930s, they almost exclusively taxed tangible goods and not services based on similar public policy considerations:

1) Taxing services would be unproductive;
2) Taxing services would be administratively difficult; and
3) Taxing business inputs increases business costs.

### *What evidence exists to show that the tax preference has contributed to the achievement of any of these public policy objectives?*

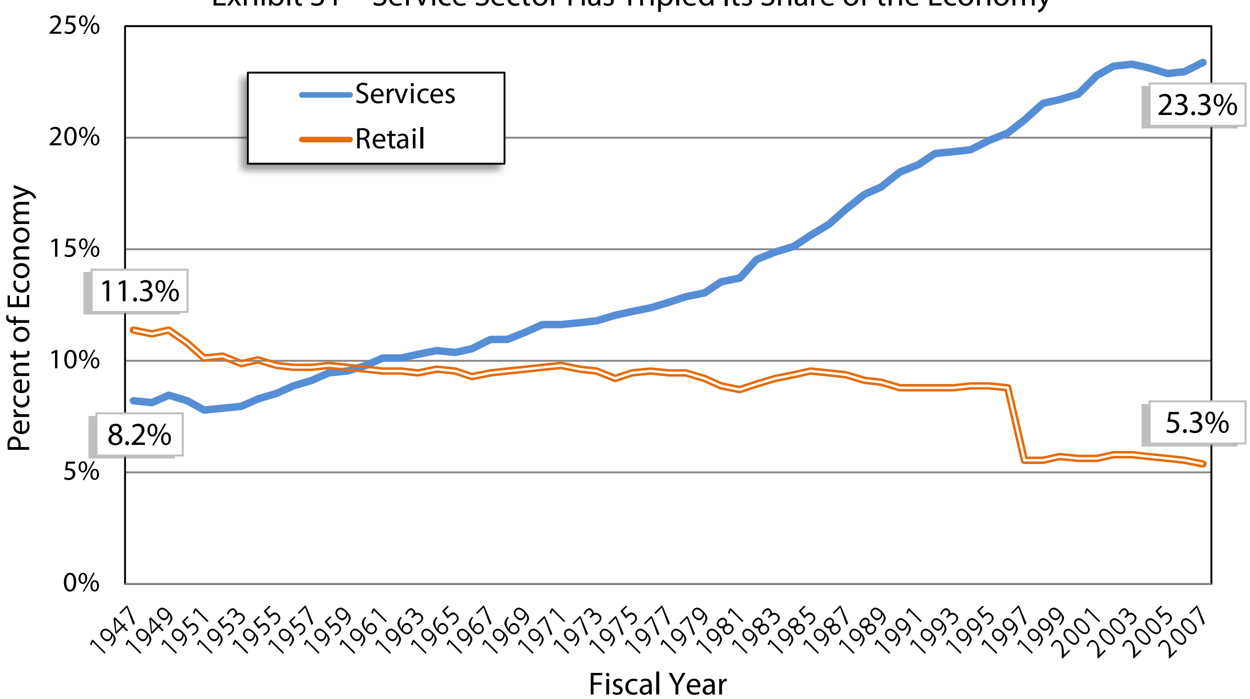
Circumstances have changed from those that existed when Washington first exempted janitorial services from the sales tax. Services now represent a much higher share of the economy. Many states are now taxing services demonstrating that administrative difficulties can be overcome. These two public policy objectives are outdated. However, the policy objective of avoiding taxes on business inputs is not outdated.

The current status of each of these three objectives is discussed below.

## Taxation of Service Sector More Productive

Services have become a much more significant share of the economy since the enactment of the state's sales tax. Since the 1940s, the service industry has nearly tripled its share of U.S. gross domestic product (23.3 percent from 8.2 percent of gross domestic product). Meanwhile, retail trade has declined considerably (5.3 percent from 11.3 percent of gross domestic product). (See Exhibit 31.)

Exhibit 31 – Service Sector Has Tripled Its Share of the Economy




Source: Gross-Domestic-Product-by-Industry Accounts, Bureau of Economic Analysis, 2008.
Note: Data transition in 1997 accounts for drop in retail trade.

## Administrative Burden has Been Addressed

In the early years of the sales tax, states avoided taxing services under the sales tax because of administrative burdens. Sales of tangible personal property could be easily identified in bills of sale. Sales of goods took place in stores whose owners could be identified as engaging in business and could be registered as taxpayers. Taxing services under the sales tax posed problems with apportioning income earned inside and outside of the taxing jurisdiction, and with enforcing payment when the sale took place at a non business location. But as more states taxed services, many of these administrative issues have been overcome.

## Concerns over Taxing Business Inputs Remain

Janitorial services are considered a business input because they are largely consumed by businesses rather than households. Businesses purchase 71 percent of all services to buildings (which includes janitorial services), while households consume 16 percent of these services. (See Exhibit 32.)

Exhibit 32 – Businesses Consume a Greater Share of Services to Buildings

| Sector | Percent Consumption |
|---|---|
| Business | 71% |
| Household | 16% |
| Government | 13% |
| Total | 100% |

Source: U.S. Bureau of Economic Analysis, Input Output Accounts, 2007.

Taxing business inputs such as janitorial services under the sales tax would increase the cost of doing business and thus could discourage business investment in Washington. In response to the higher costs, businesses that contract for janitorial services would tend to raise their prices, consume less of the service, or provide the service themselves in-house. If businesses consume less, janitorial service activity and employment would decline.

## *To what extent will continuation of the tax preference contribute to these public policy objectives?*

- The service industry has grown, making a sales tax on services more productive today. In fact, the Legislature has added services to the retail tax base over the years in order to raise revenues by capturing the growth in the service sector. The original objective to exempt unproductive revenue sources such as janitorial services is outdated.
- Washington has overcome the administrative challenges of taxing services. On the contrary, administrative problems now center on identifying which services are taxable as retail services and which are non retail services for similar activities. For example, the cleaning of the hood of a grill in a restaurant is a specialized cleaning service and is therefore taxable as a sale. Mopping the floor of a restaurant is a routine janitorial service and is exempt. The original objective to exempt janitorial services because of administrative difficulties is outdated.
- Washington's sales tax base includes many services related to personal and real property, construction and recreation services, but includes few businesses services. The tax preference continues to meet the objective of avoiding taxation of business inputs in order to minimize business costs.

A sales tax on janitorial services would be administratively feasible and more productive than in 1943 when the exemption first explicitly became law. However, the Legislature has purposely avoided taxation of certain business inputs throughout the years. This is an established justification for the exemption of many business services.

### *If the public policy objectives are not being fulfilled, what is the feasibility of modifying the tax preference for adjustment of the tax benefits?*

The public policy objective of not taxing business inputs is being fulfilled.

## Beneficiaries

### *Who are the entities whose state tax liabilities are directly affected by the tax preference?*

The beneficiaries of the tax preference are the business and household customers that do not have to pay the sales tax on janitorial services that they purchase.

### *To what extent is the tax preference providing unintended benefits to entities other than those the Legislature intended?*

There are no known unintended beneficiaries.

## Revenue and Economic Impacts

### *What are the past and future tax revenue and economic impacts of the tax preference to the taxpayer and to the government if it is continued?*

Customers of janitorial services save because they do not pay the retail sales tax. Their sales tax savings are estimated at $33 million in state sales tax and $15 million in local sales taxes in Fiscal Year 2008. (See Exhibit 33.)

The starting point for the estimate is gross income reported by janitorial services firms on their tax returns. Gross income is adjusted to reflect reduced sales if the exemption were to be repealed. The tax base for janitorial services is expected to decline because customers are sensitive to price and would tend to cut back on purchased services and either do with less of the service or perform the service with in-house employees to avoid the sales tax.

If the exemption were repealed, janitorial services would pay B&O tax at the lower rate. Currently, janitorial businesses are taxed at the 1.5 percent B&O service tax rate. If their services become subject to the retail sales tax, janitorial businesses would be taxed at the lower 0.471 percent for retail services. This would result in a savings for janitorial businesses of $5 million in Fiscal Year 2008.

Exhibit 33 – Customer Savings Due to Exemption for Janitorial Services Dollars in Millions)

| Fiscal Year | State Sales Tax Savings | Local Sales Tax Savings |
|---|---|---|
| 2006 | $28.6 | $12.8 |
| 2007 | $31.7 | $14.2 |
| 2008 | $33.0 | $14.8 |
| 2009 | $31.4 | $14.0 |
| 2010 | $32.3 | $14.5 |
| 2011 | $34.5 | $15.5 |

Source: Department of Revenue tax records.

Note: Figures for fiscal years 2009 through 2011 are estimates.

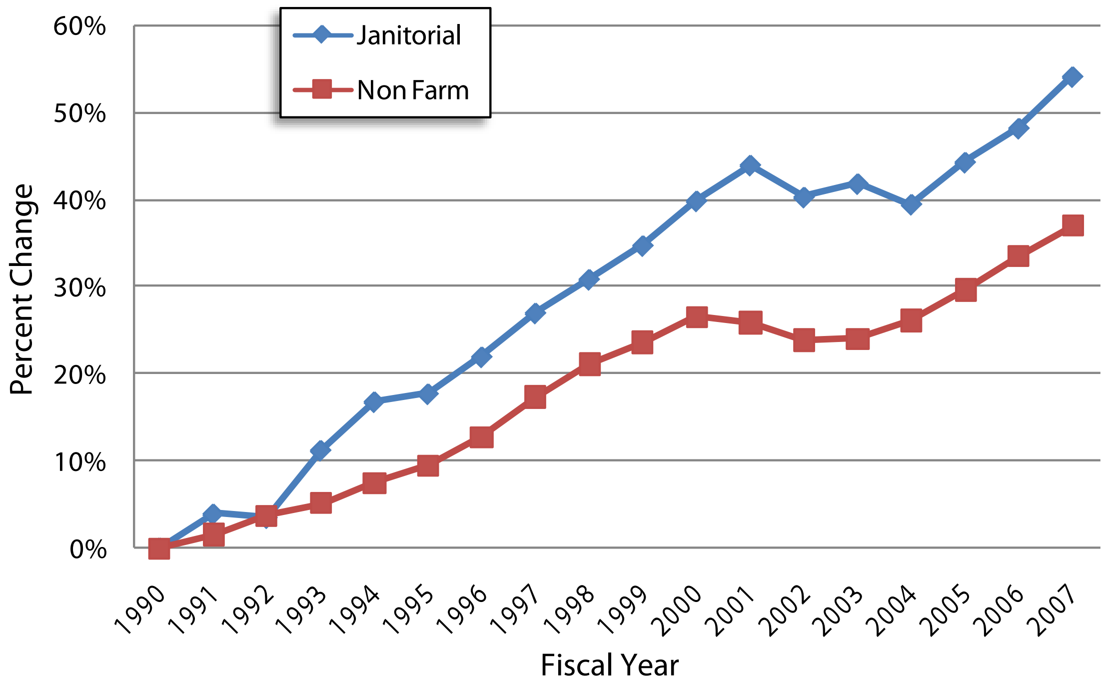
### *If the tax preference were to be terminated, what would be the negative effects on the taxpayers who currently benefit from the tax preference and the extent to which the resulting higher taxes would have an effect on employment and the economy?*

If the Legislature terminated the tax preference, the cost of doing business for customers of janitorial services would increase. Customers would tend to consume less or shift to performing the service in-house. Janitorial firms, in response, would tend to reduce their prices, reduce wages or other costs, or lay off employees. Janitorial employees represent a large portion of the unskilled workforce. Nearly 40,000 people in Washington work in janitorial services, the majority of them in business for themselves or employed by sole proprietors.[41] Median hourly wages were $11.83 in 2007, somewhat above the Washington minimum wage of $7.93 an hour. Removing the tax exemption would tend to result in layoffs or reduced wages.

Janitorial industry employment has grown faster than overall employment – 54 percent growth compared to 37 percent growth for all non-farm employment since 1990. Removing the exemption would likely slow employment growth. (See Exhibit 34.)

[41] Occupational Employment Statistics for Washington, U.S. Bureau of Labor Statistics.

Exhibit 34 – Percent Change in Janitorial Employment Since 1990

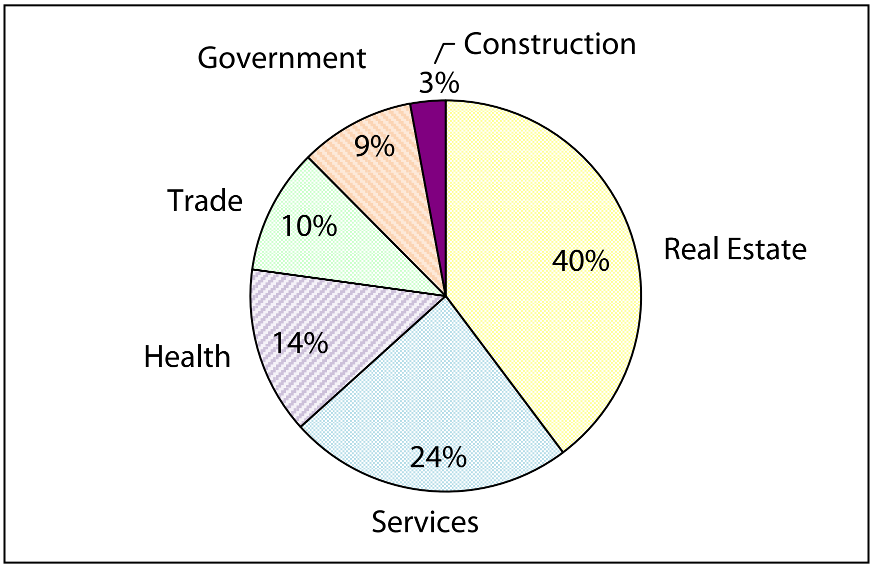



Source: U.S. Bureau of Labor Statistics, State and Metro Area Employment for Washington State.

## *If the tax preference were to be terminated, what would be the effect on the distribution of liability for payment of state taxes?*

Businesses purchase a much larger share of janitorial services than households. Janitorial services are predominantly used by the real estate industry, by other services business, and by the health care industry. These customers of janitorial services would pay state and local sales taxes if the tax preference were terminated. (See Exhibit 35.)

Exhibit 35 – Real Estate, Services and Health Sectors
Purchase 78% of all Services to Buildings




Source: U.S. Bureau of Economic Analysis, Intermediate Use data, 2007.

Taxes would decrease for janitorial service businesses because they would pay on the lower B&O retailing rate at 0.471 percent rather than the higher service rate of 1.5 percent.

## Other States

### *Do other states have a similar tax preference and what potential public policy benefits might be gained by incorporating a corresponding provision in Washington?*

There are 45 states and the District of Columbia that impose a sales tax. Of these, 29 exempt janitorial services from the sales tax. Those states where janitorial services are taxable by sales tax include: Arkansas, Connecticut, the District of Columbia, Florida, Hawaii, Iowa, Maryland, Minnesota, Nebraska, new Jersey, New Mexico, New York, Ohio, Pennsylvania, South Dakota, Texas, and West Virginia.

In Washington, the sales tax exemption for janitorial services applies to both real property (walls, windows, and floor) and tangible personal property (rugs, drapes, and upholstery). A few states note a distinction in the tax treatment based on whether cleaning services are for real or tangible personal property. Tennessee and Utah apply the exemption on janitorial services for real property while Louisiana exempts janitorial services for tangible personal property. Wisconsin exempts routine and repetitive janitorial services on both real and tangible personal property.

## Recommendation

**The Legislature should continue exempting janitorial services from sales and use taxes. The janitorial services exemption is achieving the objective of exempting these business inputs from the sales tax.**

| | |
|---|---|
| **Legislation Required:** | No. |
| **Fiscal Impact:** | None – No change in status quo. |

# FEED AND SEED EXEMPTION FROM RETAIL SALES TAX – SUMMARY

## Current Law

Washington imposes a retail sales tax based on the selling price of tangible personal property and certain services purchased at retail. Feed, seed, seedlings, fertilizer, certain pollination agents, and spray materials are exempt from the retail sales tax. The exemption applies to:

- Farmers producing agricultural products for sale;
- Farmers acting under cooperative habitat development or access contracts with a 501(c)(3) tax exempt organization or the Washington State Department of Fish and Wildlife; and
- Persons who participate in the federal Conservation Reserve Program, the Environmental Quality Incentives Program, the Wetlands Reserve Program, or the Wildlife Habitat Incentives Program.

See pages A3-11 through A3-15 in Appendix 3 for the current statute RCW 82.04.050(9).

## Legal History and Public Policy Objectives

1935 The Legislature adopted a retail sales tax as an integral part of the Revenue Act, which established much of the current state tax structure. The act defined retail sale to exclude "sales of feed to persons producing for sale milk, eggs, wool, fur, meat or other substances obtained from livestock animals or poultry."

1943 Legislation modified the definition of retail sale to further exclude sales of seed, fertilizer, and spray materials. In addition, the exclusion was applied to persons producing any agricultural product, not just those previously listed.

1967 The Legislature added a restriction that the items produced must be sold at wholesale.

1987 Legislation added seedlings to the list of excluded agricultural inputs. Christmas tree growers became eligible for the tax preference on their purchases of seed, seedlings, fertilizers and spray materials.

1988 Legislation further modified the definition of retail sale to exclude sales of vegetative cover for use on land enrolled in the federal Conservation Reserve Program.

1993 The Legislature removed the restriction that the items produced must be sold at wholesale.

1997 The Legislature expanded the exemption by adding other habitat conservation programs to the purposes for which the exempt products could be used.

The public policy objective for exempting sales to farmers relates to the definition of a retail sales tax, which is a tax on final consumption. Exempting feed and seed from the sales tax is analogous to selling ingredients and component parts, which are not considered a retail sale. The exemption for sales to persons participating in conservation and habitat protection programs is intended to encourage participation in projects that mitigate impacts on wildlife habitat, ease administration of the tax, and put into statute a prior Department of Revenue policy exempting expenditures for vegetative cover for use on land enrolled the federal Conservation Reserve Program.

## Beneficiaries

- The beneficiaries of the tax exemption are farmers. According to the 2007 Census of Agriculture, there are 39,284 farms in Washington.
- Owners of land enrolled in a federal or state conservation or habitat protection program are also benefitting to some extent from this tax exemption. However, for administrative reasons, it is unlikely that they would pay tax absent this exemption.

## Revenue and Economic Impacts

- Farmers purchased $864 million in feed and seeds in 2007. The taxpayer savings resulting from not applying the retail sales tax to farm purchases of feed, seed, and seedlings is $70 million per year. Of this amount, $57 million is in state sales taxes, and $13 million is in local sales taxes.
- The economic impact of these taxpayer savings is likely increased income to farmers and their employees. Farmers are generally "price-takers" – they are relatively small and cannot dictate the price at which they can sell their products. If the exemption were eliminated, the retail sales tax would be an added cost of production that farmers could not pass forward onto consumers. Therefore, the tax would be passed back onto the factors of production or the profits of the owners. The likely result would be less income to farmers or their employees.

## Other States

There are 45 states and the District of Columbia that impose a sales tax. Of these, 44 exempt feed and seed from the sales tax. Feed and seed are taxable in Hawaii and the District of Columbia.

## Recommendation

**The Legislature should continue the retail sales tax exemption for the sale of feed, seed and seedlings to farmers. The exemption is achieving the objectives of 1) taxing final consumption under the retail sales tax, and 2) encouraging persons to participate in conservation and habitat protection programs.**

**Legislation Required:** No.

**Fiscal Impact:** None – No change from status quo.

# FEED AND SEED EXEMPTION FROM RETAIL SALES TAX – REPORT DETAIL

## Current Law

Washington imposes a retail sales tax based on the selling price of tangible personal property and certain services purchased at retail. Feed, seed, seedlings, fertilizer, certain pollination agents, and spray materials are exempt from the retail sales tax. The exemption applies to:

- Farmers producing agricultural products for sale;
- Farmers acting under cooperative habitat development or access contracts with a 501(c)(3) tax exempt organization or the Washington State Department of Fish and Wildlife; and
- Persons who participate in the federal Conservation Reserve Program, the Environmental Quality Incentives Program, the Wetlands Reserve Program, or the Wildlife Habitat Incentives Program.

See pages A3-11 through A3-15 in Appendix 3 for the current statute RCW 82.04.050(9).

## Legal History

1935 The Legislature faced a significant revenue shortfall as it convened in 1935. To raise additional revenue, lawmakers passed the Revenue Act, which established much of the current state tax structure. As part of the act, the Legislature created the retail sales tax and a companion use tax. The act defined retail sale to exclude "sales of feed to persons producing for sale milk, eggs, wool, fur, meat or other substances obtained from livestock animals or poultry."

1943 Legislation modified the definition of retail sale to further exclude sales of seed, fertilizer, and spray materials. In addition, the exclusion was applied to persons producing any agricultural product, not just those previously listed.

1967 The Legislature added a restriction that the items produced must be sold at wholesale.

1987 Legislation added seedlings to the list of excluded agricultural inputs. Christmas tree growers became eligible for the tax preference on their purchases of seed, seedlings, fertilizers and spray materials.

1988 Legislation further modified the definition of retail sale to exclude sales of vegetative cover for use on land enrolled in the federal Conservation Reserve Program.

1993 The Legislature removed the restriction that the items produced must be sold at wholesale.

1997 The Legislature expanded the exemption by adding other habitat conservation programs to the purposes for which the exempt products could be used.

## Public Policy Objectives

### *What are the public policy objectives that provide a justification for the tax preference? Is there any documentation on the purpose or intent of the tax preference?*

**Sales to farmers:** The public policy objective for exempting from the retail sales tax the sale of feed and seed to farmers is one relating to:

- The definition of a retail sales tax, which is a tax on final consumption; and
- Equity, in that the exemption treats feed and seed like other ingredients and component parts.

The sale of feed, seed, and seedlings sold to farmers for the purpose of producing for sale agricultural products is analogous to the sale of ingredients and component parts rather than a tax on final consumption. Statute excludes the sales of ingredients and component parts from the definition of retail sale. The sales and use taxes applies only to retail sales.

In the same paragraph in which the 1935 Legislature defined a retail sale to exclude the sale of ingredients and component parts, it also defined retail sale to not include sales of feed to persons producing for sale milk, eggs, and meat obtained from livestock, animals or poultry. The State Tax Commission adopted a rule to define the sale of seeds to persons who purchase the same for use in commercial production as wholesale sales. (Wholesale sales are sales that are not retail sales.) The Legislature confirmed the rule in 1943 when it defined "retail sale" to also exclude the sale of seed, fertilizer, and spray materials for the purpose of producing for sale any agricultural product whatsoever.

**Sales to persons participating in conservation and habitat protection programs:** With regards to the retail sales tax exemptions for feed, seed and seedlings sold to farmers participating in conservation and habitat protection programs, the public policy purposes are 1) to put into statute Department of Revenue policy; 2) to ease administration of the retail sales tax; and 3) to encourage participation in projects that mitigate impacts on wildlife habitat. The federal Conservation Reserve Program (CRP) began in the mid-1980s. For administrative reasons, the policy of Department of Revenue had been to exempt from the sales tax expenditures for "vegetative cover" for use on land enrolled in the CRP. The 1988 amendment to the definition of a "retail sale" put into statute this policy. The 1997 amendments that expanded the list of conservation and habitat protection programs, initially requested by the Department of Revenue, were to clarify an area of tax law that was potentially unenforceable. Without the amendment, farmers may have had to apportion their purchases of feed, seed, and seedlings into taxable and nontaxable portions, depending on the land on which it ultimately was to be used. The prime sponsor of the legislation also wanted to provide an incentive to encourage private participation in projects that would mitigate impacts on wildlife habitat.

### *What evidence exists to show that the tax preference has contributed to the achievement of any of these public policy objectives?*

The first policy objective, that of treating feed, seed, and seedlings the same as other ingredients and component parts, is a matter of definition. Farmers purchase feed, seed, and seedlings and transform them into other products for sale. This fits within the concept of an ingredient or component part. Households that purchase feed, seed, and seedlings are subject to the retail sales tax because they do not use them to produce products for sale.

With regards to the purchase of feed, seed, and seedlings for use on lands enrolled in a conservation or habitat protection program, the Department of Revenue contends the exemption is necessary for administrative reasons. It would be administratively difficult to force farmers to allocate their purchases of feed, seed, and seedlings between the ultimate use in products produced for sale versus use on lands enrolled a conservation or habitat protection program. Enforcement of the use tax, a companion tax to the retail sales tax and applies when the retail sales tax has not been paid, is normally done through an audit of a business. Because they are not generally registered as a business, most farmers are not audited by the state.

As to the public policy purpose of encouraging landowners to participate in the conservation and habitat programs, these programs are used in Washington. However, it is difficult to connect utilization of the programs with the retail sales tax exemption for feed, seed and seedlings used on these lands. Given the Department of Revenue's position on the unenforceability of such a tax, it is unlikely that retail sales tax would be collected.

### *To what extent will continuation of the tax preference contribute to these public policy objectives?*

Continuation of the retail sales tax exemption for the purchase of feed, seed, and seedlings by farmers producing for sale agricultural products will continue the treatment of these items the same as ingredients and component parts.

Continuation of the retail sales tax exemption for the purchase of feed, seed, and seedlings by persons participating in federal and state conservation and habitat protection programs will continue to relieve the Department of Revenue from a potentially unenforceable situation. Because of the difficulty in collecting the tax even if it were to be imposed, continuation of the tax exemption may not have much impact on participation in these programs.

### *If the public policy objectives are not being fulfilled, what is the feasibility of modifying the tax preference for adjustment of the tax benefits?*

The public policy objectives are being fulfilled.

## Beneficiaries

### *Who are the entities whose state tax liabilities are directly affected by the tax preference?*

According to the 2007 Census of Agriculture, there are 39,284 farms in Washington. Exhibit 36 shows that, of these farms, 19,927 purchased feed and 11,005 purchased seeds, plants, vines, and trees. It is likely many farms purchased both feed and seeds. Family and individually-owned farms purchased 42 percent of the feed and seed in 2007. Family-held corporations purchased another 34 percent of the feed and seed.

Exhibit 36 – Purchases of Feed and Seed by Type of Ownership (Dollars in Millions)

| Farm Ownership | Purchases of Feed | | Purchases of Seed | | Total Purchases | Share of Total |
|---|---|---|---|---|---|---|
| | # of Farms | Amount | # of Farms | Amount | | |
| Family or Individual | 17,744 | $305 | 7,873 | $62 | $367 | 42% |
| Partnership | 1,030 | $125 | 1,241 | $42 | $167 | 19% |
| Family Held Corporation | 878 | $214 | 1,630 | $76 | $291 | 34% |
| Other Corporation | 74 | $12 | 161 | $20 | $31 | 4% |
| Other Ownership | 201 | $6 | 100 | $1 | $8 | 1% |
| **Total** | **19,927** | **$663** | **11,005** | **$201** | **$864** | **100%** |

Source: 2007 Census of Agriculture, U.S. Department of Agriculture.

Due to the nature of the markets for agricultural products, with agricultural prices generally not affected by individual farmers, the direct beneficiaries of the tax exemption are the farmers. It is unlikely that any taxes on feed and seed could be passed onto consumers.

Also, owners of land enrolled in a federal or state conservation or habitat protection program are benefitting to some extent from this tax exemption. Because of administrative reasons mentioned above, it is unlikely that they would pay tax absent this exemption. The largest of these programs, the Conservation Reserve Program, has 1.5 million acres enrolled.

### *To what extent is the tax preference providing unintended benefits to entities other than those the Legislature intended?*

No unintended beneficiaries are apparent.

## Revenue and Economic Impacts

### *What are the past and future tax revenue and economic impacts of the tax preference to the taxpayer and to the government if it is continued?*

Farmers purchased $864 million in feed and seeds in 2007. As shown in Exhibit 37, the taxpayer savings resulting from not applying the retail sales tax to farm purchases of feed, seed, and seedlings is $70 million per year. Of this amount, $56 million is in state sales taxes, and $13 million is in local sales taxes.

Exhibit 37 – Taxpayer Savings from the Retail Sales Tax Exemption for Sales of Feed, Seed and Seedlings to Farmers (Dollars in Millions)

| Year | State Sales Tax | Local Sales Tax | Total |
|---|---|---|---|
| 2006 | $53 | $12 | $65 |
| 2007 | $56 | $13 | $69 |
| 2008 | $57 | $13 | $70 |
| 2009 | $57 | $13 | $70 |
| 2010 | $59 | $13 | $72 |
| 2011 | $59 | $13 | $72 |

Source: JLARC analysis based on U.S. Census of Agriculture data.

Note: Figures for 2009 to 2011 are estimates.

The economic impact of these taxpayer savings is likely increased income to farmers and their employees. Farmers are generally "price-takers" – they are relatively small and cannot dictate the price at which they can sell their products. The retail sales tax would be an added cost of production that these farmers could not pass forward onto consumers. Therefore the tax would be passed back onto the factors of production or the profits of the owners. The likely result is less income to the farmer or their employees.

Exhibit 38 shows farm proprietors' income in Washington has varied from $126 million to $540 million per year over the past several years. Farm wages have been about $1 billion per year. The total "value added" by agriculture in Washington in 2006 was $3.3 billion.[42]

Exhibit 38 – Washington Farm Proprietor's Income and Wages (Dollars in Millions)

| Year | Farm Proprietor's Income | Farm Wages |
|---|---|---|
| 2004 | $540 | $985 |
| 2005 | $229 | $1,154 |
| 2006 | $126 | $1,094 |
| 2007 | $492 | $1,047 |

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

Farms owned by individuals, families, or family-held corporations purchased over three-fourths of feed and seed purchases in 2007, and thus, over three-fourths of the taxpayer savings went directly to individuals, families, or family-held corporations. If the tax preference were to be terminated,

[42] "Value added" is the difference between the value of firm's gross output and the cost of inputs purchased from another firm. It consists primarily of labor income, profits, and taxes.

what would be the negative effects on the taxpayers who currently benefit from the tax preference and the extent to which the resulting higher taxes would have an effect on employment and the economy?

If the retail sales tax exemption for feed, seed, and seedlings sold to farmers were to be terminated, farmers would need to pay sales tax on about $900 million in purchases each year, or about $70 million in state and local taxes. Since about 42 percent, or $29 million, of this amount would come from individual or family-owned farms. Depending on the year, it could range from 5 to 23 percent of farm proprietor's income.

### *If the tax preference were to be terminated, what would be the effect on the distribution of liability for payment of state taxes?*

If the sales tax exemption were terminated, farmers would pay sales tax on purchases of seed and feed. It is unlikely the tax could be passed on to consumers because farmers are "price takers" and are unable to dictate the price at which they can sell their products.

## Other States

### *Do other states have a similar tax preference and what potential public policy benefits might be gained by incorporating a corresponding provision in Washington?*

There are 45 states and the District of Columbia that impose a sales tax. Of these, 44 exempt feed and seed from the sales tax. Feed and seed are taxable in Hawaii and the District of Columbia.

## Recommendation

**The Legislature should continue the retail sales tax exemption for the sale of feed, seed and seedlings to farmers. The exemption is achieving the objectives of 1) taxing final consumption under the retail sales tax, and 2) encouraging persons to participate in conservation and habitat protection programs.**

**Legislation Required:** No.

**Fiscal Impact:** None – No change from status quo.

# GENERAL AVIATION AIRCRAFT EXEMPTION FROM PROPERTY TAXES – SUMMARY

## Current Law

Under Washington law, aircraft generally are subject to either the property tax or the aircraft excise tax, depending on the type of aircraft. The tax preference discussed in this review is for general aviation aircraft that pay the aircraft excise tax but are exempt from the personal property tax.[43] "General aviation aircraft" refers to all aircraft except those owned by the government or by commercial airlines.

See pages A3-15 through A3-17 in Appendix 3 for the current statutes, RCW 82.48.030, RCW 82.48.100, and RCW 82.48.110.

## Legal History and Public Policy Objectives

| | |
|---|---|
| Pre-1949 | General aviation aircraft were subject to personal property taxes. |
| 1949 | The Legislature imposed the aircraft excise tax on the privilege of using an aircraft in the state. The legislation included exemptions from the tax for certain types of aircraft: 1) aircraft involved in commercial flying; 2) aircraft owned by nonresidents or being held for sale or exchange; and 3) aircraft owned by the manufacturer while being operated for test or experimental purposes or for crew training. Most other general aviation aircraft are subject to aircraft excise tax. The bill further provided that those aircraft paying the aircraft excise tax are exempt from the property tax. The current exemption language has remained essentially the same as it was originally passed 60 years ago. |

The public policy objective for this preference is to avoid double taxation. When the Legislature replaced the property tax on certain aircraft with a new aircraft excise tax in 1949, the aircraft subject to the new tax became exempt from the property tax. The Legislature replaced one tax with another, and the justification for the exemption from the old tax was to avoid double taxation.

## Beneficiaries

The beneficiaries of the property tax exemption for general aviation aircraft subject to the aircraft excise tax are the owners of these aircraft that register with the Department of Transportation. There were 5,933 such aircraft in 2008 valued at $1.1 billion. Based on data from the Federal Aviation Administration, about 75 percent of the aircraft are owned by individuals, and about 23 percent are owned by corporations. The remaining aircraft are owned by partnerships of some form – individuals, clubs, or businesses.

[43] See also JLARC tax preference reviews of commercial aircraft (2009 Expedited Report, page 43) and nonresident aircraft and aircraft held for sale (2009 Expedited Report, page 49).

## Revenue and Economic Impacts

- In Fiscal Year 2008, owners of general aviation aircraft paid $300,000 in aircraft excise taxes.
- Without the exemption from the property tax, the owners of aircraft currently paying the aircraft excise tax would have paid personal property tax of about $11.1 million on aircraft in Fiscal Year 2008.
- Taxpayer savings are estimated at $10.8 million in Fiscal Year 2008.
- The net result of this tax preference is that owners of aircraft pay less in property taxes, while owners of other property pay more in property taxes. The overall impact on the state's economy is likely to be negligible, however, as owners of aircraft have additional money to spend on general consumption while other property owners have less.

## Other States

Like Washington, many states distinguish between commercial and general aviation by taxing commercial aircraft under the personal property tax and applying a separate fee or tax to general aviation aircraft. Almost every state that applies a separate tax or fee to general aviation aircraft also exempts these aircraft from the personal property tax. It appears that a purpose for the exemption in other states is to avoid double taxation because alternative taxes apply to the aircraft being exempted from the property tax.

## Recommendation

**The Legislature should continue the property tax exemption for aircraft subject to the aircraft excise tax. The tax preference is achieving the objective of avoiding double taxation.**

| | |
|---|---|
| **Legislation Required:** | No. |
| **Fiscal Impact:** | None – No change from the status quo. |

# GENERAL AVIATION AIRCRAFT EXEMPTION FROM PROPERTY TAXES – REPORT DETAIL

## Current Law

Under Washington law, aircraft generally are subject to either the property tax or the aircraft excise tax, depending on the type of aircraft. The tax preference discussed in this review is for general aviation aircraft that pay the aircraft excise tax but are exempt from the personal property tax.[44] "General aviation aircraft" refers to all aircraft except those owned by the government or by commercial airlines and includes both private and business aircraft used for recreation, flight training, air ambulance, commercial scenic flights, or crop dusting. General aviation does not include aircraft used in interstate or foreign commerce or aircraft owned by manufacturers for testing or training purposes.

See pages A3-15 through A3-17 in Appendix 3 for the current statutes, RCW 82.48.030, RCW 82.48.100, and RCW 82.48.110.

Exhibit 39 provides a summary of the tax status of aircraft in Washington. It shows the aircraft excise tax works in concert with the property tax. As a general rule, aircraft subject to the aircraft excise tax are exempt from the personal property tax, and aircraft that are exempt from the aircraft excise tax are subject to the personal property tax. Aircraft subject to the aircraft excise tax also must be registered in Washington which requires payment of the retail sales or use tax on the aircraft.

Exhibit 39 – Tax Status of Aircraft in Washington

| Type of Aircraft | Property Tax | Aircraft Excise Tax |
|---|---|---|
| General Aviation Aircraft | Exempt | Taxable |
| Commercial Aircraft Used in Interstate or Foreign Commerce | Taxable | Exempt |
| Military Aircraft | Exempt | Exempt |

Source: RCW 82.48.030, 82.48.100, 82.48.110.

The aircraft excise tax consists of an annual fee based on the type of aircraft:

- Single engine, fixed wing $50
- Small multi-engine, fixed wing $65
- Large multi-engine, fixed wing $80
- Turboprop multi-engine, fixed wing $100
- Turbojet multi-engine, fixed wing $125
- Helicopters $75
- Sailplanes, lighter-than-air, home-built $20

[44] See also JLARC tax preference reviews of commercial aircraft (2009 Expedited Report, page 43) and nonresident aircraft and aircraft held for sale (2009 Expedited Report, page 49).

## Legal History

| | |
|---|---|
| Pre-1949 | General aviation aircraft were subject to personal property taxes. |
| 1949 | The Legislature imposed the aircraft excise tax on the privilege of using an aircraft in the state. The legislation included exemptions from the tax for certain types of aircraft: 1) aircraft involved in commercial flying; 2) aircraft owned by nonresidents or being held for sale or exchange; and 3) aircraft owned by the manufacturer while being operated for test or experimental purposes or for crew training. Most other general aviation aircraft are subject to the aircraft excise tax. The bill further provided that those aircraft paying the aircraft excise tax are exempt from the property tax. |

The current exemption language has remained essentially the same as it was originally passed 60 years ago.

## Public Policy Objectives

### *What are the public policy objectives that provide a justification for the tax preference? Is there any documentation on the purpose or intent of the tax preference?*

The public policy objective for this preference is to avoid double taxation. The Legislature replaced the property tax on certain aircraft with a new aircraft excise tax in 1949. Aircraft subject to the new aircraft excise tax became exempt from the property tax. The Legislature replaced one tax with another, and the justification for the exemption from the old tax is to avoid double taxation.

The Legislature modeled the 1949 aircraft excise tax after the motor vehicle excise tax. Revenues from the one percent excise tax on the value of aircraft were to be deposited in the "Motor Vehicle Excise Fund." The distribution from the fund was as follows:

80 percent – State School Equalization Fund;
15 percent – Cities and towns; and
5 percent – State General Fund.

In 1948, the average statewide property tax levy rate in Washington was the equivalent of $12.22 per $1,000 of assessed valuation (1.222 percent). This rate was similar to the one percent tax aircraft excise tax. The proceeds from the tax were distributed 4.6 percent to the state, 24 percent to counties, 21 percent to cities, 37 percent to local school districts, and 12 percent to other taxing districts.

The net effect of creating the aircraft excise tax in 1949 was to slightly reduce the total taxes on certain aircraft and increase revenues to the State School Equalization Fund. As a result, some local taxing districts either lost revenues (those districts that were at the maximum levy rate under the 40 mill limit) or shifted property taxes onto other taxpayers via higher levy rates for those districts, such as school districts, that had voter-approved levies.

Since 1949, the form of the tax has been changed from 1 percent of value to a fixed fee based on the type of aircraft.

### *What evidence exists to show that the tax preference has contributed to the achievement of any of these public policy objectives?*

The public policy objective of avoiding double taxation by imposing one tax, either the aircraft excise tax or the property tax, is achieved by exempting these general aircraft subject to the aircraft excise tax from the property tax.

### *To what extent will continuation of the tax preference contribute to these public policy objectives?*

Continuation of the tax exemption is required if the objective is to have aircraft subject to only one tax, either the aircraft excise tax or the property tax.

### *If the public policy objectives are not being fulfilled, what is the feasibility of modifying the tax preference for adjustment of the tax benefits?*

The public policy objective is being fulfilled.

## Beneficiaries

### *Who are the entities whose state tax liabilities are directly affected by the tax preference?*

The beneficiaries of the property tax exemption for general aviation aircraft subject to the aircraft excise tax are the owners of the aircraft that register with the Department of Transportation. In 2008, there were 5,933 such aircraft. (See Exhibit 40.) The estimated value of aircraft currently paying the aircraft excise tax is about $1.1 billion. Almost 60 percent of the value is in turbojets and 25 percent of the value is in single-engine piston planes.

Exhibit 40 – Aircraft Registration, 2008

| Aircraft Type | Count |
|---|---:|
| Single engine, fixed wing | 4,514 |
| Small multi-engine, fixed wing | 252 |
| Large multi-engine, fixed wing | 8 |
| Turboprop multi-engine, fixed wing | 49 |
| Turbojet multi-engine, fixed wing | 122 |
| Helicopters | 205 |
| Home-built | 640 |
| Sailplanes | 110 |
| Lighter-than-air | 33 |
| **Total** | **5,933** |

Source: Department of Transportation.

Based on Federal Aviation Administration data, about 75 percent of the aircraft are owned by individuals and 23 percent owned by corporations. The remaining aircraft are owned by partnerships of some form – individuals, clubs, or business.

### *To what extent is the tax preference providing unintended benefits to entities other than those the Legislature intended?*

No unintended beneficiaries are apparent.

## Revenue and Economic Impacts

### *What are the past and future tax revenue and economic impacts of the tax preference to the taxpayer and to the government if it is continued?*

In Fiscal Year 2008, state and local property taxes based on the value of aircraft in Washington would amount to $11.1 million per year. Rather than paying the property tax, aircraft owners pay about $300,000 per year in aircraft excise tax. Taxpayers save the difference between the property tax and the aircraft excise tax or about $10.8 million. (See Exhibit 41.)

The state general fund receives 90 percent of the tax proceeds. The Aeronautics Account receives 10 percent of the excise tax proceeds. Overall, this is not a significant tax source.

The property tax savings are not necessarily a tax loss to the state and local governments. To the extent that property tax levies are not at the statutory maximum rates, the reduction in tax collections from owners of general aviation aircraft is shifted to other taxpayers. However, some local governments are at their maximum levy rates, and the loss of tax base is a loss in tax revenues.

Exhibit 41 – Aircraft Owner Savings Due to Exemption from Property Tax (Dollars in Millions)

| Fiscal Year | State Property Taxes | Local Property Taxes | Total Property Taxes | Aircraft Excise Taxes | Tax Savings |
|---|---|---|---|---|---|
| 2006 | $2.6 | $9.8 | $12.4 | $0.3 | $12.2 |
| 2007 | $2.4 | $9.2 | $11.6 | $0.3 | $11.3 |
| 2008 | $2.2 | $8.9 | $11.1 | $0.3 | $10.8 |
| 2009 | $2.2 | $9.0 | $11.2 | $0.3 | $11.0 |
| 2010 | $2.2 | $9.1 | $11.4 | $0.3 | $11.1 |
| 2011 | $2.2 | $9.1 | $11.3 | $0.3 | $11.1 |

Source: Transportation Revenue Forecast Council, Washington State Department of Revenue.

Note: Tax savings equal property taxes minus aircraft excise taxes. Figures for fiscal years 2009 to 2011 are estimates.

The net result of this tax preference is that owners of aircraft pay less in property taxes, while owners of other property pay more in property taxes. The overall impact on the state's economy is likely to be negligible if the tax preference is continued as owners of aircraft have additional money to spend on general consumption, while other property owners have less.

### *If the tax preference were to be terminated, what would be the negative effects on the taxpayers who currently benefit from the tax preference and the extent to which the resulting higher taxes would have an effect on employment and the economy?*

If the property tax exemption for general aviation aircraft is subject to the aircraft excise tax were to be terminated, owners of these aircraft would need to list the property with the county assessor. Listing of personal property with the county assessor is something that all businesses in the state currently do. Corporations own 23 percent of the general aviation aircraft. Individual households do not report personal property to the county assessor. In this case the county assessor would need to locate the aircraft to list them. If this were accomplished, owners of aircraft would pay about another $11.1 million annually in property taxes. As there may be a corresponding decrease in property taxes paid by other businesses and households, the net effect on the economy would be negligible.

### *If the tax preference were to be terminated, what would be the effect on the distribution of liability for payment of state taxes?*

If the property tax exemption on general aviation aircraft were to be terminated, general aviation aircraft owners would pay more in taxes, and other taxpayers would pay less.

## Other States

### *Do other states have a similar tax preference and what potential public policy benefits might be gained by incorporating a corresponding provision in Washington?*

Like Washington, many states distinguish between commercial and general aviation by taxing commercial aircraft under the personal property tax and applying a separate fee or tax to general aviation aircraft. Almost every state that applies a separate tax or fee to general aviation aircraft also exempts these aircraft from the personal property tax. It appears that a purpose for the exemption in other states is to avoid double taxation because alternative taxes apply to the aircraft being exempted from the property tax.

Fees vary by state but are generally based on some combination of weight, age, or type of aircraft. A few states impose a tax based on the value of the aircraft.

Exhibit 42 – Most States Avoid Double Taxation of General Aviation

| State | Subject to Property Tax | Registration, License Fee, or Alternate Tax Applies | State | Subject to Property Tax | Registration, License Fee, or Alternate Tax Applies |
|---|---|---|---|---|---|
| Alabama | ✓ | | Montana | | ✓ |
| Alaska | ✓ | | Nebraska | ✓ | |
| Arizona | | ✓ | Nevada | ✓ | |
| Arkansas | ✓ | | New Hampshire | | ✓ |
| California | ✓ | | New Jersey | | |
| Colorado | | | New Mexico | | ✓ |
| Connecticut | | ✓ | New York | | |
| Delaware | | | North Carolina | ✓ | |
| Florida | | | North Dakota | | ✓ |
| Georgia | ✓ | | Ohio | | ✓ |
| Hawaii | | ✓ | Oklahoma | | ✓ |
| Idaho | | ✓ | Oregon | | ✓ |
| Illinois | | ✓ | Pennsylvania | | |
| Indiana | | ✓ | Rhode Island | | ✓ |
| Iowa | | ✓ | South Carolina | ✓ | |
| Kansas | ✓ | | South Dakota | | ✓ |
| Kentucky | ✓ | | Tennessee | ✓ | |
| Louisiana | ✓ | | Texas | ✓ | |
| Maine | | ✓ | Utah | | ✓ |
| Maryland | | | Vermont | | |
| Massachusetts | | ✓ | Virginia | ✓ | ✓ |
| Michigan | | ✓ | Washington | | ✓ |
| Minnesota | | ✓ | West Virginia | ✓ | |
| Mississippi | | ✓ | Wisconsin | | ✓ |
| Missouri | ✓ | | Wyoming | ✓ | |

Source: State Taxes on Aircraft, Conklin & de Decker Associates, 2009; Commerce Clearing House.

## Recommendation

**The Legislature should continue the property tax exemption for aircraft subject to the aircraft excise tax. The tax preference is achieving the objective of avoiding double taxation.**

| | |
|---|---|
| **Legislation Required:** | No. |
| **Fiscal Impact:** | None – No change from the status quo. |

# APPENDIX 1 – SCOPE AND OBJECTIVES

## 2009 Full Tax Preference Performance Reviews

**SCOPE AND OBJECTIVES**

***REVISED***

APRIL 2009

STATE OF WASHINGTON

JOINT LEGISLATIVE AUDIT AND REVIEW COMMITTEE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### Why a JLARC Study of Tax Preferences?

Engrossed House Bill 1069 (2006) established the Citizen Commission for Performance Measurement of Tax Preferences and directed it to develop a schedule for periodic review of the state's tax preferences. The bill also directed the Joint Legislative Audit and Review Committee (JLARC) to conduct the periodic reviews.

### Background

Tax preferences are exemptions, exclusions, or deductions from the base of a state tax; a credit against a state tax; a deferral of a state tax; or a preferential state tax rate. The state has more than 580 tax preferences.

Recognizing the need to assess the effectiveness of these tax preferences in meeting their intended objectives, and an orderly process to do so, the Legislature established the Citizen Commission for Performance Measurement of Tax Preferences. The role of the commission is to develop a schedule for the performance review of all tax preferences at least once every ten years. The ten year schedule is to be revised annually.

Omitted from review are several categories of tax preferences identified by statute (e.g., tax preferences required by constitutional law). Any tax preference that the commission determines is a critical part of the structure of the tax system may also be omitted.

The commission has identified three categories of review, based on each tax preference's estimated biennial fiscal impact:

1. Full reviews (over $10 million)
2. Expedited reviews (between $2 million and $10 million)
3. Expedited light reviews ($2 million or less)

However, at their discretion, the Commission may elect to subject a tax preference with a fiscal impact of $2 million or less to the expedited review process.

This document identifies the scope and objectives for the first category: full tax preference reviews. JLARC is to review tax preferences according to the schedule developed by the commission, and consistent with guidelines set forth in statute. For each tax preference JLARC is to provide recommendations to (1) continue, (2) modify, (3) add an expiration date and conduct another review prior to the expiration date, or (4) terminate the preference. JLARC may also recommend accountability standards for future reviews of tax preferences.

### Full Study Scope

This tax preference performance review will include the tax preferences identified by the Citizen Commission to be reviewed prior to August 30, 2009. These tax preferences were recommended by the Citizen Commission as being subject to full review:

| Brief Description | RCW Citation | Year Enacted |
|---|---|---|
| 1. Motor vehicle and special fuel | 82.08.0255(1d);82.12.0256(2)(d) | 1935 |
| 2. Joint utility services | 82.16.050(3) | 1935 |
| 3. Tuition fees | 82.04.4282(5); 82.04.4332 | 1935 |
| 4. Cash discounts | 82.04.4283; 82.16.050(4); 82.08.010 | 1935 |
| 5. Investments by nonfinancial firms | 82.04.4281 | 1935 |
| 6. Income of employees | 82.04.360 | 1935 |
| 7. Motor fuel taxes | 82.04.4285 | 1935 |
| 8. Newspapers | 82.08.0253; 82.12.0345 | 1935 |
| 9. Casual sales | 82.08.0251 | 1935 |
| 10. Janitorial services | 82.04.050(2)(d) | 1935 |
| 11. Feed and seed | 82.04.050(9) | 1935 |
| 12. General Aviation | 82.48.110 | 1949 |

## Full Study Objectives

In response to the legislative directive, the study will answer, for each tax preference, the following questions (unless the commission determines that the tax preference review should be conducted as an expedited review):

### Public Policy Objectives:

1. What are the public policy objectives that provide a justification for the tax preference? Is there any documentation on the purpose or intent of the tax preference? (RCW 43.136.055(b))
2. What evidence exists to show that the tax preference has contributed to the achievement of any of these public policy objectives? (RCW 43.136.055(c))
3. To what extent will continuation of the tax preference contribute to these public policy objectives? (RCW 43.136.055(d))
4. If the public policy objectives are not being fulfilled, what is the feasibility of modifying the tax preference for adjustment of the tax benefits? (RCW 43.136.055(g))

### Beneficiaries:

5. Who are the entities whose state tax liabilities are directly affected by the tax preference? (RCW 43.136.055(a))
6. To what extent is the tax preference providing unintended benefits to entities other than those the legislature intended? (RCW 43.136.055(e))

### Revenue and Economic Impacts:

7. What are the past and future tax revenue and economic impacts of the tax preference to the taxpayer and to the government if it is continued? (This includes an analysis of the general effects of the tax preference on the overall state economy, including the effects on consumption and expenditures of persons and businesses within the state.) (RCW 43.136.055(h))
8. If the tax preference were to be terminated, what would be the negative effects on the taxpayers who currently benefit from the tax preference and the extent to which the resulting higher taxes would have an effect on employment and the economy? (RCW 43.136.055(f))
9. If the tax preference were to be terminated, what would be the effect on the distribution of liability for payment of state taxes? (RCW 43.136.055(i))

### Other States:

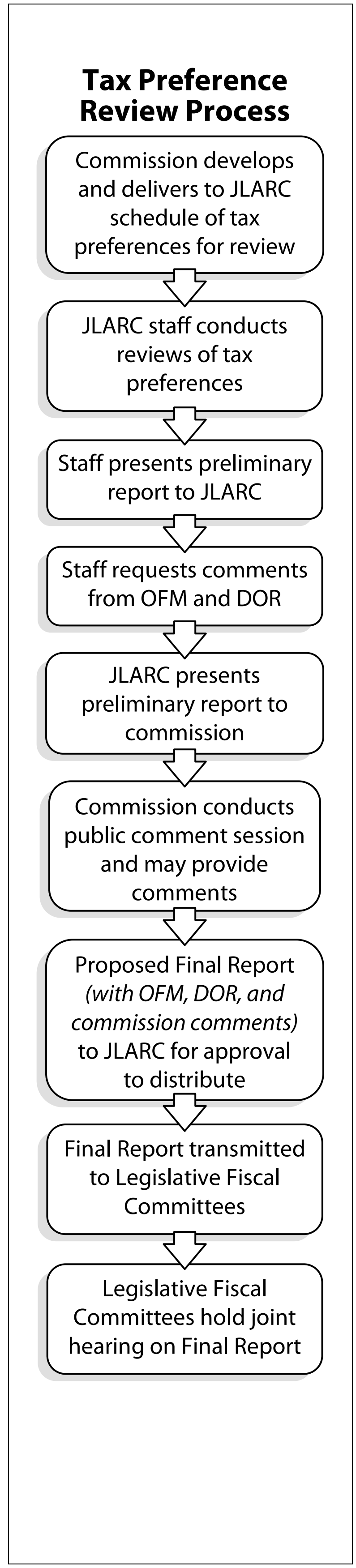
10. Do other states have a similar tax preference and what potential public policy benefits might be gained by incorporating a corresponding provision in Washington? (RCW 43.136.055(j))

## Timeframe for the Study

A preliminary audit report will be presented at the July 2009 JLARC meeting and at the August 2009 meeting of the commission. A final report will be presented to JLARC in November 2009.

## JLARC Staff Contacts for the Study

| | | |
|---|---|---|
| Mary Welsh | (360) 786-5193 | welsh.mary@leg.wa.gov |
| Gary Benson | (360) 786-5618 | benson.gary@leg.wa.gov |
| Stacia Hollar | (360) 786-5191 | hollar.stacia@leg.wa.gov |
| David Dean | (360) 786-5293 | dean.david@leg.wa.gov |



# APPENDIX 2 – AGENCY RESPONSES

- Citizen Commission for Performance Measurement of Tax Preferences
- Department of Revenue
- Department of Transportation
- Office of Financial Management
- Office of the Insurance Commissioner

State of Washington

E-mail: hennessy.lisa@leg.wa.gov
**www.citizentaxpref.wa.gov**

# Citizen Commission for Performance Measurement of Tax Preferences

**William A. Longbrake**, *Commission Chair*

**Lily Kahng**, *Vice Chair*
Associate Professor
Seattle University Law School

**James Bobst**
Human Resource Manager
Pacific Fibre Products

**Stephen Miller**
Member
Washington Education Association

**Paul Guppy**
Vice President for Research
Washington Policy Center

**Non-voting Members:**

**Brian Sonntag**
State Auditor

**Representative Troy Kelley**
Chair, Joint Legislative Audit and Review Committee

October 30, 2009

Members of the Legislature:

Enclosed are recommendations to the Legislature resulting from the comprehensive review of 75 state tax preferences. These reviews have highlighted many important performance and policy issues that should be considered by the Legislature. As Chair of the Citizens Commission for Performance Measurement of Tax Preferences, I urge you to take action on the issues identified in these reviews.

At your direction, the Joint Legislative Audit and Review Committee (JLARC) has been conducting reviews of tax preferences since 2007. These reviews are being undertaken over a ten year period to determine if the preferences are meeting their intended policy purposes. In addition to JLARC's work, the Commission has heard public testimony on these reviews, and we have adopted our own comments on the preferences and JLARC recommendations. Both JLARC's recommendations and our comments are summarized in a single document we are distributing to you.

My fellow Commissioners and I would be glad to discuss our work with any of you. If you have specific questions about any of the reviews themselves, feel free to contact Ruta Fanning, Legislative Auditor (360-786-5175 or fanning.ruta@leg.wa.gov).

Sincerely,

William A. Longbrake

William A. Longbrake, Chair

c: Lily Kahng, Commission Vice Chair
James Bobst, Commission Member
Paul Guppy, Commission Member
Rep. Troy Kelley, Commission Member
Stephen Miller, Commission Member
Brian Sonntag, State Auditor, Commission Member
Ruta Fanning, Legislative Auditor
Cindy Evans, Assistant Attorney General

STATE OF WASHINGTON

DEPARTMENT OF REVENUE

OFFICE OF THE DIRECTOR

*P.O. Box 47454 • Olympia, Washington 98504-7454 • (360) 753-5574 • FAX (360) 586-5543*

August 13, 2009

**TO:** Ruta Fanning, Legislative Auditor
Joint Legislative Audit and Review Committee

**FROM:** Cindi Holmstrom, Director
Department of Revenue

**SUBJECT:** **JLARC PRELIMINARY REPORTS ON 2009 TAX PREFERENCE PERFORMANCE REVIEWS (FULL AND EXPEDITED)**

Thank you for the opportunity to review and comment on the Joint Legislative Audit and Review Committee's (JLARC's) preliminary 2009 Tax Preference Performance Reviews.

We appreciate JLARC's efforts and those of the Citizens Commission for Performance Measurement of Tax Preferences (Commission) to identify current tax preference legislation for further review by the Legislature. Informed discussion about the original intent and assumptions underlying current tax preferences, and legislative debate about their continuing effectiveness and relevance can help state government maintain a fair and equitable tax system.

We would like to compliment your team for the thorough and thoughtful analysis of the tax preference items selected for JLARC review. Following are a few comments on parts of the report relating to the Department of Revenue.

**Recommendation to Update Administrative Rule on Newspapers – Full Review**

The JLARC report recommends that the Department should update its administrative rule for newspapers to reflect current law because the rule uses a content-based definition for newspapers. I am pleased to inform you that the Department does plan to move forward with rule making to amend WAC 458-20-143 (Publishers of newspapers, magazines, periodicals). Updating the definition of "newspaper" will be one of the changes. The subject of this rule was also affected by 2009 legislation (ESHB 2075 & EHB 2122). Formal rule making action is anticipated to begin before the end of this year.

**Patient Lifting Devices B&O Tax Credit – Expedited Review**

The JLARC report recommends that the patient lifting device B&O tax credit be allowed to expire. The Department has no position on this recommendation. We note that the preliminary report also states that the Department of Revenue's position is that the $10 million business and

*

Ruta Fanning, Legislative Auditor
August 13, 2009
Page 2

occupation (B&O) tax credit cap is a cap over the entire lifetime of the program. While we believe the Legislature originally intended this to be a lifetime cap, the statute clearly establishes it as an annual cap.

I would like to clarify that the Department has taken no official position in contradiction to the statute; however, as a practical matter we believe it will have no real impact whether it is an annual cap or a lifetime cap. Based on the amount of credit actually taken up to this time, it appears unlikely that $10 million in credit will be claimed before the scheduled expiration date of December 30, 2010.

Again, we appreciate your effort to continuously review and analyze the state's numerous tax preferences. We also appreciate the opportunity to review the reports and recommendations in order to offer our comments.

**Washington State Department of Transportation**
**Paula J. Hammond, P.E.**
Secretary of Transportation

**Transportation Building**
310 Maple Park Avenue S.E.
P.O. Box 47300
Olympia, WA 98504-7300

360-705-7000
TTY: 1-800-833-6388
www.wsdot.wa.gov

August 21, 2009

Ms. Ruta Fanning,
Legislative Auditor
Joint Legislative Audit and Review Committee
1300 Quince St SE
Olympia, WA 98504-0910

Dear Ms. Fanning:

Thank you for the opportunity to review and comment on the Joint Legislative Audit and Review Committee's (JLARC) preliminary reports on the 2009 Expedited Tax Preference Performance Reviews and 2009 Full Tax Preference Performance Review.

We appreciate the opportunity to respond to Expedited Tax Preference Performance Reviews titled: *Commercial Aircraft Exemption from Aircraft Excise Tax* and *Nonresident Aircraft and Aircraft Held for Sale Exemption from Excise Tax* and the Full Tax Preferences Performance Review titled: *General Aviation Aircraft Exemption from Property Taxes*. The Department reviewed the reports and found the information to be accurate. In addition, the Washington State Department of Transportation (WSDOT) supports the recommendations for the tax preferences.

Thank you for your effort to continuously review and analyze the state's structure of tax preferences.

Sincerely,

Stephan T. Reinmuth
Chief of Staff

STR:JAD

cc: Paula Hammond, WSDOT
Bill Ford, WSDOT
John Sibold, WSDOT
Dillon Auyoung, WSDOT
Lloyd Brown, WSDOT
Lizbeth Martin-Mahar, WSDOT
Steve McKerney, WSDOT
Robin Rettew, OFM
Keenan Konopaski, JLARC
David Dean, JLARC

STATE OF WASHINGTON
OFFICE OF FINANCIAL MANAGEMENT
*Insurance Building, PO Box 43113 • Olympia, Washington 98504-3113 • (360) 902-0555*

August 24, 2009

**TO:** Ruta Fanning, Legislative Auditor
Joint Legislative Audit and Review Committee

**FROM:** Victor A. Moore
Director

**SUBJECT: JLARC PRELIMINARY REPORTS ON 2009 TAX PREFERENCE PERFORMANCE REVIEW**

Thank you for the opportunity to review and comment on the Joint Legislative Audit and Review Committee's (JLARC's) two preliminary reports on Tax Preference Performance Reviews: the 2009 Full Tax Preference Performance Reviews, and 2009 Expedited Tax Preference Performance Reviews.

The technical review of the materials by the Office of Financial Management (OFM) staff did not turn up any substantive errors. Some minor suggested changes were directly communicated to JLARC staff and need not be catalogued here. At this time, OFM has no position on any of the recommendations for the tax preferences reviewed.

We thank JLARC and the Citizens Commission for Performance Measurement of Tax Preferences (Commission) for your work to identify current tax preference legislation for further review by the Legislature.

Please continue to consult with the Office of Financial Management as well as other agencies that would be affected by possible changes to tax preference legislation.

MIKE KREIDLER
STATE INSURANCE COMMISSIONER

STATE OF WASHINGTON

Phone: (360) 725-7000

OFFICE OF
**INSURANCE COMMISSIONER**

August 21, 2009

Ruta Fanning
Legislative Auditor
Joint Legislative Audit & Review Committee
P.O. Box 40910
Olympia, WA 98504

Re: 2009 Annual Reports on Tax Preference Reviews - Preliminary Reports

Dear Ms. Fanning,

Please accept this letter as the formal response of the Office of the Insurance Commissioner (OIC) to the findings in the 2009 Expedited Tax Preference Performance Reviews, which was presented to Joint Legislative Audit & Review Committee (JLARC) on July 23, 2009.

The OIC is responding to the findings in the report on insurance premium tax preferences for fraternal benefit societies and ocean marine insurance. The report recommends that the legislature reexamine or clarify the intent of these tax preferences. We accept that recommendation and commend your staff on the thoroughness of their work.

Thank you for the opportunity to respond to the 2009 Expedited Tax Preference Performance Reviews. Please do not hesitate to contact me if you have any questions.

Sincerely,

Mary Clogston

Mary Clogston
Deputy Commissioner for Policy and Legislative Affairs
(360) 725-7037

Mailing Address: P.O. Box 40258 • Olympia, WA 98504-0258
Street Address: Insurance Building • 302 14th Avenue SW • Olympia, WA 98504

# APPENDIX 3 – CURRENT LAW

## Motor Vehicle and Special Fuel Exemptions from Sales and Use Taxes

### *RCW 82.08.0255(1)(d)*

(1) The tax levied by RCW 82.08.020 shall not apply to sales of motor vehicle and special fuel if:

(d) The fuel is taxable under chapter 82.36 or 82.38 RCW.

[2007 c 223 § 9; 2005 c 443 § 5; 1998 c 176 § 4. Prior: 1983 1st ex.s. c 35 § 2; 1983 c 108 § 1; 1980 c 147 § 1; 1980 c 37 § 23. Formerly RCW 82.08.030(5).]

### *RCW 82.12.0256(2)(d)*

The provisions of this chapter shall not apply in respect to the use of:

(2) Motor vehicle and special fuel if:

(d) The fuel is taxable under chapter 82.36 or 82.38 RCW: PROVIDED, That the use of motor vehicle and special fuel upon which a refund of the applicable fuel tax is obtained shall not be exempt under this subsection (2)(d), and the director of licensing shall deduct from the amount of such tax to be refunded the amount of tax due under this chapter and remit the same each month to the department of revenue.

[2007 c 223 § 10; 2005 c 443 § 6; 1998 c 176 § 5. Prior: 1983 1st ex.s. c 35 § 3; 1983 c 108 § 2; 1980 c 147 § 2; 1980 c 37 § 56. Formerly RCW 82.12.030(6).]

## Joint Utility Services Deduction from Public Utility Tax

### *RCW 82.16.050(3)*

In computing tax there may be deducted from the gross income the following items:

(3) Amounts actually paid by a taxpayer to another person taxable under this chapter as the latter's portion of the consideration due for services furnished jointly by both, if the total amount has been credited to and appears in the gross income reported for tax by the former;

[2007 c 330 § 1; 2006 c 336 § 1; 2004 c 153 § 308; 2000 c 245 § 1; 1994 c 124 § 12; 1989 c 302 § 103; 1987 c 207 § 1; 1982 2nd ex.s. c 9 § 3; 1977 ex.s. c 368 § 1; 1967 ex.s. c 149 § 25; 1965 ex.s. c 173 § 22; 1961 c 15 §82.16.050 . Prior: 1959 ex.s. c 3 § 18; 1949 c 228 § 11; 1937 c 227 § 12; 1935 c 180 § 40; Rem. Supp. 1949 § 8370-40.]

## Tuition and Fees Deductions from B&O Tax

### *RCW 82.04.170*

"Tuition fee" includes library, laboratory, health service and other special fees, and amounts charged for room and board by an educational institution when the property or service for which such charges are made is furnished exclusively to the students or faculty of such institution. "Educational institution," as used in this section, means only those institutions created or generally accredited as such by the state and includes educational programs that such educational institution cosponsors with a nonprofit organization, as defined by the internal revenue code Sec. 501(c)(3), if such educational institution grants college credit for coursework successfully completed through the educational program, or an approved branch campus of a foreign degree-granting institution in compliance with chapter 28B.90 RCW, and in accordance with RCW 82.04.4332 or defined as a degree-granting institution under RCW 28B.85.010(3) and accredited by an accrediting association recognized by the United States secretary of education, and offering to students an educational program of a general academic nature or those institutions which are not operated for profit and which are privately endowed under a deed of trust to offer instruction in trade, industry, and agriculture, but not including specialty schools, business colleges, other trade schools, or similar institutions.

[1993 sp.s. c 18 § 37; 1993 c 181 § 13; 1992 c 206 § 1; 1985 c 135 § 1; 1961 c 15 § 82.04.170. Prior: 1955 c 389 § 18; prior: 1949 c 228 § 2, part; 1945 c 249 § 1, part; 1943 c 156 § 2, part; 1941 c 178 § 2, part; 1939 c 225 § 2, part; 1937 c 227 § 2, part; 1935 c 180 § 5, part; Rem. Supp. 1949 § 8370-5, part.]

## *RCW 82.04.4282(5)*

The Legislature amended RCW 82.04.4282 in 2009 in ESHB 2705, Section 410 as follows:

RCW 82.04.4282 and 1994 c 124 s 3 are each amended to read as follows:

In computing tax there may be deducted from the measure of tax amounts derived from bona fide (1) initiation fees, (2) dues, (3) contributions, (4) donations, (5) tuition fees, (6) charges made by a nonprofit trade or professional organization for attending or occupying space at a trade show, convention, or educational seminar sponsored by the nonprofit trade or professional organization, which trade show, convention, or educational seminar is not open to the general public (7) charges made for operation of privately operated kindergartens, and (8) endowment funds. This section may not be construed to exempt any person, association, or society from tax liability upon selling tangible personal property, digital goods, digital codes, or digital automated services, or upon providing facilities or other services for which a special charge is made to members or others. If dues are in exchange for any significant amount of goods or services rendered by the recipient thereof to members without any additional charge to the member, or if the dues are graduated upon the amount of goods or services rendered, the value of such goods or services shall not be considered as a deduction under this section.

[1994 c 124 § 3; 1989 c 392 § 1; 1980 c 37 § 3. Formerly RCW 82.04.430(2).]

## *RCW 82.04.4332*

An approved branch campus of a foreign degree-granting institution in compliance with chapter 28B.90 RCW is considered an educational institution for the purpose of the deduction of tuition fees provided by RCW 82.04.170 in those instances where it is recognized as an organization exempt from income taxes pursuant to 26 U.S.C. Sec. 501(c).

[1993 c 181 § 10.]

# Cash Discounts Deduction from B&O, Sales and Use, and Public Utility Taxes

### *RCW 82.04.4283*

In computing tax there may be deducted from the measure of tax the amount of cash discount actually taken by the purchaser. This deduction is not allowed in arriving at the taxable amount under the extractive or manufacturing classifications with respect to articles produced or manufactured, the reported values of which, for the purposes of this tax, have been computed according to the provisions of RCW 82.04.450.

[1980 c 37 § 4. Formerly RCW 82.04.430(3).]

### *RCW 82.08.010(1)(b)*

"Selling price" or "sales price" does not include: Discounts, including cash, term, or coupons that are not reimbursed by a third party that are allowed by a seller and taken by a purchaser on a sale; interest, financing, and carrying charges from credit extended on the sale of tangible personal property, extended warranties, digital goods, digital codes, digital automated services, or other services, if the amount is separately stated on the invoice, bill of sale, or similar document given to the purchaser; and any taxes legally imposed directly on the consumer that are separately stated on the invoice, bill of sale, or similar document given to the purchaser;

[2007 c 6 § 1302; (2007 c 6 § 1301 expired July 1, 2008); 2006 c 301 § 2; 2005 c 514 § 110; 2004 c 153 § 406; 2003 c 168 § 101; 1985 c 38 § 3; 1985 c 2 § 2 (Initiative Measure No. 464, approved November 6, 1984); 1983 1st ex.s. c 55 § 1; 1967 ex.s. c 149 § 18; 1963 c 244 § 1; 1961 c 15 § 82.08.010. Prior: (i) 1945 c 249 § 4; 1943 c 156 § 6; 1941 c 178 § 8; 1939 c 225 § 7; 1935 c 180 § 17; Rem. Supp. 1945 § 8370-17. (ii) 1935 c 180 § 20; RRS § 8370-20.]

### *RCW 82.16.050(4)*

In computing tax there may be deducted from the gross income the following items:

(4) The amount of cash discount actually taken by the purchaser or customer;

[2007 c 330 § 1; 2006 c 336 § 1; 2004 c 153 § 308; 2000 c 245 § 1; 1994 c 124 § 12; 1989 c 302 § 103; 1987 c 207 § 1; 1982 2nd ex.s. c 9 § 3; 1977 ex.s. c 368 § 1; 1967 ex.s. c 149 § 25; 1965 ex.s. c 173 § 22; 1961 c 15 §82.16.050 . Prior: 1959 ex.s. c 3 § 18; 1949 c 228 § 11; 1937 c 227 § 12; 1935 c 180 § 40; Rem. Supp. 1949 § 8370-40.]

# Investments of Nonfinancial Firms Deduction from B&O Tax

### *RCW 82.04.4281*

(1) In computing tax there may be deducted from the measure of tax:

(a) Amounts derived from investments;

(b) Amounts derived as dividends or distributions from the capital account by a parent from its subsidiary entities; and(c) Amounts derived from interest on loans between subsidiary entities and a parent entity or between subsidiaries of a common parent entity, but only if the total investment and loan income is less than five percent of gross receipts of the business annually.

(2) The following are not deductible under subsection (1)(a) of this section:

(a) Amounts received from loans, except as provided in subsection (1)(c) of this section, or the extension of credit to another, revolving credit arrangements, installment sales, the acceptance of payment over time for goods or services, or any of the foregoing that have been transferred by the originator of the same to an affiliate of the transferor; or

(b) Amounts received by a banking, lending, or security business.

(3) The definitions in this subsection apply only to this section.

(a) "Banking business" means a person engaging in business as a national or state-chartered bank, a mutual savings bank, a savings and loan association, a trust company, an alien bank, a foreign bank, a credit union, a stock savings bank, or a similar entity that is chartered under Title 30, 31, 32, or 33 RCW, or organized under Title 12 U.S.C.

(b) "Lending business" means a person engaged in the business of making secured or unsecured loans of money, or extending credit, and (i) more than one-half of the person's gross income is earned from such activities and (ii) more than one-half of the person's total expenditures are incurred in support of such activities.

(c) The terms "loan" and "extension of credit" do not include ownership of or trading in publicly traded debt instruments, or substantially equivalent instruments offered in a private placement.

(d) "Security business" means a person, other than an issuer, who is engaged in the business of effecting transactions in securities as a broker, dealer, or broker-dealer, as those terms are defined in the securities act of Washington, chapter 21.20 RCW, or the federal securities act of 1933. "Security business" does not include any company excluded from the definition of broker or dealer under the federal investment company act of 1940 or any entity that is not an investment company by reason of sections 3(c)(1) and 3(c)(3) through 3(c)(14) thereof.

[2007 c 54 § 9; 2002 c 150 § 2; 1980 c 37 § 2. Formerly RCW 82.04.430(1).]

## Income of Employees Exemption from B&O Tax

### *RCW 82.04.360*

(1) This chapter shall not apply to any person in respect to his or her employment in the capacity of an employee or servant as distinguished from that of an independent contractor. For the purposes of this section, the definition of employee shall include those persons that are defined in section 3121(d)(3)(B) of the Internal Revenue Code of 1986, as amended through January 1, 1991.

(2) A booth renter, as defined by *RCW 18.16.020, is an independent contractor for purposes of this chapter.

[1991 c 324 § 19; 1991 c 275 § 2; 1961 c 15 § 82.04.360. Prior: 1959 c 197 § 20; prior: 1945 c 249, § 2, part; 1943 c 156 § 4, part; 1941 c 178 § 6, part; 1939 c 225 § 5, part; 1937 c 227 § 4, part; 1935 c 180 § 11, part; Rem. Supp. 1945 § 8370-11, part.]

# Motor Fuel B&O Tax Deduction

### *RCW 82.04.4285*

In computing tax there may be deducted from the measure of tax so much of the sale price of motor vehicle fuel as constitutes the amount of tax imposed by the state under chapters 82.36 and 82.38 RCW or the United States government, under 26 U.S.C., Subtitle D, chapters 31 and 32, upon the sale thereof.

[1998 c 176 § 3; 1980 c 37 § 6. Formerly RCW 82.04.430(5).]

# Newspaper Exemptions from Sales and Use Taxes

### *RCW 82.08.0253*

The Legislature amended RCW 82.08.0253 in 2009 in ESHB 2705, Section 506 as follows:

**Sec. 506.** RCW 82.08.0253 and 1980 c 37 s 21 are each amended to read as follows:

(1) The tax levied by RCW 82.08.020 does not apply to:

(a) The distribution and newsstand sale of printed newspapers; and

(b) The sale of newspapers transferred electronically, provided that the electronic version of a printed newspaper:

(i) Shares content with the printed newspaper; and

(ii) Is prominently identified by the same name as the printed newspaper or otherwise conspicuously indicates that it is a complement to the printed newspaper.

(2) For purposes of this section, "printed newspaper" means a publication issued regularly at stated intervals at least twice a month and printed on newsprint in tabloid or broadsheet format folded loosely together without stapling, glue, or any other binding of any kind, including any supplement of a printed newspaper.

[1980 c 37 § 21. Formerly RCW 82.08.030(3).]

### *RCW 82.12.0345*

The Legislature amended RCW 82.12.0345 in 2009 in ESHB 2705, Section 618 as follows:

**Sec. 618.** RCW 82.12.0345 and 1994 c 124 s 11 are each amended to read as follows:
The tax imposed by RCW 82.12.020 ((shall)) does not apply in respect to the use of:

(1) Printed newspapers as defined in RCW 82.08.0253; and

(2) Newspapers transferred electronically, provided that the electronic version of a printed newspaper:

(a) Shares content with the printed newspaper; and

(b) Is prominently identified by the same name as the printed newspaper or otherwise conspicuously indicates that it is a complement to the printed newspaper.

[1994 c 124 § 11.]

## Casual Sales Exemption from Retail Sales Tax

### *RCW 82.08.0251*

The tax levied by RCW 82.08.020 shall not apply to casual and isolated sales of property or service, unless made by a person who is engaged in a business activity taxable under chapters 82.04 or 82.16 RCW: PROVIDED, That the exemption provided by this section shall not be construed as providing any exemption from the tax imposed by chapter 82.12 RCW.

[1980 c 37 § 19. Formerly RCW 82.08.030(1).]

## Janitorial Services Exemptions from Sales and Use Taxes

### *RCW 82.04.050(2)(d)*

The Legislature amended RCW 82.04.050 in 2009 in ESHB 2705, Section 301 as follows:

**Sec. 301.** RCW 82.04.050 and 2007 c 54 s 4 and 2007 c 6 s 1004 are each reenacted and amended to read as follows:

1) "Sale at retail" or "retail sale" means every sale of tangible personal property (including articles produced, fabricated, or imprinted) to all persons irrespective of the nature of their business and including, among others, without limiting the scope hereof, persons who install, repair, clean, alter, improve, construct, or decorate real or personal property of or for consumers other than a sale to a person who presents a resale certificate under RCW 82.04.470 and who:

(a) Purchases for the purpose of resale as tangible personal property in the regular course of business without intervening use by such person, but a purchase for the purpose of resale by a regional transit authority under RCW 81.112.300 is not a sale for resale; or

(b) Installs, repairs, cleans, alters, imprints, improves, constructs, or decorates real or personal property of or for consumers, if such tangible personal property becomes an ingredient or component of such real or personal property without intervening use by such person; or

(c) Purchases for the purpose of consuming the property purchased in producing for sale a new article of tangible personal property or substance, of which such property becomes an ingredient or component or is a chemical used in processing, when the primary purpose of such chemical is to create a chemical reaction directly through contact with an ingredient of a new article being produced for sale; or

(d) Purchases for the purpose of consuming the property purchased in producing ferrosilicon which is subsequently used in producing magnesium for sale, if the primary purpose of such property is to create a chemical reaction directly through contact with an ingredient of ferrosilicon; or

(e) Purchases for the purpose of providing the property to consumers as part of competitive telephone service, as defined in RCW 14 82.04.065. The term shall include every sale of tangible personal property which is used or consumed or to be used or consumed in the performance of any activity classified as a "sale at retail" or "retail sale" even though such property is resold or utilized as provided in (a), (b), (c), (d), or (e) of this subsection following such use. The term also means every sale of tangible personal property to persons engaged in any business which is taxable under RCW 82.04.280(2) and (7), 82.04.290, and 82.04.2908; or

(f) Purchases for the purpose of satisfying the person's obligations under an extended warranty as defined in subsection (7) of this section, if such tangible personal property replaces or becomes an ingredient or component of property covered by the extended warranty without intervening use by such person.

(2) The term "sale at retail" or "retail sale" includes the sale of or charge made for tangible personal property consumed and/or for labor and services rendered in respect to the following:

(a) The installing, repairing, cleaning, altering, imprinting, or improving of tangible personal property of or for consumers, including charges made for the mere use of facilities in respect thereto, but excluding charges made for the use of self-service laundry facilities, and also excluding sales of laundry service to nonprofit health care facilities, and excluding services rendered in respect to live animals, birds and insects;

(b) The constructing, repairing, decorating, or improving of new or existing buildings or other structures under, upon, or above real property of or for consumers, including the installing or attaching of any article of tangible personal property therein or thereto, whether or not such personal property becomes a part of the realty by virtue of installation, and shall also include the sale of services or charges made for the clearing of land and the moving of earth excepting the mere leveling of land used in commercial farming or agriculture;

(c) The constructing, repairing, or improving of any structure upon, above, or under any real property owned by an owner who conveys the property by title, possession, or any other means to the person performing such construction, repair, or improvement for the purpose of performing such construction, repair, or improvement and the property is then reconveyed by title, possession, or any other means to the original owner;

(d) The cleaning, fumigating, razing, or moving of existing buildings or structures, but may not include the charge made for janitorial services; and for purposes of this section the term "janitorial services" shall mean those cleaning and caretaking services ordinarily performed by commercial janitor service businesses including, but not limited to, wall and window washing, floor cleaning and waxing, and the cleaning in place of rugs, drapes and upholstery. The term "janitorial services" does not include painting, papering, repairing, furnace or septic tank cleaning, snow removal or sandblasting;

(e) Automobile towing and similar automotive transportation services, but not in respect to those required to report and pay taxes under chapter 82.16 RCW;

(f) The furnishing of lodging and all other services by a hotel, rooming house, tourist court, motel, trailer camp, and the granting of any similar license to use real property, as distinguished from the renting or leasing of real property, and it is presumed that the occupancy of real property for a continuous period of one month or more constitutes a rental or lease of real property and not a mere license to use or enjoy the same. For the purposes of this subsection, it shall be presumed that the sale of and charge made for the furnishing of lodging for a continuous period of one month or more to a person is a rental or lease of real property and not a mere license to enjoy the same;

(g) The installing, repairing, altering, or improving of digital goods for consumers;

(h) Persons taxable under (a), (b), (c), (d), (e), (f), and (g) of this subsection when such sales or charges are for property, labor and services which are used or consumed in whole or in part by such persons in the performance of any activity defined as a "sale at retail" or "retail sale" even though such property, labor and services may be resold after such use or consumption. Nothing contained in this subsection shall be construed to modify subsection (1) of this section and nothing contained in subsection (1) of this section may be construed to modify this subsection.

(3) The term "sale at retail" or "retail sale" includes the sale of or charge made for personal, business, or professional services including amounts designated as interest, rents, fees, admission, and other service emoluments however designated, received by persons engaging in the following business activities:

(a) Amusement and recreation services including but not limited to golf, pool, billiards, skating, bowling, ski lifts and tows, day trips for sightseeing purposes, and others, when provided to consumers;

(b) Abstract, title insurance, and escrow services;

(c) Credit bureau services;

(d) Automobile parking and storage garage services;

(e) Landscape maintenance and horticultural services but excluding

(i) horticultural services provided to farmers and

(ii) pruning, trimming, repairing, removing, and clearing of trees and brush near electric transmission or distribution lines or equipment, if performed by or at the direction of an electric utility;

(f) Service charges associated with tickets to professional sporting events; and

(g) The following personal services: Physical fitness services, tanning salon services, tattoo parlor services, steam bath services, turkish bath services, escort services, and dating services.

(4)(a) The term also includes:

(i) The renting or leasing of tangible personal property to

37 consumers; and

(ii) Providing tangible personal property along with an operator for a fixed or indeterminate period of time. A consideration of this is that the operator is necessary for the tangible personal property to perform as designed. For the purpose of this subsection (4)(a)(ii), and operator must do more than maintain, inspect, or set up the tangible personal property.

(b) The term does not include the renting or leasing of tangible personal property where the lease or rental is for the purpose of sublease or subrent.

(5) The term also includes the providing of "competitive telephone service," "telecommunications service," or "ancillary services," as those terms are defined in RCW 82.04.065, to consumers.

(6)(a) The term also includes the sale of prewritten computer software other than a sale to a person who presents a resale certificate under RCW 82.04.470, regardless of the method of delivery to the end user. For purposes of this subsection (6)(a), the sale of prewritten computer software includes the sale of or charge made for a key or an enabling or activation code, where the key or code is required to activate prewritten computer software and put the software into use. There is no separate sale of the key or code from the prewritten computer software, regardless of how the sale may be characterized by the vendor or by the purchaser. The term "retail sale" does not include the sale of or charge made for:

(i) Custom software; or

(ii) The customization of prewritten computer software.

(b) The term also includes the charge made to consumers for the8 right to access and use prewritten computer software, where possession of the software is maintained by the seller or a third party, regardless of whether the charge for the service is on a per use, per user, per license, subscription, or some other basis.

(7) The term also includes the sale of or charge made for an extended warranty to a consumer. For purposes of this subsection, "extended warranty" means an agreement for a specified duration to perform the replacement or repair of tangible personal property at no additional charge or a reduced charge for tangible personal property, labor, or both, or to provide indemnification for the replacement or repair of tangible personal property, based on the occurrence of specified events. The term "extended warranty" does not include an agreement, otherwise meeting the definition of extended warranty in this subsection, if no separate charge is made for the agreement and the value of the agreement is included in the sales price of the tangible personal property covered by the agreement. For purposes of this subsection, "sales price" has the same meaning as in RCW7 82.08.010.

(8)(a) The term also includes the following sales to consumers of digital goods, digital codes, and digital automated services:

(i) Sales in which the seller has granted the purchaser the right of permanent use;

(ii) Sales in which the seller has granted the purchaser a right of use that is less than permanent;

(iii) Sales in which the purchaser is not obligated to make continued payment as a condition of the sale; and

(iv) Sales in which the purchaser is obligated to make continued payment as a condition of the sale.

(b) A retail sale of digital goods, digital codes, or digital automated services under this subsection (8) includes any services provided by the seller exclusively in connection with the digital goods, digital codes, or digital automated services, whether or not a separate charge is made for such services.

(c) For purposes of this subsection, "permanent" means perpetual or for an indefinite or unspecified length of time. A right of permanent use is presumed to have been granted unless the agreement between the seller and the purchaser specifies or the circumstances surrounding the transaction suggest or indicate that the right to use terminates on the occurrence of a condition subsequent.

(9) The term does not include the sale of or charge made for labor and services rendered in respect to the building, repairing, or improving of any street, place, road, highway, easement, right-of- way, mass public transportation terminal or parking facility, bridge, tunnel, or trestle which is owned by a municipal corporation or political subdivision of the state or by the United States and which is used or to be used primarily for foot or vehicular traffic including mass transportation vehicles of any kind.

(10) The term also does not include sales of chemical sprays or washes to persons for the purpose of postharvest treatment of fruit for the prevention of scald, fungus, mold, or decay, nor does it include sales of feed, seed, seedlings, fertilizer, agents for enhanced pollination including insects such as bees, and spray materials to: (a) Persons who participate in the federal conservation reserve program, the environmental quality incentives program, the wetlands reserve program, and the wildlife habitat incentives program, or their successors administered by the United States department of agriculture; (b) farmers for the purpose of producing for sale any agricultural product; and (c) farmers acting under cooperative habitat development or access contracts with an organization exempt from federal income tax under Title 26 U.S.C. Sec.2 501(c)(3) or the Washington state department of fish and wildlife to produce or improve wildlife habitat on land that the farmer owns or leases.

(11) The term does not include the sale of or charge made for labor and services rendered in respect to the constructing, repairing, decorating, or improving of new or existing buildings or other structures under, upon, or above real property of or for the United States, any instrumentality thereof, or a county or city0 housing authority created pursuant to chapter 35.82 RCW, including the installing, or attaching of any article of tangible personal property therein or thereto, whether or not such personal property becomes a part of the realty by virtue of installation. Nor does the term include the sale of services or charges made for the clearing of land and the moving of earth of or for the United States, any instrumentality thereof, or a county or city housing authority. Nor does the term include the sale of services or charges made for cleaning up for the United States, or its instrumentalities, radioactive waste and other byproducts of weapons production and 30 nuclear research and development.

(12) The term does not include the sale of or charge made for labor, services, or tangible personal property pursuant to agreements providing maintenance services for bus, rail, or rail fixed guideway equipment when a regional transit authority is the recipient of the labor, services, or tangible personal property, and a transit agency, as defined in RCW 81.104.015, performs the labor or services.

[2007 c 54 § 4; 2007 c 6 § 1004. Prior: 2005 c 515 § 2; 2005 c 514 § 101; prior: 2004 c 174 § 3; 2004 c 153 § 407; 2003 c 168 § 104; 2002 c 178 § 1; 2000 2nd sp.s. c 4 § 23; prior: 1998 c 332 § 2; 1998 c 315 § 1; 1998 c 308 § 1; 1998 c 275 § 1; 1997 c 127 § 1; prior: 1996 c 148 § 1; 1996 c 112 § 1; 1995 1st sp.s. c 12 § 2; 1995 c 39 § 2; 1993 sp.s. c 25 § 301; 1988 c 253 § 1; prior: 1987 c 285 § 1; 1987 c 23 § 2; 1986 c 231 § 1; 1983 2nd ex.s. c 3 § 25; 1981 c 144 § 3; 1975 1st ex.s. c 291 § 5; 1975 1st ex.s. c 90 § 1; 1973 1st ex.s. c 145 § 1; 1971 ex.s. c 299 § 3; 1971 ex.s. c 281 § 1; 1970 ex.s. c 8 § 1; prior: 1969 ex.s. c 262 § 30; 1969 ex.s. c 255 § 3; 1967 ex.s. c 149 § 4; 1965 ex.s. c 173 § 1; 1963 c 7 § 1; prior: 1961 ex.s. c 24 § 1; 1961 c 293 § 1; 1961 c 15 § 82.04.050; prior: 1959 ex.s. c 5 § 2; 1957 c 279 § 1; 1955 c 389 § 6; 1953 c 91 § 3; 1951 2nd ex.s. c 28 § 3; 1949 c 228 § 2, part; 1945 c 249 § 1, part; 1943 c 156 § 2, part; 1941 c 178 § 2, part; 1939 c 225 § 2, part; 1937 c 227 § 2, part; 1935 c 180 § 5, part; Rem. Supp. 1949 § 8370-5, part.]

# Feed and Seed Exemption from Retail Sales Tax

## *RCW 82.04.050(9)*

The Legislature amended RCW 82.04.050 in 2009 in ESHB 2705, Section 301 as follows:

**Sec. 301.** RCW 82.04.050 and 2007 c 54 s 4 and 2007 c 6 s 1004 are each reenacted and amended to read as follows:

(1) "Sale at retail" or "retail sale" means every sale of tangible personal property (including articles produced, fabricated, or imprinted) to all persons irrespective of the nature of their business and including, among others, without limiting the scope hereof, persons who install, repair, clean, alter, improve, construct, or decorate real or personal property of or for consumers other than a sale to a person who presents a resale certificate under RCW 82.04.470 and who:

(a) Purchases for the purpose of resale as tangible personal property in the regular course of business without intervening use by such person, but a purchase for the purpose of resale by a regional transit authority under RCW 81.112.300 is not a sale for resale; or

(b) Installs, repairs, cleans, alters, imprints, improves, constructs, or decorates real or personal property of or for consumers, if such tangible personal property becomes an ingredient or component of such real or personal property without intervening use by such person; or

(c) Purchases for the purpose of consuming the property purchased in producing for sale a new article of tangible personal property or substance, of which such property becomes an ingredient or component or is a chemical used in processing, when the primary purpose of such chemical is to create a chemical reaction directly through contact with an ingredient of a new article being produced for sale; or

(d) Purchases for the purpose of consuming the property purchased in producing ferrosilicon which is subsequently used in producing magnesium for sale, if the primary purpose of such property is to create a chemical reaction directly through contact with an ingredient of ferrosilicon; or

(e) Purchases for the purpose of providing the property to consumers as part of competitive telephone service, as defined in RCW 14 82.04.065. The term shall include every sale of tangible personal property which is used or consumed or to be used or consumed in the performance of any activity classified as a "sale at retail" or "retail sale" even though such property is resold or utilized as provided in (a), (b), (c), (d), or (e) of this subsection following such use. The term also means every sale of tangible personal property to persons engaged in any business which is taxable under RCW 82.04.280(2) and (7), 82.04.290, and 82.04.2908; or

(f) Purchases for the purpose of satisfying the person's obligations under an extended warranty as defined in subsection (7) of this section, if such tangible personal property replaces or becomes an ingredient or component of property covered by the extended warranty without intervening use by such person.

(2) The term "sale at retail" or "retail sale" includes the sale of or charge made for tangible personal property consumed and/or for labor and services rendered in respect to the following:

(a) The installing, repairing, cleaning, altering, imprinting, or improving of tangible personal property of or for consumers, including charges made for the mere use of facilities in respect thereto, but excluding charges made for the use of self-service laundry facilities, and also excluding sales of laundry service to nonprofit health care facilities, and excluding services rendered in respect to live animals, birds and insects;

(b) The constructing, repairing, decorating, or improving of new or existing buildings or other structures under, upon, or above real property of or for consumers, including the installing or attaching of any article of tangible personal property therein or thereto, whether or not such personal property becomes a part of the realty by virtue of installation, and shall also include the sale of services or charges made for the clearing of land and the moving of earth excepting the mere leveling of land used in commercial farming or agriculture;

(c) The constructing, repairing, or improving of any structure upon, above, or under any real property owned by an owner who conveys the property by title, possession, or any other means to the person performing such construction, repair, or improvement for the purpose of performing such construction, repair, or improvement and the property is then reconveyed by title, possession, or any other means to the original owner;

(d) The cleaning, fumigating, razing, or moving of existing buildings or structures, but may not include the charge made for janitorial services; and for purposes of this section the term "janitorial services" shall mean those cleaning and caretaking services ordinarily performed by commercial janitor service businesses including, but not limited to, wall and window washing, floor cleaning and waxing, and the cleaning in place of rugs, drapes and upholstery. The term "janitorial services" does not include painting, papering, repairing, furnace or septic tank cleaning, snow removal or sandblasting;

(e) Automobile towing and similar automotive transportation services, but not in respect to those required to report and pay taxes under chapter 82.16 RCW;

(f) The furnishing of lodging and all other services by a hotel, rooming house, tourist court, motel, trailer camp, and the granting of any similar license to use real property, as distinguished from the renting or leasing of real property, and it is presumed that the occupancy of real property for a continuous period of one month or more constitutes a rental or lease of real property and not a mere license to use or enjoy the same. For the purposes of this subsection, it shall be presumed that the sale of and charge made for the furnishing of lodging for a continuous period of one month or more to a person is a rental or lease of real property and not a mere license to enjoy the same;

(g) The installing, repairing, altering, or improving of digital goods for consumers;

(h) Persons taxable under (a), (b), (c), (d), (e), (f), and (g) of this subsection when such sales or charges are for property, labor and services which are used or consumed in whole or in part by such persons in the performance of any activity defined as a "sale at retail" or "retail sale" even though such property, labor and services may be resold after such use or consumption. Nothing contained in this subsection shall be construed to modify subsection (1) of this section and nothing contained in subsection (1) of this section may be construed to modify this subsection.

(3) The term "sale at retail" or "retail sale" includes the sale of or charge made for personal, business, or professional services including amounts designated as interest, rents, fees, admission,

and other service emoluments however designated, received by persons engaging in the following business activities:

(a) Amusement and recreation services including but not limited to golf, pool, billiards, skating, bowling, ski lifts and tows, day trips for sightseeing purposes, and others, when provided to consumers;

(b) Abstract, title insurance, and escrow services;

(c) Credit bureau services;

(d) Automobile parking and storage garage services;

(e) Landscape maintenance and horticultural services but excluding

(i) horticultural services provided to farmers and

(ii) pruning, trimming, repairing, removing, and clearing of trees and brush near electric transmission or distribution lines or equipment, if performed by or at the direction of an electric utility;

(f) Service charges associated with tickets to professional sporting events; and

(g) The following personal services: Physical fitness services, tanning salon services, tattoo parlor services, steam bath services, turkish bath services, escort services, and dating services.

(4)(a) The term also includes:

(i) The renting or leasing of tangible personal property to consumers; and

(ii) Providing tangible personal property along with an operator for a fixed or indeterminate period of time. A consideration of this is that the operator is necessary for the tangible personal property to perform as designed. For the purpose of this subsection (4)(a)(ii), and operator must do more than maintain, inspect, or set up the tangible personal property.

(b) The term does not include the renting or leasing of tangible personal property where the lease or rental is for the purpose of sublease or subrent.

(5) The term also includes the providing of "competitive telephone service," "telecommunications service," or "ancillary services," as those terms are defined in RCW 82.04.065, to consumers.

(6)(a) The term also includes the sale of prewritten computer software other than a sale to a person who presents a resale certificate under RCW 82.04.470, regardless of the method of delivery to the end user. For purposes of this subsection (6)(a), the sale of prewritten computer software includes the sale of or charge made for a key or an enabling or activation code, where the key or code is required to activate prewritten computer software and put the software into use. There is no separate sale of the key or code from the prewritten computer software, regardless of how the sale may be characterized by the vendor or by the purchaser. The term "retail sale" does not include the sale of or charge made for:

(i) Custom software; or

(ii) The customization of prewritten computer software.

(b) The term also includes the charge made to consumers for the8 right to access and use prewritten computer software, where possession of the software is maintained by the seller or a third party, regardless of whether the charge for the service is on a per use, per user, per license, subscription, or some other basis.

(7) The term also includes the sale of or charge made for an extended warranty to a consumer. For purposes of this subsection, "extended warranty" means an agreement for a specified duration to perform the replacement or repair of tangible personal property at no additional charge or a reduced charge for tangible personal property, labor, or both, or to provide indemnification for the replacement or repair of tangible personal property, based on the occurrence of specified events. The term "extended warranty" does not include an agreement, otherwise meeting the definition of extended warranty in this subsection, if no separate charge is made for the agreement and the value of the agreement is included in the sales price of the tangible personal property covered by the agreement. For purposes of this subsection, "sales price" has the same meaning as in RCW7 82.08.010.

(8)(a) The term also includes the following sales to consumers of digital goods, digital codes, and digital automated services:

(i) Sales in which the seller has granted the purchaser the right of permanent use;

(ii) Sales in which the seller has granted the purchaser a right of use that is less than permanent;

(iii) Sales in which the purchaser is not obligated to make continued payment as a condition of the sale; and

(iv) Sales in which the purchaser is obligated to make continued payment as a condition of the sale.

(b) A retail sale of digital goods, digital codes, or digital automated services under this subsection (8) includes any services provided by the seller exclusively in connection with the digital goods, digital codes, or digital automated services, whether or not a separate charge is made for such services.

(c) For purposes of this subsection, "permanent" means perpetual or for an indefinite or unspecified length of time. A right of permanent use is presumed to have been granted unless the agreement between the seller and the purchaser specifies or the circumstances surrounding the transaction suggest or indicate that the right to use terminates on the occurrence of a condition subsequent.

(9) The term does not include the sale of or charge made for labor and services rendered in respect to the building, repairing, or improving of any street, place, road, highway, easement, right-of- way, mass public transportation terminal or parking facility, bridge, tunnel, or trestle which is owned by a municipal corporation or political subdivision of the state or by the United States and which is used or to be used primarily for foot or vehicular traffic including mass transportation vehicles of any kind.

(10) The term also does not include sales of chemical sprays or washes to persons for the purpose of postharvest treatment of fruit for the prevention of scald, fungus, mold, or decay, nor

does it include sales of feed, seed, seedlings, fertilizer, agents for enhanced pollination including insects such as bees, and spray materials to:

(a) Persons who participate in the federal conservation reserve program, the environmental quality incentives program, the wetlands reserve program, and the wildlife habitat incentives program, or their successors administered by the United States department of agriculture;

(b) farmers for the purpose of producing for sale any agricultural product; and

(c) farmers acting under cooperative habitat development or access contracts with an organization exempt from federal income tax under Title 26 U.S.C. Sec.2 501(c)(3) or the Washington state department of fish and wildlife to produce or improve wildlife habitat on land that the farmer owns or leases.

(11) The term does not include the sale of or charge made for labor and services rendered in respect to the constructing, repairing, decorating, or improving of new or existing buildings or other structures under, upon, or above real property of or for the United States, any instrumentality thereof, or a county or city0 housing authority created pursuant to chapter 35.82 RCW, including the installing, or attaching of any article of tangible personal property therein or thereto, whether or not such personal property becomes a part of the realty by virtue of installation. Nor does the term include the sale of services or charges made for the clearing of land and the moving of earth of or for the United States, any instrumentality thereof, or a county or city housing authority. Nor does the term include the sale of services or charges made for cleaning up for the United States, or its instrumentalities, radioactive waste and other byproducts of weapons production and 30 nuclear research and development.

(12) The term does not include the sale of or charge made for labor, services, or tangible personal property pursuant to agreements providing maintenance services for bus, rail, or rail fixed guideway equipment when a regional transit authority is the recipient of the labor, services, or tangible personal property, and a transit agency, as defined in RCW 81.104.015, performs the labor or services.

[2007 c 54 § 4; 2007 c 6 § 1004. Prior: 2005 c 515 § 2; 2005 c 514 § 101; prior: 2004 c 174 § 3; 2004 c 153 § 407; 2003 c 168 § 104; 2002 c 178 § 1; 2000 2nd sp.s. c 4 § 23; prior: 1998 c 332 § 2; 1998 c 315 § 1; 1998 c 308 § 1; 1998 c 275 § 1; 1997 c 127 § 1; prior: 1996 c 148 § 1; 1996 c 112 § 1; 1995 1st sp.s. c 12 § 2; 1995 c 39 § 2; 1993 sp.s. c 25 § 301; 1988 c 253 § 1; prior: 1987 c 285 § 1; 1987 c 23 § 2; 1986 c 231 § 1; 1983 2nd ex.s. c 3 § 25; 1981 c 144 § 3; 1975 1st ex.s. c 291 § 5; 1975 1st ex.s. c 90 § 1; 1973 1st ex.s. c 145 § 1; 1971 ex.s. c 299 § 3; 1971 ex.s. c 281 § 1; 1970 ex.s. c 8 § 1; prior: 1969 ex.s. c 262 § 30; 1969 ex.s. c 255 § 3; 1967 ex.s. c 149 § 4; 1965 ex.s. c 173 § 1; 1963 c 7 § 1; prior: 1961 ex.s. c 24 § 1; 1961 c 293 § 1; 1961 c 15 § 82.04.050; prior: 1959 ex.s. c 5 § 2; 1957 c 279 § 1; 1955 c 389 § 6; 1953 c 91 § 3; 1951 2nd ex.s. c 28 § 3; 1949 c 228 § 2, part; 1945 c 249 § 1, part; 1943 c 156 § 2, part; 1941 c 178 § 2, part; 1939 c 225 § 2, part; 1937 c 227 § 2, part; 1935 c 180 § 5, part; Rem. Supp. 1949 § 8370-5, part.]

## General Aviation Aircraft Exemption from Property Taxes

### *RCW 82.48.110*

The first tax to be collected under this chapter shall be for the calendar year 1968. No aircraft with respect to which the excise tax imposed by this chapter is payable shall be listed and assessed for ad valorem taxation so long as this chapter remains in effect, and any such assessment heretofore made except under authority of section 13, chapter 49, Laws of 1949 and section 82.48.110, chapter 15, Laws of 1961 is hereby directed to be canceled: PROVIDED, That any aircraft, whether or not subject to the provisions of this chapter, with respect to which the excise tax imposed by this chapter will not be paid or has not been paid for any year shall be listed and assessed for ad valorem taxation in that year, and the ad valorem tax liability resulting from such listing and assessment shall be collected in the same manner as though this chapter had not been passed: PROVIDED FURTHER, That this chapter shall not be construed to affect any ad valorem tax based upon assessed valuations made in 1948 and/or any preceding year for taxes payable in 1949 or any preceding year, which ad valorem tax liability tax for any such years shall remain payable and collectible in the same manner as though this chapter had not been passed.

[1967 ex.s. c 9 § 6; 1961 c 15 § 82.48.110. Prior: 1949 c 49 § 13; Rem. Supp. 1949 § 11219-43.]

## *RCW 82.48.030*

(1) The amount of the tax imposed by this chapter for each calendar year shall be as follows:

| Type of aircraft | Registration fee |
|---|---|
| Single engine fixed wing | $ 50 |
| Small multi-engine fixed wing | 65 |
| Large multi-engine fixed wing | 80 |
| Turboprop multi-engine fixed wing | 100 |
| Turbojet multi-engine fixed wing | 125 |
| Helicopter | 75 |
| Sailplane | 20 |
| Lighter than air | 20 |
| Home built | 20 |

(2) The amount of tax imposed under subsection (1) of this section for each calendar year shall be divided into twelve parts corresponding to the months of the calendar year and the excise tax upon an aircraft registered for the first time in this state after the last day of any month shall only be levied for the remaining months of the calendar year including the month in which the aircraft is being registered: PROVIDED, That the minimum amount payable shall be three dollars.

An aircraft shall be deemed registered for the first time in this state when such aircraft was not previously registered by this state for the year immediately preceding the year in which application for registration is made.

[1983 2nd ex.s. c 3 § 22; 1967 ex.s. c 9 § 3; 1963 c 199 § 6; 1961 c 15 § 82.48.030. Prior: 1949 c 49 § 3; Rem. Supp. 1949 § 11219-35.]

## *RCW 82.48.100*

This chapter shall not apply to:

Aircraft owned by and used exclusively in the service of any government or any political subdivision thereof, including the government of the United States, any state, territory, or possession of the

United States, or the District of Columbia, which are not engaged in carrying persons or property for commercial purposes;

Aircraft registered under the laws of a foreign country;

Aircraft which are owned by a nonresident and registered in another state: PROVIDED, That if any such aircraft shall remain in and/or be based in this state for a period of ninety days or longer it shall not be exempt under this section;

Aircraft engaged principally in commercial flying which constitutes interstate or foreign commerce; and aircraft owned by the manufacturer thereof while being operated for test or experimental purposes, or for the purpose of training crews for purchasers of the aircraft;

Aircraft being held for sale, exchange, delivery, test, or demonstration purposes solely as stock in trade of an aircraft dealer licensed under Title 14 RCW;

Aircraft owned by a nonresident of this state if the aircraft is kept at an airport in this state and that airport is jointly owned or operated by a municipal corporation or other governmental entity of this state and a municipal corporation or other governmental entity of another state, and the owner or operator of the aircraft provides the department with proof that the owner or operator has paid all taxes, license fees, and registration fees required by the state in which the owner or operator resides.

[1999 c 302 § 3; 1965 ex.s. c 173 § 28; 1961 c 15 § 82.48.100. Prior: 1955 c 150 § 12; 1949 c 49 § 10; Rem. Supp. 1949 § 11219-42.]