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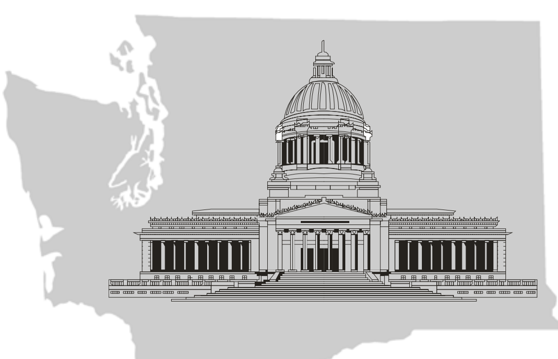

2008 Expedited Tax Preference Performance Reviews

Report 09-4

January 7, 2009

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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.

TABLE OF CONTENTS

REPORT SUMMARY 1
PUBLIC UTILITY TAX CREDIT LOSSES – SUMMARY 7
PUBLIC UTILITY TAX CREDIT LOSSES – REPORT DETAIL 9
PROCESSING HORTICULTURAL PRODUCTS – SUMMARY 17
PROCESSING HORTICULTURAL PRODUCTS – REPORT DETAIL 19
FRATERNAL INSURANCE – SUMMARY 27
FRATERNAL INSURANCE – REPORT DETAIL 29
IRRIGATION WATER – SUMMARY 37
IRRIGATION WATER – REPORT DETAIL 39
SALES FOR RESALE BY WATER AND GAS UTILITIES – SUMMARY 49
SALES FOR RESALE BY WATER AND GAS UTILITIES – REPORT DETAIL 51
RADIO AND TV BROADCASTING – SUMMARY 57
RADIO AND TV BROADCASTING – REPORT DETAIL 61
MINIMUM GROSS INCOME FILING THRESHOLD – SUMMARY 71
MINIMUM GROSS INCOME FILING THRESHOLD – REPORT DETAIL 73
PUBLIC UTILITY OPERATING PROPERTY – SUMMARY 81
PUBLIC UTILITY OPERATING PROPERTY – REPORT DETAIL 83
GAS TAX EXEMPTION FOR HANDLING LOSSES – SUMMARY 89
GAS TAX EXEMPTION FOR HANDLING LOSSES – REPORT DETAIL 93
AIRPORTS OWNED BY CITIES IN OTHER STATES – SUMMARY 107
AIRPORTS OWNED BY CITIES IN OTHER STATES – REPORT DETAIL 109
FARM AUCTION SALES – SUMMARY 113
FARM AUCTION SALES – REPORT DETAIL 115
WOOD BIOMASS FUEL: PRODUCTION FACILITIES/SALE/DISTRIBUTION – SUMMARY 123
WOOD BIOMASS FUEL: PRODUCTION FACILITIES/SALE/DISTRIBUTION – REPORT DETAIL 127
ALCOHOL/BIODIESEL FUEL PRODUCTION FACILITIES – SUMMARY 139
ALCOHOL/BIODIESEL FUEL PRODUCTION FACILITIES – REPORT DETAIL 141
APPENDIX 1: SCOPE AND OBJECTIVES 155
APPENDIX 2: TAX PREFERENCE COMMISSION AND AGENCY RESPONSES 157
APPENDIX 3: CURRENT LAW 169

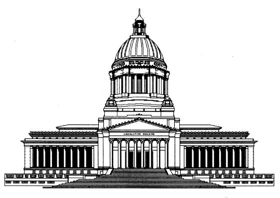
Committee Approval

On January 7, 2009, this report was approved for distribution by the Joint Legislative Audit and Review Committee.

2008 EXPEDITED TAX PREFERENCE PERFORMANCE REVIEWS

REPORT 09-4

JANUARY 7, 2009



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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 550 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.

Second, the legislation gives the Commission the option to schedule an expedited review for any tax preference that has an estimated biennial fiscal impact of $10 million or less. Expedited reviews incorporate a less detailed analysis than the full reviews of tax preferences.

In September 2007, the Commission adopted its second ten-year schedule for the tax preference reviews. The schedule for 2008 includes a total of 37 statutes containing tax preferences: eight property tax, five public utility tax, five retail sales tax, four use tax, 11 business and occupation tax, three fuel tax, and one leasehold excise tax. Of these 37 statutes, the law allowed 20 tax preferences to have an expedited review process.

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 20 tax preferences scheduled by the Commission for expedited review.

JLARC's Approach to the Tax Preference Reviews

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

- **Public Policy Objectives:**
  1. What are the public policy objectives that provide a justification for the tax preference? Is the purpose or intent of the tax preference clear?
  2. Is there any readily available evidence related to the achievement of any of these public policy objectives?
- **Beneficiaries:**
  3. Who are the entities whose state and/or local tax liabilities are directly affected by the tax preference?
- **Revenue and Economic Impacts:**
  4. What are the past and future tax revenue impacts of the tax preference to the taxpayer and to the government if it is continued?

Methodology

JLARC staff analyzed the following evidence in conducting these expedited 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; and 4) revenue impacts of the 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, and Board of Tax Appeals decisions relevant to each tax preference. Staff interviewed the agencies that administer the tax preferences (primarily the Department of Revenue and the Department of Licensing), as well as several county assessors. 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 exhibit on page 4 provides a summary of the recommendations from JLARC's analysis of the tax preferences scheduled for expedited review in 2008. Of the 20 tax preferences included in this volume, this report recommends that the Legislature continue seven tax preferences as they are, and continue seven other tax preferences by modifying their expiration dates. The expedited report raises issues for the Legislature's consideration for four of the current tax preferences. The report recommends terminating two tax preferences.

The exhibit on page 5 provides a summary of JLARC's recommendations for the expedited reviews completed last year in 2007. Given the fact that these tax preference reviews are part of an on-going examination of all state tax preferences in Washington, the 2007 recommendations for the expedited reviews are included in this 2008 expedited report.

Organization of This Report

This report includes 13 separate chapters for review of the 20 tax preferences. Each chapter consists of a review of one or more related tax preferences. There are four chapters (sales of public utility property, farm auction sales, biodiesel production/sales and wood biomass production/distribution) which contain an evaluation of multiple related tax preferences. The other nine chapters review a single tax preference.

Each chapter begins with a summary of the findings and recommendations from JLARC's analysis of the individual tax preferences. Then, each chapter provides additional detail, including additional information supporting the answers to the questions outlined in the approach. The current appendices in the preliminary report provide the Scope and Objectives and the text of current law for each preference.

Summary of Recommendations—2008 Expedited Tax Preference Reviews

Tax Preference	Year Enacted	RCW Citation	# of Claimants in 2007 ($ amount)	Summary of Recommendation
Public Utility Tax Credit Losses (p. 7)	1935	RCW 82.16.050(5)	170 ($2 million)	Legislature should continue the tax preference
Processing Horticultural Products (p. 17)	1935	RCW 82.04.4287	Unknown* ($1 million)	
Fraternal Insurance (p. 27)	1935	RCW 82.04.370	23 ($2 million)	
Sales for Resale by Water and Gas Utilities (p. 49)	1935	RCW 82.16.050(2)	81 ($2 million)	
Minimum Income Threshold (p. 71)	1935	RCW 82.16.040	Unknown* ($1.2 million)	
Public Utility Operating Property (p. 83)	1935	RCW 82.08.0256; RCW 82.12.0257	Unknown* ($244,000)	
Alcohol and Biodiesel Fuel Production (p. 143)	2003	RCW 82.04.260(1e); RCW 84.36.635; RCW 82.29A.135	See detailed report	Legislature should continue the tax preference and modify the expiration date
Wood Biomass Fuel: Production Facilities/ Sales / Distribution (p.127)	2003	RCW 82.08.960; RCW 84.36.640; RCW 82.29A.135; RCW 82.12.960; RCW 82.04.4335	0 ($0)	
Irrigation Water (p. 37)	1935	RCW 82.16.050(7)	Unknown* ($669,000)	Legislature should re-examine or clarify the intent of the tax preference**
Radio and TV Broadcasting (p. 57)	1935	RCW 82.04.280(6)	65 ($2 million)	
Farm Auction sales (p. 117)	1943	RCW 82.08.0257 RCW 82.12.0258	Unknown* ($2 million)	
Gas Tax Exemption for Handling Losses (p. 93)	1939	RCW 82.36.029	179 ($2.5 million)	Legislature should terminate the tax preference
Airports Owned by Cities in Other States (p. 111)	1941	RCW 84.36.130	0 ($0)	

*No specific data maintained and no annual reporting requirement for preference.

**See specific sections for detail on the issues recommended for the Legislature's consideration.

Summary of Recommendations—2007 Expedited Tax Preference Reviews

Tax Preference	Year Enacted	RCW Citation	# of Claimants in 2006 ($ amount)	Summary of Recommendation
Nonprofit Libraries	1854	RCW 84.36.040(1)(b)	10 ($36,000)	Legislature should continue the tax preference
Fire Companies	1890	RCW 84.36.060(1)(c)	1 ($5,500)	
Growing Crops	1890	RCW 84.40.030(3)	1,179 ($2.6 million)	
Humane Societies	1915	RCW 84.36.060(1)(d)	22 ($170,000)	
Collections and Museums	1915	RCW 84.36.060(1)(a)	145 ($3.1 million)	
Veterans Organizations	1929	RCW 84.36.030(4)	159 ($570,000)	
Nonprofit Youth Organizations	1933	RCW 84.36.030(3)	115 ($1.9 million)	
Contributions and Donations	1935	RCW 82.04.4282	Unknown ($56 million)	
Boxing and Wrestling Matches	1935	RCW 82.04.340	14 ($18,000)	
Lost or Destroyed Fuel	1923	RCW 82.36.370 RCW 82.38.180(4)-(6)	*	
Historic Auto Museums	2005	RCW 82.32.580	0 ($0)	
Nonprofit Nursing Homes	1891	RCW 84.36.040(1)(d)	42 ($2.8 million)	Legislature should re-examine or clarify the intent of the tax preference**
Membership Dues and Fees	1935	RCW 82.04.4282	218 ($2 million)	
Horse Racing	1933	RCW 82.04.350	5 ($2 million)	
Refunded Fuel Tax for Nonhighway Use	1923	RCW 82.36.280 RCW 82.38.180(1)	4,967 ($20.3 million)	
Orphanages	1891	RCW 84.36.040(1)(c)	2 ($138,000)	Legislature should terminate the tax preference and allow beneficiaries to qualify for another tax preference

*No specific data maintained; there are very few claims for refunds of lost or destroyed fuel in a given year, and the fiscal impact is in the hundreds or low thousands of dollars.

** See specific sections for detail on the issues recommended for the Legislature's consideration.

PUBLIC UTILITY TAX CREDIT LOSSES – SUMMARY

Current Law

The public utility tax is a state tax on the "act or privilege of engaging within this state" in any one or more specified utility or public service businesses. The base of the tax is the gross income derived from the operation of public and privately-owned utilities, including the general categories of transportation, and the supply of energy and water. Income from utility or public service operations is taxed under the public utility tax in lieu of the business and occupation tax. Other income of a utility or public service company (e.g., retail sales of tangible personal property) is subject to the business and occupation tax.

Under current law, these utility and public service businesses may deduct credit losses or bad debts from the public utility tax. Washington law connects to the federal Internal Revenue Code (26 U.S.C. Sec. 166), as of January 1, 2003, for the definition of "bad debt." See Appendix 3 for the current law statute RCW 82.16.050(5).

Findings and Recommendations

This review of the public utility tax deduction for credit losses or bad debt incurred by businesses has evaluated the legal history, public policy objectives, and revenue impacts. The audit determined the following:

Legal History and Public Policy Objectives

- The Legislature established this public utility tax deduction for credit losses in 1935. Originally, this tax preference was targeted at utility businesses that used an accrual accounting system. Those taxpayers with accrual accounting could claim this bad debt deduction.
- In 2004, the Legislature amended this deduction to link Washington's deduction to the federal Internal Revenue Code definition of "bad debt."

There are three public policy objectives associated with this tax deduction:

1. To define the public utility tax base as excluding bad debt for firms that employed the accrual accounting system;
2. To provide equitable tax treatment to all businesses subject to the public utility tax, regardless of the type of accounting system; and
3. To provide similar tax treatment as other excise taxes (business and occupation tax, retail sales and use tax) with the same type of preference for credit losses.

This tax preference has achieved its public policy objectives of defining the tax base, providing equitable tax treatment to all taxpayers subject to the public utility tax, and providing a similar type preference to all excise taxpayers.

Beneficiaries

- Between 2000 and 2006, on average 170 taxpayers claimed this deduction on their public utility tax.

Revenue Impacts

- Since 2004, the public utility taxpayer savings for credit losses has been approximately $2 million per year. The annual taxpayer savings is projected to be approximately the same over the next two biennia.

Recommendation

The Legislature should continue this public utility tax deduction for credit losses incurred by businesses.

Legislation Required: None.

Fiscal Impact: None.

PUBLIC UTILITY TAX CREDIT LOSSES – REPORT DETAIL

Statutory History

The Legislature enacted this public utility tax preference in 1935 as follows:

> *In computing tax there may be deducted from the gross operating revenue the following items:*
>
> *(e) The amount of credit losses actually sustained by taxpayers whose regular books of accounts are kept upon an accrual basis;*

Originally, this tax preference benefited utility and public service businesses that used accrual accounting. There has been only one major change to this tax preference since its enactment in 1935. In 2004, the Legislature linked the bad debt deduction to qualifying for the definition of "bad debt" in the federal Internal Revenue Code (IRC).[1] This tax preference is explicitly dependent on a utility company having bad debts that meet the federal IRC definition in place on January 1, 2003. The public utilities tax change in 2004 that connected state law to the federal definition of bad debt provided the same definition for bad debt in the retail sales tax and business and occupation tax preferences.

Other Relevant Background

Washington Public Utility Tax

The Legislature faced a revenue shortfall as it convened in January 1933. The prior November, the voters had passed Initiative Measure No. 64, a 40-mill property tax limit bill. The initiative limited property tax levies for state purposes to a maximum of five mills on a 50 percent valuation.[2] This measure effectively reduced the income from state taxes by approximately 50 percent, beginning with the second year of the 1933-35 Biennium. Assessed valuations and levies were already reduced due principally to the depressed economic conditions of the time. The Legislature also adopted in 1933 the Showalter Bill, a measure increasing, by about two-thirds, the state's obligation to support local school districts. The voters passed another initiative in 1932, Initiative Measure No. 69, imposing a state income tax on all corporations and individuals.

In response, the Legislature adopted a temporary business activities tax in 1933. The tax was to be in place from August 1, 1933 to July 31, 1935. The tax was measured by the application of

[1] Internal Revenue Code: Section 166 Bad Debts.

[2] In other terms, this is equivalent to a maximum levy rate of $2.50 per $1,000 of assessed value at 100 percent valuation.

rates against "value of products," "gross proceeds of sales," or "gross income of the business." The rates varied depending on the type of business activity.

The 1933 temporary business activities tax imposed taxes upon the privilege of engaging in business activities, including public service and utility activities. Generally, public service companies and utilities were subject to state regulation of rates or state supervision or control. Service needed to be rendered to all who requested the service, the "right to refuse to serve being dependent solely upon the limitations of capacity and obnoxious character of the person or property involved."[3] These public service and utility activities included light and power companies, telephone and telegraph companies, water companies (except irrigation companies), manufactured gas companies, steam railways, highway transportation companies, street railways, and other public service companies such as docks, warehouses, and ferries. Public service and utility activities were taxed at four basic rates ranging from 0.5 percent to 3.0 percent. In 1933, public service and utility companies subject to the business and activities tax were allowed a deduction from gross sales for credit losses and bad debts.

The revenue shortfall continued into 1935. The State Supreme Court found the graduated net personal and corporate income tax adopted by the voters in 1932 to be unconstitutional.[4] At the general election in 1934, voters again passed the 40-mill limit.[5] This 1934 initiative further reduced the state levy from five mills to two mills, exclusively for the institutions of higher education. The Legislature, meeting in 1935, faced the problems of replacing the revenue previously received from property taxes levied for the state general fund, as well as the state's obligations under the Showalter Act to support common schools, and payment for relief and welfare work. To raise the required revenue, the Legislature enacted the Revenue Act of 1935. The new act supplanted the temporary 1933 act and continued in general effect the business taxes imposed by it. The 1935 act also added several new consumer taxes, including a two percent retail sales tax and a complementary use tax.

The Revenue Act of 1935 consisted of twelve titles, with the business and occupation tax (Title II) clearly separated from the public utility tax (Title V). The tax base for the public utility tax is gross income from the operation of public and privately-owned utilities and public service companies. Utility and public service companies provide services in the areas of energy, water, communications, and transportation. The original legislation included four public utility tax rates:

- 3% of gross operating revenue
    - Railroads, water, light and power, telephone and telegraph
- 2% of gross operating revenue
    - Gas distribution

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[3] "Business Tax Instructions, Revised Rules and General Instructions," Tax Commission of the State of Washington, 1934.

[4] Culliton v. Chase, 174 Wash. 363 (1933).

[5] By passing the limit again after first adopting it two years prior, the voters restricted the Legislature's ability to amend the limit. Within two years of enactment, an initiative measure may only be amended by the Legislature with a two-thirds vote.

- 1.5% of gross operating revenue
    - Highway transportation and all other public service businesses subject to control by the state such as airplane transportation, ferry, water transportation, public warehouse, toll bridge, and wharf businesses
- 0.5% of gross operating revenue
    - Urban or interurban transportation and vessels under 65 feet in length operating upon Washington waters

The 1935 legislation also identified exemptions from the public utility tax, including several allowed in 1933 for the business and activities tax. Credit losses or bad debts were allowed as a deduction in both the temporary business and activities tax and the public utilities tax.[6] This was one of eight public utility tax exemptions enacted in 1935.[7]

The public utility tax applies only on sales to consumers. The tax is a state tax only. Currently, the companies in the business of distributing water pay the highest rate of 5.029 percent, and urban transportation and watercraft vessels under 65 feet pay the lowest rate of 0.642 percent. In recent years, public utility tax collections have grown from $203 million in 1997 to $340 million by 2006. The public utility tax is reported by about 5,000 firms annually. Approximately 110 electric companies account for more than 50 percent of the tax liability.

Exhibit 1 – History of the Public Utility Tax Collections: 1997 – 2006

Fiscal Year	Collections ($ 000)	% Change
1997	$203,178	1.7
1998	$211,783	4.2
1999	$221,397	4.5
2000	$246,383	11.3
2001	$267,624	8.6
2002	$274,581	2.6
2003	$269,821	-1.7
2004	$292,831	8.5
2005	$303,778	3.7
2006	$339,874	11.9

Source: 2007 Tax Reference Manual.

[6] "Biennial Report of the Tax Commission of the State of Washington," September 30, 1936.

[7] Eight public utility tax preferences in 1935: minimum monthly threshold of gross operating revenue, irrigation water, sales of commodities to other persons for resale purposes, payments to other persons taxable under public utility tax for service rendered jointly, taxes received by municipal utilities, sales and service to federal govt. and in interstate and foreign commerce, credit losses and cash discounts.

Cash Basis vs. Accrual Basis

This tax preference benefits public service and utility companies that use an accrual accounting system. Under general accounting principles, financial statements are prepared following one of two accounting methods: accrual or cash basis. The accrual method records revenue at the time of sale and expenses when they actually incur. The accrual basis of accounting assumes the business will receive revenues that may not have been received yet, such as installment payments or uncollectable revenue from bad debt. The cash basis accounting method only records revenues when they are actually received and expenses when the cash flows out for the business. The cash basis method reflects the timing of actual inflows and outflows of cash.[8]

Federal Law Definition for Bad Debt

When a business has accounts it cannot collect payment on, it has bad debt. Washington State statute uses the IRC definition for bad debt stated in 26 USC Sec.166. A business can claim bad debt only if it has first included it in business gross income. Bad debt can consist of both business and nonbusiness bad debt. Generally, bad debt of a business comes from operating a trade or business, and this debt can be deducted from federal business taxes.[9]

A business bad debt is a loss from a debt that was either:

- Created or acquired in a trade or business, or
- Closely related to a trade or business when it became partly or totally worthless.

A debt is closely related to a trade or business if the primary motive for incurring the debt is business-related. Bad debts of a corporation are always business bad debts. Business bad debts are usually the result of credit sales to customers. Goods that have been sold, but not yet paid for, and services that have been performed, but not yet paid for, are recorded in business books as either accounts receivable or notes receivable. After a reasonable period of time, the uncollectible part of the account is considered bad debt.

State statute links the definition of bad debt to the specific IRC as of January 1, 2003. If there are changes at the federal level in the definition of bad debt, then Washington will not incorporate those changes in this deduction. Businesses that employ accrual accounting practices can deduct the amount uncollectible in debt from the public utility tax in the current year. In subsequent years, businesses are required to add back any amount already deducted as credit losses on their excise tax returns. In the long-term, one would estimate the value of this tax preference to be close to $0 since most businesses will be able to collect on most of their accounts eventually.

[8] "Introduction to Finance," by Laurence J. Gitman and Jeff Madura 2001.

[9] IRS Publication 535 Business Expenses.

Public Policy Objectives

What are the public policy objectives that provide a justification for the tax preference?

There are three primary public policy objectives for this tax preference:

Tax Base: Tax base defining theory states that at the time Legislatures are developing a tax, they will define the elements that will be subject to the tax and the elements excluded.

Since this tax preference was enacted in 1935 at the same time as the public utility tax, one public policy objective of this tax preference was to define the tax base for the public utility tax as excluding credit losses.

Equal tax treatment among businesses: An objective of this tax preference was to compensate businesses that have an accrual accounting system from having to pay public utility tax on sales they could not collect on. Businesses that report on a cash basis are not required to report credit losses or bad debt in their gross revenue.

Equal tax treatment of credit losses among excise taxes: Another objective of this tax deduction was to provide all excise taxes (retail, business and occupation, and public utilities tax) with the same type of deduction. Both business and occupation taxes and public utility taxes have the credit losses deduction reported on the excise tax return. The retail sales and use tax has a credit or refund against current sales tax liability for bad debts.

Is the purpose or intent of the tax preference clear?

It is clear that the purpose of this tax preference is to exempt from the public utility tax the credit losses for public services and utility businesses that use an accrual accounting system. These are businesses that have already included their uncollectible bad debt in gross income. The statute does not have a specific statement of intent as to why credit losses are allowed to be deducted from gross income on both the public utility and business and occupation tax. Allowing credit losses to be deducted from gross income is a common tax deduction in defining most tax bases.

Is there any readily available evidence related to the achievement of any of these public policy objectives?

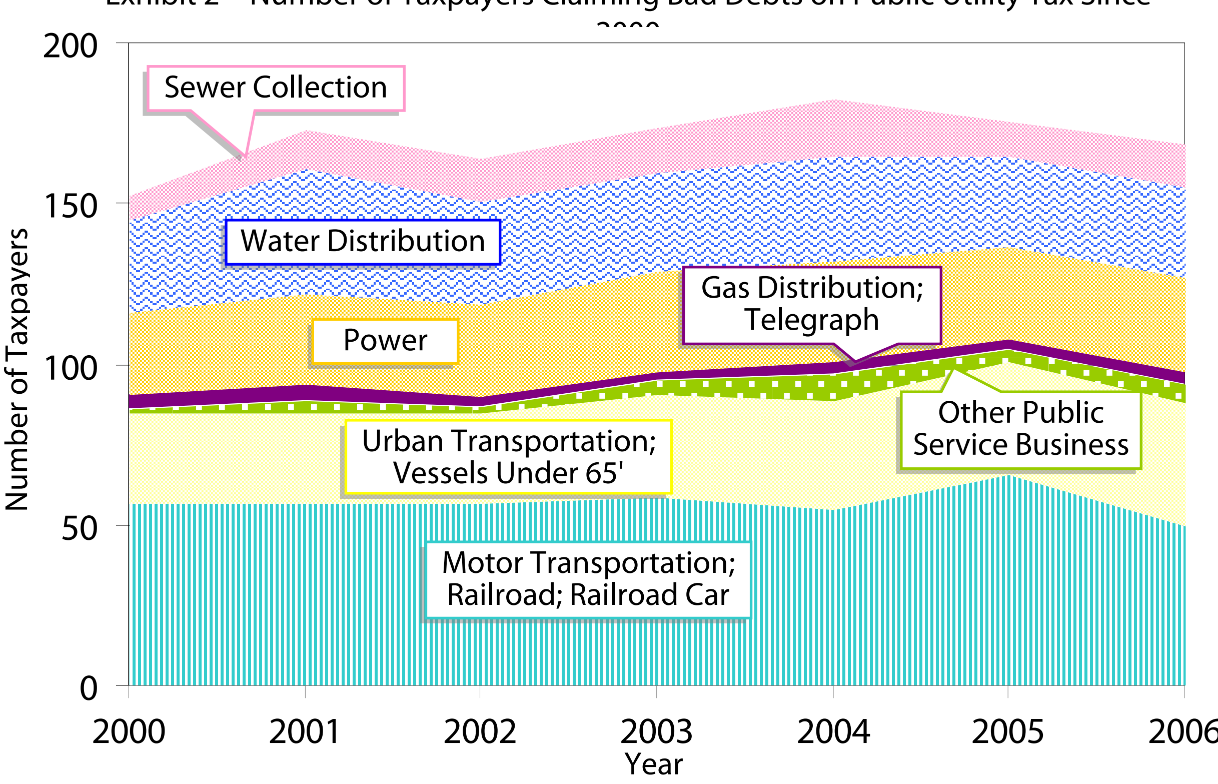
Since 1935, public service and utility businesses that worked on an accrual basis have not had to pay public utility tax on credit accounts that they could not collect on; therefore, this tax preference has met its objective of defining the public utility tax base. For 73 years, businesses have been able to exclude the income that could not be collected due to bad debt from the public utility tax. This tax preference has achieved the objective of providing similar tax treatment to all businesses. It has also achieved the objective of providing similar tax treatment of bad debt for all excise taxes in Washington.

Beneficiaries

Who are the entities whose state tax and/or local tax liabilities are directly affected by the tax preference?

Statistics on the number of beneficiaries for this tax preference comes from the state excise tax returns, as there is a specific line for the credit loss deduction on the excise tax return form. Between 2000 and 2006, on average 170 taxpayers claimed this deduction. The types of taxpayers claiming this bad debt deduction are as follows: water distribution, sewer collections, power, gas distribution, motor transportation, railroad, urban transportation of vessels under 65 feet, and other public service businesses. In 2006, the motor transportation taxpayers were the largest share of taxpayers claiming this deduction at 34 percent. The second largest industry was the water distribution businesses at 20 percent, and urban transportation made up the third largest share of all companies at 19 percent.

Exhibit 2 – Number of Taxpayers Claiming Bad Debts on Public Utility Tax Since 2000



Source: DOR excise tax return database.

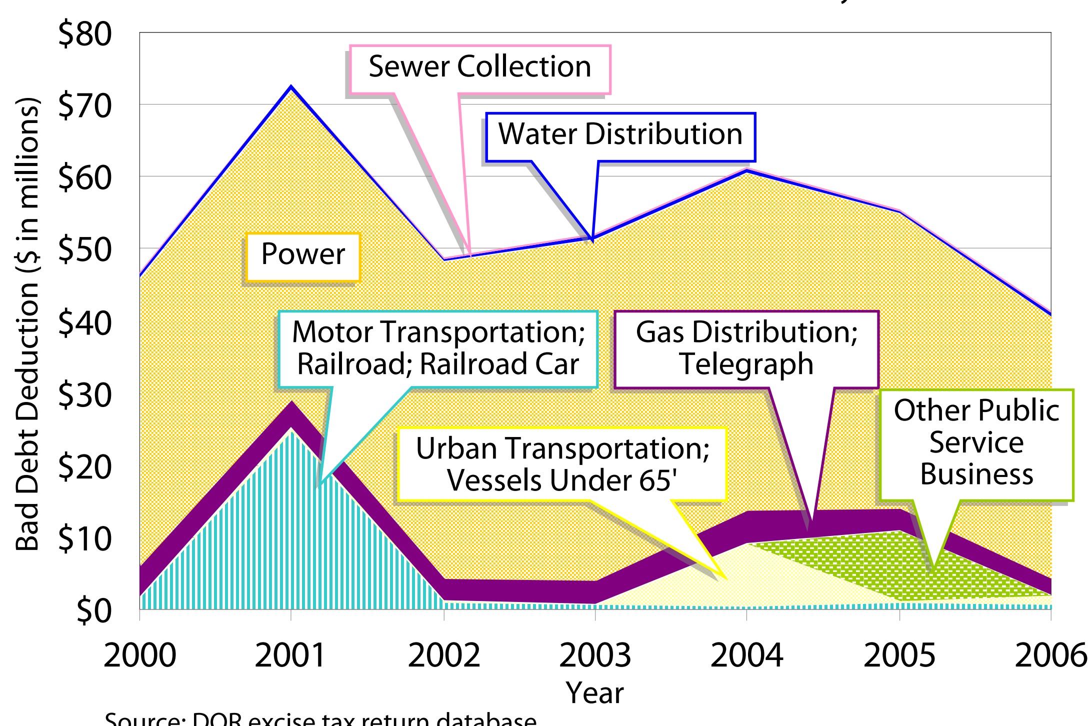
Revenue Impacts

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

The amount of bad debt exempt from the public utility tax has ranged from a high of nearly $80 million in 2001 to a recent low in 2006 of $45.7 million. In 2006, electrical power businesses claimed 87 percent of the total deduction amount even though those companies only comprised

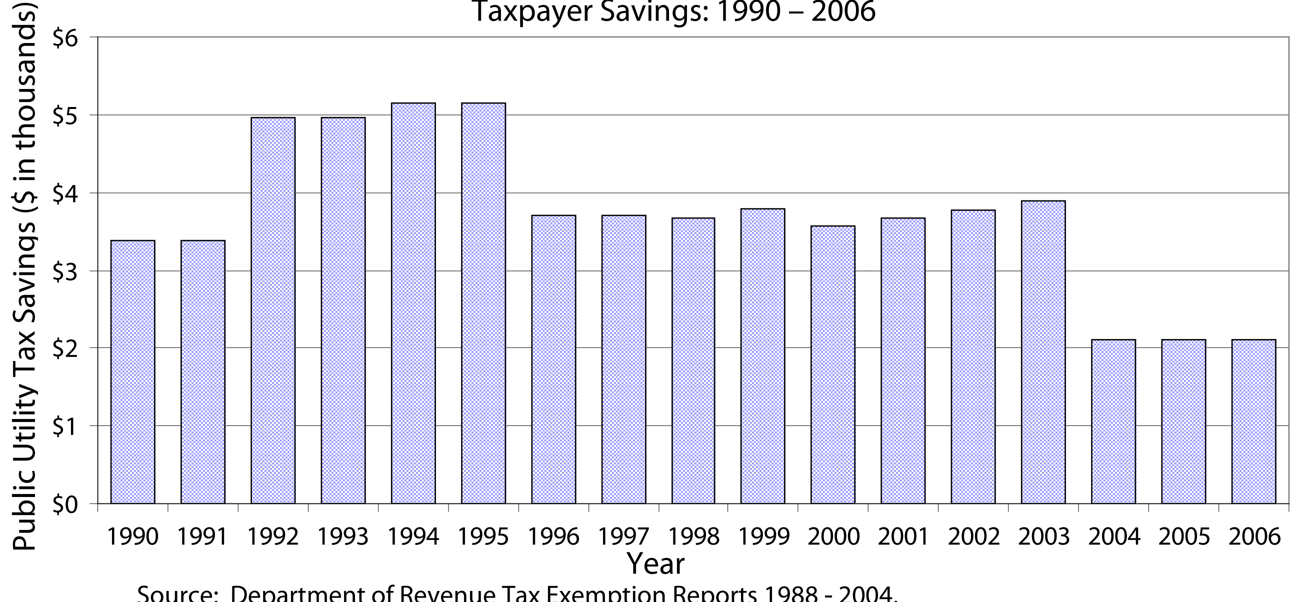
17 percent of all businesses claiming the deduction. Even though motor transportation has the highest number of taxpayers claiming the deduction, it comprises 1.4% of total public utility tax deduction. The value of this tax preference is cyclical depending on the economic conditions in Washington's economy. In 2006, of all the companies claiming this bad debt deduction, the total credit losses deduction from the public utility tax was 0.44 percent of the total gross income subject to the public utility tax.

Exhibit 3 – Amount of Bad Debt Deduction on Public Utility Tax Since 2000



Source: DOR excise tax return database.

Exhibit 4 – Exemption from Public Utility Tax for Credit Losses
Taxpayer Savings: 1990 – 2006



Source: Department of Revenue Tax Exemption Reports 1988 - 2004.

According to the Department of Revenue's past reports on the taxpayer savings for this tax preference, the annual revenue loss estimate has ranged from more than $5 million in 1994 and 1995 to approximately $2 million in recent years. According to DOR excise tax return deduction information, the amount of bad debt claimed by public utility taxpayers has been falling since the mid-1990s.

JLARC's forecast of the taxpayer public utility tax savings for credit losses is based on the deduction amount claimed on the excise tax returns by different industry sectors in 2006, the latest year of data. The tax rates for the public utility tax vary depending on the type of industry. The forecast for this tax preference is $1.9 million in 2007, falling slightly to $1.8 million per year in the next Biennium. The taxpayer savings in public utility tax is the same as the loss in state general fund revenue.

Exhibit 5 – Taxpayer Savings from Public Utility Tax Deduction for Credit Losses

Fiscal Year	Amount of Credit Loss Deduction ($000)	Public Utility Taxpayer Savings ($000)
2007	$50,878	$1,945
2008	$51,386	$1,965
2009	$48,817	$1,866
2010	$47,841	$1,829
2011	$47,362	$1,811

Source: JLARC forecast.

Recommendation

The Legislature should continue this public utility tax deduction for credit losses incurred by businesses.

Legislation Required: None.

Fiscal Impact: None.

PROCESSING HORTICULTURAL PRODUCTS – SUMMARY

Current Law

This business and occupation tax deduction is for income earned in receiving, washing, sorting, and packing of fresh horticultural products. The work must be performed for a farmer. See Appendix 3 for current law statute RCW 82.04.4287.

Findings and Recommendations

This review has evaluated the legal history, public policy objectives, and revenue impacts of the business and occupation tax deduction for income earned in receiving, washing, sorting, and packing fresh horticultural products. This audit determined the following:

Legal History and Public Policy Objectives

- The Legislature enacted this business and occupation tax deduction in 1935. This tax preference originated with the enactment of the general business and occupation tax for agents who assisted farmers with post-harvest activities of fresh horticultural products.
- Since 1935, this deduction has not changed substantially.
- This tax preference originally had the public policy objective of defining the tax base as the Legislature enacted the business and occupation tax.
- Another public policy objective for this tax preference was to support farmers by providing a tax deduction for businesses which contract with farmers to receive, wash, sort, and package fresh horticultural products.
- This tax preference has achieved the objectives of defining the tax base and providing similar tax exempt status to contractors who work for farmers in receiving, washing, sorting, and packing fresh horticultural products.

Beneficiaries

- The direct beneficiaries are businesses which serve the agricultural community by receiving, washing, sorting, and packing of fresh horticultural products.
- The indirect beneficiaries are farmers who potentially receive these preparatory services at a lower cost.

Revenue Impacts

- The Department of Revenue's 2008 Tax Exemption Study reports that the value of this deduction has grown to nearly $1 million per year. This was based on horticultural production including fruit, tree nuts, berries and vegetables.
- JLARC projects higher growth for this tax preference, between $1.4 million in 2008 and increasing to $1.8 million in 2011. The JLARC estimate also includes the value of nursery stock in the total horticultural production in the state.

Recommendation

The Legislature should continue the business and occupation tax preference for the income earned in receiving, washing, sorting, and packing of fresh horticultural products.

Legislation Required: None.

Fiscal Impact: None.

PROCESSING HORTICULTURAL PRODUCTS – REPORT DETAIL

Statutory History

In 1933, SHB 92 established a temporary two-year business and activities tax to generate additional revenue for the state at a time when the state faced severe financial hardship. This new business activities tax was based on the gross income of the businesses, and the tax rates ranged from 0.5 percent to 3 percent. The legislation imposed a lower rate imposed on people engaging in the business of growing or raising for sale, profit, or use any commodity, product, or crop. The amount of the business activities tax assessed on farmers was the product of the sales of the crop produced, grown, or raised for sale multiplied by 0.1 percent. The law stipulated that the tax be based on the entire value of the crop grown or produced for sale, regardless of the place of sale or where the crops would be delivered. The Governor vetoed that portion of the 1933 Tax Upon Business Activities.[10] In the Governor's veto message, he said that the amount of revenue that would be generated from a business and occupation tax of 1 percent on farmers would not be enough to justify collecting the tax. In a subsequent special session, the Legislature completely exempted farmers from the temporary business activities tax.

The Legislature enacted the permanent business and occupation tax in 1935. The 1935 legislation included a broad deduction for a variety of agricultural producers. In addition, the bill included a deduction from the business and occupation tax for individuals receiving, washing, sorting, and packing fresh horticultural products:

> *In computing tax there may be deducted from the measure of tax the following items:*
>
> > *(g) Amounts derived by any person as compensation for the receiving, washing, sorting and packing of fresh horticultural products and the material and supplies used therein when performed for the person exempted in subsection (d) of section 11, this title, either, as agent or as independent contractor;*

This language provided a deduction for agents or contractors who assist farmers with post-harvest services for fresh horticultural products. The language for this horticultural contractors' tax preference has not changed significantly since enactment.

[10] Law Providing for a Tax Upon Business Activities, Chapter 191, Laws of 1933, Tax Commission of the State of Washington.

If a farmer is processing his own horticultural products, those activities are already tax exempt under the general agricultural producers' business and occupation tax exemption in RCW 82.04.330. This tax preference is intended to benefit those contractors who work for farmers in receiving, washing, sorting, and packing horticultural products, providing them with similar tax treatment as farmers.

Relevant Background

Definitions: Horticultural plant, products and services

According to RCW 15.13.250, "horticultural plant" includes the following:

> *"Horticultural plant" includes, but is not limited to, any horticultural, floricultural, or viticultural plant, or turf, for planting, propagation or ornamentation growing or otherwise. The term does not apply to potato, garlic, or onion planting stock or to cut plant material, except plant parts used for propagative purposes.*

In the administrative rule for this tax preference as well as the farming for hire tax preference, horticultural services are defined as follows:

> *"Horticultural services" include services related to the cultivation of vegetables, fruits, grains, field crops, ornamental floriculture, and nursery product.*[11]

The agricultural services which are covered under "horticultural services" are quite broad in the administrative rule. These services include soil preparation services like plowing or weed control before planting; crop cultivation services such as planting, thinning, pruning, or spraying; crop harvesting of field crops and grains, and mowing and baling of hay. Given that this tax preference for contractors is restricted to just the services of washing, sorting, and packing "fresh" horticultural products, then it is unlikely that grains and field crops would have those types of services performed by contractors.

Washington Agriculture in 1930s

Even though the economic depression hurt all individuals and businesses in the 1930s, the depression hit the agricultural industry especially hard. In 1934, the average farm per capita income was $166, about 1/3 lower than that of the nonfarm sector. The price parity ratio, which is the ratio of prices received by farmers relative to prices paid by farmers, had fallen from 89 in 1929 to 55 in 1932.[12] Prices for agricultural commodities had fallen very low, and input prices for agricultural production had not fallen very much with the Great Depression.

Typically during the 1920s and early 1930s, tree fruits provided the second largest agricultural income in Washington. Apple production had provided nearly 83 percent of the farm value of

[11] WAC 458-20-209.

[12] 1982 Tax Exemptions Report, Washington State Department of Revenue.

tree fruits, since 1928.[13] A 1936 Washington State College article summarized the problems of Washington's apple industry in the early 1930s:

> *In general, the apple industry of the central irrigated region of Washington was in a healthy economic condition until 1930 and 1931. Then came drastic reductions in gross income of orchardists as a result of the decided decline in prices received for apples….The price decline of 1934-1935 eliminated the net income of most growers. The decided decline in apple prices since 1929 accompanied by much smaller reductions in cash costs resulted in an accumulation of indebtedness and difficulties in crop financing.*[14]

One of the major recommendations for improving agriculture by agriculture research specialists during this time period was to lower the costs of production. Taxes were one component of the overhead costs of production for agricultural commodities. In 1935 with the adoption of the business and occupation tax, there was concern over keeping taxes low for farmers since their output commodity prices were so low. Extending this business and occupation tax deduction to other contractors working for farmers on processing and packing their horticultural products was consistent with the tax assistance provided by the larger tax exemption for all farmers and lowering the overall costs of production for farmers.

Washington Agricultural Statistics on Horticultural Products

This business and occupation tax deduction for contractors assisting farmers with processing horticultural products does not have a reporting requirement. Therefore, there is no readily available data on which to evaluate this tax preference. Agricultural statistics are available on the value of production of horticultural products in Washington from USDA – National Agricultural Statistics Service. JLARC made an assumption that 10 percent of the value of agricultural production would be for processing of horticultural products.

Washington's value of horticultural products (fruits and nuts, berries, and vegetables) has been growing since 1997. The total value of these three horticultural crops has exceeded $1.5 billion every year except in 1998. The value of horticultural products is rising. In 2006, the production value reached nearly $2.5 billion.[15] When greenhouse and nursery production data is added, then the total value of all four categories of horticultural crops' total production is $2.88 billion in 2006.

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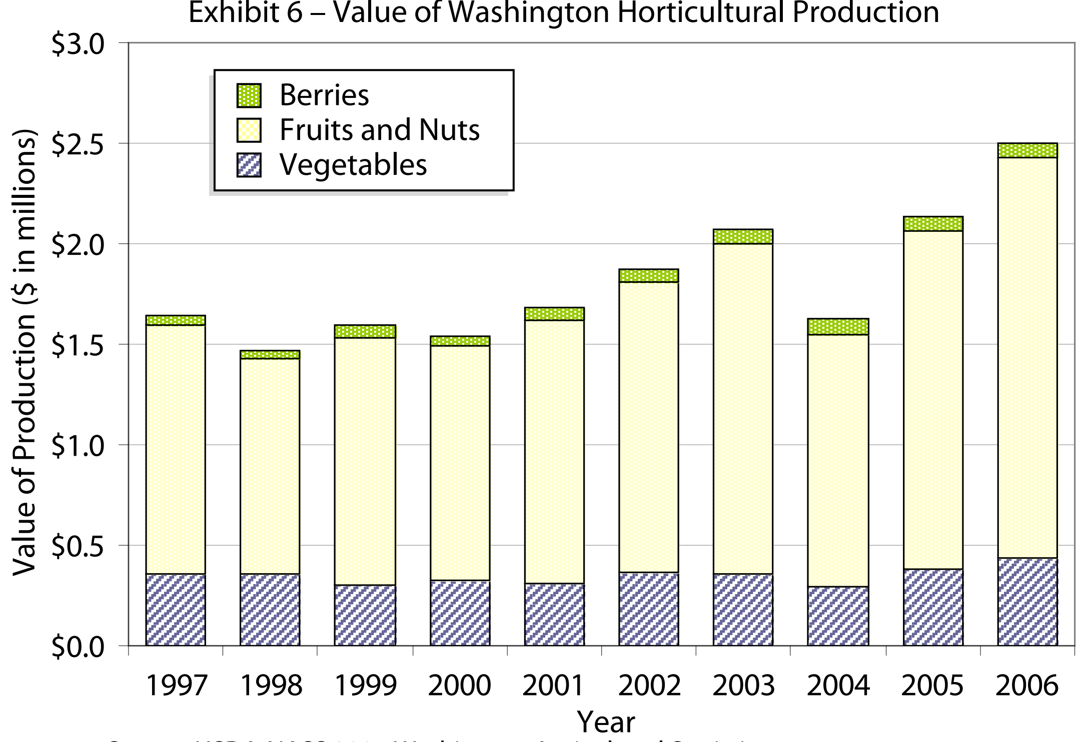
[13] "Trends and Desirable Adjustments in Washington Agriculture" by A.E. Orr, C.P. Heisig, J.C. Knott and C.L. Vincent State College of Washington. Agricultural Experiment Station, no. 335, 1936.

[14] Ibid.

[15] "2007 Washington Annual Agriculture Bulletin," compiled by the USDA/NASS Washington Field Office.

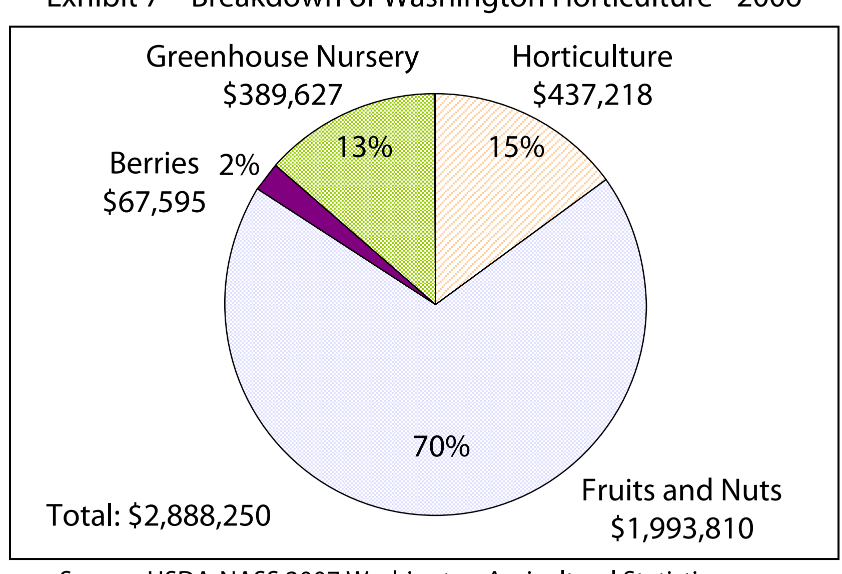
Exhibit 6 – Value of Washington Horticultural Production



Source: USDA-NASS 2007 Washington Agricultural Statistics.

As the pie graph reveals, fruits and nuts comprise the largest share of all Washington horticultural commodities at 70 percent in 2006. Vegetable production comprised 15 percent, greenhouse nursery production at 13 percent and berries at 2 percent.

Exhibit 7 – Breakdown of Washington Horticulture - 2006



Source: USDA-NASS 2007 Washington Agricultural Statistics.

Public Policy Objectives

What are the public policy objectives that provide a justification for the tax preference?

There are three public policy objectives for this business and occupation tax preference:

Tax Base: Tax base defining theory states that at the time Legislatures are developing a tax, they will define the elements which will be subject to the tax and the elements excluded. Since the Legislature enacted this tax preference in 1935 at the same time as the business and occupation tax, one public policy objective of this tax preference was to define the tax base for the business and occupation tax. Another justification for the tax base defining theory is that at the time of enactment of the tax preference, the activity of the exempt organizations did not rise to the level of taxable activity. To the extent that income derived from farmers and contractors working for farmers did not amount to significant gross business income in 1935, the Legislature had not assumed farmers and contractors working for farmers in processing horticultural products would be a large part of the business and occupation taxpayers' tax base.

Subsidy: A second public policy objective could have been to benefit agricultural farmers and contractors to horticultural farmers at a time when farming was in financial trouble during the Great Depression. This is consistent with the subsidy theory of exemptions, when the Legislature grants exemptions because the exempted organization lessens the burden on government or provides a public benefit. Originally, an objective in this business and occupation tax deduction could have been to lower the costs to contractors of processing and packing horticultural products so they would pass on the benefits to farmers by providing them with cheaper processing services. The belief may have been that farmers would have to pay higher contractor costs without this deduction.

Equal Tax Treatment: This business and occupation tax deduction is similar to the general business and occupation tax exemption for agricultural producers. Another objective may have been to ensure that private contractors were given the same tax exempt benefits for washing, sorting, and packing horticultural products that a farmer would receive if he/she completed the work. If a farmer washed and sorted his/her own horticultural commodities, these activities would be tax exempt from the business and occupation tax, but if a private contractor performed these activities, then he/she would have to pay B&O tax if this tax preference were not in law.

Is the purpose or intent of the tax preference clear?

Given this tax preference's inclusion in the broader business and occupation tax exemption for agricultural producers, the legislative intent was reasonably clear that this tax preference was targeted at providing contractors of farmers with the same tax exempt status for gross income earned washing, sorting, and packing horticultural products. This intent has not changed over the years.

Is there any readily available evidence related to the achievement of any of these public policy objectives?

There is evidence that this tax deduction did define the business and occupation tax base as excluding the gross income from contractors who worked for farmers processing horticultural products. This tax preference did subsidize contractors who performed services for farmers. There is no readily available evidence that contractors have been passing on the business and occupation tax deduction savings to farmers. This tax deduction does provide contractors working for farmers similar tax exempt status as farmers would receive if they performed these horticultural product processing services themselves.

Beneficiaries

Who are the entities whose state tax and/or local tax liabilities are directly affected by the tax preference?

The direct beneficiaries of this tax preference are contractors of farmers who assist in washing, sorting, and packing of fresh horticultural products. Farmers could also be indirect beneficiaries of this tax preference because they could potentially be receiving their contract work at lower costs.

The exact number of contractor beneficiaries is uncertain as the taxpayers do not specially report this deduction on the excise tax return, and there is no annual reporting requirement. Department of Revenue excise tax data indicates there are 91 active companies in the industry sector of post-harvest crop activities. Not all of these companies would be washing, sorting or packing fresh horticultural products to qualify as beneficiaries of this tax preference. Some companies could be performing post-harvest activities for other non-horticultural crops. The actual number of direct beneficiaries of this business and occupation tax deduction is unknown.

According to the 2006 Agricultural Workforce in Washington State, there are 2,893 fruit and tree nut farms in Washington. There are also 368 vegetable and melon farms, and 355 greenhouse, nursery and floriculture operations. These horticultural farms are the potential indirect beneficiaries of this tax preference if they have hired contractors to assist them in washing, sorting, and packing fresh horticultural products. This assumes that the contractors have passed on their tax deduction savings to farmers in the form of lower prices to provide their post-harvest services.

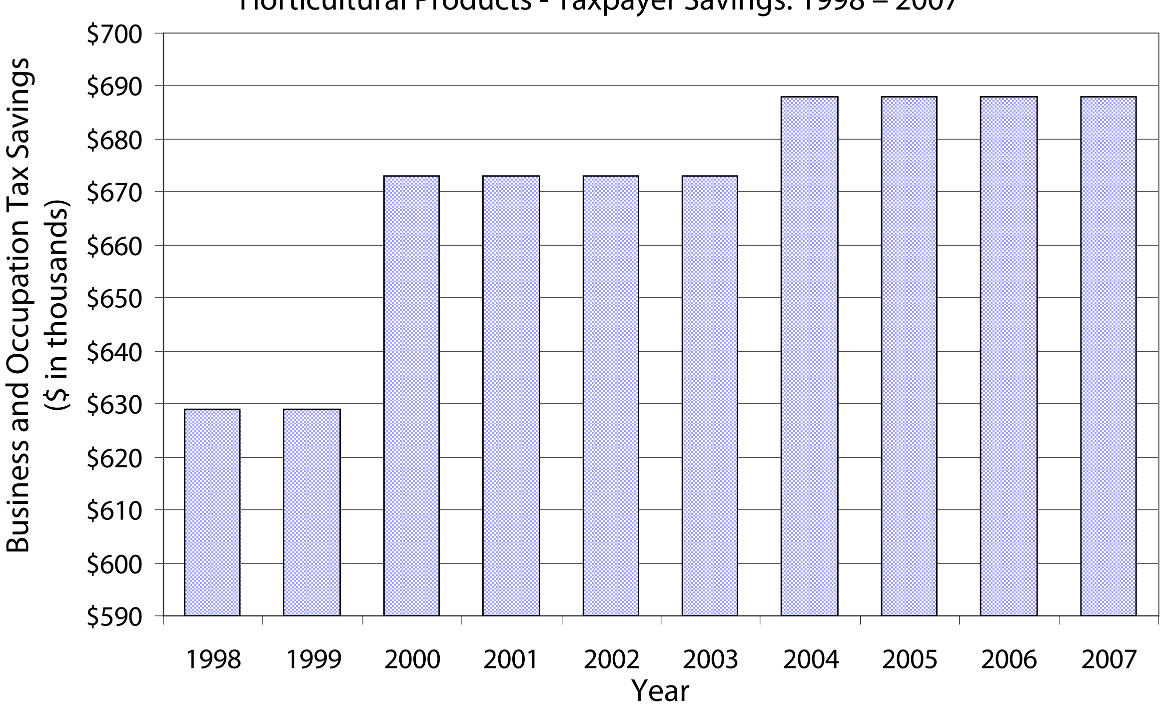
Revenue Impacts

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

Since 1998, the DOR estimate of the value of this business and occupation tax deduction has been a little more than $600,000 per year. In the latest 2008 Tax Exemption Study, the DOR reports that value of this deduction has grown to nearly $1 million. This taxpayer savings estimate is

based on the value of horticultural production (fruit, tree nuts, berries, and vegetables) reported by U.S. Department of Agriculture Ag. Statistics Service for Washington in 2006.

Exhibit 8 – Deduction from Business and Occupation Tax for Processing Horticultural Products - Taxpayer Savings: 1998 – 2007



Source: Department of Revenue Tax Exemption Study estimates – 2004 and prior editions.

JLARC projections of taxpayer savings from this tax preference are based on the 2007 USDA Ag. Statistics Service for Washington. In addition, the JLARC estimate also includes nursery stock in the total value of the horticultural production. The taxpayer savings estimate also assumes that the process cost of washing, sorting, and packaging of the horticultural products is 10 percent of the production horticultural value each year. The JLARC estimate also assumes a business and occupation tax rate of 0.484 percent. JLARC estimates the taxpayer savings from this business and occupation tax deduction to be $1.28 million in 2007, growing to $1.8 million by 2011. The taxpayer savings estimates are the same as the loss in government revenue from this tax preference since it is a business and occupation tax preference.

Exhibit 9 – JLARC estimates of B&O Taxpayer Savings from Deduction for Processing Horticultural Products

Year	Value of contracted processing costs/income ($ millions)	B&O taxpayer savings ($ millions)
2007	$264.8	$1.3
2008	$290.2	$1.4
2009	$318.1	$1.5
2010	$348.6	$1.7
2011	$382.1	$1.8

Source: JLARC based on USDA Ag. Statistics Service data for Washington for 2007.

Recommendation

The Legislature should continue the business and occupation tax preference for the income earned in receiving, washing, sorting, and packing of fresh horticultural products.

Legislation Required: None.

Fiscal Impact: None.

FRATERNAL INSURANCE – SUMMARY

Current Law

Gross income from premiums, fees, assessments, dues, or other charges directly attributable to insurance or death benefits provided by fraternal benefit societies or fraternal fire insurance associations is exempt from the business and occupation tax. All of these exempt fraternal beneficiary organizations must provide members with insurance policies that include death benefits. Another provision of this tax preference is that the exempt income is restricted to just income from premiums, fees, assessments, dues or other charges directly attributable to the insurance premiums with death benefits provided by fraternal beneficiary societies, associations, or corporations. Other business activities of fraternal benefit societies are not exempt from the business and occupation tax. See Appendix 3 for the current law statute, RCW 82.04.370.

Findings and Recommendations

This review has evaluated the legal history, public policy objectives, and revenue impacts of the business and occupation tax exemption for income derived from insurance premiums collected by fraternal beneficiary organizations. The audit determined the following:

Legal History and Public Policy Objectives

- Washington law has provided fraternal organizations that provide insurance benefits to their members with a broad exemption from all state, county, district, municipal, and school taxes since 1911. The statute also exempts these organizations from all provisions of the insurance laws in Washington.
- The Legislature enacted the business and occupation tax exemption for insurance premiums by fraternal benefit societies and fraternal fire insurance associations in 1935. This tax preference has had only minor changes since 1935. This tax preference is consistent with the tax-exempt status provided to fraternal organizations on other state and local taxes since 1911.

This tax exemption has achieved three public policy objectives:

1. To define the business and occupation tax base since the Legislature created the exemption at the same time as the business and occupation tax;
    - To limit this business and occupation tax exemption to only income derived directly from premiums, fees, dues, and other charges for the insurance or death benefits provided by these fraternal organizations.

2. To subsidize fraternal nonprofit organizations with charitable purposes and benefits for their members. This is consistent with subsidy theory of tax exemptions; and
3. To provide tax-exempt status consistent with previous tax treatment for fraternal organizations since 1911.

Beneficiaries

- In 2008, 23 fraternal benefit societies in Washington were beneficiaries of this business and occupation tax exemption.

Revenue Impacts

- Since 2004, the taxpayer savings for fraternal organizations has been $2 million per year.
- The annual taxpayer savings is projected to be approximately the same over the next two biennia.

Recommendation

The Legislature should continue the business and occupation tax preference for fraternal beneficiary organizations.

Legislation Required: None.

Fiscal Impact: None.

FRATERNAL INSURANCE – REPORT DETAIL

Statutory History

In 1935, the Legislature enacted the business and occupation tax exemption for the gross income from premiums, fees, assessments, dues, or other charges directly attributable to the insurance or death benefits provided by fraternal benefit societies or fraternal fire insurance associations. The original statute stated that fraternal benefit societies, fire insurance association, and beneficiary corporations or societies were not subject to the business and occupation tax. In 1941, the law specified a requirement that the fraternal organizations or societies provide in their by-laws for the payment of death benefits. In 1961, the Legislature amended the statute to clarify that this B&O tax exemption is limited to gross income from premiums, fees, assessments, dues, or other charges directly attributable to the insurance or death benefits provided. Since 1961, the substance of this tax preference has not changed. Current law specifies that this tax exemption applies to fraternal benefit societies or fraternal fire insurance associations as described in Washington's insurance laws (Chapter 48.36A RCW). In addition, this exemption also applies to other beneficiary corporations or societies that are organized as nonprofit corporations or associations as outlined in Title 24 of state law.

Other Relevant Background

This business and occupation tax preference can be claimed only by fraternal organizations that provide life and fire insurance benefits to their members. Not all fraternal societies provide these types of insurance benefits. Some examples of national fraternal beneficiary societies, operating in Washington State and providing insurance benefits to their members, are the following: Sons of Norway, Knights of Columbus, Mennonite Mutual Aid Association, Thrivent Financial for Lutherans, Baptist Life Association, and Western Fraternal Life Association. Another example of a fraternal benefit society operating in Washington is the Fraternal Beneficial Association in Spokane which offers fire protection property coverage to farmers in Spokane and Whitman Counties. [16]

Federal Nonprofit Status Designations

Fraternal beneficiary societies, orders or associations are classified under the nonprofit federal tax code section 501 subsection (c)(8). According to the IRC 501(c) (8), an organization must meet the following requirements:

- It must have a fraternal purpose;

[16] "Report of Examination Fraternal Beneficial Association As of December 31, 2000" conducted by the Washington Insurance Commissioner, May 3, 2002.

- It must operate under the lodge system; and
- It must provide for the payment of life, sick, accident, or other benefits.

The IRS code provides an exception for separately organized insurance branches of fraternal societies. These need not operate under the lodge system, but they must provide benefits exclusively to members of the lodge system.

In 1969, the US Congress expanded the Internal Revenue Code to create a new nonprofit designation for domestic fraternal societies in IRC 501 (c)(10). The domestic fraternal societies were fraternal societies, operating under the lodge system, which did not provide payment of life, sick, and accident benefits to their members. Now, fraternal societies are categorized into two types under federal law: those which are beneficiary societies and those which are not beneficiary societies because they do not provide for the payment of life, sick, accident or other benefits to their members. Fraternal beneficiary societies play a dual role because they include both a fraternity and an insurance company.

Brief History of Fraternal Organizations

Member-serving associations, like fraternal societies, were popular among early Americans. The Freemasons have their roots in 17th century England. [17] Fraternal societies have existed in the U.S. at least since the 19th century. They began providing insurance-type benefits to their members around the mid-19th century. [18] Fraternal beneficiary societies were first exempted from federal income taxation in 1909.

In 1891, Washington imposed a statewide insurance premiums tax. The initial rate was 2 percent of the gross premiums written. Since 1911, Washington law has provided a broad tax exemption for fraternal organizations. Chapter 49, section 236 of the 1911 law defined the tax exemption as follows:

> *Every fraternal benefit society organized or licensed under this act is hereby declared to be a charitable and benevolent institution, and all of its funds shall be exempt from all and every state, county, district, municipal, and school tax, other than taxes on real estate and office equipment.*

In 1911, fraternal beneficiary organizations selling insurance policies to their members were exempted in state law from all provisions of the insurance laws of Washington. Later in 1935, when the Legislature established the business and occupation tax, the Legislature also exempted fraternal beneficiary organizations from that tax as well. Fraternal organizations were filing reports with the Insurance Commissioner. In calendar year 1939, 47 fraternal insurance businesses provided insurance to their members in Washington. According to reports filed with

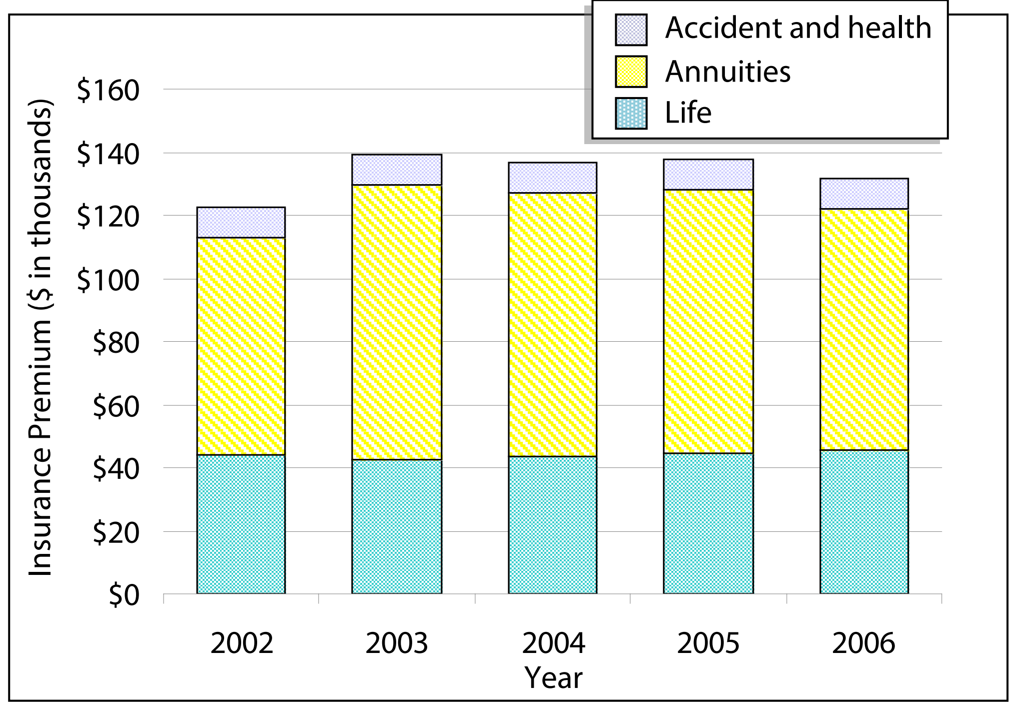
[17] "A History of the Tax-Exempt Sector: An SOI Perspective" by Paul Arnsberger, Melissa Ludlum, Margaret Riley and Mark Stanton Statistics of Income Bulletin, Winter 2008.

[18] "IRC 501(c)(8) Fraternal Beneficiary Societies and IRC 501(c)(10) Domestic Fraternal Societies" by Sean M. Barnett and Ward L. Thomas in 2004 EO CPE Text.

the Insurance Commissioner, these fraternal businesses wrote a total of $6.58 million in new premiums and paid $1 million in total benefits to members in calendar year 1939. [19]

Currently, fraternal organizations still report their insurance premiums to the Washington Office of Insurance Commissioner, even though they are exempt from the insurance premiums tax. Fraternal benefit societies have written premiums averaging $133.5 million per year over the past five years. On average over the last five years, 60 percent of the fraternal premiums written were for annuities, 33 percent for life and 7 percent for accident and health premiums.

Exhibit 10 – Insurance Premiums Written by Fraternal Companies: 2002 - 2006



Source: Washington Office of Insurance Commission reports.

[19] "Forty-sixth Annual Report of the Washington Insurance Commissioner," 1939.

Washington State Definition: Fraternal Benefit Societies

State law defines fraternal benefit society in RCW 48.36A.010:

> *Any incorporated society, order or supreme lodge, without capital stock, including one exempted under the provisions of RCW 48.36A.370(1)(b) whether incorporated or not, conducted solely for the benefit of its members and their beneficiaries and not for profit, operated on a lodge system with ritualistic form of work, having a representative form of government, and which provides benefits in accordance with this chapter, is hereby declared to be a fraternal benefit society.*

State law also specifies the type of contractual benefits these fraternal societies may provide their members, including the following benefits: death, endowment, annuity, temporary or permanent disability, hospital, medical or nursing, monument or tombstone, and other similar benefits as authorized life insurers. [20]

Public Policy Objectives

What are the public policy objectives that provide a justification for the tax preference?

There are three primary public policy objectives for this tax preference:

Tax Base: Since the Legislature enacted this tax preference in 1935 at the same time as the business and occupation tax began, one public policy objective of this tax preference was to define the tax base for the B&O tax. Tax base defining theory states that at the time Legislatures are developing a tax, they will define the elements that will be subject to the tax and the elements excluded. Another component for the tax base defining theory is that at the time of enactment of the tax preference, the activity of the exempt organizations did not rise to the level of taxable activity. To the extent that fraternal beneficiary organizations did not produce significant gross income in 1935, they were not intended to be part of the business and occupation tax base.

A portion of the tax base defining objective for this tax preference is to restrict the business and occupation tax exemption to just the income from premiums, fees, assessments, dues, or other charges directly attributable to the insurance or death benefits provided. All other income earned by fraternal insurance organizations outside the insurance policies with death benefits is subject to the business and occupation tax.

Subsidy: A second public policy objective could have been to benefit fraternal beneficiary organizations for their charitable community activities and benefits they provide their members. This is consistent with the subsidy theory of exemptions that the state grants exemptions because the exempted organization lessens the burden on government or provides a public benefit. An objective in this business and occupation tax exemption could have been to benefit these

[20] RCW 48.36A.160.

fraternal organizations by giving them tax exempt status under the assumption that they would pass on the benefits to their members and provide needed community social service activities.

Equal B&O tax treatment with other insurance carriers: A third public policy objective for this tax preference is to provide equal tax exempt status for gross premiums of all insurance policies since all insurance carriers receive a business and occupation tax exemption on their income derived from insurance premiums. With the exception of fraternal beneficiary societies, most insurance carriers' income from insurance premiums is already taxed under the insurance premiums tax.

Is the purpose or intent of the tax preference clear?

It is clear that the purpose of this tax preference is to exempt fraternal beneficiary organizations from the business and occupation tax for certain gross income they derived from insurance policies. The statute does not have a specific statement of intent as to why fraternal beneficiary organizations are tax exempt from both the business and occupation tax and the insurance premiums tax, which will be reviewed in a subsequent year.

Is there any readily available evidence related to the achievement of any of these public policy objectives?

Since 1935, fraternal beneficiary organizations have not paid the business and occupation tax on their gross incomes from insurance policies, so the objective of defining the tax base had been achieved. If the public policy objective was to provide a subsidy to fraternal beneficiary organizations, then this has been accomplished. According to these organizations, they have provided their members with the ability to purchase life and fire insurance policies at lower costs. Having more Washington residents insured lessens the burden on government. This tax preference has achieved its goal of targeting the business and occupation tax exemption to just gross income of premiums from life and fire insurance policies. The fraternal beneficiary organizations that have additional income generated from other sources are paying the business and occupation tax on that income.

Beneficiaries

Who are the entities whose state tax and/or local tax liabilities are directly affected by the tax preference?

According to Washington's Office of the Insurance Commissioner, as of March 2008, there were 23 fraternal beneficiary organizations. These organizations may be either national fraternal beneficiary associations that operate in Washington, or they could be Washington insurers only.

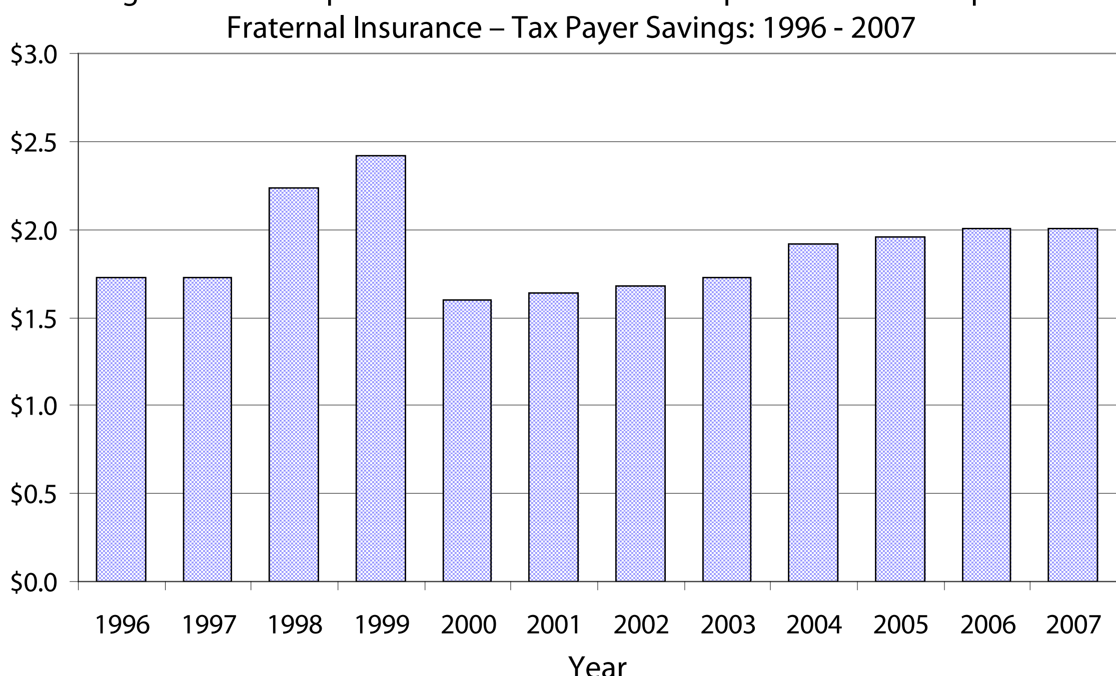
Revenue Impacts

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

According to the DOR previous Tax Exemption Reports, the fraternal insurance business and occupation tax preference is valued at approximately $2 million per year. The Department of Revenue estimates were based on Washington Office of Insurance Commission's (OIC) reports by insurers for the income generated from premiums of fire and life insurance policies. The amount of insurance premiums written by fraternal organizations has remained fairly constant in recent years.

JLARC's projections for this tax preference are based on more recent data from the Washington OIC. These projections also assume a business and occupation tax rate of 1.5 percent. The projections are fairly constant at $2 million per year over the next two biennia.

Figure 11 – Exemption from Business and Occupation Tax for Nonprofit Fraternal Insurance – Tax Payer Savings: 1996 - 2007



Source: Department of Revenue past editions of Tax Exemption Reports.

Exhibit 12 – State Business and Occupation Tax Savings:
Fraternal Beneficiary Societies Exemption

Year	Premiums Income Exemption Amount ($ millions)	B&O Taxpayer Savings ($ millions)
2006	$131.7	$1.9
2007	$133.0	$2.0
2008	$134.4	$2.0
2009	$135.7	$2.0
2010	$137.1	$2.1
2011	$138.4	$2.1

Source: JLARC projections based on Washington Office of Insurance Commission data.

The taxpayer savings estimates are the same as the loss in government revenue from this tax preference since it is a business and occupation tax preference.

Recommendation

The Legislature should continue the business and occupation tax preference for fraternal beneficiary organizations.

Legislation Required: None.

Fiscal Impact: None.

IRRIGATION WATER – SUMMARY

Current Law

The public utility tax is a state tax on the "act or privilege of engaging within this state" in any one or more specified utility or public service businesses. The base of the tax is the gross income derived from the operation of public and privately-owned utilities, including the general categories of transportation, and the supply of energy and water. Income from utility or public service operations is taxed under the public utility tax in lieu of the business and occupation tax. Other income of a utility or public service company (e.g., retail sales of tangible personal property) is subject to the business and occupation tax.

Utilities may deduct the income they derive from the distribution of irrigation water from their public utility tax. The main requirement for this public utility tax deduction is that the distribution of water must be through an irrigation system. See Appendix 3 for the current law statute RCW 82.16.050(7).

Findings and Recommendations

This review has evaluated the legal history, public policy objectives, and revenue impacts of the public utility tax deduction for gross income from distributing irrigation water. The audit determined the following:

Legal History and Public Policy Objectives

- The Legislature established this public utility tax deduction for irrigation water in the Revenue Act of 1935, and the deduction has not changed for 73 years.
- A public policy objective of this tax deduction was to define the public utility tax base as excluding the gross income from the distribution of irrigation water.
- Another public policy objective was to benefit farmers who would have to pay higher costs for irrigation water without the tax deduction.
- For more than 70 years, this tax preference has achieved the objectives of defining the tax base, subsidizing irrigation districts, and lowering production costs for farmers.

Beneficiaries

- The direct beneficiaries of this public utility tax deduction for irrigation water are irrigation/water/utility districts and municipalities in Washington. Farmers are the indirect beneficiaries.

- Not all beneficiaries, including a large number of small irrigation districts, are claiming this deduction on the excise tax returns with the Department of Revenue.
- There may be unintended beneficiaries in this tax preference as eight out of the top ten known beneficiaries of this irrigation water tax deduction are municipalities, which typically do not sell irrigation water for agricultural purposes.

Revenue Impacts

- The projected taxpayer savings from this public utility tax exemption is $1 million in fiscal year 2008, growing to $1.3 million by 2011.

Recommendation

Due to the lack of legislative intent and growth in beneficiaries of the public utility tax deduction for irrigation water, the Legislature should clarify if gross income derived from non-agricultural uses of irrigation water should be allowed for this tax deduction.

Legislation Required: Yes.

Fiscal Impact: Depends on proposal.

IRRIGATION WATER – REPORT DETAIL

Statutory History

The Legislature created the public utility tax deduction for water distributed through an irrigation system in the original Revenue Act of 1935:

> *In computing tax there may be deducted from the gross operating revenue the following items:*
>
> *(g) Amounts derived from the distribution of water through an irrigation system, for irrigation purposes;*

There has been no change to this original language.

Public Utility Tax Background

The Legislature faced a revenue shortfall as it convened in January 1933. The prior November, the voters had passed Initiative Measure No. 64, a 40-mill property tax limit bill. The initiative limited property tax levies for state purposes to a maximum of five mills on a 50 percent valuation.[21] This measure effectively reduced the income from state taxes by approximately 50 percent, beginning with the second year of the 1933-35 Biennium. Assessed valuations and levies were already reduced due principally to the depressed economic conditions of the time. The Legislature also adopted in 1933 the Showalter Bill, a measure increasing, by about two-thirds, the state's obligation to support local school districts. The voters passed another initiative in 1932, Initiative Measure No. 69, imposing a state income tax on all corporations and individuals.

In response, the Legislature adopted a temporary business activities tax in 1933. The tax was to be in place from August 1, 1933 to July 31, 1935. The tax was measured by the application of rates against "value of products," "gross proceeds of sales," or "gross income of the business." The rates varied depending on the type of business activity.

The 1933 temporary business activities tax imposed taxes upon the privilege of engaging in business activities, including public service and utility activities. Generally, public service companies and utilities were subject to state regulation of rates or state supervision or control. Service needed to be rendered to all who requested the service, the "right to refuse to serve being dependent solely upon the limitations of capacity and obnoxious character of the person or property involved."[22] These public service and utility activities included light and power companies, telephone and telegraph companies, water companies (except irrigation companies),

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[21] In other terms, this is equivalent to a maximum levy rate of $2.50 per $1,000 of assessed value at 100 percent valuation.

[22] "Business Tax Instructions, Revised Rules and General Instructions," Tax Commission of the State of Washington, 1934.

manufactured gas companies, steam railways, highway transportation companies, street railways, and other public service companies such as docks, warehouses, and ferries. Public service and utility activities were taxed at four basic rates ranging from 0.5 percent to 3.0 percent. In 1933, public service and utility companies subject to the business and activities tax were allowed a deduction from gross sales for irrigation water.

The revenue shortfall continued into 1935. The State Supreme Court found the graduated net personal and corporate income tax adopted by the voters in 1932 to be unconstitutional.[23] At the general election in 1934, voters again passed the 40-mill limit.[24] This 1934 initiative further reduced the state levy from five mills to two mills, exclusively for the institutions of higher education. The Legislature, meeting in 1935, faced the problems of replacing the revenue previously received from property taxes levied for the state general fund, as well as the state's obligations under the Showalter Act to support common schools, and payment for relief and welfare work. To raise the required revenue, the Legislature enacted the Revenue Act of 1935. The new act supplanted the temporary 1933 act and continued in general effect the business taxes imposed by it. The 1935 act also added several new consumer taxes, including a two percent retail sales tax and a complementary use tax.

The Revenue Act of 1935 consisted of twelve titles, with the business and occupation tax (Title II) clearly separated from the public utility tax (Title V). The tax base for the public utility tax is gross income from the operation of public and privately-owned utilities and public service companies. Utility and public service companies provide services in the areas of energy, water, communications, and transportation. The original legislation included four public utility tax rates:

- 3% of gross operating revenue
    - Railroads, water, light and power, telephone and telegraph
- 2% of gross operating revenue
    - Gas distribution
- 1.5% of gross operating revenue
    - Highway transportation and all other public service businesses subject to control by the state such as airplane transportation, ferry, water transportation, public warehouse, toll bridge, and wharf businesses
- 0.5% of gross operating revenue
    - Urban or interurban transportation and vessels under 65 feet in length operating upon Washington waters

[23] Culliton v. Chase, 174 Wash. 363 (1933).

[24] By passing the limit again after first adopting it two years prior, the voters restricted the Legislature's ability to amend the limit. Within two years of enactment, an initiative measure may only be amended by the Legislature with a two-thirds vote.

The 1935 legislation also identified exemptions from the public utility tax, including several allowed in 1933 for the business and activities tax. Irrigation water was allowed as a deduction in both the temporary business and activities tax and the public utilities tax. [25] This was one of eight public utility tax exemptions enacted in 1935.[26]

The public utility tax applies only on sales to consumers. The tax is a state tax only. Currently, the companies in the business of distributing water pay the highest rate of 5.029 percent, and urban transportation and watercraft vessels under 65 feet pay the lowest rate of 0.642 percent. In recent years, public utility tax collections have grown from $203 million in 1997 to $340 million by 2006. The public utility tax is reported by about 5,000 firms annually. Approximately 110 electric companies account for more than 50 percent of the tax liability, and water district companies accounted for 11 percent of the tax liability.

Exhibit 13 – Public Utility Tax Breakdown by Type of Utility
Fiscal Year 2006

Type of Utility	**Percent**
Distribution of electricity	56.9%
Distribution of natural gas	20.3%
Distribution of water	11.1%
Collection of sewerage	2.6%
Motor/rail transportation	7.1%
Urban transportation	.9%
Other public service	1.1%
Total: $339.9 M	

Source: Department of Revenue Excise Tax database.

Other Relevant Background

In 1935 when the Legislature enacted this tax preference, the amount of land irrigated for farming was still minimal. In 1930, there was a little less than 500,000 acres irrigated and 15,949 irrigated farms in Washington. This represented just 3.7 percent of all agricultural land and 22.5 percent of all farms in Washington. Sixty-five percent of all irrigated farmland in Washington was on the Yakima River and tributaries in 1930.[27] The expansion of irrigation systems was expensive. The average investment in irrigation infrastructure was $64 per acre in 1930, and this represented a 40 percent increase over the cost in 1920. Irrigation systems were needed on certain farmland to grow a variety of crops, especially tree fruits. In the late 1920s, there were

[25] "6th Biennial Report of the Tax Commission of the State of Washington," September 30 1936.

[26] Eight public utility tax preferences in 1935: minimum monthly threshold of gross operating revenue, irrigation water, sales of commodities to other persons for resale purposes, payments to other persons taxable under public utility tax for service rendered jointly, taxes received by municipal utilities, sales and service to federal govt. and in interstate and foreign commerce, credit losses and cash discounts.

[27] "Fifteenth Census of the United States 1930 (Washington State) – Irrigation" U.S. Census Bureau.

two main commercial fruit areas in Washington: the Yakima and Wenatchee-Okanogan area. Orchard crops depended heavily on irrigation water for fruit production.

The federal government began major land reclamation projects in Washington, the biggest being construction of Grand Coulee Dam in the 1930s and 1940s. The completion of the McNary Dam in 1954 marked the beginning of other dams being built and irrigation acreage increasing. By 1950, the amount of irrigated land in Washington had increased 18 percent from 1930 to 589,035 acres. By 1959, the amount of irrigated land had nearly doubled from 1950 to 1 million acres.[28] This trend of irrigated acres increasing continued, with nearly 1.8 million irrigated acres in the latest Census of Agriculture.[29]

State of Agriculture in the late 1920s and early 1930s

The Legislature enacted this tax preference in 1935 when the farming sector in Washington was experiencing more severe economic hardships than other sectors of the economy during the Great Depression. In 1934, average farm per capita income was $166, about 1/3 lower than that of the nonfarm sector. The price parity ratio, which is the ratio of prices received by farmers relative to prices paid by farmers, had fallen from 89 in 1929 to 55 in 1932.[30] In his Oral History of Washington, Charles Hodde recalls irrigation districts facing bankruptcy when he was a lobbyist for the Grange in the early 1930s:

> *The Burbank irrigation district went bankrupt before 1935 and you'd drive through that area and here were all these fields that were lush irrigated fields, all dried up and pumping equipment that took water out of the Snake River sitting there just rusting away. Nothing done; no way to reclaim it because the bond holders couldn't be paid. There was no way they could pay the interest on the bonds .Then, we had two districts in Yakima that were ready to go under and one in Okanogan, that I recall.*[31]

The depression years saw sharp declines in prices of agricultural commodities and only small decreases in input costs. In addition, there were losses of export markets for Washington agricultural commodities. Typically during the 1920s and early 1930s, tree fruits provided the second largest agricultural income in Washington. Apple production had provided nearly 83 percent of the farm value of tree fruits since 1928.[32] A 1936 Washington State College article summarized the problems of Washington's apple industry in the early 1930s:

> *In general, the apple industry of the central irrigated region of Washington was in health economic condition until 1930 and 1931. Then came drastic reductions in gross income of orchardists as a result of the decided decline in prices received for*

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[28] "Census of the United States 1950 and 1960 (Washington State) – Irrigation" U.S. Census Bureau.

[29] "2002 Census of the Agriculture (Washington State)" U.S. Census Bureau.

[30] 1982 Tax Exemptions Report, Washington State Department of Revenue.

[31] "Charles Hodde: An Oral History Mr Speaker of the House" Legislative Oral History Project Washington State Archives Office of Secretary of State 1986.

[32] "Trends and Desirable Adjustments in Washington Agriculture" by A.E. Orr, C.P. Heisig, J.C. Knott and C.L. Vincent State College of Washington. Agricultural Experiment Station, no. 335, 1936.

> *apples….The price decline of 1934-1935 eliminated the net income of most growers. The decided decline in apple prices since 1929 accompanied by much smaller reductions in cash costs resulted in an accumulation of indebtedness and difficulties in crop financing.*[33]

One of the major recommendations for improving agriculture by research specialists during this time period was to lower the costs of production. Taxes and irrigated water charges were two components of overhead costs of production for certain agricultural commodities. These costs were reduced for farmers after the Legislature enacted several tax preferences in 1935, including this tax deduction for irrigation water on the public utility tax.

Administrative Rule and DOR Rulings

The administrative rule for this statute has been in place since 1970. The rule duplicates the statute except it adds the word "solely" to indicate that the irrigation system cannot be used for any other purposes other than irrigation. As the purposes for having irrigation systems have expanded beyond irrigating agricultural land to other uses like landscaping yards and golf courses, appeals were brought to the court to rule on the broadness of this public utility tax deduction for irrigation water. Initially, in 1995, the Appeals Division of Department of Revenue concluded that the irrigation water deduction taken by utility districts for water separately supplied for the purpose of watering golf courses and landscaping could only be taken if there was an agricultural component.[34] Over time, the Department of Revenue changed its position requiring an agricultural component in order to claim the irrigation water deduction. In a 1998 appeals case, DOR overturned earlier rulings and concluded that if irrigation or water districts supply potable water and differentiate this potable water from water for nourishing plant life, then the irrigation water qualifies for a deduction from the public utility tax.[35] In another ruling, DOR found that irrigation water that is used to nourish plant life (including non-agricultural plants like grass) can be deducted from the public utility tax.[36] DOR found that, so long as the irrigation district or water district supplier segregates and separates supplies of water solely for nourishing plant life as opposed to water supplied for domestic, municipal or industrial uses, the water can be considered distributed through an "irrigation system for irrigation purposes."

Public Policy Objectives

What are the public policy objectives that provide a justification for the tax preference?

There are two primary public policy objectives for this tax preference:

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[33] "Trends and Desirable Adjustments in Washington Agriculture" by A.E. Orr, C.P. Heisig, J.C. Knott and C.L. Vincent State College of Washington. Agricultural Experiment Station, no. 335, 1936.

[34] DOR Appeals Division determinations, Det. No. 95-002, 15 WTD 106 (1995) and Det. No. 95-201, 15 WTD 166 (1995).

[35] DOR Appeals Division case Det. No. 98-208, 19 WTD 332 (2000).

[36] DOR Appeals Division case Det. No. 98-187, 19 WTD 328 (2000).

Tax Base: Tax base defining theory states that at the time Legislatures are developing a tax, they will define the elements that will be subject to the tax and the elements excluded. Since this tax preference was enacted in 1935 at the same time as the public utility tax, one public policy objective of this tax preference was to define the tax base for the public utility tax. Another justification for the tax base defining theory is that at the time of enactment of the tax preference, the activity of the exempt organizations did not rise to the level of taxable activity. To the extent that income derived from irrigation water was not a large portion of total gross income of public utility taxpayers in 1935, the Legislature was not considering irrigation water to be a large part of public utility taxpayers' tax base.

Subsidy: A second public policy objective could have been to benefit irrigation districts and agricultural farmers at a time when farming was in financial trouble during the Great Depression. This is consistent with the subsidy theory of exemptions where the state grants exemptions because the exempted organization lessens the burden on government or provides a public benefit. Originally, an objective in this public utility tax deduction could have been to lower the costs of water for these irrigation and water districts so they would pass on the benefits to farmers by providing them with cheaper irrigation water. This public utility tax deduction is similar to other deductions for other inputs in the farming production process, such as the retail sales and use tax exemption on feed, seed, fertilizer, and chemical sprays used in agricultural production.[37]

Is the purpose or intent of the tax preference clear?

The purpose of the tax exemption for irrigation water is not stated in law and therefore is not clear. When the Legislature enacted this tax preference in 1935, farmers used irrigation systems to irrigate their agricultural crops. In 2008, irrigation systems are used for a variety of purposes including golf courses, parks, landscaping, and other non-agricultural uses. From reviewing this tax preference, it is unclear if there was a public policy objective to benefit utility taxpayers for their irrigation water sales for non-agricultural purposes.

Is there any readily available evidence related to the achievement of any of these public policy objectives?

Since the Legislature enacted this tax preference, it has achieved its objective of providing water districts and irrigation districts with a deduction for irrigation water from the public utility tax. There is evidence that the public utility tax base was defined as excluding irrigated water. It was unclear from this review if the Legislature wanted to give this deduction to other public utility taxpayers, like municipalities, for irrigation water used for other non-agricultural uses like golf courses, landscaping and parks.

This public utility tax deduction did lower the costs of distributing water for irrigation districts, water districts, and municipalities. Given the benefits farmers experienced from having irrigated land to grow their crops, clearly agriculture has benefited from having irrigated land. In terms of

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[37] "Tax Exemptions 1982" Washington Department of Revenue 1982.

achieving the objective of subsidizing farmers with lower water charges from utility districts and municipalities, there is no evidence that irrigation and water districts lowered their water charges to subsidize farmers and other water uses.

Beneficiaries

Who are the entities whose state tax and/or local tax liabilities are directly affected by the tax preference?

When this public utility tax preference was enacted, the primary beneficiaries were irrigation districts, water districts, and private irrigation companies. Over the more than 70 years of utilization of this tax deduction, municipalities have also become beneficiaries as they sell water distributed through irrigation systems for non-agricultural uses.

The taxpayers that sell irrigation water may not be required to pay the public utility tax unless they have income from other sources subject to excise tax. As a result, irrigation districts typically are not reporting the amount of their irrigation water on the excise tax return because the income derived from irrigation water is tax exempt. Some irrigation districts are small and would not be subject to the public utility tax even without this tax preference because their gross income would not meet the minimum threshold. Since many irrigation districts are not in the Department of Revenue's excise tax database, JLARC consulted other sources of information on irrigation districts in Washington.

According to the State Auditor's data, which audits local governments and utility districts, it has audited 96 irrigation and drainage districts in 2006. These districts are benefiting from the irrigation water deduction from the public utility tax.

The Department of Revenue excise tax returns indicate which taxpayers are claiming this public utility tax deduction. Since 2000, there has been a significant increase in the number of beneficiaries as well as the deduction amount. In 2000, 28 taxpayers claimed the irrigation water deduction. By 2006, 53 taxpayers claimed it. Out of the top ten beneficiaries claiming this deduction in 2006, seven were municipalities, and the other beneficiaries were water and utility districts. Out of the 53 taxpayers claiming this public utility tax deduction, only five were irrigation districts. However, other irrigation districts may not be filing excise tax returns under the assumption that they have no taxable income under law.

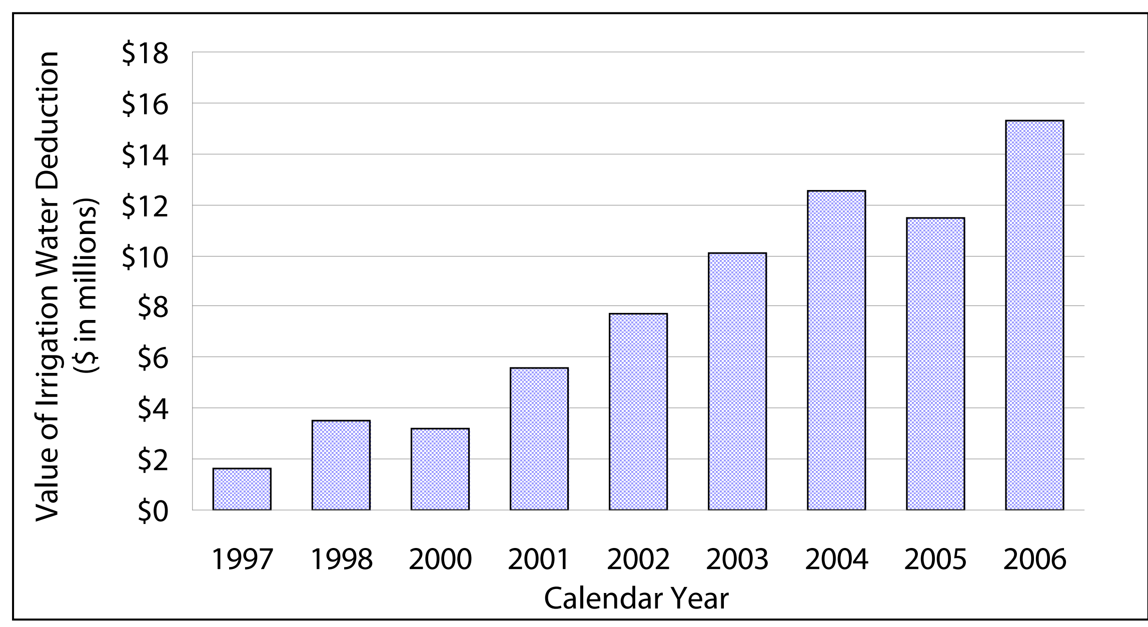
Revenue Impacts

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

Due to DOR's Appeals Division rulings in the last ten years, the purpose of this tax preference has expanded beyond irrigation water for agricultural purposes. Therefore, the number of the taxpayers claiming this deduction and the amount of the deduction has grown significantly.

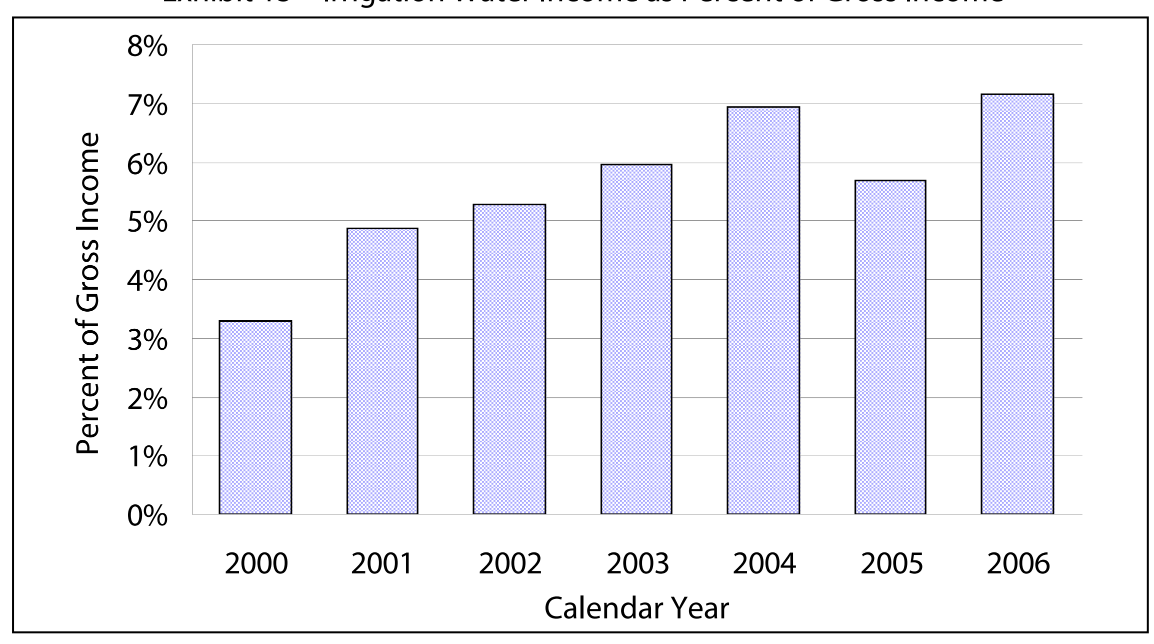
Exhibit 14 indicates the strong growth in the tax deduction. The irrigation water income deduction grew from $1.8 million in 1997 to more than $15 million in 2006. In addition, the average deduction per taxpayer grew from $114,758 in 2000 to $288,668 in 2006. The importance of the irrigation water deduction has been expanding as the deduction as a percent of total gross income from water distribution has increased from 3.3 percent in 2000 to 7.2 percent in 2006.

Exhibit 14 – Value of the Irrigation Water Deduction from Public Utility Tax Since 1997



Source: Department of Revenue excise tax return information.

Exhibit 15 – Irrigation Water Income as Percent of Gross Income



Source: Department of Revenue excise tax return information.

Exhibit 16 – Taxpayer Savings from the Irrigation Water Deduction

Year	Income Deduction Amount ($ millions)	Public Utility Taxpayer Savings ($ millions)
2007	$18.9	$0.9
2008	$20.5	$1.0
2009	$22.1	$1.1
2010	$23.9	$1.2
2011	$26.0	$1.3

Source: JLARC forecast.

Exhibit 16 above provides estimates of future public utility tax taxpayer savings from the irrigation water deduction. JLARC based these estimates on a review of the number of taxpayers and deduction amount claimed of irrigation water in 2006 and 2007 and expanding on that estimate by projecting the amount of deduction utilized by irrigation districts that are not reporting this deduction to the Department of Revenue. JLARC estimates that the amount of the income deducted for irrigation water will be $20 million in 2008, increasing to $26 million in 2011. The associated public utility taxpayer savings will be a little more than $1 million in 2008, growing to $1.3 million by 2011. Since this is a public utility tax preference, the taxpayer savings is equivalent to the loss in state government revenue.

Recommendation:

Due to the lack of legislative intent and growth in beneficiaries of the public utility tax deduction for irrigation water, the Legislature should clarify if gross income derived from non-agricultural uses of irrigation water should be allowed for this tax deduction.

Legislation Required: Yes.

Fiscal Impact: Depends on proposal.

SALES FOR RESALE BY WATER AND GAS UTILITIES – SUMMARY

Current Law

The public utility tax is a state tax on the "act or privilege of engaging within this state" in any one or more specified utility or public service businesses. The base of the tax is the gross income derived from the operation of public and privately-owned utilities, including the general categories of transportation and the supply of energy and water. Income from utility or public service operations is taxed under the public utility tax in lieu of the business and occupation tax. Other income of a utility or public service company (e.g., retail sales of tangible personal property) is subject to the business and occupation tax.

Current law allows a deduction from gross income for amounts derived from the sale of commodities to firms in the same utility business as the seller, for resale within this state. This deduction is allowed only with respect to water distribution, gas distribution or other public service businesses which furnish water, gas or any other commodity in the performance of their public service business. The effect of this deduction is that successive sales of water and gas are not taxed; only the sale to the final consumer in this state is subject to tax. See Appendix 3 for the current law statute RCW 82.16.050(2).

Another subsection, RCW 82.16.050(11), provides a deduction for the sale of electrical energy for resale. This tax preference is currently scheduled for a full JLARC review in 2014.

Findings and Recommendations

This review evaluated the legal history, public policy objectives, and revenue impacts of Washington's public utility tax deduction for amounts derived from the sale for resale within Washington of water and gas utilities. The audit determined the following:

Legal History and Public Policy Objectives

- The Legislature, faced with a revenue shortfall in 1933, adopted a temporary business activities tax. This new tax system included a tax on the privilege of engaging in business activities, including those businesses engaged in delivering public services and utilities. The amount of tax was equal to the gross income of the business multiplied by a specific rate. Public service and utility companies could deduct from their gross income amounts derived from sales for resale to another business delivering the same public service or utility. Furthermore, the Legislature instructed that certain utilities, including gas and water, shall add the new tax to the charge to be paid by the consumer; however, the Governor vetoed this provision.

- In 1935, the Legislature readopted the business activities tax and called the portion dealing with public services and utilities the "public utility tax." Water distribution, light and power, gas distribution, and other public service companies that furnished water, electrical energy, gas, or any other commodity could deduct from gross income amounts derived from sale for resale to persons in the same public service business.
- The Legislatures in 1933 and 1935 made distinctions between multiple-turnover taxes where a tax was imposed on each transaction or sale of a good (called "pyramiding") and single-turnover taxes where a tax was imposed only once on the sale of a good. The business and occupation tax is a multiple-turnover tax while the public utility tax is more characteristic of a single-turnover tax.
- When creating a new tax system for Washington, the Legislature needed to define the nature of the new taxes. The deduction for water and gas distributors of income earned from sales to other water or gas distributors for resale in Washington prevents pyramiding of the tax and makes the tax on a distributor's final sales. One public policy objective of the Legislature was to define the public utility tax as a producer's tax on the final sale within Washington. This objective is being fulfilled.

Beneficiaries

- Water and gas distributors are the initial and intermediary beneficiaries of this tax preference. However, the final customers of the utilities are the ultimate beneficiaries of the single turn-over tax structure to the extent that the water and gas distributors would pass on the costs of multiple taxation to them.

Revenue Impacts

- The estimated tax savings was $2.1 million in Fiscal Year 2006.
- The tax savings is expected to be $2.6 million per year in Fiscal Year 2008 and beyond.

Recommendation

The Legislature should continue the public utility deduction for amounts derived from the sale for resale in Washington by water and gas utilities.

Legislation Required: None.

Fiscal Impact: None.

SALES FOR RESALE BY WATER AND GAS UTILITIES – REPORT DETAIL

Statutory History

The Legislature faced a revenue shortfall as it convened in January 1933. The prior November, the voters had passed Initiative Measure No. 64, a 40-mill property tax limit bill. The initiative limited property tax levies for state purposes to a maximum of five mills on a 50 percent valuation.[38] This measure effectively reduced the income from state taxes by approximately 50 percent, beginning with the second year of the 1933-35 Biennium. Assessed valuations and levies were already reduced due principally to the depressed economic conditions of the time. The Legislature also adopted in 1933 the Showalter Bill, a measure increasing, by about two-thirds, the state's obligation to support local school districts. The voters passed another initiative in 1932, Initiative Measure No. 69, imposing a state income tax on all corporations and individuals.

In response, the Legislature adopted a temporary business activities tax in 1933. The tax was to be in place from August 1, 1933 to July 31, 1935. The new tax was generally of a "functional multiple-turnover nature" (often called pyramiding) upon persons for the privilege of engaging in business activities. This means income was taxed every time it was earned by a business, regardless if the income was from an intermediate sale or a sale to the final consumer. The tax was measured by the application of rates against "value of products," "gross proceeds of sales," or "gross income of the business." The rates varied depending on the type of business activity. According to the State Tax Commission, the theory upon which the tax was framed was the same as that of the occupation tax laws then in effect in Arizona, West Virginia, and Mississippi and did not follow the theory of the retail sales tax laws of Michigan, Illinois, and California.

The 1933 temporary business activities tax imposed taxes upon the privilege of engaging in business activities, including public service and utility activities. Generally, public service companies and utilities were subject to state regulation of rates or state supervision or control. Service needed to be rendered to all who requested the service, the "right to refuse to serve being dependent solely upon the limitations of capacity and obnoxious character of the person or property involved."[39] These public service and utility activities included light and power companies, telephone and telegraph companies, water companies (except irrigation companies), manufactured gas companies, steam railways, highway transportation companies, street railways, and other public service companies such as docks, warehouses, and ferries. Public service and utility activities were taxed at four basic rates ranging from 0.5 percent to 3.0 percent.

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[38] In other terms, this is equivalent to a maximum levy rate of $2.50 per $1,000 of assessed value at 100 percent valuation.

[39] "Business Tax Instructions, Revised Rules and General Instructions," Tax Commission of the State of Washington, 1934.

Another provision in the 1933 act provided that all of the public service and utility businesses could exempt from their gross income amounts derived from sales of services or commodities for resale to another business taxable under the same schedule. Furthermore, utility companies with charges fixed or regulated by a governmental entity, the tax was to be added to the charge (to be plainly shown as such on the bill) and paid by the consumer. Governor Martin vetoed this latter provision because "there is no good reason for the provision…"

The revenue shortfall continued into 1935. The State Supreme Court found the graduated net personal and corporate income tax adopted by the voters in 1932 to be unconstitutional.[40] At the general election in 1934, voters again passed the 40-mill limit.[41] This 1934 initiative further reduced the state levy from five mills to two mills, exclusively for the institutions of higher education. The Legislature, meeting in 1935, faced the problems of replacing the revenue previously received from property taxes levied for the state general fund, as well as the state's obligations under the Showalter Act to support common schools, and payment for relief and welfare work. To raise the required revenue, the Legislature enacted the Revenue Act of 1935. The new act supplanted the temporary 1933 act and continued in general effect the business taxes imposed by it. The 1935 act also added several new consumer taxes, including a two percent retail sales tax and a complementary use tax.

The Revenue Act of 1935 consisted of twelve titles, with the business and occupation tax (Title II) clearly separated from the public utility tax (Title V). The tax base for the public utility tax is gross income from the operation of public and privately-owned utilities and public service companies. Utility and public service companies provide services in the areas of energy, water, communications, and transportation. The original legislation included four public utility tax rates:

- 3% of gross operating revenue
  - Railroads, water, light and power, telephone and telegraph
- 2% of gross operating revenue
  - Gas distribution
- 1.5% of gross operating revenue
  - Highway transportation and all other public service businesses subject to control by the state such as airplane transportation, ferry, water transportation, public warehouse, toll bridge, and wharf businesses
- 0.5% of gross operating revenue
  - Urban or interurban transportation and vessels under 65 feet in length operating upon Washington waters

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[40] Culliton v. Chase, 174 Wash. 363 (1933).

[41] By passing the limit again after first adopting it two years prior, the voters restricted the Legislature's ability to amend the limit. Within two years of enactment an initiative measure may only be amended by the Legislature with a two-thirds vote.

The Legislature included a non-pyramiding provision in the public utility tax such that when computing the tax, public service and utility businesses may deduct from gross operating revenue amounts derived from the sale of commodities to firms in the same public service business as the seller, for resale. This deduction was allowed only for water distribution, light and power, gas distribution, or other public service businesses that furnish water, electrical energy, gas, or any other commodity in the performance of public service businesses. Generally, a "public service business" meant any business subject to control by the state.

Later changes to the non-pyramiding provision affected light and power and electrical energy. The changes had no material effect on the overall non-pyramiding intent. In 1982, the Legislature removed light and power from the original subsection and added it to another section. The Legislature made this change in an overall attempt to tax out-of-state sales of electrical energy under the public utility tax rather than the business and occupation tax. In 1986 the Thurston County Superior Court found the 1982 amendments to be unconstitutional.[42] The Legislature tried again in 1989, but the Governor vetoed a portion of the bill. The veto had the effect of putting the anti-pyramiding language for light and power and for electrical energy back into the same subsection as water and gas. In 2000, light and power and electrical energy again received their own subsection in the law. The restriction on the deduction for the sale for resale of electrical energy was no longer limited to sales to other light and power companies but was expanded to apply to income earned by any entity involved in the production, sale, or transfer of electrical energy for resale either within or outside the state.

"Turnover Taxation"

In 1929, the National Industrial Conference Board published a book on sales or "turnover" taxation.[43] This book provided great detail on turnover taxes and their application worldwide. The characteristic of a general sales or turnover tax is that it attaches, directly or indirectly, to all commodity and property sales in a prescribed general class, such as sales at retail, sales at wholesale, manufacturers' sales, and so forth. The authors identified two classes of turnover taxes: multiple-turnover taxes and single-turnover taxes. The distinction is whether the tax is imposed on all or several transfers or stages in the economic progress of a commodity, or whether the tax is imposed only once on each commodity. Multiple-turnover taxes can be further subdivided according to the scope of the tax: a commodity transfer tax is limited to the sale or transfer of tangible materials and commodities; a general turnover tax expands to include commercial or professional services, the sale of real property, or other particular categories. Single-turnover taxes can be classified according to the transaction that gives rise to tax liability: a production tax is imposed on sales by producers or manufacturers; while a retail sales tax is on the sale to the ultimate consuming purchaser.

While the State Tax Commission characterized the 1933 temporary business activities tax as a multiple-turnover tax, the tax had aspects of both a general turnover tax and a production or

[42] "Washington Water Power v. State of Washington," No. 83-2-00977-1, Thurston County Superior Court (1986).
[43] "General Sales or Turnover Taxation," National Industrial Conference Board, New York, 1929.

retail sales tax. The portions of the 1933 act that became the business and occupation tax are akin to a general turnover tax – a broad-based tax on commodities and services. The tax was imposed on all sales of manufacturers, wholesalers, and retailers with a single good being taxed several times. 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 services was a retail sales tax; however, with the Governor's veto of the section directing that the tax be passed onto to the consumer, the public utility tax became a tax on producers. Intermediary sales of a commodity to businesses in the same industry are 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 "sales taxes" in the Conference Board book.[44] 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 the purpose or intent of the tax preference clear?

When creating a new tax, the legislative body enacting the tax must make a number of "base-defining" decisions. The legislative body needs to decide the nature of the tax and what is to be taxed. The public utility tax has the nature of being a producer's tax on the final sale within Washington of selected commodities and utilities. Thus intermittent sales of these commodities are not taxed.

When writing the deduction for sales of selected public service commodities for resale within Washington, the Legislature defined the nature of the tax and the base of the tax. In essence the Legislature made a portion of the public utility tax a retail sales tax. It is clear from 1933 tax legislation that, with regard to the taxation of public services and utilities, the Legislature (1) did not want to tax sales for resale within Washington of these commodities or services to other firms within the same sector, and (2) in the case of light and power, telephone, telegraph, water, and manufactured gas, wanted the tax to be paid by the final consumer. With the Governor's veto of the requirement to pass the tax onto the final consumer, the tax became a producer's tax on the final sale within Washington. The 1935 legislation, while not written as broadly, did not

[44] The report of the 1929 Washington Tax Investigation Commission includes a discussion of the "sales tax" which they discovered referred to "a number of different kinds of taxes unlike in effect and operation." They eliminated from consideration the general sales or turnover tax "because of the inequities in final incidence that would result from the cumulative effect of the tax…" They recommended the book, "General Sales or Turnover Taxation," to those interested in an exhaustive treatment of the sales tax. "Report of the Washington Tax Investigation Commission," Olympia, Washington, 1930, pages 52-53.

tax sales for resale within Washington of commodities to firms in the same public service business, specifically mentioning water, light and power, and gas distribution.

Is there any readily available evidence related to the achievement of any of these public policy objectives?

The deduction of income earned from the sale of water and gas to another water or gas distributor for resale within Washington accomplishes the public policy objective of making the tax a producer's tax on the final sale of water and gas distribution.

Beneficiaries

Who are the entities whose state tax and/or local tax liabilities are directly affected by the tax preference?

The immediate beneficiaries of the deduction of income earned from the sale for resale within Washington of water and natural gas are the initial and intermediary water and natural gas utilities that buy and sell water and natural gas from each other prior to selling it to the final consumer. In recent years, this appears to be about 66 water utilities and 15 gas companies. To the extent that these utilities are monopolies and have the ability to pass costs onto the final consumer, it is the consumer of these utilities that benefit. Without the deduction, the water and natural gas could be taxed twice or more before reaching the consumer.

Revenue Impacts

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

The estimated tax savings to water and natural gas distributors by allowing a deduction for sales for resale within Washington to other distributors is $2.0 to $3.9 million per year over the past several years. The forecasted tax savings is $2.6 million per year. With the public utility tax, the taxpayer savings are the same as the impact to the state government from having the deduction.

Exhibit 17 – Estimated Revenue Impact of Deducting Utility Sales to Other Utilities
(dollars in millions)

	Income Deduction		
Fiscal Year	**Water Utilities**	**Natural Gas Utilities**	**Combined Tax Savings**
2006	$37.1	$4.9	$2.1
2007	$58.8	$6.4	$3.2
2008	$33.8	$24.3	$2.6
2009	$33.8	$24.3	$2.6
2010	$33.8	$24.3	$2.6
2011	$33.8	$24.3	$2.6

Source: Department of Revenue.

Recommendation

The Legislature should continue the public utility deduction for amounts derived from the sale for resale in Washington by water and gas utilities.

Legislation Required: None.

Fiscal Impact: None.

RADIO AND TV BROADCASTING – SUMMARY

Current Law

The state's primary tax on business is the business and occupation tax (B&O tax). The major tax rate categories are:

- Manufacturing/wholesaling 0.484 percent
- Retailing 0.471 percent
- Services 1.5 percent

The gross income received from advertising by radio and television broadcasting is subject to the B&O tax at a rate of 0.484 percent. Broadcasters receive advertising income from two sources: (1) network, national, and regional sources, and (2) local sources. State law allows two deductions from gross income received from advertising by radio and television broadcasting:

1) Income earned from network, national, and regional advertising sources may be fully deducted by either:

(a) Using a computed standard deduction from total gross advertising income based on the national average of network, national, and regional advertising as a percent of total advertising income as reported annually by the Federal Communications Commission (FCC); or

(b) Itemizing actual network, national, and regional advertising income received by the individual broadcasting station.

2) Income earned from local advertising sources may be apportioned between the in-state and out-of-state listening/viewing audience of the broadcaster. Income represented by the out-of-state audience computed as a ratio to the station's total audience may be excluded from tax.

See Appendix 3 for the current law statute RCW 82.04.280(6).

Findings and Recommendations

This review evaluated the legal history, public policy objectives, and revenue impacts of Washington's B&O tax deductions for radio and television broadcasters for amounts derived from the sale of network, national, and regional advertising and apportioning income from the sale of local advertising. The audit determined the following:

Legal History and Public Policy Objectives

- The Legislature attempted to tax the income of radio broadcasters in 1933 and 1935. This occurred when the Legislature was broadening the state's tax base and taxing the income from most business activities.
- In a case called "Fisher's Blend," the U.S. Supreme Court held Washington's tax on all gross receipts of radio broadcasting stations to be an unconstitutional burden upon interstate commerce. The State Tax Commission in 1936 declared the tax on radio broadcasters inoperative, and income earned by broadcasters from selling advertising was not subject to tax in Washington.
- On further review of more recent U.S. Supreme Court decisions, the Department of Revenue determined that some of the advertising income of radio and television broadcasters could be taxed. In the mid-1960s, the Department proposed a rule to tax a portion of broadcaster's advertising revenues at a rate of 1.0 percent.
- In 1967, the Legislature imposed the B&O tax on radio and television broadcasters advertising income at a rate of 0.44 percent (0.484 percent today), the same rate as for newspapers. Only local advertising income was to be taxed. Broadcasters could deduct from their total advertising income an amount for network, national, and regional advertising equal to either the actual amount for such income or a "standard deduction." The "standard deduction" was based on the national average of network, national, and regional advertising as a percent of total advertising income as reported annually by the FCC. In addition, broadcasters could apportion local advertising income based on their out-of-state audience as a share of the broadcaster's total audience.
- The FCC stopped collecting and reporting the national data on network, national, and regional advertising in the early 1980s. The Department revised its rule in 1983 to allow the data to be supplied directly by the industry. The industry as a whole has never supplied the data to the Department. As a matter of practice, the Department has allowed broadcasters to take a standard deduction of 62 percent of gross advertising income. (The 62 percent figure is either from the last year for which the FCC data was available or the average of the last five years for which the data was available.) Some broadcasters may individually be supplying the Department with data in support of another amount. This practice does not match state law or the Department's rule. More recent Census data on the industry show a decline in income from network, national, and regional advertising as a share of total advertising income.
- There are three aspects to this tax preference:
    - Radio and television broadcasting advertising income is currently taxed at a rate of 0.484 percent. This rate is the same as for newspapers; however, the rate is less than the tax rate of 1.5 percent for other forms of advertising such as billboards, direct mail, and the Internet.

  - Network, national, and regional advertising income is exempt from taxation. Broadcasters may either deduct the actual income from network, national, and regional advertising or broadcasters may take a standard deduction. U.S. Supreme Court and Ninth District Court of Appeals decisions made since 1936 call into question a constitutional need for a complete exemption on all network, national, and regional advertising income.
  - A broadcaster may apportion local advertising income between a station's in-state and out-of-state listening/viewing audience. This allowance for apportionment appears to be required by the U.S. Supreme Court.
- The public policy objectives of this tax preference are:
  - To provide equal tax treatment to competing industries. This objective is being met with regards to newspapers but not other forms of advertising.
  - With regards to network, national and regional advertising, the objective of the exemption in general is to comply with the interstate commerce clause of the U.S. Constitution, and the objective of the standard deduction method is to grant small stations a simple option when filing tax returns. The exemption goes beyond what appears to be required by the U.S. Constitution, as a complete exemption for all network, national, and regional advertising income may not be necessary. What may be necessary under the Constitution is an exemption for advertising income earned from broadcasting to out-of-state audiences. However, the standard deduction percentage has not been updated since 1982, and its use appears to be inconsistent with industry trends.
  - With regards to local advertising income, the objective is to comply with the U.S. Constitution. This objective is being met.

Beneficiaries

- More than 130 licensees operate 324 broadcasting stations in the state. All of the stations and licensees are potentially a beneficiary of this tax preference. In addition, cable and satellite television services may take the preferential treatment on advertising income.

Revenue Impacts

- The B&O tax savings to the taxpayers taking deductions from income for the sale of network, national, and regional advertising and/or apportioning the sales of local advertising is $2.0 million in 2006.
- The taxpayer savings is forecast to $2.5 million in 2011.

Recommendation

(1) The Department of Revenue should conform its rule and practice on radio and television broadcasting advertising income to comply with the statute that allows two means for broadcasters to deduct income earned from the sale of network, national, and regional advertising. Since one of these means is no longer operative, broadcasters should deduct only actual sales of network, national, and regional advertising.

Legislation Required:	None.
Fiscal Impact:	Not clear without auditing the taxpayers; perhaps a revenue increase to the state of $100,000 to $500,000.

(2) The Legislature should review the policy of exempting all network, national, and regional advertising from the B&O tax.

Legislation Required:	Yes.
Fiscal Impact:	Indeterminable from available data.

RADIO AND TV BROADCASTING – REPORT DETAIL

Statutory History

1930s – First Attempt at Taxation

Faced with a serious fiscal shortfall in 1933, the Legislature passed the temporary business activities tax. This tax act included a tax on persons engaged within this state in the business of radio broadcasting, with the tax equal to one percent of gross income.

The fiscal shortfall facing the state continued, and the 1935 Legislature responded by passing the 1935 Revenue Act. Among other things, this act made permanent the business and occupation tax and instituted the retail sales tax. The 1935 legislation included a radio broadcasting tax. For the privilege of engaging in the business of radio broadcasting, the state intended to collect a tax equal to one-half of one percent of the gross income of the business.

The industry challenged the 1933 radio broadcasting tax under the U.S. Constitution as being an unconstitutional interference with interstate commerce. In a decision called "Fisher's Blend," the Washington State Supreme Court found the tax to be constitutional.[45] However, the U.S. Supreme Court reversed the state's "Fisher's Blend" decision and held that a state occupation tax measured by the entire gross receipts from radio broadcasting was an unconstitutional burden upon interstate commerce.[46] The federal court released this decision in March 1936.

In May 1936, the State Tax Commission declared the radio broadcasting tax contained in the 1935 Revenue Act to be inoperative. Income earned by radio broadcasters (and later television broadcasters) from selling advertising was not subject to tax in Washington.

1960s – Review of Court Decisions and Imposition of Tax

In the mid-1960s, the Department of Revenue reviewed the case law regarding "Fisher's Blend" to determine whether the decision was still "good law." Based on more recent court decisions, the Department judged it possible for a state to tax the intrastate portion of the business of radio and television broadcasting. In a 1964, decision the U.S. Supreme Court found that it was constitutionally valid to tax a foreign corporation where the tax is levied on the incidents of the taxpayer's substantial local business.[47] While unapportioned local taxes measured by gross receipts from interstate commerce were suspect, such taxation was constitutionally proper if it was fairly apportioned, or divided between an in-state and out-of-state audience.

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[45] "Fisher's Blend Station v. The State Tax Commission," 182 Wash. 163 (1935).

[46] "Fisher's Blend Station v. The State Tax Commission," 297 U.S. 650 (1936).

[47] "General Motors Corp. v. Washington," 377 U.S. 436, (1964).

The 1966 Tax Advisory Council recommended that the B&O tax be extended to the business of radio and television broadcasting to make this tax uniformly applicable to all news media, such as newspapers. The Department of Revenue had legal authority to impose a tax on a portion of the advertising income of radio and television broadcasters by rule; however, the tax rate would be the same as for services and other activities not specified (1.0 percent). Newspapers had a B&O tax rate of 0.44 percent.

The 1967 Legislature, in an omnibus revenue act, extended the B&O tax to include radio and television broadcasting. A portion of the advertising income of radio and television broadcasters became subject to the B&O tax at a rate of 0.44 percent (later changed to .484 percent). The Department of Revenue had requested that radio and television broadcasting become subject to the B&O tax. By rule the Department would separate the taxable income from the nontaxable. The Senate Ways and Means Committee added an amendment so that network, national, and regional advertising income was not subject to tax, while an apportioned share of local advertising income became subject to tax.

The statute provided two methods for a taxpayer to deduct income earned from network, national, and regional advertising. This income could be deducted either by (a) using actual receipts, or (b) could be taken as a “standard deduction” based on FCC national data of national, network and regional advertising receipts as a share of total advertising receipts. The FCC published this data annually. Furthermore, local advertising revenues could be apportioned based on a station’s out-of-state listening or viewing audience.

On June 29, 1967, after the Legislature had acted, the Department of Revenue adopted a rule that covered only the reporting period prior to July 1, 1967. Radio and television broadcasters were subject to the business and occupation tax on their local advertising income at the services and other activities rate of one percent. The local advertising income could be apportioned to remove from the tax base income from advertising intended to reach potential customers outside the state. While network, national, and regional advertising income was not subject to tax, there was no “standard deduction” to account for this income.

The Department adopted another rule for the period following July 1, 1967, on which date the statute took effect. This rule conformed to the statute and allowed for the “standard deduction” for network, national, and regional advertising.

1980s – FCC Stopped Data Collection

The FCC stopped collecting the data from radio and television broadcasters regarding sources of advertising income in 1980 and last published the data in 1981. In 1982, the Department of Revenue issued an Excise Tax Advisory notifying radio and television broadcasters that for calendar year 1982 only, the most recent statistics resulted in a standard deduction of 62 percent that could be applied against total gross advertising income.[48]

[48] The Department of Revenue cancelled the Excise Tax Advisory in June 2007.

The Department then, by rule, created a third method to take an income deduction for network, national, and regional advertising. In 1983, the Department amended the rule to recognize that FCC data were no longer available and that it would become the responsibility of the industry to annually provide the figures to the Department. The figures used needed to be verified by the Department.

In a comment on the proposed rule change, the Washington State Association of Broadcasters suggested that until such time as the industry begins supplying the data, broadcasters could use an average of the standard deductions previously documented. The average over ten years, 1973 through 1982, was 63 percent; the average over five years, 1978 through 1982, was 62 percent. The broadcasters suggested that 62 percent be used until such time as reliable national figures became available.

The national figures were never provided to the Department. The Department has allowed a fourth method for deducting income earned from network, national, and regional advertising. As a practical matter, since 1982 the Department has allowed radio and television broadcasters to use a standard deduction of 62 percent. This is based on either the last year in which the data were published by the FCC (1981) or the average of the last five years documented by the Department (1978 through 1982).

Other Court Decisions

Policymakers also have additional information from a 1954 federal court decision. In 1945, Hawaii imposed a general gross receipts tax on business activities in Hawaii. The tax rate on radio broadcasting stations was 2.5 percent. This tax was on the gross receipts of the broadcaster with no distinction as to whether the source of receipts was local or from outside the territory. Unlike Washington's first attempt at taxation in the 1930s, Hawaii's tax, however, was imposed only on broadcasts within the territory and not on those broadcasts carried in or out of the territory.

When this tax was challenged in court, the Ninth Circuit Court of Appeals saw a distinction between Washington's 1930s tax and Hawaii's.[49] Washington did not attempt to segregate receipts from local broadcasts from those crossing state lines. Hawaii's tax was only on broadcasts within the territory, and this approach was upheld by the Court as consistent with the commerce clause.

Unlike Hawaii's tax, Washington's 1960s tax exempts income from network, national, and regional advertising from taxation. Similar to Hawaii, Washington's 1960s tax does attempt to tax only in-state broadcasts. Washington's exemption for network, national, and regional advertising income may not be constitutionally required.

[49] "McCaw v. Fase," 216 F2d 700 (Ninth Circuit, 1954).

Tax Rates on Advertising

The B&O tax is levied for the privilege of doing business in the state. The tax is levied on the value of products, gross proceeds of sales, or gross income of business activities conducted within the state. There are several different tax rates. The three principal rates are manufacturing/wholesaling (0.484 percent), retailing (0.471 percent), and services (1.5 percent).

Advertising income earned by radio and television broadcasters is taxed under a special tax provision. The taxable portion of this income is subject to a tax rate of 0.484 percent. Also, the taxable advertising income earned by subscriber television services such as cable and satellite television is subject to the same tax rate.

Printing is subject to a tax rate of 0.484 percent. Publishing newspapers, magazines, and periodicals is also taxed at a rate of 0.484 percent. Taxpayers that both print and publish books, circulars, and materials other than newspapers, magazines, or periodicals are also taxed at 0.484 percent. Publishers, other than publishers of newspapers, magazines, and periodicals, which do not print their own material, are taxed on sales of the material at the retailing rate (0.471 percent) or the wholesaling rate (0.484 percent) and are taxed at the services rate (1.5 percent) on income received from advertising. With legislation passed in 2008, advertising income related to web-based newspaper material is subject to the 0.484 percent printing and publishing tax rate. Previously, the Department of Revenue did not consider posting materials on the Internet to constitute printing or publishing and, thus, advertising income received by newspapers for their web-based materials had been subject to tax at 1.5 percent.

Income from other forms of advertising is subject to a tax rate of 1.5 percent. Income earned from outdoor advertising (e.g., billboards) and public signage (e.g., ads on busses) is taxed at 1.5 percent. Fliers (not distributed in newspapers) and direct mail is not considered to be printing and publishing and is taxed at 1.5 percent. Income earned from selling advertising on the Internet, except that earned by newspapers, is subject to tax at 1.5 percent.

Public Policy Objectives

What are the public policy objectives that provide a justification for the tax preference? Is the purpose or intent of the tax preference clear?

The initial public policy objective in the 1930s was to tax the income earned by radio broadcasters. The initial tax exemption for radio broadcasters resulted from a U.S. Supreme Court decision. The Legislature attempted to tax the gross income of radio broadcasters in 1933 and 1935. The U.S. Supreme Court found this tax to be an unconstitutional burden upon interstate commerce, and the tax was never imposed.

In the mid-1960s the Department determined that a portion of the advertising income of radio and television broadcasters could be made subject to tax. The Department had legal authority to accomplish this by rule, but the tax rate of 1.0 percent would be in excess of the competition, newspapers, which was 0.44 percent. Instead, the Legislature adopted a statute in 1967 that set the tax rate for radio and television broadcasters at the same level as newspapers. That measure also, however, broadened the portion of income that was **not** subject to tax beyond what the

Department had proposed. The Legislature allowed for a standard deduction for network, national, and regional advertising income.

There are three aspects to this tax preference:

(1) The preferential tax rate of 0.484 percent;

(2) The exemption of network, national, and regional advertising income and the method used to determine this amount; and

(3) The apportionment of local advertising income.

(1) The public policy objective for providing a preferential tax rate appears to be to provide equal tax treatment to competing industries. The tax rate of 0.484 percent (0.44 percent in 1967) was chosen by the Legislature, as opposed to allowing the Department to implement a rule and impose a tax of 1.5 percent (1.0 percent in 1967). The Legislature chose a tax rate that was the same as for newspapers, a major competitor of broadcasting. From comments made on the Senate floor, it is clear that there was concern about competition in advertising between the public press and radio and television broadcasting. The comments had to do with the exemption for out-of-state advertising being allowed for broadcasting while no such allowance was being granted the press. Other forms of advertising such as billboards, direct mail, and the Internet are taxed at 1.5 percent.

(2) The public policy purpose of exempting network, national, and regional advertising from state taxation appears to have been done in the belief this exemption was related to interstate commerce and required by the U.S. Constitution. The Ninth Circuit Court of Appeals decision regarding the Hawaii tax on broadcasting, however, appears to make the taxing of network, national, and regional advertising permissible, as long it does not tax broadcasts beyond the state.

The purpose or intent of why the Legislature provided for the standard deduction for income earned from network, national or regional advertising based on national averages is not stated in the statute. According to the industry, the Legislature took this step to permit an option for small, rural stations that did not have the ability to do the kind of bookkeeping required for an itemized deduction.[50]

(3) The public policy purpose of not taxing income earned from out-of-state broadcasts is to comply with the U.S. Constitution. Some apportionment of broadcasting advertising income is required by the U.S. Constitution. The method applied to local advertising revenues is based on signal strength and the in-state/out-of-state population within the signal area. This method appears to be a reasonable form of apportionment, and this review found no challenges to this method.

[50] E-mail from Mark Allen, President, Washington State Association of Broadcasters, March 25, 2008.

Is there any readily available evidence related to the achievement of any of these public policy objectives?

(1) **The preferential tax rate of 0.484 percent:** Printing and publishing, and radio and television broadcasting share the same tax rate. In this instance, this achieves taxing two major competitors at the same rate. However, this rate is lower than for other forms of advertising such as billboards, direct mail, and the Internet.

(2) **The exemption of network, national, and regional advertising income and the method used to determine this amount:** It does not appear that the U.S. Constitution requires a full exemption for network, national, and regional advertising income. The U.S. Supreme Court ruled that a state tax on all advertising income earned by broadcasters to be unconstitutional. The Ninth Circuit Court of Appeals ruled that a tax on income earned on broadcasts within a state was consistent with the commerce clause. In this case, income earned from broadcasts outside the state was not taxed. In this sense the public policy objective is being met, but the amount of the exemption goes beyond what the U.S. Constitution requires.

As to the method of determining the untaxed amount of network, national, and regional advertising, the standard deduction would generally benefit radio broadcasters more than television broadcasters. Advertising income of radio broadcasters at the time was comprised of 35 percent from network, national, and regional advertising. The weighted average for both radio and television broadcasters was 66 percent, which was the first standard deduction adopted in 1967. Locally-oriented radio broadcasters with relatively greater portion of their income derived from sales of local advertising could deduct 66 percent of their advertising income before applying the tax rate. Television broadcasters, that may have had more than 66 percent of their income derived from sales of network, national, and regional advertising, could itemize their sales and take the larger deduction.

There is some evidence that the practices of the industry have changed. The standard deduction adopted in 1982 may no longer be relevant.

Exhibit 18 – Network, National, and Regional Advertising
as a Percent of Total Advertising

	1965 U.S.	2002 U.S.	2002 Washington
Radio Broadcasting	35%	29%	30%
Television Broadcasting	81%	65%	44%
Weighted Average	66%	54%	37%

Sources: 1965 FCC data obtained from Department of Revenue; 2002 data obtained from U.S. Census Bureau, 2002 Economic Census.

Network, national, and regional advertising income have declined as a share of total advertising income. Data from the 2002 Economic Census published by the U.S. Census Bureau indicate that for radio and television broadcasting combined, network, national, and regional advertising income nationally comprised 54 percent of total advertising income. For radio broadcasting, the share was 29 percent, and for television broadcasting, the share was 65 percent. Data specific to Washington State indicate the share for radio broadcasting was about the same as the national average at 30 percent. Television broadcasting in Washington had a significantly lower share than the national average at 44 percent. The combined average was 37 percent.

Washington's mix of advertising income between network, national, and regional advertising income and local advertising income is significantly different than the national average. The difference lies in the advertising income of television broadcasters. Radio advertising income in Washington is split between the two sources virtually the same as the nation as a whole – 70 percent local, and 30 percent network, national, and regional. Washington's share of total U.S. radio advertising is two percent – in line with Washington's share of total population. In television broadcasting, local advertising comprises 56 percent of the total in Washington while for the U.S. it is 35 percent. Washington's share of total advertising income is 1 percent of the U.S. total – half of Washington's population share.

The concept of the standard deduction still provides smaller stations an option to itemizing advertising receipts. In this sense, the public policy objective is being met.

(3) **The apportionment of local advertising income:** There does not appear to be any controversy or challenges to this method of apportionment. In this sense the public policy objective has been achieved.

Beneficiaries

Who are the entities whose state tax and/or local tax liabilities are directly affected by the tax preference?

Exhibit 19 – Washington Broadcasters

	Commercial Stations	Noncommercial Stations	Total Stations
AM	103	3	106
FM	111	62	173
TV	35	7	42
Other	2	1	3
Total	**251**	**73**	**324**

Source: Washington State Association of Broadcasters.

The directory of Washington broadcasters maintained by the Washington State Association of Broadcasters identifies 324 stations in Washington licensed to 132 separate entities (with another

18 AM and FM stations where the licensee is not identified). Potentially, all of these stations and licensees may be beneficiaries of the income deduction for network, national, and regional advertising, and some of these stations may also benefit from the apportionment of local advertising income. Stations with no advertising income, or stations with gross income under $28,000 per year that do not need to file tax returns, do not benefit.

Gross advertising income earned by radio and television broadcasters, as well as subscriber television services (including cable and satellite television), is supposed to be reported on a specific line of the Department's Combined Excise Tax Return. Income earned by broadcasters from retail sales and the provision of services is to be reported on other lines. From the gross income reported as advertising income, itemized deductions may be taken to arrive at taxable income.

In calendar year 2006, 114 taxpayers reported radio and television advertising income to the Department. Of these taxpayers, 65 took itemized deductions that could be attributed to nonlocal radio/TV advertising – either network, national, and regional advertising and/or apportionment of local advertising. The network, national, and regional advertising deductions taken by the broadcasters may have been taken either by using a standard deduction or by itemization.

Twelve taxpayers took deductions of exactly 62 percent; 27 taxpayers took more than 62 percent; and 26 taxpayers took less than a 62 percent deduction. The remaining 49 taxpayers reported no deductions – however, some of these taxpayers reported just their net taxable income only and did not report the amount of deductions. Taxpayers taking more than 62 percent could do so either because they could itemize network, national, and regional advertising in excess of 62 percent and/or took the standard 62 percent deduction and then apportioned local advertising based on their out-of-state audience. Taxpayers taking deductions of less than 62 percent may have been itemizing network, national, and regional advertising or taking a "standard deduction" in an amount different than 62 percent. The 2002 Economic Census supports a standard deduction of 54 percent. There were nine broadcasters taking deductions ranging from 53 percent to 56 percent. The 49 taxpayers showing no deductions either reported only taxable income to the Department by taking deductions for advertising income prior to completing the tax return, or had no network, national, and regional advertising income or out-of-state audience.

Exhibit 20 – Radio and Television Broadcasters Claiming Income Deductions Related to Nonlocal Advertising, As a Percent of Total Gross Income, 2006

Amount of Deduction As Percent of Gross Income	Number of Taxpayers	Total Amount of Income Deductions (millions)
63% or more	27	$280
62%	12	$29
1% to 61%	26	$104
0%	49	$0

Source: Department of Revenue tax records.

Revenue Impacts

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

In calendar year 2006, the 65 taxpayers that took deductions from advertising income had a total gross income of $596 million. The average deduction was 69 percent for a total deduction of $413 million. The B&O tax on this amount would have been $2.0 million. Some of this deducted amount is required by the U.S. Constitution. Of the $2.0 million in tax savings, those taxpayers claiming more than a 62 percent deduction accounted for $1.4 million of the savings, while those taxpayers claiming a deduction of less than 62 percent accounted for $0.5 million of the savings. Taxpayers clearly claiming the a deduction of 62 percent accounted for $0.1 million of the savings.

Exhibit 21 – Advertising Income Deductions
($ in millions)

Calendar Year	Gross Income Deducted	B&O Tax Savings
2006	$413	$2.0
2007	$451	$2.2
2008	$465	$2.2
2009	$480	$2.3
2010	$499	$2.4
2011	$520	$2.5

Sources: 2006 estimates derived from Department of Revenue data; forecasts for 2007-11 prepared by JLARC.

The exact nature of the deductions is not clear from the tax records. Taxpayers taking more than a 62 percent deduction may be doing so because actual receipts from network, national, and regional advertising may exceed 62 percent, or they may be taking the standard deduction of 62 percent and then adding the apportioned local advertising income. Taxpayers taking exactly a 62 percent deduction may be taking the standard deduction and actually have something less than 62 percent of their advertising income derived from network, national, and regional advertising, but it is impossible to determine how much less. Taxpayers taking less than the standard

deduction may be basing their deduction on actual income or may be using a different "standard deduction."

Recommendation

(1) The Department of Revenue should conform its rule and practice on radio and television broadcasting advertising income to comply with the statute that allows two means for broadcasters to deduct income earned from the sale of network, national, and regional advertising. Since one of these means is no longer operative, broadcasters should deduct only actual sales of network, national, and regional advertising.

Legislation Required: None.

Fiscal Impact: Not clear without auditing the taxpayers; perhaps a revenue increase to the state of $100,000 to $500,000.

(2) The Legislature should review the policy of exempting all network, national, and regional advertising from the B&O tax.

Legislation Required: Yes.

Fiscal Impact: Indeterminable from available data.

MINIMUM GROSS INCOME FILING THRESHOLD – SUMMARY

Current Law

The public utility tax is a state tax on the "act or privilege of engaging within this state" in any one or more specified utility or public service businesses. The base of the tax is the gross income derived from the operation of public and privately-owned utilities, including the general categories of transportation, and the supply of energy and water. Income from utility or public service operations is taxed under the public utility tax in lieu of the business and occupation tax. Other income of a utility or public service company (e.g., retail sales of tangible personal property) is subject to the business and occupation tax.

Small public service and utility businesses with gross income of less than $2,000 per month are exempt from the public utility tax. The law stipulates that if monthly filers have gross income that equals or exceeds $2,000, no exemption of the public utility tax is allowed. The law does not mandate that these businesses under the minimum monthly gross income threshold complete an excise tax return with the Department of Revenue. See Appendix 3 for the current law statutes RCW 82.32.030, 82.32.045 and 82.16.040.

Findings and Recommendations

This review has evaluated the legal history, public policy objectives, and revenue impacts of the public utility tax minimum gross income threshold exemption. The audit has determined the following:

Legal History and Public Policy Objectives

- The Legislature established a minimum income threshold for payment of the public utility tax in 1935. Originally, the gross revenue thresholds for the public utility tax and the business and occupation tax were the same.
- The Legislature has since changed the income threshold; the threshold has been $2,000 per month for monthly filers, $6,000 per quarter for quarterly filers and $24,000 per year for annual filers since 1996.

This tax preference has achieved three public policy objectives associated with this exemption:

1. To define the public utility tax base.

2. To provide a temporary subsidy to start-up small public service and utility businesses. Once those businesses start growing and their gross revenue exceeds the minimum threshold, they will be required to pay the public utility tax.
3. To ease the administration of the public utility tax by eliminating the tax burden and filing requirement for these small businesses and for the Department of Revenue.

Beneficiaries

- The beneficiaries of this public utility tax exemption are small public service and utility businesses.
- The exact number of small businesses exempt from the public utility tax is unknown as it is not mandatory that small businesses file an excise tax return if their gross income is under the minimum threshold amount.

Revenue Impacts

- The estimated annual taxpayer savings from this tax preference is projected to be between $1.2 and $1.3 million per year over the next two biennia.

Recommendation

The Legislature should continue this public utility tax minimum income threshold exemption.

Legislation Required: None.

Fiscal Impact: None.

MINIMUM GROSS INCOME FILING THRESHOLD – REPORT DETAIL

Statutory History

Public Utility Tax

This minimum gross income threshold for the public utility tax started at $1,000 per bi-monthly period at enactment in the Revenue Act of 1935. In 1959, the Legislature lowered the threshold to $500 per bi-monthly period. In 1996, the Legislature raised the minimum gross income threshold $2,000 per month for monthly filers, $6,000 per quarter for quarterly filers, and $24,000 per year for annual filers. The 1996 legislation also included a new exemption from registering with the Department of Revenue for public utility taxpayers with less than $12,000 per year in income. The 1996 legislation included the following intent section:

> *The Legislature finds that small businesses play a vital role in the state's current and future economic health. The legislature also finds that the state's excise tax reporting and registration requirements are unduly burdensome for small businesses incurring little or no tax liability. The Legislature recognizes the costs associated in complying with the reporting and registration requirement that are hindering the further development of those businesses. For these reasons, the legislature with this act simplifies the tax reporting and registration requirements for certain small businesses.*[51]

Since 1996, the public utility tax has had the same registration filing threshold of $12,000 per year and the same minimum gross income threshold of $24,000 per year for annual filers, $6,000 for quarterly filers, and $2,000 for monthly filers.

Other Relevant Background

Public Utility Tax

The Legislature faced a revenue shortfall as it convened in January 1933. The prior November, the voters had passed Initiative Measure No. 64, a 40-mill property tax limit bill. The initiative limited property tax levies for state purposes to a maximum of five mills on a 50 percent valuation.[52] This measure effectively reduced the income from state taxes by approximately 50 percent, beginning with the second year of the 1933-35 Biennium. Assessed valuations and levies were already reduced due principally to the depressed economic conditions of the time. The Legislature also adopted in 1933 the Showalter Bill, a measure increasing, by about two-thirds,

[51] HB 2789, Section 1.

[52] In other terms, this is equivalent to a maximum levy rate of $2.50 per $1,000 of assessed value at 100 percent valuation.

the state's obligation to support local school districts. The voters passed another initiative in 1932, Initiative Measure No. 69, imposing a state income tax on all corporations and individuals.

In response, the Legislature adopted a temporary business activities tax in 1933. The tax was to be in place from August 1, 1933 to July 31, 1935. The tax was measured by the application of rates against "value of products," "gross proceeds of sales," or "gross income of the business." The rates varied depending on the type of business activity.

The 1933 temporary business activities tax imposed taxes upon the privilege of engaging in business activities, including public service and utility activities. Generally, public service companies and utilities were subject to state regulation of rates or state supervision or control. Service needed to be rendered to all who requested the service, the "right to refuse to serve being dependent solely upon the limitations of capacity and obnoxious character of the person or property involved."[53] These public service and utility activities included light and power companies, telephone and telegraph companies, water companies (except irrigation companies), manufactured gas companies, steam railways, highway transportation companies, street railways, and other public service companies such as docks, warehouses, and ferries. Public service and utility activities were taxed at four basic rates ranging from 0.5 percent to 3.0 percent. In 1933, public service and utility companies were allowed an exemption from the business and activities tax if gross receipts were minimal.

The revenue shortfall continued into 1935. The State Supreme Court found the graduated net personal and corporate income tax adopted by the voters in 1932 to be unconstitutional.[54] At the general election in 1934, voters again passed the 40-mill limit.[55] This 1934 initiative further reduced the state levy from five mills to two mills, exclusively for the institutions of higher education. The Legislature, meeting in 1935, faced the problems of replacing the revenue previously received from property taxes levied for the state general fund, as well as the state's obligations under the Showalter Act to support common schools, and payment for relief and welfare work. To raise the required revenue, the Legislature enacted the Revenue Act of 1935. The new act supplanted the temporary 1933 act and continued in general effect the business taxes imposed by it. The 1935 act also added several new consumer taxes, including a 2 percent retail sales tax and a complementary use tax.

The Revenue Act of 1935 consisted of twelve titles, with the business and occupation tax (Title II) clearly separated from the public utility tax (Title V). The tax base for the public utility tax is gross income from the operation of public and privately-owned utilities and public service companies. Utility and public service companies provide services in the areas of energy, water, communications, and transportation. The original legislation included four public utility tax rates:

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[53] "Business Tax Instructions, Revised Rules and General Instructions," Tax Commission of the State of Washington, 1934.

[54] Culliton v. Chase, 174 Wash. 363 (1933).

[55] By passing the limit again after first adopting it two years prior, the voters restricted the Legislature's ability to amend the limit. Within two years of enactment, an initiative measure may only be amended by the Legislature with a two-thirds vote.

- 3% of gross operating revenue
    - Railroads, water, light and power, telephone and telegraph
- 2% of gross operating revenue
    - Gas distribution
- 1.5% of gross operating revenue
    - Highway transportation and all other public service businesses subject to control by the state such as airplane transportation, ferry, water transportation, public warehouse, toll bridge, and wharf businesses
- 0.5% of gross operating revenue
    - Urban or interurban transportation and vessels under 65 feet in length operating upon Washington waters

The 1935 legislation also identified exemptions from the public utility tax, including several allowed in 1933 for the business and activities tax. A minimum monthly gross operating revenue threshold was allowed in both the temporary business and activities tax and the public utilities tax. [56] This was one of eight public utility tax exemptions enacted in 1935.[57]

The public utility tax applies only on sales to consumers. The tax is a state tax only. In recent years, the tax collections have grown from $203 million in 1997 to $340 million in 2006. The public utility tax is reported by about 5,000 firms annually with approximately 110 electric companies paying more than 50 percent of the tax.

[56]"6th Biennial Report of the Tax Commission of the State of Washington," September 30 1936.
"Introduction to Finance," by Laurence J. Gitman and Jeff Madura 2001.

[57]Eight public utility tax preferences in 1935: minimum monthly threshold of gross operating revenue, irrigation water, sales of commodities to other persons for resale purposes, payments to other persons taxable under public utility tax for service rendered jointly, taxes received by municipal utilities, sales and service to federal govt. and in interstate and foreign commerce, credit losses and cash discounts.

Exhibit 22 – History of the Public Utility Tax Collections: 1997 – 2006

Fiscal Year	Collections ($ in millions)	% Change
1997	$203.2	1.7
1998	$211.8	4.2
1999	$221.4	4.5
2000	$246.4	11.3
2001	$267.6	8.6
2002	$274.6	2.6
2003	$269.8	-1.7
2004	$292.8	8.5
2005	$303.8	3.7
2006	$339.9	11.9

Source: 2007 Tax Reference Manual.

Business and Occupation Small Business Tax Credit

Originally, the minimum gross income filing thresholds for the business and occupation tax and the public utility tax were the same. Both taxes had a minimum gross revenue filing threshold until 1994. In 1994, the Legislature replaced the business and occupation tax minimum gross income threshold with a small business tax credit of a maximum amount of $60 per month. One reason for the tax policy change was to assist new start-up businesses. This change to a small business tax credit eliminated the inherent problem in the tax that once a taxpayer exceeded the gross revenue threshold, the taxpayer had to pay the B&O tax on all its income. The B&O tax credit is reduced by the amount of tax liability that exceeds the maximum small business credit amount for higher income businesses. Another advantage of the tax credit over the minimum income threshold is that it equalizes the benefit to all B&O taxpayers since there are different tax rates assessed on B&O taxpayers.

In 1997, the Legislature passed HB 1261, a bill requiring the Department of Revenue to create a tax table for small business taxpayers so it would be easier for these businesses to calculate the small business tax credit. In addition to specifying tax tables be created, HB 1261 added an intent section in the business and occupation tax small business tax credit indicating the reasons for simplifying the B&O small business tax credit calculation:

> ***Findings – Intent – 1997 c 238:*** *"The Legislature finds that many businesses have difficulty applying the small business credit under RCW 82.04.4451. Further, the Legislature appreciates the valuable time and resources small businesses expend on calculating the amount of credit based upon a statutory formula. For the purpose of tax simplification, it is the intent of this act to direct the Department of Revenue to create a schedule, in standard increments, to replace required calculations for the small business credit. Each taxpayer can make reference to the taxpayer's tax range on the schedule and find the amount of the taxpayer's small business credit. Further, no taxpayer will owe a greater amount of tax nor*

will any taxpayer be responsible for a greater amount of taxes otherwise due." [1997 c 238 § 1.]

Public Policy Objectives

What are the public policy objectives that provide a justification for the tax preference?

There are three public policy objectives justifying this tax preference:

Tax Base: Tax base defining theory states that at the time Legislatures are developing a tax, they will define the elements that will be subject to the tax and the elements excluded. Since this tax preference was enacted in 1935 at the same time as the public utility tax, one public policy objective of this tax preference was to define the tax base as excluding certain small businesses from this tax. Another justification for the tax base defining theory is that at the time of enactment of the tax preference, the activity of the exempt businesses did not rise to the level of taxable activity. To the extent that small public service and utility businesses did not produce significant income in 1935, they were not intended to be part of the public utility tax base.

Temporary subsidy: Another public policy objective of having a minimum gross income threshold is the goal to provide start-up businesses with a temporary tax break with the long-term objective being that, once businesses expand, they would start to pay the public utility tax.

Ease of administering the tax: Another public policy objective of this minimum gross income filing threshold is that it eliminates the administrative burden on small public service and utility business owners. The administrative cost of filing is likely to be higher than the potential tax revenue that could be gained from assessing the tax on these taxpayers.

Is the purpose or intent of the tax preference clear?

The legislative intent to have a minimum gross income threshold is clear in the law and is consistent with most other taxes that define the tax base and ease the administration of the tax by giving an exemption for small businesses.

The legislative intent is not clear in why the Legislature did not convert the public utility tax minimum income threshold to a small business tax credit like the business and occupation tax. It may be that the Legislature thought there were not enough public utility taxpayers negatively affected by the design of the minimum gross revenue threshold of the public utility tax minimum to change these provisions for small businesses.

Is there any readily available evidence related to the achievement of any of these public policy objectives?

This tax preference achieves the objective of defining the public utility tax base. In addition, having a minimum gross income threshold does ease the administration of the public utility tax by not requiring these small businesses to file reports with the Department of Revenue. There is no evidence to verify if the small businesses with income less than the minimum gross income

filing threshold are new start-up businesses or established small businesses. Therefore, it is not possible to determine whether the tax preference is providing a temporary subsidy to new or existing businesses.

Beneficiaries

Who are the entities whose state tax and/or local tax liabilities are directly affected by the tax preference?

Past Department of Revenue (DOR) Tax Exemption Reports have not estimated the number of taxpayers benefiting from this tax exemption. Determining the exact number of beneficiaries is difficult for this tax preference, as these businesses are not required to report to DOR if they are under the minimum gross income threshold. Generally, the small private utility companies and special purpose districts are the primary beneficiaries of this minimum income threshold.

During this review, JLARC identified the number of companies not paying the public utility tax because their reported business income was below the income threshold. JLARC queried DOR's excise tax returns for calendar year 2006 to identify those small taxpayers that are under the public utility tax income threshold. Of the more than 7,000 public utility taxpayers, 799 businesses (11 percent) fell under the public utility tax threshold and paid no tax. Exhibit 23 provides a further breakdown of the types of businesses that fell below the income threshold, which are typically small in scale and do not have public utility tax liability. Taxi cabs (18 percent) were under the income filing threshold. General freight trucking, and local and long distance hauling comprise the second largest category at 16 percent.

Exhibit 23 – Small Public Utility Taxpayers Filing Tax Returns:
Income Under the Minimum Income Threshold

Industry	Number of small businesses not subject to PU tax	Percent of all PU taxpayers not subject to PU tax
Taxi Service	145	18%
General Freight Trucking – Local and Long Distance	128	16%
Local Messengers & Local Delivery	50	6%
Specialized Freight Trucking, Local	44	6%
Limousine Service	44	6%
Couriers	21	3%
Others	367	46%
Total	**799**	**100%**

Source: Washington DOR excise tax database.

Note: This Exhibit does not include small water and sewer utility companies.

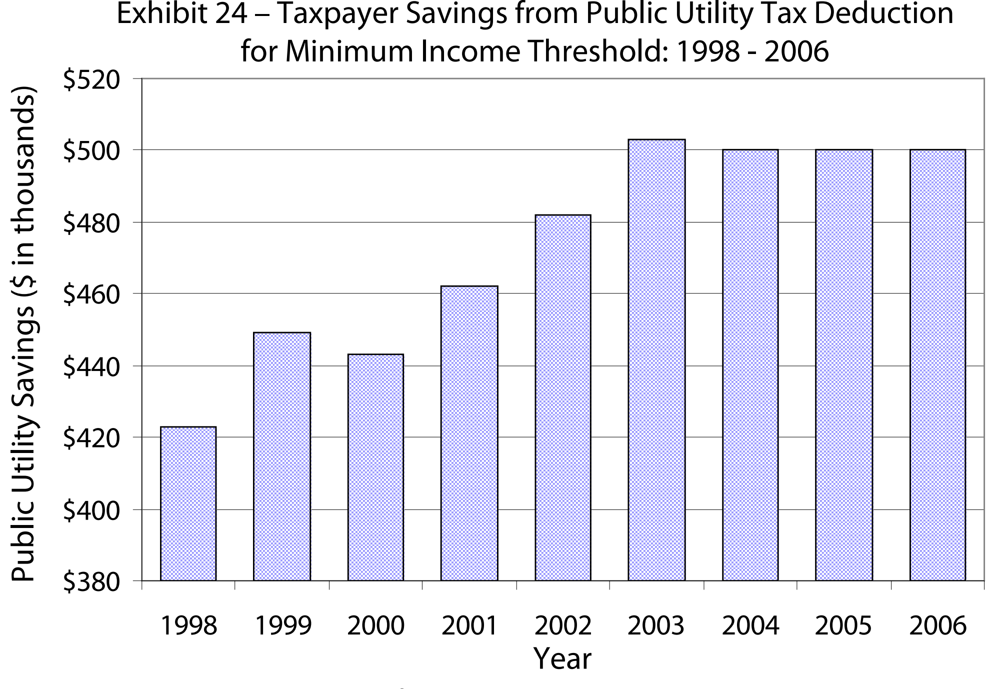
Unfortunately, not all small utility companies file the excise tax return. In particular, JLARC identified numerous small water, irrigation, and sewer utility companies that do not file the excise tax return with DOR. According to the Department of Health data on water systems, statewide there are more than 3,000 water systems with 15 or more connections each. Of these 3,000 water systems, 470 filed an excise tax return in 2006. Of those 470, only 20 entities (4 percent) had gross income below the minimum income threshold. More than 2,500 water and sewer districts and companies are not filing the excise tax return. Potentially these companies either do not have sufficient gross income to have public utility tax liability or have only sales that qualify for another tax deduction like the irrigation water deduction.

Revenue Impacts

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

According to the Department of Revenue's Tax Exemption Reports, DOR has estimated the value of this tax preference at approximately $500,000. DOR bases its estimate on the difference between the value of the public utility tax paid by taxpayers under a lower threshold of $500 (in 1996) versus those that are exempt under a higher threshold of $2,000 beginning in 1997. This data is now more than ten years old, and many of the companies on the list of public utility taxpayers in 1996 are no longer in business.

Exhibit 24 – Taxpayer Savings from Public Utility Tax Deduction for Minimum Income Threshold: 1998 - 2006



Source: Department of Revenue past Tax Exemption Reports.

In order to project the value of this public utility tax minimum gross income threshold in this report, JLARC examined the 2006 public utility taxpayers that fell under the gross income threshold. JLARC summed the gross income of those taxpayers and multiplied by the appropriate public utility tax rate to generate the amount of tax that could have been collected if this tax preference had not been in place. JLARC identified 799 taxpayers that were under the minimum income filing threshold, and these taxpayers had a total of $6.775 million in income. Not all taxpayers under the minimum income filing threshold file the excise tax return. In particular, there are many small water and sewer utility companies, as well as small irrigation districts, that are not in the Department of Revenue's excise tax database. In order to consider these special districts and companies, JLARC evaluated the Department of Health's (DOH) database on the companies filing reports. These districts file reports with DOH because they are supplying drinking water to Washington's communities. To supplement the DOR database, JLARC identified the water and sewer companies and districts that did not file an excise tax return in 2006, estimated their gross income based on the size of the water system. JLARC estimated the amount of the taxpayer savings based on a tax rate of 5.03 percent. Over the next two biennia, JLARC estimated the annual public utility taxpayer savings for the small businesses and districts, with gross income below the minimum income threshold, to be between $1.2 and $1.3 million per year. The taxpayer savings estimates are equivalent to the loss in state government revenue from continuing this public utility tax exemption.

Exhibit 25 – Public Utility Tax Income Exempted and Taxpayer Savings from Minimum Income Threshold

Year	Amount of Income Exempted ($ millions)	Taxpayer Savings ($ millions)
2007	$22.6	$1.1
2008	$23.6	$1.2
2009	$24.5	$1.2
2010	$25.5	$1.3
2011	$26.5	$1.3

Source: JLARC forecast.

Recommendation

The Legislature should continue this public utility tax minimum income threshold exemption.

Legislation Required: None.

Fiscal Impact: None.

PUBLIC UTILITY OPERATING PROPERTY – SUMMARY

Current Law

Sales of operating utility property to state or local governments or public utility districts are exempt from retail sales and use tax. Since Washington's retail sales and use tax typically applies to sales of personal property, this tax exemption for operating utility property consists of sales/transfers of the entire operating property of a public utility or a complete integral section of the entire operating property. These sales include properties such as water systems and electrical substations. Statute defines this tax preference narrowly. One requirement for this tax exemption is that the utility property must be operating as utility property before the sale, and the new owner must continue to operate the property as a utility. Another requirement is that the purchaser of the operating utility property must be a state agency or political subdivision. See Appendix 3 for the current law statutes RCW 82.08.0256 and 82.12.0257.

Findings and Recommendations

This review has evaluated the legal history, public policy objectives, and revenue impacts of the retail sales and use tax exemptions for sales of operating utility property. The audit determined the following:

Legal History and Public Policy Objectives

- The Legislature enacted the retail sales and use tax exemptions for operating utility property in 1943. At that time, the exemptions applied to sales of operating utility property made to any person for use in conducting business subject to the public utility tax. In 1951, the Legislature restricted retail sales and use tax exemptions to apply only to sales of operating utility property made by the state or a political subdivision. The Legislature has not made substantive changes to the law since 1951.
- An initial public policy objective of these retail sales and use tax exemptions was to provide equal tax treatment among all businesses subject to the public utility tax by providing utility companies with retail sales and use tax exemptions for purchases of operating utility property. These sales of operating utility property might have been seen as just transfers of ownership, with the property still being used as utility property to serve Washington residents.
- When the Legislature narrowed these tax preferences in 1951, another public policy objective of these retail sales and use tax exemptions was to assist government utility agencies when they needed to expand and purchase additional operating property.

- These tax preferences have achieved the original objective of assisting all utility company taxpayers by providing retail sales and use tax exemptions for purchases of operating utility property. However, by 1951, the only public policy objective achieved was an objective of providing a tax break to the state and political subdivisions that purchased operating utility property.
- The 1951 legislation did not include a clear statement of the Legislature's intent behind narrowing these preferences to utilities operated by state and local political subdivisions.

Beneficiaries

- Since 1951, the beneficiaries of these tax preferences have been state and local political subdivisions that purchase operating utility property. This includes municipal utilities and public utility districts.
- The exact number of beneficiaries is unknown, as the utilities do not report these purchases.
- JLARC conducted a survey of utility agencies that could have received a retail sales or use tax exemption for purchases of operating utility property. The 15 respondents reported seven purchases of operating utility property within the last five years, with a total value of $9.1 million.

Revenue Impacts

- There is no readily available history of how often these sales have occurred because the utility agencies do not report them.
- JLARC conducted a survey to assist in estimating the value of these tax preferences. Purchases of operating utility property by public utility districts or municipal utilities do not occur very often based on JLARC's survey.
- In fiscal year 2007, the annual retail sales and use tax taxpayer savings is estimated at $236,500.
- The projected annual retail sales and use tax taxpayer savings are estimated to be between $244,000 and $266,000 over the next two biennia.

Recommendation

The Legislature should continue these retail sales and use tax exemptions for sales of operating utility property to state and local political subdivisions.

Legislation Required: None.

Fiscal Impact: None.

PUBLIC UTILITY OPERATING PROPERTY – REPORT DETAIL

Statutory History

Retail Sales and Use Tax Exemptions:

The Legislature established the original retail sales and use tax exemptions for operating utility property, with the following language for the retail sales tax exemption:

> The tax hereby levied shall not apply to the following sales:
>
> (f) Sales (including transfers of title through decree of appropriation) heretofore or hereafter made of the entire operating property of a publicly or privately owned public utility, or of a complete operating integral section thereof, to a person for use in conducting any business defined in subdivisions (a), (b), (c), (d), (e), (f), (g) or (h) of section 37 of Title V of this act;[58]

The legislation included a similar use tax exemption:

> The provisions of this title shall not apply:
>
> (g) In respect to the use of any article of tangible personal property included within the transfer of the title to the entire operating property of a publicly or privately owned public utility, or of a complete operating integral section thereof, by a person in conducting any business defined in subdivisions (a), (b), (c), (d), (e), (f), (g), or (h) of section 37 of title V of this act;[59]

The reference to Title V in both subsections corresponded to the public utility tax. Essentially, any businesses subject to the public utility tax qualified for this retail sales and use tax exemption for selling operating utility property. In 1951, the Legislature narrowed the exemptions from all utility businesses to purchases of operating utility property by state agencies, municipal utilities, local governments, and public utility districts. The purchaser had to continue to use the property as utility property. The Legislature has not made substantive changes to these statutes since the 1951 legislation.

Other Relevant Background

Retail Sales Tax History

Facing a severe revenue shortfall, the Legislature established the retail sales tax as part of the Revenue Act of 1935. The original retail sales tax was on retail sales of tangible personal

[58] Chapter 156, section 7, 1943 laws.

[59] Chapter 156, section 9, 1943 laws.

property, with no services taxed in 1935. There were seven major exemptions provided in the retail sales tax at that time.[60]

Sales of Operating Utility Property

During the late 1930s, there was growing interest in expanding public ownership of utility property. Various municipalities and public utility districts were looking for ways to start and expand their utility services.

In 1933, 287 companies were required to file annual reports with the Department of Public Works of Washington. There were 45 electric, nine gas, 102 telephone, four telegraph, 124 water and three irrigation companies.[61] By 1940, municipalities had purchased several of the largest private water utilities. For example, the City of Vancouver purchased the water system for the city from the Peoples Water and Gas Company, and Skagit County PUD #1 purchased the water systems for Mount Vernon, Burlington and Sedro Woolley. The City of Arlington purchased its water system from the Puget Sound Power & Light Company.[62] These purchases of water systems by municipalities and public utility districts in the 1930s were the type of sales of utility property that would have been exempt from the retail sales and use tax under these current tax preferences.

This interest in public entities providing utility service extended to provision of electricity as well. In the 1930s, electricity was largely unavailable in farms, ranches, and other rural places. Congress responded to this problem by establishing the Rural Electrification Act (REA) in 1936. This Act provided federal funding for installation of electrical distribution systems to serve rural areas of the United States. In addition, the REA was authorized to offer loans to companies willing to supply electricity to rural areas not already served by any other company. The funding was channeled through cooperative electric power companies. According to the oral history of Charlie Hodde, the development of public power in Washington occurred in the late 1940s and early 1950s. Mr. Hodde recalls a bill in the 1943 Legislative Session that would have allowed public utility districts to purchase the private Puget Sound Power and Light system.[63] Mr. Hodde recalls that Puget Sound Power and Light wanted to sell their company because their stock price was down. In each county in which Puget Sound Power and Light had utility property, the proposal would have allowed each county with a public utility district to purchase the Puget Sound Power and Light property. Eventually this proposal lost support, but it reflects the amount of interest that existed in the early 1940s to expand public ownership of utilities. With this tax preference in place in 1943, any purchases of electrical utility property by government entities would have received tax exemptions from the retail sales and use taxes.

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[60] Original retail sales tax exemptions: Casual or isolated sales, sales of newspapers, sales prohibited by the federal constitution, sales made by persons subject to the public utility tax, sales made by businesses subject to the motor vehicle fuel tax, sales made on relief vouchers issued by a welfare agency, sales of certain dairy products, fresh fruits and vegetables, canned milk and bread.

[61] 17th Report of the Department of Public Service to the Governor for period October 1, 1938 – September 30, 1940.

[62] Ibid.

[63] "Charles W. Hodde – Legislative Oral History Project" compiled by Timothy Frederick of Washington State Archives, August 1985.

Assessment of the Retail Sales Tax on Utility Companies

As this tax preference under review provides, there are retail sales and use tax exemptions for purchases of operating utility property by state agencies and local political subdivisions. This can include sales/transfers of the entire operating property of a public utility or a complete integral section of the entire operating property.

These are other tax preferences for utility companies. Utility sales that are the basis for the public utility tax and are made by companies in the normal course of business are also tax exempt from the retail sales and use tax.[64]

Generally, all sales of tangible personal property to consumers for their own use are considered retail sales.[65] According to the definition of tangible personal property in RCW 82.08.010(7), it includes utility property such as electricity, water and gas. Unless statute provides an exemption, government entities as well as private companies are subject to paying the retail sales or use tax on purchases. For example, if a utility company sells other tangible personal property like electrical appliances or other goods, then those sales are subject to the retail sales tax.

JLARC Survey

Since enactment of this tax exemption, there has been no reporting to the state of tax exempt purchases of operating utility property. As a result, it is unclear how often these purchases of operating utility property occur and the magnitude of the utilization of this tax preference in recent years. In 2008, JLARC conducted a survey of municipalities with their own utilities, public utility districts, electric cooperatives, and private utility companies. The purpose of the survey was to identify if sales/purchases of operating property to municipalities, local governments, and public utility districts had occurred and the value of those purchases. The response rate from companies and government agencies was low. Out of 50 solicitations, JLARC received 15 responses. Larger government utilities were included in the responses.

Utility staff surveyed acknowledged that most of the sales by public utility districts or municipal utilities are of property that is deemed surplus property. Therefore, the sale of the property to the state or other local political subdivision results in the property being used for some other non-utility related purpose. For example, sometimes public utility districts will sell a portion of their property to a state agency or local government for a right of way, easement, road expansion, or park. In most of these cases, the utility will move the original utility operating property to a new location, or the utility district will continue to operate the utility property. These sales of property do not qualify as sales of operating utility property which are targeted with this retail and use tax exemption. Purchases of operating utility by local political subdivisions would qualify for these tax exemptions if the property continues to be used as utility property.

In total, survey respondents reported nine sales and purchases by local governments and public utility districts between 1993 and the end of 2006 that would qualify for the retail sales and use tax exemptions. The total exempt value of these sales was $9.38 million. For the last five years,

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[64] RCW 82.08.0252; 82.08.950; 82.12.950.

[65] "Retail Sales Tax" Washington State Department of Revenue, Aug. 2007.

respondents reported five sales for a total value of $9.1 million. From these survey results, the average value of the tax exempt purchase of operating utility property has been $1.8 million.

Public Policy Objectives

What are the public policy objectives that provide a justification for the tax preference?

There are two public policy objectives identified in these retail sales and use tax exemptions:

Equal tax treatment among utility taxpayers: Originally, these tax exemptions applied to all businesses paying the public utility tax. There was a public policy objective of providing equal tax treatment to all businesses purchasing operating utility property. These transfers of operating utility property among utility owners may have been seen as just a transfer of ownership reflecting which entity would be providing the utility service to residents of a certain area.

Subsidize state and political subdivisions: In later years, the public policy objective of these tax preferences shifted to support government utility agencies when they needed to purchase additional operating property. There was an interest in the 1940s and 1950s to expand public ownership of utilities. One way to assist in achieving this was to exempt from retail sales and use taxes the purchase of operating utility property by publicly-owned utilities. This goal of expanding publicly-owned utilities was consistent with a goal of expanding the number of Washington residents receiving basic utility services.

Is the purpose or intent of the tax preference clear?

These tax preferences' purpose has changed since enactment. Originally, these retail sales and use tax exemptions were provided to all public utility taxpayers purchasing operating utility property in 1943. In 1951, the legislative changes modified these tax preferences to apply only to purchases made by state and local political subdivisions. The Legislature did not provide an intent statement with the changes made in 1951.

Is there any readily available evidence related to the achievement of any of these public policy objectives?

Since these retail sales and use tax preferences originally applied to all businesses subject to the public utility tax, these preferences did achieve the objective of providing equal tax exempt status to all utility businesses until 1951. Since 1951, these tax preferences have only benefited local political subdivisions. This objective of subsidizing the public utility districts and municipalities has been achieved. Certainly since 1951, there has been growth in the number of public utility districts statewide as well as the amount of sales and property owned by PUDs. This review found no readily available evidence of a linkage between having these retail sales and use tax exemptions for sales of operating utility property and the growth in the number of public utility districts and their operating utility property assets. These tax exemptions currently provide different tax treatment of purchases of operating utility property based on the ownership type of the utility company.

Beneficiaries

Who are the entities whose state tax and/or local tax liabilities are directly affected by the tax preference?

The beneficiaries of these tax preferences are public utility districts, municipal utilities, and other political subdivisions. Currently in Washington, there are a total of 28 public utility districts in the Washington Public Utility Districts Association.[66] These public utility districts serve more than 1.7 million citizens across the state. There were 19 municipal utilities and 16 cooperative mutual utilities providing electrical services to customers in Washington in 2002. In any given year, not all of these potential beneficiaries will have purchases of operating utility property that qualify for the retail sales and use tax exemptions. The exact number of beneficiaries is unknown because there is no reporting of exempt sales of operating utility property.

Revenue Impacts

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

The utilization of these tax preferences have not been reported and tracked in the past. Since 1988, the Department of Revenue's Tax Exemption Report has stated that the taxpayer savings is minimal and that there are a few sales involving utility operating property to or among government jurisdictions. Past exemption reports or underlying documentation have not indicated how many sales occur over a biennium or the value of these types of sales. Due to the lack of information, JLARC surveyed public utility districts, municipal utilities, electric cooperatives, and private utility companies. The survey results from 15 respondents revealed five sales of operating utility property in the last five years. The total value of those five sales was $9.4 million. The average value of these sales was $1.88 million. The survey results formed the basis for the future projections of taxpayer savings for this tax preference. The retail sales and use tax state and local taxpayer savings for local government and public utility districts is estimated to equal $236,500 in 2007, growing at 3 percent each year to $266,200 by 2011. The taxpayer savings estimates are equivalent to the loss in state and local government revenue from continuing this retail sales and use tax exemption.

[66] Washington Public Utility Districts Association web site statistics.

Exhibit 26 – Taxpayer Savings from Retail Sales and Use Tax
for Public Utility Operating Property Sales

Calendar Year	Exempt Value ($ 000)	State taxpayer savings ($ 000)	Local taxpayer savings ($ 000)	Total taxpayer savings ($ 000)
2007	$2,815.6	$180.2	$56.3	$236.5
2008	$2,900.0	$185.6	$58.0	$243.6
2009	$2,987.1	$191.2	$59.7	$250.9
2010	$3,076.7	$196.9	$61.5	$258.4
2011	$3,168.9	$202.8	$63.4	$266.2

Source: JLARC forecast.

Recommendation

The Legislature should continue these retail sales and use tax exemptions for sales of operating utility property to state and local political subdivisions.

Legislation Required: None.

Fiscal Impact: None.

GAS TAX EXEMPTION FOR HANDLING LOSSES – SUMMARY

Current Law

The state levies a tax on motor vehicle fuel licensees (other than licensed motor vehicle fuel distributors)[67] for each gallon of motor vehicle fuel[68] that is removed from a terminal rack.[69] The licensee is to pay the tax to the Department of Licensing (DOL). On July 1, 2008, the tax rate became 37.5 cents per gallon. Nothing prohibits the licensee liable for payment of the tax from including the tax in the selling price of the fuel.

The licensee that removes the fuel from a terminal rack is entitled to a deduction from tax liability on the volume of fuel removed in order to account for handling losses. The amount of deduction for handling losses is 0.25 percent for a supplier acting as a distributor and 0.30 percent for all other licensees, including distributors.[70] On 10,000 gallons, this deduction allows for either a reduction of 25 or 30 gallons, or at the current tax rate either $9.375 or $11.25.

The handling loss deduction applies to the loading and transport of gasoline between the terminal rack and delivery to a retailer or non-licensed customer. The deduction does not apply to any losses that a supplier may incur in the transport of gasoline from a refinery to a terminal rack or during storage of fuel at a terminal rack. The deduction does not apply to any losses sustained by a retailer when receiving fuel, nor to final consumers filling a tank in a motor vehicle.

The handling loss deduction applies only to motor vehicle fuel (gasoline) and does not apply to special fuel (diesel).[71]

See Appendix 3 for the current law statute RCW 82.36.029.

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[67] There are six separate motor vehicle fuel licenses: supplier, importer, exporter, blender, distributor, and international fuel tax agreement license. A person engaged in more than one activity for which a license is required must have a separate license for each activity, but a supplier is not required to obtain a separate license for any other activity. Thus, a licensed supplier may both supply and distribute motor vehicle fuel while a licensed distributor may only distribute motor vehicle fuel.

[68] Motor vehicle fuel means gasoline or other inflammable liquid which is used as fuel for the propulsion of motor vehicles or motor boats. It does not include "special fuel" such as diesel. The motor vehicle fuel tax is found in Chapter 82.36 RCW, and the special fuel tax is found in Chapter 82.38 RCW.

[69] There are several other instances that can trigger the imposition of the tax, such as importing fuel into the state outside of the bulk-transfer terminal system. Also, there are some exemptions from the tax when the fuel is removed at the terminal rack, such as when the fuel is removed by a licensed exporter for direct delivery to a destination outside of the state. For simplicity, the discussion in this chapter will be about removing fuel at the terminal rack, either by a licensed supplier or a licensed distributor.

[70] There is some confusion about whether the handling loss for all other licensees should be 0.30 percent or 0.31 percent. This issue is discussed later in this report.

[71] Diesel is less volatile than gasoline and does not evaporate as rapidly.

Findings and Recommendations

This review evaluated the legal history, public policy objectives, and revenue impacts of Washington's motor vehicle fuel tax deduction for handling losses. The audit determined the following:

Legal History and Public Policy Objectives

- The Legislature established the motor vehicle fuel tax in 1921. In 1939, the Legislature provided that fuel distributors could deduct one percent of the volume before computing the tax (100 gallons per 10,000 gallons loaded). Originally, this was to account for losses the distributors sustained through "evaporation and handling."
- In 1951, the Legislature reduced the handling loss deduction to 0.25 percent (25 gallons per 10,000 gallons loaded) and deleted the term "evaporation" from the statute, leaving "handling losses" as the rationale for the deduction.
- Nothing in the statute indicates that the purpose of the handling loss deduction was to reimburse distributors for costs incurred in remitting the tax to the state. The state has not generally reimbursed taxpayers for collection costs.
- In an effort to stem motor vehicle fuel tax fraud and evasion, the Legislature changed the point of taxation, effective January 1, 1999. Previously the point of taxation was when a distributor sold the fuel to a non-distributor (a retailer or bulk fuel user). The new point of taxation became when fuel was removed from a terminal rack. The legislation created new licenses for suppliers, importers, exporters, and distributors. The legislation maintained the handling loss deduction for suppliers acting as distributors at 0.25 percent and increased the handling loss deduction for distributors and importers to 0.30 percent (thirty one-hundredths of one percent – or 30 gallons per 10,000 gallons loaded).
- The Department of Licensing has interpreted the increased handling loss for distributors and importers as 0.31 percent rather than 0.30 percent (thirty-one one-hundredths of one percent – or 31 gallons per 10,000 gallons loaded).
- A 2005 Federal District Court decision concerning the tax liability of taxing motor vehicle fuel sales to retailers on Indian reservations found that the statutory tax liability fell on retailers, rather than suppliers, distributors, or consumers. In an effort to address the Court's decision and restore the state's ability to tax fuel sold on Indian reservations, the Department of Licensing proposed statutory changes in 2006 and 2007, and the Legislature adopted changes in 2007. The results are ambiguous. Some sections of tax law place the statutory tax liability on licensees other than distributors; other sections of law place the statutory tax liability on distributors.
- The transportation and marketing of gasoline involves many distinct operations, each of which represents a potential source for evaporation loss. Gasoline vapors are a precursor to ground-level ozone, a serious air pollutant and a key component of smog. Air

pollution control agencies at the federal, state, and local levels attempt to control the release of gasoline vapors into the atmosphere. Regulations concerning the methods and equipment used in the transportation and marketing of gasoline are far more strict today than they were in 1939 or 1951. The Department of Ecology's regulations direct the type of methods that must be used to fill tanker trucks at terminal racks and the control measures that must be used to limit vapor emissions. The vapor recovery systems at terminals must not allow organic vapors emitted to the ambient air to exceed 325 milligrams per gallon of gasoline loaded (about 1.2 gallons per 10,000 gallons loaded).

- The Department of Ecology estimates that the amount of vapors a tanker truck might initially emit when being loaded would be nine gallons per 10,000 gallons being loaded, when a clean truck is being loaded. If the truck already has vapors in the tank, which is typical if it is dedicated to gasoline delivery, and if vapor controls are in place at the site of last delivery, then the amount of vapor loss would approach zero. Only a small percentage of these vapors escape into the atmosphere, as the vapor recovery system should capture 94 percent or better of the vapors.
- The initial public policy objective in 1939 may have been to recognize that losses occur in the transport of gasoline from the terminal rack to a retailer or bulk user. At this time, distributors remitted the tax to the state when delivery was made. Loading practices and environmental regulations have changed significantly, and the amount of loading losses has been greatly reduced. Also, while ambiguous, the statutory incidence of the tax has been moved up the distribution chain. Prior to 1999 the tax was imposed when the distributor made a delivery to a retailer or bulk user. Since then the tax has been imposed when fuel is removed from a terminal rack. The handling loss deduction gives the impression that the tax is not on the amount of fuel removed at the terminal rack, but rather on an estimated amount of fuel delivered by a distributor to a customer. It contributes to the ambiguity about the incidence of the tax.

Beneficiaries

- There are 67 licensed motor vehicle fuel suppliers. There are 112 licensed motor vehicle fuel distributors and/or licensed motor vehicle fuel importers. All of these licensees can deduct the fuel handling loss.

Revenue Impacts

- The fuel handling loss deduction amounted to 7.2 million gallons in fiscal year 2007. Suppliers, distributors, and importers had a total tax savings of $2.5 million. Suppliers had a savings of $1.7 million; distributors, over $700,000; and importers, $42,000.
- The forecasted amount of tax savings is $2.8 million in 2011.

Recommendation

The Legislature should terminate the motor vehicle fuel handling loss deduction.

Legislation Required:	Yes
Fiscal Impact:	An increase in state revenues of $2.8 million in fiscal year 2009.

GAS TAX EXEMPTION FOR HANDLING LOSSES – REPORT DETAIL

Statutory History

General

The Legislature first imposed the motor vehicle fuel tax in 1921. The tax was one cent per gallon imposed on the sale of liquid fuel – gasoline and other fuel for use in internal combustion engines. Revenues were credited to the Motor Vehicle Fund. The Motor Vehicle Fund was a fund dedicated to, among other things, "paving and general road construction of the state primary highways."

In 1923, the Legislature raised the tax to two cents per gallon and drew the tax base more narrowly. The tax applied to sales of liquid fuel to everyone who used liquid fuel for the purpose of operating motor vehicles upon the public highways. Tax receipts were still credited to the Motor Vehicle Fund.

"Distributors" paid the tax for each gallon of fuel sold, distributed, or used by the distributor in the state. "Distributor" meant everyone who produced, refined, or manufactured motor vehicle fuel and sold, distributed, or used it in the state; wholesale merchants dealing in motor vehicle fuel on which the tax had not been paid; and importers of fuel who sold, distributed, or used it in the state. The sale of fuel from one licensed distributor to another licensed distributor was not subject to tax.

Handling Losses

1939

The Legislature in 1939 provided that the distributor could deduct 1 percent of the net volume otherwise taxable before computing the tax due.[72] This was to account for losses sustained through "evaporation and handling."

The handling loss deduction appears to be recognition that there was a difference between the amount of fuel that a distributor obtained tax-free and the amount of fuel delivered to a customer on which tax was due.

1951

In an omnibus highways and motor vehicles bill in 1951, the Legislature reduced the amount that could be deducted by distributors before computing the amount of tax from 1 percent to 0.25

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[72] The impact of providing an across-the-board deduction for all taxpayers is to lower the effective fuel tax rate, in 1939 from five cents per gallon to 4.95 cents per gallon.

percent. The rationale for allowing the deduction was to account for losses sustained through handling. The Legislature removed the term "evaporation" from the statute leaving only the term "handling losses." At the same time, the Legislature revised the distribution of fuel tax revenues. The bill provided that the tax on the 0.75 percent of volume that could no longer be deducted by the distributors be deposited directly to the Motor Vehicle Fund.

1998

In an effort to stem motor vehicle fuel tax fraud and evasion, the Legislature changed the point of taxation in 1998 (effective January 1, 1999) to the terminal rack.[73] Prior to 1999, licensed distributors that purchased untaxed motor vehicle fuel from refineries, terminals, or other licensed distributors paid taxes directly to the DOL when the distributor sold the fuel, with taxes included, to unlicensed buyers.[74] These distributors could take the handling loss deduction on their tax forms.

The 1998 legislation moved the point of collection for motor vehicle fuel (and special fuel) taxes to a higher point on the fuel distribution chain. The change requires the refiner, terminal operator, or party owning the fuel at the time of removal from the terminal rack to collect the taxes on the fuel and to remit them to the DOL.[75] The legislation also eliminated the old general purpose license of distributor and created new specialized licenses. These new licenses included motor vehicle fuel supplier, motor vehicle fuel distributor, motor vehicle fuel exporter, motor vehicle fuel importer, and motor vehicle fuel blender. A motor vehicle fuel supplier is a business that owns and stores motor vehicle fuel in a terminal facility or that refines and stores motor vehicle fuel at a refinery. A motor vehicle fuel distributor is a business that acquires motor vehicle fuel from a supplier, distributor, or other licensee for subsequent sale and distribution. A business engaged in more than one activity for which a license is required must have a separate license for each activity, except a motor vehicle fuel supplier does not need to obtain a separate license for any other activity. Thus a supplier can also act as a distributor. The legislation also provided the intent that the ultimate liability for the tax was on the motor vehicle fuel user, regardless of the manner of collection of the tax.

Even though the 1998 legislation moved the point of taxation, the bill retained the handling loss deduction. For suppliers acting as distributors, the handling loss continued at 0.25 percent. For all other licensees, the handling loss deduction increased to 0.30 percent. Licensees required to file tax reports reported the handling loss deduction on the reports. Motor vehicle fuel distributors received the handling loss deduction on the invoice provided by the seller to the distributor.

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[73] Substitute House Bill 2659 (1998), Chapter 176, Washington Laws of 1998.

[74] Also, licensed special fuel bulk users, that purchased special fuel without paying the special fuel tax, paid the tax to the DOL on any fuel subsequently used on-road.

[75] In addition, importers were liable for paying the fuel tax on fuel removed from a terminal rack in another state and imported into Washington.

Department of Licensing Implementation

The DOL's Motor Vehicle Fuel Supplier Tax Return allows a space for deductions of 0.0031 (0.31 percent) for sales to licensed distributors and for deductions of 0.0025 (0.25 percent) for all other taxable sales. DOL understood the 1998 legislation to increase the handling loss deduction for distributors by six one-hundredths of one percent (0.25 percent plus 0.06 percent equals 0.31 percent). However, the statute reads: "… and for all other licensees, thirty one-hundredths of one percent." The hyphen is between "one" and "hundredths," rather than between "thirty" and "one" (see RCW 82.36.029). The proper interpretation of the statute is the fraction 30/100, not 31/100. The Legislature has on occasion used the term "one-hundredths" to describe a percentage or an amount, primarily in tax law.[76] Seldom has the Legislature used just the term "hundredths" and never in tax law. Furthermore, the legislative bill reports describing the changes made in the 1998 legislation all describe the change made in the handling loss deduction as "The shrinkage allowance for motor vehicle fuel taxes paid by distributors is increased from 0.25 percent to 0.3 percent."

Federal Court

In a 2005 Federal District Court case involving the taxation of fuel sold to retailers on Indian reservations, the Court concluded that the legal incidence of Washington's fuel taxes fell on retailers.[77] This resulted in the state being prohibited from the collection of taxes on fuel sold on tribal lands.

The State had argued that the legal incidence of the tax is borne by motor vehicle fuel users, or alternatively, that the incidence is borne by the supplier. The Court found that fuel taxes were paid to the State when a supplier removed fuel from a terminal rack. In turn, distributors were required to remit the fuel tax to the supplier. A supplier that did not receive the fuel tax from the distributor was entitled to a full refund from the State. Suppliers thus bore little risk; they collected and remitted the taxes and were reimbursed for any deficiency. Similar rules applied between distributors and retailers. A distributor could obtain a full refund for fuel taxes that could not be collected from a retailer. In contrast, there was no similar legal connection between the retailer and the consumer.

Department of Licensing Proposals

In an effort to address the Court's decision and restore the State's ability to obtain taxes from fuel sold on Indian reservations, DOL proposed legislation in 2006 and 2007. The intent of the proposed legislation was to place the incidence of taxation on motor fuel on the suppliers. The proposed changes included:

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[76] Examples include: RCW 66.25.210(4) – "twenty-three and forty-four one-hundredths cents per liter"; RCW 67.40.090(2)(g) – "seventy-one and forty-three one-hundredths percent"; RCW 82.16.020(1)(b)– "three and sixty-two one-hundredths percent"; RCW 82.16.130(1) – "twenty-five one-hundredths of one percent"; RCW 82.23A.020 – "fifty one-hundredths of one percent"; RCW 82.27.020(4)(a) – "five and twenty-five one-hundredths percent"; RCW 82.45.060 – "one and twenty-eight one-hundredths percent."

[77] "Squaxin Island Tribe v. Fred Stephens," 400 F. Supp. 2d 1250 (W.D. WA, 2005).

- Eliminating the ability of distributors to seek a refund of tax paid to the state that they did not or could not collect from the purchaser;[78]
- Repealing provisions allowing fuel distributors to defer payment of the fuel tax to suppliers ("distributor float"); and
- Eliminating the motor vehicle fuel handling loss deduction for distributors.

The DOL proposal also eliminated the motor vehicle fuel distributor license and repealed the section of law stating the intent that the ultimate liability for the tax was the motor vehicle fuel user. A new intent section stated that the tax should be imposed at the time and place of the first taxable event and upon the first taxable person within Washington. The tax was to be levied and imposed not on users, but rather on licensees (which would no longer include distributors). Licensees no longer were to just "remit tax" to the DOL, but rather were to be "liable for and pay tax" to the DOL.

While the DOL proposal called for eliminating the fuel handling loss deduction for distributors, the proposal did not eliminate the deduction for suppliers or importers. In fact, the DOL intended to expand the handling loss deduction for suppliers by allowing suppliers to take a deduction against fuel being removed by distributors. The 1998 law allowed fuel distributors a 0.31 percent (according to DOL) handling loss deduction. The proposal allowed suppliers to claim this deduction at a rate of 0.25 percent. The difference of 0.6 percent was to go to the Motor Vehicle Fund. Thus suppliers were to receive a handling loss deduction for fuel that they no longer possessed. The estimated fiscal impact in FY 2008 to distributors was a loss of $740,000; the gain to suppliers was $597,000; and the gain for the Motor Vehicle Fund was $143,000.

2007

In 2007, the Legislature made some, but not all, of the changes DOL had proposed. The Legislature made the requested change to the handling loss deduction, but then the Governor vetoed the change.[79] The Legislature repealed the statute declaring that motor vehicle fuel taxes are imposed on the end user and instead enacted a new statute declaring that the tax was imposed at the time and place of the first taxable event and upon the first taxable person in Washington. The tax is levied and imposed upon motor vehicle fuel licensees, other than motor vehicle fuel distributors. The licensed supplier is liable for and is to pay the tax to the DOL.

[78] The Department characterized this point as "eliminating the ability of licensees to claim bad debt credit or seek a refund of tax they have paid to the state, but did not or could not collect from the purchaser." They did propose eliminating the distributor license and the distributor bad debt credit; the Department did not propose amending or repealing RCW 82.36.044, the bad debt credit for suppliers.

[79] The veto message simply stated that the section limits the handling loss to licensed suppliers and importers; without the section fuel distributors would retain the handling loss that had been available to them; that the handling loss allowance is provided as an offset for evaporation and shrinkage that occurs in the transfer of fuel from terminal racks to fuel tank trucks; and for these reasons the section was vetoed.

However, the Legislature maintained the motor vehicle fuel distributor license. The Legislature also chose not to repeal the provision allowing fuel distributors to defer payment of the fuel tax ("distributor float").

Distribution of Gasoline, Points of Gasoline Emissions and Incidence of Tax

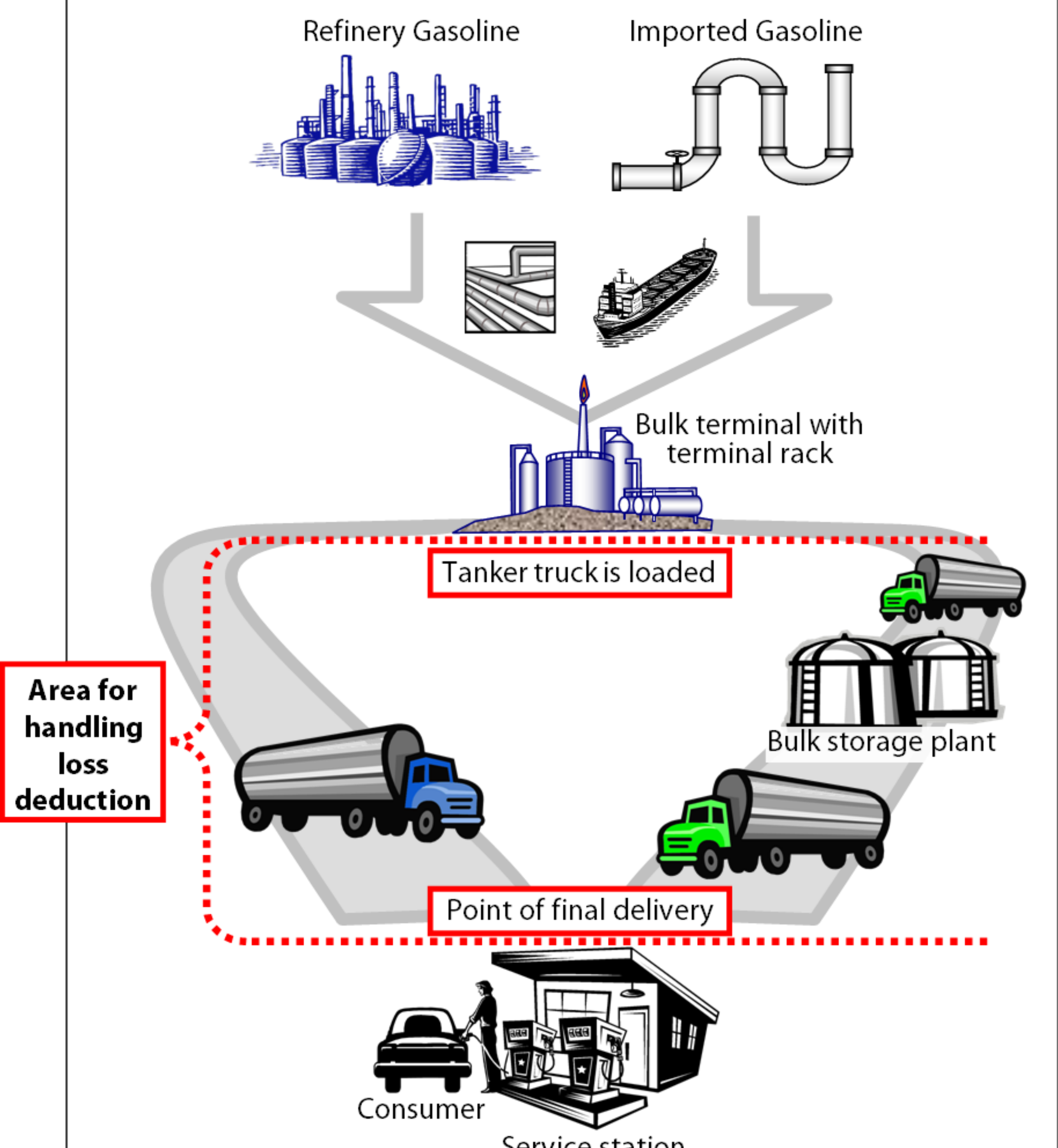
Generally, gasoline is either refined at one of the state's refineries or enters the state in a pipeline. It is transported to a bulk terminal with a terminal rack either through a pipeline or by a barge. Tanker trucks are loaded with fuel at the terminal rack and take the gasoline to the retailer or bulk consumer (such as a farmer, contractor, or logger). Prior to reaching the retailer or bulk consumer, the gasoline may be temporarily stored at a bulk storage facility.

Tanker trucks may be owned by a supplier or by an independent distributor. In the first case, the supplier is acting as a distributor when filling their own trucks. The service station where delivery is made may be owned by the supplier, the distributor, or may be independently-owned.

Losses of fuel through emissions can occur at any of these points. Emissions may occur at the refineries, during storage at the bulk terminal, during the loading and unloading of the tanker trucks. Emissions also occur when filling individual vehicles at the service station. The handling loss deduction is only for losses that may occur between the point of loading fuel into a tanker truck at the terminal rack and the point of final delivery. Losses that occur prior to loading the fuel into the tanker truck or after final delivery are not part of the handling loss deduction.

Since 1999, the point of taxation has been when fuel is removed at the terminal rack. Prior to that time, the point of taxation was when the fuel was delivered to the retailer or bulk consumer.

Exhibit 27 – Distribution of Gasoline



Source: JLARC description of gas handling losses.

The Math of Across-the-Board Tax Cuts

Conceptually, across-the-board percentage tax credits or deductions have no impact on the distribution of taxes paid by taxpayers. These credits or deductions only change the effective tax rate paid by all taxpayers. They have the same impact as an across-the-board tax rate reduction.

The Science and Regulation of Vapor Emissions

The gasoline marketing network consists of storage and transfer facilities that move gasoline from production to end consumption. The transportation and marketing of gasoline involve

many distinct operations, each of which represents a potential source of product loss.[80] Refined petroleum products are conveyed to fuel marketing terminals by tankers, barges, rail tank cars, tank trucks, and pipelines. From the fuel marketing terminals, tank trucks deliver the fuels to service stations, commercial accounts, and bulk storage plants. The final destination for gasoline is usually a motor vehicle gasoline tank.

Loading losses are the primary source of evaporative emissions from tank truck operations. Loading losses occur as hydrocarbon volatile organic vapors in "empty" cargo tanks are displaced to the atmosphere by the gasoline being loaded into the tanks. These vapors are a composite of (1) vapors formed in the empty tank by evaporation of residual product from previous loads, (2) vapors transferred to the tank in vapor balance systems as product is being unloaded, and (3) vapors generated in the tank as new product is being loaded.

Hydrocarbons are a precursor to ground-level ozone, a serious air pollutant in cities across the United States. A key component of smog, ground-level ozone is formed by reactions involving hydrocarbons and nitrogen oxides in the presence of sunlight. Hydrocarbon emissions result from incomplete fuel combustion and from fuel evaporation. Because of the serious health threats from ground-level ozone, the U.S. Environmental Protection Agency regulates ozone pollution.

The method of loading affects vapor generation. In the splash loading method (no longer allowed in Washington), the fill pipe dispensing the gasoline is lowered only part way into the cargo tank. Significant turbulence and vapor/liquid contact occur during the splash loading operation, resulting in high levels of vapor generation and loss. A second method of loading is submerged loading (now required in Washington). The two types of submerged loading are the submerged fill pipe method and the bottom loading method. In the submerged fill pipe method, the fill pipe extends almost to the bottom of the cargo tank. In the bottom loading method, a permanent fill pipe is attached to the cargo tank bottom. During most of submerged loading by both methods, the fill pipe opening is below the liquid surface level. Liquid turbulence is controlled significantly during submerged loading, resulting in much lower vapor generation than encountered during splash loading.

Another control measure for vapors displaced during liquid loading is called a "vapor balance system" in which the cargo tank retrieves the vapors displaced during product unloading and transports the vapors back to the loading terminal. When a tanker truck makes a delivery, vapors are forced out of the service station's tank and are captured by the tanker truck.[81] Then when the tanker truck gets a new load at a terminal rack, the vapors from the service station are displaced and are captured at the terminal rack. The system is closed, and the supposition of the air pollution regulators is that the tanker trucks are not venting vapors in between making a delivery

[80] This information is from "Compilation of Air Pollutant Emission Factors, Volume I: Stationary Point and Area Sources, AP-42," Office of Air Quality Planning and Standards, U.S. Environmental Protection Agency, January 1995. See chapter 5.2, "Transportation and Marketing of Petroleum Liquids."

[81] Stage I emission controls reduce emissions from underground tank filling operations at service stations by use of a vapor balance system which consists of a hose that returns gasoline vapors displaced from the underground tanks during filling back to the tank truck, as well as measures to ensure tightness of the truck.

and receiving a new load. Based on total statewide sales, 98 percent of retail gasoline sales are subject to these vapor controls.

The Washington Department of Ecology (DOE) attempts to control loading losses. Controls include specific regulations pertaining to gasoline loading terminals. DOE regulations concerning gasoline vapor control requirements apply statewide and cover all terminal racks.[82] All local clean air agencies are responsible for registering the air pollution sources in their areas and enforcing the Department of Ecology regulations as a minimum. Facilities for the purpose of loading gasoline into a transport tank must be equipped with a vapor control system. The loading facility must use submerged or bottom loading; the vapor control system must be connected during the loading of the tank; and the loading must be vapor-tight. The vapor control system must be designed and built according to accepted industrial practices that do not allow organic vapors emitted to the ambient air to exceed 325 milligrams per gallon of gasoline loaded. This allowable amount is about 1.2 gallons per 10,000 gallons loaded.

Estimated Amount of Losses

The Environmental Protection Agency has developed a formula for air quality engineers to use to estimate emissions from loading petroleum liquid.[83] Using this formula, the air quality engineering staff at the Washington Department of Ecology, in consultation with several local air agency engineers, believes that the maximum difference between the terminal rack meter and the load the truck drives away would be 0.09 percent when a clean truck is being loaded (nine gallons loss per 10,000 gallons loaded).[84]

Trucks routinely used for gasoline delivery already contain gasoline vapors (not clean) and in these cases, the difference between the terminal rack meter and the loaded gasoline volume would be less than 0.09 percent, approaching zero.

The terminal rack's vapor collection system captures and treats the vapors escaping from the cargo tank (94 percent or better capture rate). These vapors are combusted in a thermal oxidizer. Only a very small amount is released directly to the atmosphere.

There may also be evaporation of gasoline from loaded tank trucks during transportation of gasoline from the terminal rack to the service station or other delivery point. There is a pressure relief system on the trucks so if temperatures get too hot or pressures increase too much, vapor is allowed to escape. The Department of Ecology, using Environmental Protection Agency emission factors, has estimated that a gasoline tanker truck with a typical 8,000 gallon load could lose up to a 0.1 gallon in transit due to pressure relief systems under extreme conditions.

[82] WAC 173-491-040.

[83] "Compilation of Air Pollutant Emission Factors," op. sit. See chapter 5.2, "Transportation and Marketing of Petroleum Liquids."

[84] E-mail from Stuart Clark, Department of Ecology, regarding "Vapor Losses from Gasoline Transfer," August 23, 2007; and e-mail from Julie Knittle, Department of Licensing, regarding "Vapor Loss/Expansion and Contraction Questions," November 5, 2007.

Temperature Change Effects

Gasoline expands or contracts with temperature changes. There is about a 1 percent change in volume for each 15 degree change in temperature. When there is a time delay between original loading and when the fuel is delivered at a retail location, the amount of gasoline dispensed could be different because temperatures have changed. For an initial load of 10,000 gallons of gasoline and a one degree change in the temperature of the load between loading and unloading, the volume change would be plus or minus 6.9 gallons. This issue is not addressed in state law.

Statutory and Economic Incidence of Tax

The "statutory incidence" of a tax pertains to the party with the legal obligation to pay a tax. The "economic incidence" of a tax is a question of who bears the final burden of a tax. Economic incidence takes into account how taxes are shifted from one group to another. Depending on market conditions, taxes may be shifted backwards as lower profits or lower wages onto the owners or employees of a company, or taxes may be shifted forwards as higher prices onto the customers of a company.

The statutory incidence of the motor vehicle fuel tax is ambiguous. Some sections of Chapter 82.36 RCW clearly state that the motor vehicle fuel supplier, or other licensee, but not a motor vehicle fuel distributor, is liable for the tax.[85] However, another section states that a motor vehicle fuel distributor is to remit the tax on purchases from a supplier.[86]

In the end, the consumer bears the economic incidence of the tax. Until recently, the demand for gasoline has been "price inelastic." The consumer demand for gasoline has not been greatly affected by its price. Being price inelastic means that a tax can be passed forward onto consumers without a proportionate loss in sales.

Collection Fee

Nothing in the statutes pertaining to the motor vehicle fuel taxes suggests that licensees are to be reimbursed anything for the costs of paying or collecting fuel taxes. Some of the parties involved in the payment and collection of the motor vehicle fuel tax have likened the handling loss deduction to a "collection fee." A collection fee would allow the entity collecting and remitting the taxes to the state to retain a portion of the collections as an offset for the collection costs. However, Washington State generally does not follow this policy in the management of its tax system, and nothing in the law indicates this was a reason for providing the handling loss deduction.

[85] See RCW 82.36.020, 022, 025, and 026.

[86] See RCW 82.36.035(5).

Public Policy Objectives

What are the public policy objectives that provide a justification for the tax preference? Is the purpose or intent of the tax preference clear?

Amount of Handling Losses

In 1939, the public policy objective of allowing a one percent handling loss deduction (100 gallons per 10,000 gallons) to account for losses sustained through handling and evaporation likely was to recognize the difference in volume between the tax-free purchase of motor vehicle fuel and the subsequent taxable sale of the fuel by a distributor. Air pollution regulations, if they existed at all, were not as stringent as today. Top splash loading, lack of vapor control systems, and tank leaks no doubt contributed to a loss of fuel between loading and unloading. There does not appear to be a scientific reasoning for the original setting of the amount of the across-the-board deduction. Distributors did not need to verify any losses to claim the handling loss deduction.

In 1951, when the Legislature reduced the handling loss deduction to 0.25 percent (25 gallons per 10,000 gallons), the action appears to have been taken to increase the amount of revenues going to the Motor Vehicle Fund. This change specifically removed "evaporation" as a rationale for the loss of fuel.

Since the 1960s, there have been dramatic changes in the regulation of and methods used in loading tanker trucks. Splash loading is no longer allowed and submerged loading is required along with vapor control systems. The Department of Ecology estimates the amount of fuel being lost to be about nine gallons per 10,000 gallons when loaded into vapor-free tanks and less, approaching zero gallons when loaded into a tank already containing vapors. Tank trucks dedicated to gasoline delivery would have vapors in the tank if the last delivery were to a facility with a vapor balance system in place.

Tax Incidence

In 1998, when the handling loss for distributors (as opposed to suppliers acting as distributors) increased to 0.30 percent (30 gallons per 10,000 gallons), the Legislature needed to garner support for a major overhaul of the motor vehicle fuel tax. The point of taxation changed from when a distributor delivered the fuel to non-licensed customer to when the fuel was removed from a terminal rack. The increase recognized that independent distributors sometimes transfer fuel to intermediary storage tanks before delivering the fuel to a retailer – and such transfers could involve increased losses of fuel.

The intent of the handling loss deduction today is less clear with the revisions made in the motor vehicle fuel tax in 2007. The statutory incidence of the motor vehicle fuel tax is now ambiguous. On one hand, the intent of the 2007 changes was to more clearly impose the motor vehicle fuel tax at the terminal rack (more than had been done with the 1998 changes); to place the liability for the tax on motor vehicle fuel licensees, other than motor vehicle fuel distributors; and to clearly state that the motor vehicle fuel tax is imposed on motor vehicle fuel licensees, other than

motor vehicle fuel distributors. The tax is imposed prior to any losses that occur after the fuel has been loaded.

However, continuing the handling loss deduction gives the impression that the tax is not on the amount of fuel removed at the terminal rack, but rather on the estimated amount of fuel delivered by a distributor or a supplier acting as a distributor to a customer.

The actual liability of the supplier for motor vehicle fuel taxes is ambiguous. By requiring a motor vehicle fuel distributor to remit taxes on motor vehicle fuel to motor vehicle fuel suppliers, it appears that the tax is on the distributor. Distributors may purchase fuel tax-deferred (payment of the tax by distributors to suppliers is required by seven business days before the 26th day of the following month; suppliers need to remit the tax to the Department on the 26th day of the month following the reporting period). If a purchaser does not pay a supplier for fuel, the supplier may take a credit against the fuel tax owed the state. The tax imposed is held in trust by a licensee, including a distributor, and may not be used other than for payment of the tax on the due date. All licensees, including distributors, must be bonded in an amount equal to twice the estimated monthly excise due; licensed distributors may not need a bond if the distributor has sufficient resources to adequately make payments on the estimated monthly motor vehicle fuel taxes. Finally, if any person liable for the tax (and the Department of Licensing believes this includes licensed distributors) fails to pay the tax, the Department may place a lien may be placed against that person's property.

Is there any readily available evidence related to the achievement of any of these public policy objectives?

The initial public purpose of the handling loss deduction may have been recognition that losses due to handling and evaporation occur in the transport of motor vehicle fuel from the terminal rack to the retailer. The Legislature removed evaporation as a rationale in 1951. The initial loading of the tanker truck is the primary source of these losses.

> (1) Loading practices have changed significantly since the initial enactment of the handling loss deduction. Vapor recovery systems are now in place. The industry has gone from the splash loading method to submerged loading that reduces the amount of vapors generated. The Department of Ecology estimates that the amount of gasoline lost from a clean tank is nine gallons per 10,000 gallons loaded. If the cargo tank is dedicated to gasoline and already contains vapors, then the amount lost would be less and approach zero. If the splash loading method were to be used (no longer allowed in Washington), the amount of loss would be about 24 gallons per 10,000 gallons loaded. Department of Ecology regulations limit a maximum of up to 1.2 gallons per 10,000 gallons loaded to be released into the atmosphere.
>
> Air pollution control authorities assume that cargo tanks already contain vapors as they are being loaded. This is a result of vapor balance systems in place at retail service stations. This reduces the loading losses to the tank truck.

(2) To the extent that the public policy of the motor vehicle fuel tax is a tax on the supplier at the time and on the amount of fuel that is removed at the rack, the handling loss deduction is in conflict with this policy. Amendments to the motor vehicle fuel tax adopted by the Legislature in 2007 imposed the tax on motor vehicle fuel licensees, other than motor vehicle fuel distributors, and made these licensees liable for paying the tax to the Department. However, other sections of law appear to make the licensed distributor liable for the tax.

Beneficiaries

Who are the entities whose state tax and/or local tax liabilities are directly affected by the tax preference?

As of January 2008, there are 67 licensed motor vehicle fuel suppliers. There are 112 licensed motor vehicle fuel distributors and/or licensed motor vehicle fuel importers (58 distributors only, 29 importers only, and 25 both distributor and importer). All of these licensees may be benefitting from the handling loss deduction.

Revenue Impacts

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

In fiscal year 2007, licensed suppliers, distributors, and importers deducted 7.2 million gallons of gasoline as handling losses. The taxes on this gasoline would have been nearly $2.5 million. The supplier's share was nearly five million gallons with a tax savings of nearly $1.7 million. Distributors took a deduction of slightly more than two million gallons with a tax savings of $723,000. The handling loss deduction for importers was $42,000.

The tax savings to the motor vehicle fuel taxpayers is equivalent to the loss to the state.

Using the gasoline sales projection provided by the Transportation Revenue Forecast Council, JLARC is forecasting that 7.5 million gallons will be deducted in 2011 for a tax savings of $2.8 million.[87] The increased savings is due both to an increase in the expected volume of gasoline to be sold and to an increase in the tax rate from 36 cents per gallon to 37.5 cents per gallon on July 1, 2008.

[87] Gasoline sales projection taken from "Motor Vehicle Fuel Tax Revenue Forecast," Transportation Revenue Forecast Council, June 2008.

Exhibit 28 – Handling Loss Deduction Tax Savings
(gallons and dollars in millions)

Fiscal Year	Gallons	Tax Savings
2007	7.239	$2.461
2008	7.222	$2.600
2009	7.068	$2.651
2010	7.268	$2.725
2011	7.488	$2.808

Source: 2007 data from Department of Licensing; forecast 2008-11 prepared by JLARC.

Exhibit 29 – Handling Loss Deduction by Type of Licensee, FY 2007
(gallons and dollars in millions)

	Gallons	Tax Savings
Suppliers (0.25%)	4.990	$1.697
Distributors (0.31%)	2.126	$0.723
Importers (0.31%)	0.122	$0.042
Total	**7.239**	**$2.461**

Source: Department of Licensing.

Recommendation

The Legislature should terminate the motor vehicle fuel handling loss deduction.

Legislation Required: Yes.

Fiscal Impact: An increase in state revenues of $2.8 million in fiscal year 2009.

AIRPORTS OWNED BY CITIES IN OTHER STATES – SUMMARY

Current Law

All real and personal airport property owned by a municipality in an adjoining state is exempt from Washington's property tax. The law requires the out-of-state municipality to exclusively own the airport property. In addition, the airport cannot exceed 500 acres in size to qualify for this property tax exemption. See Appendix 3 for the current law statute RCW84.36.130.

Findings and Recommendations

This review has evaluated the legal history, public policy objectives, and revenue impacts of the property tax exemption for real and personal property owned by municipalities in adjoining states. This audit determined the following:

Legal History and Public Policy Objectives

- The Legislature enacted the property tax exemption for out-of-state municipalities owning airport property in 1941. The exemption applies to all real and personal property owned exclusively by the out-of-state municipality.
- In 1998, the Legislature placed a requirement on the airport size and restricted the exemption to airports with 500 acres or less in size. Since then, this property tax exemption has not changed.
- One objective of this tax preference, when it was originally enacted, was to support smaller regional airports in Washington when they could have been necessary to aid the war effort for the U.S.
- Another public policy objective of this tax preference was to provide out-of-state municipalities that owned airport property with the same property tax exemption as Washington municipalities.
- This tax preference did achieve its objective of helping support out-of-state municipality owners of regional airports.
- In the future, this tax preference does not appear necessary as there are no regional airports owned solely by an out-of-state municipality.

Beneficiaries

- Currently, there are no out-of-state municipalities that own airport property in Washington.
- Originally in 1941, this property tax exemption benefited the City of The Dalles, Oregon. This tax exemption continued to benefit this regional airport until 1998.
- While listed in Department of Revenue reports as a beneficiary of this tax preference, the Moscow-Pullman airport property is owned by the City of Pullman and is already exempt as government property under other laws in Washington.

Revenue Impacts

- Since there are no out-of-state municipalities owning property of a regional airport, the taxpayer savings are $0 from this tax preference.

Recommendation

Given that there are no out-of-state municipalities owning airport property in Washington, the Legislature should terminate this property tax exemption.

Legislation Required: Yes.

Fiscal Impact: $0.

AIRPORTS OWNED BY CITIES IN OTHER STATES – REPORT DETAIL

Statutory History

This property tax exemption is for cities of adjoining states that own airport property located in Washington. The exemption applies to both real and personal property.

The 1941 legislation creating this exemption stated the following:

> *All property whether real or personal, belonging exclusively to any municipal corporation in an adjoining state legally empowered by the laws of such adjoining state to acquire and hold property within this state, and which property is used primarily for airport purposes and other facilities for landing, terminals, housing, repair and care of dirigibles, airplanes and seaplanes for the aerial transportation of persons, property or mail, or in the armed forces of the United States, and upon which property there is expended funds by the federal, county or state agencies, or upon which funds are allocated by the federal government agencies on national defense projects, is hereby exempted from ad valorem taxation.*

Originally, this 1941 language provided a tax exemption for any airport owned by a city in an adjoining state. The language did not specify airports with joint ownerships. In the 1940s, two regional airports potentially could have qualified for this tax exemption: the Moscow-Pullman and the city of The Dalles airports. However, only the city of The Dalles airport was owned exclusively by an out-of-state municipality in the 1940s. Then in 1998, the Legislature placed a requirement on the airport size and restricted the exemption to airports with 500 acres or less. That change excluded the city of The Dalles airport from qualifying for the tax exemption.

Other Relevant Background

The Legislature enacted this tax preference in 1941. The original statute allowed the exempt real and personal airport property to be used for transporting armed forces or to be funded by national defense projects.

Originally, there were two regional airports, The Dalles and Moscow-Pullman, which were owned or jointly owned or managed by cities in neighboring states. In the 1940s, the city of The Dalles airport in Oregon was the only regional airport owned exclusively by an out-of-state municipality. The city of The Dalles airport covers a little less than 1,000 acres. It was not until 1998 that the city of The Dalles formed an agreement with Klickitat County to jointly own the airport property. After the acreage limit was put into effect in 1998, the Moscow-Pullman airport was the only regional airport which potentially could qualify for the tax exemption as it had 468 acres. The airport will be starting a new expansion in two years which will cause this airport's total acres to exceed 500 acres.

After discussions with the airport manager at the Moscow-Pullman airport and the Finance Director at the city of Pullman and review of airport legal documents, JLARC learned that the airport property has always been owned by the city of Pullman and jointly managed by the two neighboring cities of Moscow and Pullman and the Port of Whitman County. In recent years the joint ownership has expanded to additional public entities. However, according to the Whitman County Assessor's office, the airport property has always been solely owned by the city of Pullman. The city of Moscow has never been the airport property owner on property tax records. Since the actual owner of the airport property in Whitman County is the city of Pullman, the property would be tax exempt already because it is government-owned property. Therefore, this tax preference is not necessary.

Public Policy Objectives

What are the public policy objectives that provide a justification for the tax preference?

There are four primary public policy objectives for this tax preference:

Equal Tax Treatment - Municipalities: One objective of this tax preference is to provide equal tax treatment to all cities owning property located in Washington regardless of whether the city is located within Washington or an adjoining state.

The next two public policy objectives are consistent with the subsidy theory of why governments have tax exemptions. The subsidy theory essentially explains that the state and local governments grant exemptions because the exempted organization lessens the burden on government or provides a public benefit. In this case, when this tax preference was first enacted, the federal government was subsidizing the development of the city of The Dalles regional airport.

Support military effort: Another objective of this property tax exemption was to support smaller regional airports that were being funded by the federal government. The U.S. Navy provided a significant amount of funding to assist in the development of the city of The Dalles airport in the early 1940s.[88]

Subsidize smaller airports for their local public good: A third public policy objective could have been to assist neighboring cities in adjoining states when they were financing and running a regional airport that could be used by the general public. Various local communities including Washington cities, residents, and U.S. military forces were benefiting from this regional airport.

Limited to Small Regional Airports: Since 1998, there has been a public policy objective of limiting this property tax exemption to smaller regional airports with less than 500 acres.

[88] Discussions with airport and city of The Dalles staff.

Is the purpose or intent of the tax preference clear?

It is clear that the purpose of this tax preference is targeted at cities in neighboring states, which own airport property in Washington. The legislative changes in 1998 were clearly intended to eliminate this tax preference for the city of The Dalles airport.[89] This is the summary of the testimony in support of the 1998 legislation SB 6731:

> *Ownership of The Dalles Airport has been a long-term aggravation for the area and caused many problems. Tax exempt status prevents the area from moving forward. Economic development is going on across the river on the Oregon side. Klickitat County should also benefit. The Gorge Act has prevented development in the area. There is virtually no property that can be developed. This is a first step in helping the area get jurisdictional control.*

Is there any readily available evidence related to the achievement of any of these public policy objectives?

At the beginning of operation of the city of The Dalles airport, this tax preference originally achieved its public policy objective of providing this Oregon city with a similar property tax exemption as that extended to Washington cities. Since this tax preference was enacted at a time when there was a need to maintain regional airports for the U.S. war effort, this tax preference did originally achieve the objective of supporting public regional airports. However, this tax preference has now been changed and the exemption is no longer provided to the city of The Dalles airport. In the case of the Moscow-Pullman airport, this tax preference appears unnecessary for this airport since the city of Pullman has always been the owner of the airport property. This airport property is tax exempt under other provisions.

Beneficiaries

Who are the entities whose state tax and/or local tax liabilities are directly affected by the tax preference?

In past editions of the DOR Tax Exemption Reports prior to 2000, DOR reported that the Moscow-Pullman and the city of The Dalles airports qualified for this tax exemption. In addition, the DOR Tax Exemption Reports since 2000 have assumed that the Moscow-Pullman airport was the only airport which needed this property tax exemption in order to qualify for tax exempt status. In addition, the bill reports and fiscal notes for the 1998 legislative changes also stated that the Moscow-Pullman airport qualified for this tax preference.[90]

In fact, prior to 1998, the only beneficiary of this tax exemption was the city of The Dalles, in Oregon. Since 1998, the city of The Dalles airport has been paying property taxes. The Moscow-Pullman airport has not been a beneficiary of this property tax exemption because the owner of the airport property is the city of Pullman, not the city of Moscow. This airport property is

[89] Tapes of public hearings and other supporting legislative documents on SB 6731 in 1998.

[90] SB 6731.

exempt from property tax under other provisions of state law. Currently, no airports qualify for this tax preference since no airport is exclusively owned by an out-of-state municipality.

Revenue Impacts

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

The 2000, 2004, and 2008 editions of the DOR Tax Exemption Reports assumed that the Moscow-Pullman airport was the only airport using this property tax exemption to qualify for tax exempt status. Under that assumption, the taxpayer savings to the Moscow-Pullman airport was approximately $11,000 for state taxes and $42,000 in local property taxes.

JLARC's review indicates no airports in the state qualify for this tax exemption. Currently and in the future, the taxpayer savings of this tax exemption are $0 since the Moscow-Pullman airport property is deeded to the city of Pullman, and is already tax exempt as property of a government entity.

Recommendation

Given that there are no out-of-state municipalities owning airport property in Washington, the Legislature should terminate this property tax exemption.

Legislation Required:	Yes.
Fiscal Impact:	$0.

FARM AUCTION SALES – SUMMARY

Current Law

Current law exempts from the retail sales and use tax the sales of farming machinery and equipment sold at farm auctions occurring on farmland. This exemption applies to sales of tangible personal property that have been used on a farm. In order for the sale to be tax exempt, the owner of the agricultural equipment must be a farmer, and the sale must be conducted by an auctioneer on a farm. These tax exemptions apply to household goods and autos as well as farm equipment as long as the property has been used in farming activities. See Appendix 3 for the current law statutes, RCW 82.08.0257 and 82.12.0258.

Findings and Recommendations

This review has evaluated the legal history, public policy objectives, and revenue impacts of the retail sales and use tax exemption for farm machinery and equipment sold at farm auction sales. This audit determined the following:

Legal History and Public Policy Objectives

- The Legislature enacted these retail sales and use tax exemptions for personal property sold at farm auctions in 1943. These tax preferences had only slight modifications in 1961 and 1980.
- These tax preferences originally had the public policy objective of benefiting farmers who were selling their machinery and equipment on a farm.
- Another public policy objective of these tax preferences could have been to assist farmers in exchanging their old farm machinery and equipment with newer machinery in order to increase agricultural production to meet U.S. and world demand for food during World War II.
- For the past 65 years, these tax preferences have allowed purchasers of farm machinery and equipment at farm auction sales to buy equipment without retail sales and use taxes. These exemptions have achieved the purpose of assisting farmers and other purchasers of farm machinery and equipment.
- Since the enactment of these tax preferences, the methods of selling farm machinery and equipment have evolved and expanded beyond having on-the-farm auction sales conducted by auctioneers.
- These tax preferences have had unintended beneficiaries over the years because the purchasers of the farm machinery and equipment are not only farmers. The personal property that can be sold at the farm auctions can be any property used on the farm including cars and trucks. Items such as these could be of interest to people other than

- farmers. In addition, farmers do not need to sell only their own machinery and equipment on their own farm. Farmers could bring their equipment to another producer's farm and have a farm auction sale of various farmers' machinery and equipment.

Beneficiaries

- The beneficiaries of these retail sales and use tax exemptions are buyers at farm auction sales in rural farm communities. Anyone who purchases personal property at farm auction sales is a beneficiary, as well as farmers who conduct these farm auctions with tax exempt sales.
- These tax preferences do not have accountability reporting attached to them. As a result, the number of farm auctions and the volume of sales which qualify for the retail sales and use tax preferences are unknown.

Revenue Impacts

- Since these tax preferences do not have reporting requirements, the value of the tax preferences is difficult to estimate. In the past, the Department of Revenue has assumed 17 farm auctions are conducted per year, with taxpayer savings estimated to be $500,000 per year.
- Based on a U.S. national survey of auctioneers, sales of agricultural machinery and equipment totaled $18 billion for the U.S. Washington's share of U.S. total agricultural machinery and equipment sales totaled $309 million in 2007. Using the assumption that 10 percent of all agricultural machinery and equipment sales take place at on-farm auctions, JLARC estimates Washington's taxpayer savings at $2 million per year.

Recommendation

Due to the fact that Washington currently does not have uniform tax treatment for all purchases of used farm machinery and equipment regardless of location and method by which the property is acquired, the Legislature should require reporting information of on-farm auction sales and review the policy of these retail sales and use tax exemptions.

Legislation Required: Yes.

Fiscal Impact: Depends on the proposal.

FARM AUCTION SALES – REPORT DETAIL

Statutory History

The Legislature established the retail sales and use taxes with the 1935 Revenue Act. Due to the economic hard times in the state, there was a need to generate money for state and local governments. The original retail sales tax targeted retail sales of tangible personal property, with no services taxed in 1935. The Legislature provided seven major exemptions in the retail sales tax at that time:

1. Casual or isolated sales
2. Sales of newspapers
3. Sales prohibited by the federal constitution
4. Sales made by persons subject to the public utility tax
5. Sales made by businesses subject to the motor vehicle fuel tax
6. Sales made on relief vouchers issued by a welfare agency
7. Sales of certain dairy products, fresh fruits and vegetables, canned milk and bread[91]

The tax exemption for casual and isolated sales of tangible personal property covered sales by people not typically engaged in selling property at retail.[92] This included sales by a farmer of his farm machinery and other farm equipment. A 1935 Attorney General's Opinion, as well as Administrative Rule 107 in 1936, discussed these farm sales:

> *As we understand your statement, these auction sales are held by farmers in disposing of their equipment and do not include auction sales by auctioneers who gather together equipment and are in the business of holding auctions at certain times or merchants holding auction sales as is often done to reduce their stock.*[93]

A retail sales tax exemption was not allowed when the sales were made of a consignee or auctioneer. If the farm auction sales were held by farmers, then the farmer was not required to collect retail sales tax. Even though a retail sales tax exemption had been in place since 1935 for sales of farm machinery and equipment by farmers, the purchasers at these farm machinery sales were still liable for the use tax until 1943.

[91] "The Economics & Politics of Taxation in the Other Washington" draft document by Don Burrows.

[92] "Rules and Regulations Relating to the Revenue Act of 1935 of the State of Washington," by Washington Tax Commission, revised April 1, 1936.

[93] "Sales Tax – Auction Sales Held by Farmers Exempt," Attorney General Opinion November 15, 1935.

The Legislature enacted a specific retail sales and use tax exemption for farm machinery and equipment in 1943. This exemption applies to farm auction sales conducted by an auctioneer on farm property for personal property owned by a farmer and used on a farm. The following language is the original retail sales tax exemption statute from 1943:

> *The tax hereby levied shall not apply to the following sales:*
>
> *(g) Auction sales made by or through auctioneers of tangible personal property (including household goods) which have been used in conducting a farm activity, when the seller thereof is a farmer and the sale is held or conducted upon a farm and not otherwise.*

The following language is the original use tax exemption statute from 1943:

> *The provisions of this title shall not apply:*
>
> *(h)In respect to the use of tangible personal property (including household goods) which have been used in conducting farm activity: Provided, such property was purchased from a farmer at an auction sale held or conducted by an auctioneer upon a farm and not otherwise.*

Both 1943 statutes for the farm auction sales retail sales and use tax exemptions have had only slight technical modifications in the past 65 years.

Washington Agricultural Environment in early 1940s

Farm production in the early 1940s was booming to assist the war effort. The 1940 farm census showed 15.1 million acres in farms, increasing to 16.7 million acres by 1945. U.S. Secretary Wickard of the Department of Agriculture advocated farmers to help in the war effort by increasing agricultural production:

> *We must organize to produce in 1942 the biggest output of farm products in our history… The surest way to increase production is to assure farmers it will be profitable…Government buying for Britain under the huge lease-lend program will support the better price levels.*
>
> *If we have food ready to pour into the occupied countries-and even into Germany as soon as the battle for democracy has been won- Hitler's strength will crumble sooner. Food will win the war and write the peace. At the peace table the existence here of a great reserve of food will reinforce our views as to what the peace should be.*[94]

Farmers are essentially individual producers who operate their own machinery and equipment using many times their own family labor.[95] The Agriculture Secretary stressed the need to upgrade farmers' machinery and equipment:

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[94] "Big Job Before Farmers" article published in the Northwest Farm News, January 29, 1942.

[95] "Washington Agriculture" report created by the Washington State Senate Interim Committee on Agriculture 1946.

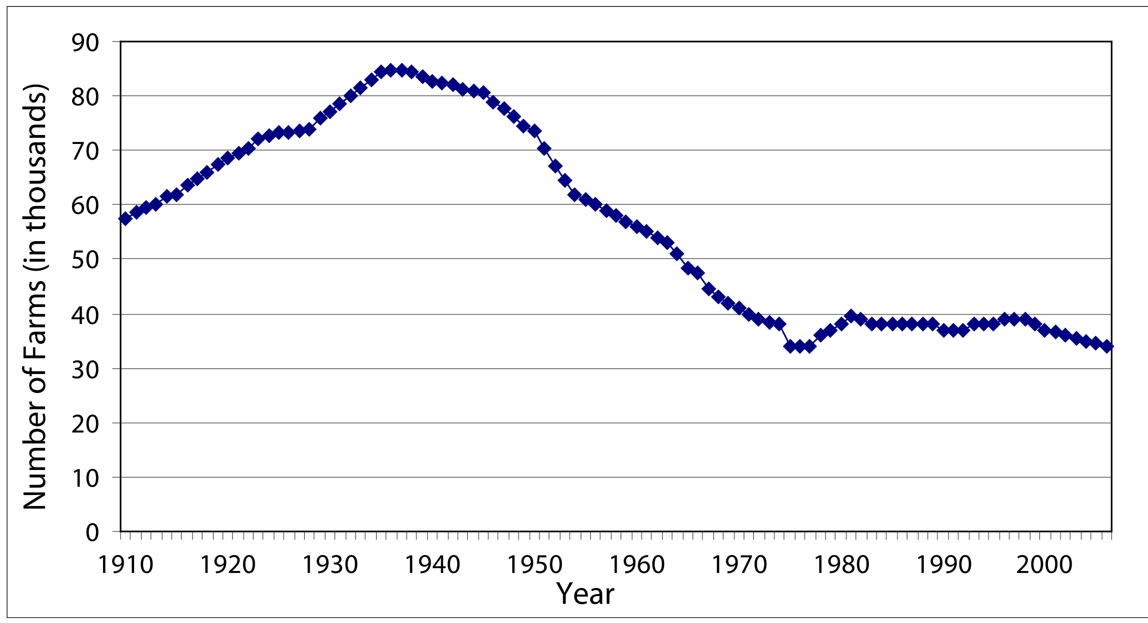
> *Farmers can always increase their output a lot without buying new machinery if the market justifies it and if they have manual labor. But they can expand their production only so far without either more labor or more machines and they can work the old machines only so far before it breaks down.*
>
> *The farmers of America are being called upon to do agriculture's biggest job in history. They need all the machines that can be spared from the factories now building tanks and other supplies.*[96]

Given the demands placed on U.S. agriculture at the time, Washington farmers needed to sell their older machinery and equipment and replace it with more advanced equipment. When the Washington Legislature enacted the retail sales and use tax exemption in 1943 for farm auction sales, its intent may have been to lower the costs of acquiring used equipment.

Trends in Washington Farms

This graph shows the change in number of farms in Washington from 1910 through 2006. The number has been declining since the mid-1930s when the number of farms exceeded 80,000 farms in Washington. Since 1980, the number of farms in the state has been relatively stable and shows a slow downward trend since 1998. In 2006, there were 34,000 farms in Washington.

Exhibit 30 – Number of Farms in Washington



Source: USDA-NASS 2007 Washington Agricultural Statistics.

[96] "Farmer Has a Vital Role in Helping to Win War," Northwest Farm News January 1, 1942.

Retail Sales and Use Tax – Application to Farmers

The Legislature enacted both the retail sales tax and the use tax as part of the Revenue Act of 1935. The retail sales tax is generally calculated as a percentage of the selling price of a transaction. In 1935, the retail sales tax rate was 2 percent, and the rate has been raised numerous times since then. The current state government sales tax rate is 6.5 percent, the rate established in 1983. From 1935 to 1970, only the state government imposed a retail sales tax.[97] The combined state-local retail sales tax rates currently range from 7.0 to 8.9 percent, with King County having the highest combined state and local retail sales tax.

The use tax is imposed on the use of tangible personal property in Washington, unless the person has already paid the retail sales tax in Washington. Washington was the first state to impose a general use tax, and the initial tax rate was 2 percent.[98] The compensating or use tax acts as a companion tax to the retail sales tax so Washington residents do not have an incentive to make purchases outside the state to avoid the retail sales tax. The use tax is applicable to items purchased from out-of-state businesses when those items are first put to use in Washington. The use tax also applies to successive sales of the same property in the state, such as certain sales of used farm machinery and equipment between private farmers. Since the use tax complements the sales tax, it is computed at the same rate.

Unless specifically exempted from law in RCW 82.08.0257 and 82.12.0258, tangible farm machinery and equipment used in this state is subject to either the sales tax or the use tax but not both, no matter how the property is acquired.[99]

Sales of New Farm Machinery and Equipment

Under current law, farmers who purchase new machinery and equipment to produce wholesale agricultural commodities are subject to the retail sales tax based on the cost of new equipment if purchased from an equipment dealer in Washington. If a farmer purchases new machinery and equipment from an out-of-state equipment dealer, who does not collect retail sales tax and the farmer brings the equipment to Washington to use here, then the farmer must pay use tax based on the value of the new machinery and equipment. If a farmer orders a new tractor from a mail-order catalog or Internet site, and the seller does not collect Washington retail sales tax, then the farmer must pay the use tax when using the equipment in Washington.

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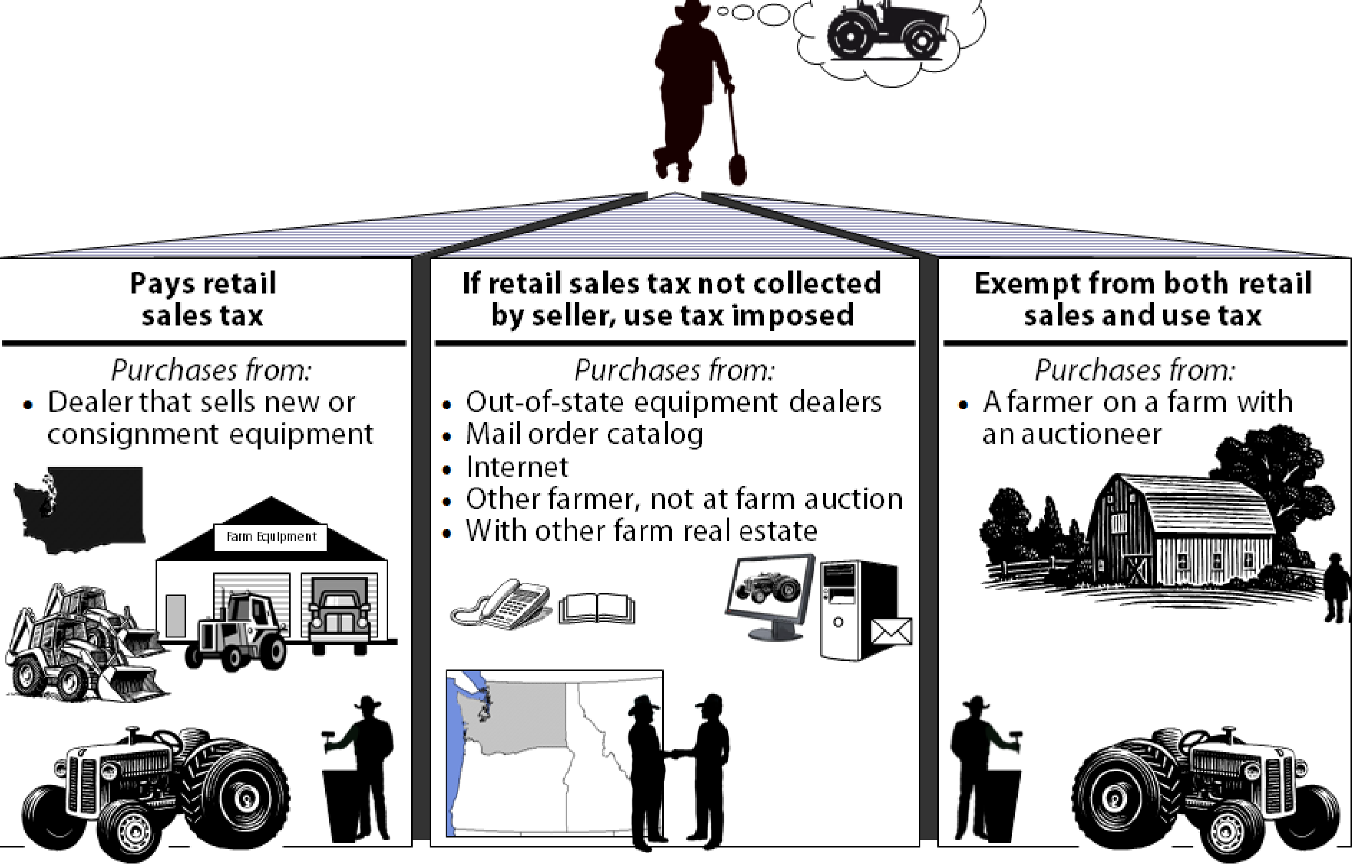
[97] In 1967 the Legislature allowed King County to impose a 2% motel/hotel sales tax to help finance the construction of the King Dome. The County tax was allowed as a credit against the state sales tax so the total tax rate was not increased. Excerpts from Don Burrows draft book titled "The Economics & Politics of Taxation in the Other Washington.

[98] Ibid.

[99] RCW 82.08.855 and 82.12.855 also exempt eligible farmers from the retail sales and use tax for replacement parts on farm machinery and equipment.

Exhibit 31 – Tax on Purchases of Farm Equipment



Source: JLARC analysis.

Sales of Used Farm Machinery and Equipment

Under current law, farmers who purchase **used** machinery and equipment from a farm equipment dealer in Washington are subject to the retail sales tax on the value of this purchase. If the farmer purchased a tractor from an out-of-state dealer or another farmer who was not conducting a farm auction sale, then the farmer pays the use tax on the value of the tractor purchased, provided the retail sales tax has not been collected on the sale. If a farmer purchased a tractor that was on consignment with an equipment dealer, then the farmer is subject to retail sales tax. If the farmer purchased used machinery and equipment through the Internet or mail order catalog, then the farmer would be subject to the use tax, provided the seller does not collect Washington's sales or use tax. If a farmer acquires personal property at the time of purchasing an entire farm, then the purchaser is responsible for paying use tax on the tangible personal property like machinery and equipment. The only time the purchase of farm machinery and equipment is tax exempt is when the farmer purchases the machinery and equipment at a farm auction sale conducted by an auctioneer on a farm.

These tax preferences for sales of personal property at farm auction sales is not limited to just agricultural machinery and equipment. These tax preferences also apply to household goods, cars, and trucks used on the farm. The owner of the personal property must be a farmer, but this tax exemption does not require the farm auction to occur on the owner's farm. The auction may occur on any farm. As a result, several farmers can bring their used farm machinery, equipment, and other items used in farming together to one farm for an auction.

Public Policy Objectives

What are the public policy objectives that provide a justification for the tax preference?

Subsidize Farmers to Encourage Exchanges of Farm Machinery and Equipment: One of the public policy objectives of these tax preferences is to assist farmers who need to sell their farm machinery and equipment, and those that need to purchase additional farm equipment, by providing this retail sales and use tax exemption. The retail sales and use tax exemptions may have provided a subsidy to farmers so they could obtain used farm machinery and equipment at a lower cost to assist them in expanding agricultural production to meet war demands for food worldwide. These tax preferences helped sellers of agricultural machinery and equipment find buyers since the farm auction machinery was exempt from retail sales and use tax.

Is the purpose or intent of the tax preference clear?

The purpose for the retail sales and use tax exemption for sales of used machinery and equipment seems consistent with the time period in which it was enacted to assist farmers in their role of providing food for the rest of the world. It is unclear exactly why sales had to be conducted by an auctioneer on the farm. It is uncertain if the Legislature in 1943 contemplated all the different locations and methods by which farmers would be acquiring used farm machinery and equipment outside a farm auction sale on a farm. The legislative intent is unclear on why on-the-farm auction sales are considered tax exempt when all other purchases of farm machinery and equipment is not tax exempt from retail sales and use tax. This has created an unequal sales and use tax treatment of purchases of used farm machinery and equipment.

Is there any readily available evidence related to the achievement of any of these public policy objectives?

Since 1943, these tax preferences have assisted farmers who needed to purchase farm machinery and equipment by having specific farm auction sales be tax exempt. However, these tax preferences have unintended beneficiaries as they provide tax exempt sales to individuals and non-farm businesses besides farmers. These tax preferences have created non-uniform tax treatment for purchases of farm machinery and equipment depending on the location and method by which the property is acquired.

Beneficiaries

Who are the entities whose state tax and/or local tax liabilities are directly affected by the tax preference?

The beneficiaries of these tax preferences are buyers at farm auction sales. Primarily, farmers purchase used farm machinery and equipment, but anyone may purchase the other items sold at these auctions. In addition, the 34,000 farms in Washington which have the ability to hold a farm auction on site also benefit because they can attract more buyers since the sales are retail sales and use tax exempt. Due to the fact that there is no reporting requirement for these exemptions, it is unclear exactly how many farm auctions are conducted on farms and the number of buyers and value of these sales statewide every year.

Revenue Impacts

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

The Department of Revenue's Tax Exemption Reports have estimated the state and local taxpayer savings from these preferences at a little more than $500,000 annually since 2004. The DOR estimate was based on an assumption that there were 17 farm auctions each year. The Department also assumed that the only farms under auction would be bankrupt farms. In examining the Washington Agricultural Statistics, the number of farms in Washington has declined by 500 farms per year for the last six years. DOR's assumption of a reduction in farms of only 17 is a low estimate given the state agricultural statistics. In addition, DOR's assumption of limiting the application of these tax preferences to bankrupt farms underestimates this tax preference. This exemption applies not only to farms where items are auctioned for bankruptcy purposes; it also applies to any farmer when he/she wants to sell some used farm machinery, equipment, and other personal property.

To develop its own estimate of the value of these tax preferences, JLARC began with data collected by the National Auctioneers Association in a nationwide survey of auctioneers. Survey results include information on the total sales of agricultural machinery and equipment sold at auction sales. Throughout the U.S., the gross sales value of agricultural machinery and equipment sold at auctions totaled $18.2 billion in 2007. This represented 5.1 percent of all U.S. auction sales that year. JLARC estimated Washington's share of total U.S. machinery and equipment sold at auctions to be 1.7 percent based on the 10-year average portion of the number of Washington's farms to total U.S. farms. JLARC assumed that 10 percent of all agricultural machinery and equipment auction sales were on-the-farm auctions. In 2007, Washington's total value of agricultural machinery and equipment was $29.4 million and sales were projected to rise to $30.9 million by 2009 and remain fairly constant. JLARC assumed a total retail sales and use tax rate of 8.4 percent. The projected taxpayer savings from these retail sales and use tax preferences is approximately $2 million per year. If JLARC's assumption that 10 percent of the auctions of agricultural machinery and equipment is on a farm is too low, then these estimates would underestimate the value of these tax preferences.

Exhibit 32 – State and Local Retail and Use Tax Savings:
Farm Auction Sales Deduction

Year	Income Deduction Amount ($ millions)	State and Local Taxpayer Savings ($ millions)
2007	$29.4	$1.9
2008	$31.3	$2.1
2009	$30.9	$2.1
2010	$30.7	$2.0
2011	$30.9	$2.1

Source: JLARC projections.

The taxpayer savings estimates are equivalent to the loss in state and local government revenue from continuing this retail sales and use tax exemption.

Recommendation

Due to the fact that Washington currently does not have uniform tax treatment for all purchases of used farm machinery and equipment regardless of location and method by which the property is acquired, the Legislature should require reporting information of on-farm auction sales and review the policy of these retail sales and use tax exemptions.

Legislation Required: Yes.

Fiscal Impact: Depends on the proposal.

WOOD BIOMASS FUEL: PRODUCTION FACILITIES/SALE/DISTRIBUTION – SUMMARY

Current Law

In 2003, the Legislature enacted a set of five tax preferences to promote the production of biofuels from wood biomass feedstock:

- **A six-year property tax exemption** for all buildings, machinery and equipment, and other personal property used primarily in manufacturing wood biomass fuel;
- **A six-year exemption from the leasehold excise tax** for holders of leasehold interest in property used for the manufacture of alcohol, biodiesel, and wood biomass fuels as well as biodiesel feedstock;
- **A retail sales tax exemption** for all sales of machinery and equipment used in constructing, repairing, cleaning, altering, or improving structures or machinery and equipment used in the retail sale of wood biomass blended fuel;
- **A use tax exemption** for the use of machinery and equipment or services rendered with respect to constructing, repairing, cleaning, altering or improving structures or machinery and equipment used in the retail sale of wood biomass blended fuel; and
- **A business and occupation tax deduction** for retail sales or distribution of wood biomass fuel.

The property tax and leasehold excise tax preferences have filing deadlines of December 31, 2009. The retail sales, use, and business and occupation tax preferences expire on July 1, 2009. Because of the 2009 expiration dates, JLARC is including these tax preferences in its 2008 reviews. See Appendix 3 for the current law statutes, RCW 84.36.640, 82.29A.135, 82.08.960, 82.12.960 and 82.04.4335.

Findings and Recommendations

This review has evaluated the legal history, public policy objectives, and revenue impacts of the various tax preferences for production and distribution of wood biomass biofuels. The audit determined the following:

Legal History and Public Policy Objectives

- The Legislature created these five tax exemptions in 2003 in Engrossed HB 2146.
- The 2003 legislation included six tax preferences for the biomass fuel producing industry in Washington. JLARC is currently reviewing the five tax preferences with expiration dates in 2009.
- There have been no legal changes to these tax preferences since their enactment in 2003.
- One of the public policy objectives of these tax preferences is to encourage renewable fuel generation from biomass in the state.
- Another objective of these tax preferences is to reduce air pollution and greenhouse gas emissions by encouraging the production of renewable energy fuel sources.
- A third objective is to promote new ways to use wood biomass in generating biofuels.

Beneficiaries

- There have been no beneficiaries of these five tax preferences as no new wood biomass fuel producing facilities have started up in Washington.
- The technology for converting wood biomass into fuel is still emerging worldwide.

Revenue Impacts

- There have been no revenue impacts from all five of these tax preferences as no new facilities have started here.
- At this point, it is difficult to determine the importance of these tax preferences to businesses planning on locating a new biofuel facility based on wood biomass feedstock in Washington.

Even though no wood biomass producing facilities have started here in Washington since these tax preferences were enacted in 2003, research on the conversion of wood biomass into biofuels is currently being developed. There are federal research grants available for universities to develop new technology in converting local biomass into biofuels as well as federal tax incentives for constructing new facilities. If cost-effective wood biomass conversion technology is developed, the commercial-scale ethanol plants could be started. Since it is unclear when the new technology will become cost-effective, it will be important for the Legislature to review these tax preferences again when there are some beneficiaries.

Recommendations

1) The Legislature should continue the property tax exemption for machinery and equipment used in producing wood biomass fuel. Since this tax preference is not currently being utilized, it should be reviewed for effectiveness in the future once it is used.

2) The Legislature should continue the leasehold excise tax exemption for leasehold interests of machinery and equipment used in producing wood biomass fuel. Since this tax preference is not currently being utilized, it should be reviewed for effectiveness in the future once it is used.

3) The Legislature should continue the retail sales tax exemption for sales of machinery and equipment used in constructing, altering or updating equipment which is used in selling wood biomass fuel. Since this tax preference is not currently being utilized, it should be reviewed for effectiveness in the future once it is used.

4) The Legislature should continue the use tax exemption for use of machinery and equipment used in constructing, altering or updating equipment which is used in selling wood biomass fuel. Since this tax preference is not currently being utilized, it should be reviewed for effectiveness in the future once it is used.

5) The Legislature should continue the business and occupation tax deduction for sales or distribution of wood biomass fuel. Since this tax preference is not currently being utilized, it should be reviewed for effectiveness in the future once it is used.

Legislation Required: Yes, to modify the expiration dates.

Fiscal Impact: Currently $0.

WOOD BIOMASS FUEL: PRODUCTION FACILITIES/SALE/DISTRIBUTION – REPORT DETAIL

Statutory History

The Legislature enacted these tax exemptions in 2003 in Engrossed HB 2146. This bill actually included six tax preferences for the biomass producing industry in Washington. JLARC is reviewing the five tax preferences that are scheduled to expire in 2009:

- A property tax exemption for all buildings, machinery and equipment, and other personal property used primarily in manufacturing wood biomass fuel;
- An exemption from the leasehold excise tax for holders of leasehold interest in property used for the manufacture of alcohol, biodiesel, and wood biomass fuels as well as biodiesel feedstock;
- A retail sales tax exemption for all sales of machinery and equipment used directly in the sale of wood biomass fuel and also for services rendered in respect to constructing, repairing, decorating, installing, cleaning, altering or improving structures or machinery and equipment used directly in the retail sale of wood biomass blended fuel;
- A use tax exemption for the use of machinery and equipment used directly in the sale of wood biomass fuel and also for services rendered in respect to constructing, repairing, cleaning, installing, altering or improving structures or machinery and equipment which are used in the retail sale of wood biomass blended fuel; and
- A business and occupation tax deduction for retail sales or distribution of wood biomass fuel.

The sixth tax preference from Engrossed HB 2146, which JLARC is not reviewing in 2008, is a preferential business and occupation tax rate for the amount of alcohol fuel or wood biomass fuel manufactured (RCW 82.04.260). Even though this tax preference was also in EHB 2146, this tax preference does not have an expiration date and so it will be subject to a later JLARC tax preference review.

Another tax preference included in EHB 2146 was a retail sales and use tax deferral for projects that manufacture wood biomass fuel in certain counties with eligible areas (community empowerment zones) throughout the state. The provisions contained in EHB 2146 for retail sales and use tax deferral had a null and void clause dependent on whether the expiration date of the rural county retail sales and use tax deferral program was extended beyond July 1, 2004. In 2004, the Legislature enacted SB 6240, which extended the expiration date on the general rural county retail sales and use tax deferral program to July 1, 2010. Because of the passage of SB 6240

in 2004, the retail sales and use tax deferral provisions for counties with community empowerment zone areas in EHB 2146 did not take effect.

The Legislature has not made additional changes to the five tax preferences under review since their enactment in 2003. The property tax and leasehold excise tax preferences have expiration dates of December 31, 2009. The retail sales, use, and business and occupation tax preferences expire on July 1, 2009.

Property Tax (RCW 84.36.640) and Leasehold Excise Tax (RCW 82.29A.135) Exemptions

Property taxes consist of annual payments by owners of real property (land, buildings, and other structures) and personal property. Property taxes are measured by the value of the property as determined by assessors applying standard appraisal methods. Property taxes in Washington are a levy-based system where the government entities determine the amount of taxes they need and impose those taxes on all property owners within their jurisdiction. There are legal limitations in place to restrict the amount of annual increase in property taxes. Real estate and personal property owned by a government entity are not subject to any property tax. Leasehold excise taxes are imposed when government-owned property is leased to a private owner. The leasehold interest in the public land or publicly-owned structures is subject to the leasehold tax, while the privately-owned improvements are subject to the property tax. The purpose of the leasehold excise tax is to compensate governmental entities for services rendered to lessees of public property. The leasehold excise tax is generally measured by contract rent, the amount for use of the public property.[100] However in certain circumstances the Department of Revenue can establish taxable rent that differs from contract rent.

The property tax exemption under review is for all real property including land, buildings, structures and improvements, and personal property including machinery and equipment used primarily in manufacturing wood biomass fuel. The leasehold excise tax exemption is for all leasehold interests in buildings, machinery, equipment, and other personal property used primarily for the manufacturing of wood biomass fuel. Both exemptions are for six years from the date when the facility becomes operational. The property tax claims must be filed with the county assessor, and the leasehold excise tax exemption is filed with the Department of Revenue. The property tax exemption is based on the county assessor's value of all real and personal property. The amount of leasehold excise tax exemption depends on the value of the wood biomass fuels manufactured compared to other manufactured products at the facility. If the facility only produces wood biomass fuels, then the value of the exemption is based on the value of the wood biomass fuels manufactured. Both the property tax and the leasehold excise tax exemptions have apportioning provisions for manufacturing facilities which manufacture additional products besides wood biomass fuels. If the company produces other products in addition to wood biomass fuels then the amount of the leasehold excise or property tax

[100] "2007 Tax Reference Manual – Information on State and Local Taxes in Washington State," Department of Revenue.

exemption is based on the annual percentage of total value of all products manufactured which is the value of the wood biomass fuels manufactured. Both tax exemptions have filing deadlines of December 31, 2009. No new claims for exemptions can be approved after that date but the property and leasehold excise tax exemptions will still apply for a six-year period following the date that a facility becomes operational.

Retail Sales (RCW 82.08.960) and Use Tax Exemptions (RCW 82.12.960)

The retail sales tax applies to goods, construction including labor, repair of tangible personal property, certain lodging activities, telephone services, and participatory recreational activities. Some personal and professional services are also subject to the sales tax. The state tax rate is 6.5 percent, and local sales tax rates range from 0.5 to 2.4 percent depending on the jurisdiction. Use tax is imposed on items used in the state. If at the time of purchase of taxable property, retail sales tax is not collected, then the purchaser is responsible for paying the use tax once the property is used in Washington. This includes purchases made from out-of-state sellers, purchases made from sellers who are not required to collect Washington's sales tax, items produced for use by the producers, and gifts and prizes. The use tax is measured by the value of the item at the time of the first use within Washington. The use tax rates are the same as for the retail sales tax.[101]

The retail sales and use tax exemptions under review are for machinery and equipment used directly for the retail sale of wood biomass fuel blend. In addition, services rendered in respect to constructing, repairing, decorating, installing, cleaning, altering, or improving structures or machinery and equipment used directly in the retail sale of wood biomass fuel blend are retail sales tax exempt. The use tax exemption is also for services rendered in respect to constructing, repairing, installing, cleaning, altering, or improving machinery and equipment used directly in the retail sale of wood biomass fuel blend. Both retail and use tax exemptions apply to not only machinery and equipment but also tangible personal property that become an ingredient or component of the structures or machinery and equipment. Fuel delivery vehicles may also be retail sales or use tax exempt if at least 75 percent of the fuel distributed by the vehicle is a wood biomass fuel blend. Both retail sales and use tax preferences expire on July 1, 2009.

Business and Occupation Tax Deduction (RCW 82.04.4335)

The Legislature enacted the business and occupation tax in the Revenue Act of 1935. This tax is based on the gross receipts. Initially the tax rates were 0.25 percent for all businesses except services, which were taxed at 0.5 percent. Over time, the Legislature has developed a number of specialized tax rates for particular types of businesses.[102] For most companies, the business and occupation tax rates range from 0.13 percent to 1.5 percent. The retailing business and occupation tax rate is 0.471 percent, and the wholesaling and manufacturing tax rate is 0.484

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[101] "2007 Tax Reference Manual – Information on State and Local Taxes in Washington State," Department of Revenue.

[102] Ibid.

percent. Those businesses which are not otherwise covered by another tax rate pay the B&O tax rate of 1.5 percent.[103] The B&O tax does not permit deductions for the costs of doing business, such as payments for raw materials and wages of employees. Any exemptions and deductions from the B&O tax are specified separately in law. Under current law, there is a permanent preferential B&O tax rate of 0.138 percent for the value of the manufactured wood biomass and alcohol fuel. [104] There is a similar business and occupation tax rate for manufacturing of biofuels. That preferential rate has an expiration date. JLARC will review this tax preference at a later date.

The business and occupation tax deduction under review is for retail sales or distribution of wood biomass fuel. This is in addition to the business and occupation tax preferential rate for manufacturing of biofuels. This particular B&O tax deduction for the distribution facilities of the wood biomass biofuels industry is not provided to other biofuels produced from non-wood biomass. This tax deduction expires on July 1, 2009.

Other Relevant Background

Definitions of terms: Bioenergy, Biomass, Biofuels, Biodiesel, Cellulosic ethanol

Bioenergy is useful, renewable energy produced from organic matter. Biomass is any organic matter that is available on a renewable or recurring basis, including agricultural crops and trees, wood and wood residues, and other residue materials. Biofuels are fuels made from biomass resources. Biofuels include ethanol, biodiesel, and methanol.[105] Biodiesel is non-petroleum diesel fuel derived from vegetable oils or animal fats. It is produced when a vegetable oil or animal fat is chemically reacted with an alcohol, and it can be used as a pure product or blended with petroleum diesel. Cellulosic ethanol is a type of biofuel produced from mass of plants. Cellulosic ethanol is chemically identical to ethanol.

Overview of Ethanol Fuel Production from Biomass Feedstock

Conventional ethanol and cellulosic ethanol are the same product, but they are produced using different feedstock and processes. Conventional ethanol is derived from grains such as corn, wheat, or soybeans. Since most of the ethanol Americans use today has come from corn, which is also used to feed animals, ethanol production has driven up the price of livestock and decreased profits of the poultry industry. Prices of other grains, such as soybeans and wheat, have risen due to more farmers choosing to plant corn instead of wheat and soybeans. Rather than using corn kernels or other edible plants for fuel, scientists hope to turn agricultural and

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[103] "2007 Tax Reference Manual – Information on State and Local Taxes in Washington State," Department of Revenue.

[104] RCW 82.04.260(1)(f).

[105] Biomass Energy Data Book Edition 1, US Department of Energy – Energy Efficiency and Renewable Energy September 2006.

wood waste into ethanol.[106] Cellulosic ethanol can be produced from a wide variety of cellulosic biomass feedstock including agricultural plant wastes (corn stover, cereal straws, sugarcane bagasse), forest residue, plant wastes from industrial processes (sawdust, paper pulp), and energy crops grown specifically for fuel production, such as switchgrass. The ground of North American forests is covered by millions of tons of cellulose from wood including bark, branches, and leaf litter. This wood biomass material could be harvested and converted into ethanol fuel. In addition, the processes that produce lumber products also generate cellulose waste that could be used to produce cellulosic ethanol.

In both productions of ethanol (wood biomass or corn-based), the fermentable sugars must be extracted from the feedstock. However, traditional corn-based ethanol uses fossil fuels to produce heat during the conversion process, generating substantial greenhouse gas emissions.[107] On the other hand, cellulosic ethanol production substitutes biomass for fossil fuels, substantially reducing greenhouse gas emissions. According to a U.S. Department of Energy study conducted by the Argonne Laboratories of the University of Chicago, one of the benefits of cellulosic ethanol is that it reduces greenhouse gas emissions by 85 percent over reformulated gasoline.[108]

Biomass Inventory

Biomass raw material is cheap and plentiful. Cellulosic is present in straw, grass, and wood. Most of these “biomass” products are currently discarded. In recent years, researchers have attempted to quantify the amount of under-utilized biomass matter. Several national and state projects have been completed to inventory the available biomass either at a national, regional, or state level.

In 2003, the Washington State Department of Ecology developed a preliminary biomass and bioenergy study for Eastern Washington.[109] In December 2005, the Department of Ecology and WSU completed a statewide inventory on the amount of under-utilized ‘waste’ biomass resources by county.[110] This study found that Washington has an annual production of over 16.9 million tons of underutilized dry biomass capable of producing 1,769 MW of electrical power. This amount of energy is equivalent to about 50 percent of Washington’s annual residential electrical consumption. The biomass categories in this inventory included field residues, animal manures, forestry residues, food packing/processing waste, and municipal wastes. Approximately 14 percent of all under-utilized biomass is from forest residue (logging and forest thinning), and another 31 percent is from mill residue. Forest and mill residues are the two primary sources of

[106] “Researchers combine efforts and explore options in developing alternative fuels,” Future Fuel March 2008, Vol. 87: No. 2.

[107] Creating Cellulosic Ethanol: Spinning Straw into Fuel, by Diane Greer in Biocycle April 2005.

[108] Wikipedia Cellulosic ethanol.

[109] Bioenergy Inventory and Assessment for Eastern Washington, by Department of Ecology, INTEC, WSU September 2003.

[110] Biomass Inventory and Bioenergy Assessment – An Evaluation of Organic Material Resources for Bioenergy Production in Washington State, by Department of Ecology and WSU in December 2005.

wood biomass, and they comprise nearly half of the total under-utilized dry biomass in the state.[111]

Exhibit 33 – Washington Wood Biomass Inventory Data - 2005

Type of Residue	Total Statewide	% of Total Biomass
Logging	1,901,072	11%
Forest Thinning	505,666	3%
Mill	5,278,353	31%
Wood (Municipal Solid Waste)	834,057	5%
Total (Wood Biomass) =	**8,519,148**	**50%**
Total (All Biomass) =	**16,900,000**	

Source: Biomass Inventory and Bioenergy Assessment – An Evaluation of Organic Material Resources for Bioenergy Production in Washington State, by Department of Ecology and WSU in December 2005.

Federal and state government grants

The U.S. Department of Energy Strategic Plan and Energy and Efficiency Renewable Energy (EERE) Strategic Plan contain mandates to pursue biofuels production from biomass resources to help establish the bioindustry. In 2008, six federally funded research and development centers and national laboratories have ongoing programs in biomass focused on energy research and development. In the Energy Independence and Security Act (EISA) of 2007, Congress mandated that the government facilitate the successful development of converting biomass to biofuels via biological, chemical, and thermochemical processing.[112] The EISA requires the Department of Energy to engage universities in biofuels research and to provide grant assistance funding. The University of Georgia received a grant for finding efficient ways to turn the tough, fibrous parts of plants into ethanol. A team of researchers at the University of Georgia has also developed an entirely new biofuel derived from wood chips.[113] In addition to grant money, the federal government has provided tax credits: a small agri-biodiesel or ethanol producer tax credit, and a volumetric ethanol or biodiesel 'blender' excise tax credit.

In March 2008, the Washington Department of Ecology announced that six research projects and two demonstration projects would receive grant funding.[114] The focus of these research projects is converting organic wastes to energy. For example, one research proposal receiving a grant was to the University of Washington to study using woody urban waste to produce bioethanol.

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[111] Biomass Inventory and Bioenergy Assessment – An Evaluation of Organic Material Resources for Bioenergy Production in Washington State, by Department of Ecology and WSU in December 2005.

[112] "Financial Assistance Funding Opportunity Announcement," U.S. Department of Energy – Office of the Biomass Program.

[113] "Researchers combine efforts and explore options in developing alternative fuels," Future Fuel March 2008, Vol. 87: No. 2.

[114] "Ecology Boosts Efforts to Convert Organic Wastes to Energy," Department of Ecology News Release March 19, 2008.

Washington State University received funding to study the process of using woody biomass waste to produce crude bio-oils that can be converted into transportation fuels.

Cellulosic Ethanol Plants in the U.S.

Currently, Washington does not have any biomass fuel plants in the state. In the past, Washington has had a few ethanol plants, but the feedstock was not wood biomass. The high cost of transportation and lack of pipelines has limited the expansion of traditional corn-fueled ethanol plants beyond the Midwest. Cellulosic ethanol breaks down that barrier by allowing almost any state to use its native agriculture.

One of the reasons the federal government set an ambitious biofuels goal to be achieved by expansion of the cellulosic ethanol production is because of new technology developing in this area. For instance, the company Range Fuel has an innovative cellulosic technology. In 2008, they started the first commercial scale cellulosic ethanol plant in the United States in Georgia. This plant will be a 20-million gallon ethanol plant fueled by wood waste.[115] The company and state official say there is enough waste wood from its timber industry to produce as much as 2 billion gallons of ethanol annually, and this could displace about 1 percent of U.S. gasoline consumption.

In January 2008, Pacific Ethanol announced that it had won a Department of Energy matching grant of $24.32 million to build the first cellulosic ethanol demonstration plant in the Northwest.[116] This pilot plant will be located in Boardman, Oregon, and it will be designed to produce 2.7 million gallons of ethanol annually. This plant hopes to demonstrate the potential of a new technology to produce ethanol from a diverse mixture of biomass like wheat straw and wood chips. Numerous efforts are also underway in other states. In October 2007, Abengoa Bioenergy opened a pilot plant in York, Nebraska for the conversion of biomass into biofuel. This plant is exclusively dedicated to the research and development of biofuel production processes from biomass.[117] The intent of the research is to develop a new technology for use in commercial-scale conversion of biomass into ethanol. In 2008, KL Process Design Group opened the first small commercial scale cellulosic ethanol facility in South Dakota. This plant utilizes an enzymatic method to break down wood and waste materials such as cardboard and paper. [118] Another ethanol commercial demonstration facility by AE Biofuels, Inc. began construction in February 2008 in Butte, Montana.[119] This plant will use a new technology to produce ethanol from multiple feedstocks. Non-food ethanol feedstocks used by the facility will include switch

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[115] "Turning to chemistry for alternative fuel," by Matthew L. Ward International Herald Tribune, November 8, 2007.

[116] "Pacific Ethanol Wins DOE Cellulosic Energy Grant," Pacific Ethanol news release January 29, 2008.

[117] "Abengoa Bioenergy opens pilot plant for the energy of the future," Abengoa Bioenergy new release October 15, 2007.

[118] "KL Process Design Group Producing Ethanol from Waste Wood" in Ethanol Market News Release January 29, 2008.

[119] "AE Biofuels Builds Integrated Cellulose Ethanol Commercial Demonstration Plant," AE Biofuels web site February 19, 2008.

grass, grass seed straw, small grain straw and corn stalks. Several other U.S. and foreign companies are experimenting with cellulosic systems. In Madison Wisconsin, a company called Virent is turning sugar into gasoline, diesel, kerosene and jet fuel, with the long-run plan of getting the sugars from biomass. In Chicago, a Honeywell subsidiary called OUP is cooking various forms of biomass into synthetic oil that can be refined. In California, BlueFire ethanol is using acid to break down organic material to convert to fuel.[120] Most states are still developing smaller pilot plants with no commercial output. Experts say it is possible that more than one type of plant will reach commercial success with the ideal technique for a given locale depending on what material is available to convert to fuel. However, the technology of converting a variety of different types of biomass into biofuels like ethanol is still in the development stages.

State Tax Preferences for Producing Wood Based Biofuels

In 2003, Washington was the first state to enact specific tax preferences for biofuel produced from wood biomass. Since that time, Georgia has implemented a temporary exemption from its retail sales and use tax for sales of tangible personal property made to or used in the construction of alternative fuel facilities dedicated to processing ethanol, biodiesel, butanol, and their by-products when these fuels are derived from biomass materials. The exemption applies to qualified sales that occur from July 1, 2007, through June 30, 2012. Utah also has sales and use tax exemptions for machinery and equipment used in new or expanding renewable energy production facilities that produce fuel from biomass energy. For a facility that produces fuel from biomass energy, the exemption applies to machinery and equipment leased for more than four years, or purchased after June 30, 2004, but before July 1, 2009. The facility must be operational after June 30, 2004. Other states have general tax preferences for ethanol or biofuel production but not specific exemptions for biofuels produced from wood waste.

Federal Renewable Fuels Mandate

The U.S. Energy Policy Act of 2005 (EPACT) legislation established a U.S. renewable fuels standard at 4 billion gallons in 2006, increasing to 7.5 billion gallons by 2012.[121] In his 2006 State of the Union address, President Bush proposed expanding the use of cellulosic ethanol. In his 2007 State of the Union address, President Bush proposed mandating 35 billion gallons of ethanol production in the U.S. by 2017. According to studies on ethanol production in the U.S., the maximum amount of ethanol that can be produced from corn starch is 15 billion gallons per year, implying a proposed mandate for production of 20 billion gallons per year of cellulosic ethanol by 2017. Bush's 2007 proposed plan includes $2 billion in funding for cellulosic ethanol plants, with additional funding of $1.6 billion announced by USDA later in January 2007.[122]

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[120] "Turning to chemistry for alternative fuel," by Matthew L. Ward International Herald Tribune, November 8, 2007.

[121] "Biofuels in the U.S. transportation sector," Energy Information Administration - February 2007.

[122] "Federal government programs to finance biodiesel production / oilseed crushing and ethanol venture," December 17, 2007.

Washington State Policy Encouraging Renewable Energy Source

Legislation in 2006 established minimum renewable fuel standards in ESSB 6508. The legislation mandated that, beginning December 1, 2008, all gasoline sold or offered for sale in Washington must contain at least 2 percent ethanol. In addition, certain special fuel licensees must provide that at least 2 percent of total annual diesel fuel sales are biodiesel fuel sales by no later than November 30, 2008.

In 2006, the Legislature also enacted a bill that requires investor-owned and consumer–owned electric utilities with more than 25,000 customers to develop integrated resource plans by September 1, 2008.[123] Each plan must include, among other elements, a comparative evaluation of renewable and nonrenewable generating technologies. In addition, the plan must explain why renewable resources or conservation and efficiency resources were not included. In the 2006 legislation, the Legislature appropriated $17 million to the Department of Agriculture for the Energy Freedom Loan Program. This program offers eligible public entities an interest rate of 1 percent for renewable energy projects, including projects in the development of oilseed crushing capacity and all processes that convert agricultural waste into energy.

On November 7, 2006, Washington voters approved Initiative 937, the Energy Independence Act. This initiative requires large utilities to obtain 15 percent of their electricity from new renewable resources such as solar and wind by 2020. The following statement is the initiative's declaration of Washington's intent to promote energy independence:

> *Increasing energy conservation and the use of appropriately sited renewable energy facilities builds on the strong foundation of low-cost renewable hydroelectric generation in Washington State and will promote energy independence in the state and Pacific Northwest region. Making the most of our plentiful local resources will stabilize electricity prices for Washington residents, provide economic benefits for Washington counties and farmers, create high-quality jobs in Washington, provide opportunities for training apprentice workers in the renewable energy field, protect clean air and water and position Washington State as a national leader in clean energy technologies.*[124]

In 2007, the Legislature established greenhouse gas emissions goals for Washington.[125] The legislation also requires the reporting of greenhouse gas emissions to the Legislature. It directs the Governor to develop policy recommendations to the Legislature for consideration in the 2008 Legislative Session on how the state can achieve the greenhouse gas reduction goals.

[123] HB 1010 (2006).
[124] RCW 19.285.020.
[125] ESSB 6001.

Public Policy Objectives

What are the public policy objectives that provide a justification for the tax preference?

These five tax preferences lack any specific stated intent. There is legislative intent in other sections of the law on encouraging the production of renewable fuel sources in Washington. The three public policy objectives were derived from general legislative intent on renewable energy sources and testimony on the bill when it was enacted in 2003.

Promote Production and Distribution of Biofuels in Washington

One of the public policy objectives of these tax exemptions is to attract this type of new renewable fuel production and distribution of biofuels to Washington. According to testimony on this bill advocates for these tax preferences stated that these new exemptions would make Washington a national leader in the production of ethanol from wood biomass. According to advocates of the bill, Washington was to be the first state to provide tax incentives for producing biofuels from wood biomass.

Reduce Air Pollution and Greenhouse Gas Effect

Another objective of these tax preferences is to encourage production of renewable fuels to reduce air pollution and greenhouse gas effect. The traditional method of producing corn ethanol requires burning of fossil fuels. Switching to producing cellulosic ethanol from wood biomass substantially reduces air pollution in the processing of ethanol.

Utilize Wood Waste for Bioindustry

Another objective of these tax preferences is to find ways to utilize wood waste and recycle it to make biofuels.

Is the purpose or intent of the tax preference clear?

This tax preference lacks any specific stated intent in the statute in which the exemptions and deductions are defined. There is legislative intent in other sections of the state and federal law on encouraging the production of renewable energy sources in Washington. The beneficiaries of these tax preferences are clearly defined in law.

Is there any readily available evidence related to the achievement of any of these public policy objectives?

Since there are no new wood biomass fuel production facilities in Washington, there is no evidence that these tax preferences have achieved any of the public policy objectives to date. These tax incentives are consistent with other federal tax incentives, mandates, and grant programs in place to encourage the biofuels industry nationwide. The question is how important are Washington's tax incentives in attracting businesses to locate a new wood biomass fuel

production facility in Washington? Washington's experience since 2003 has been that, if the technology for the biomass conversion process is not yet cost-effective, the ethanol production facilities will not locate here, regardless of whether the state has tax incentives in place.

In 2003, Washington was the only state with tax incentives specific for businesses producing biofuels from wood biomass. Some federal fuel tax credits were enacted in 2004. As far as evidence that the tax preferences have accomplished their goal of making Washington a national leader in the wood biomass fuel production area, there is no such evidence. Even though tax preferences were in place in Washington, the first commercial scale ethanol production facility from wood biomass feedstock began in Georgia in 2008, and other pilot plants are being built in other states like Montana and Oregon. This result demonstrates that the decision of where to locate a new fuel production facility depends on a number of factors, only one of which is the tax incentives in states. Another important factor is the advancement of research in converting the wood biomass specific to each state into biofuels. Another factor is the cost associated with the conversion process of producing wood biomass fuel. This is a critical factor in determining whether a state's facility will be cost-effective or not.

Beneficiaries

Who are the entities whose state tax and/or local tax liabilities are directly affected by the tax preference?

Currently there are no beneficiaries. Since these tax preferences were enacted, there have been no wood biomass fuel producing facilities constructed in Washington. There are no gasoline stations selling wood biomass fuel. Throughout the U.S., this new technology of producing fuel from any wood biomass is just starting, with the first commercial size ethanol producing facility beginning in Georgia in 2008.

Revenue Impacts

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

The past and near future tax revenue impacts are $0 as the technology for converting wood biomass into biomass alternative fuel is still emerging.

Recommendations

1) The Legislature should continue the property tax exemption for machinery and equipment used in producing wood biomass fuel. Since this tax preference is not currently being utilized, it should be reviewed for effectiveness in the future once it is used.

2) The Legislature should continue the leasehold excise tax exemption for leasehold interests of machinery and equipment used in producing wood biomass fuel. Since this tax preference

is not currently being utilized, it should be reviewed for effectiveness in the future once it is used.

3) The Legislature should continue the retail sales tax exemption for sales of machinery and equipment used in constructing, altering or updating equipment which is used in selling wood biomass fuel. Since this tax preference is not currently being utilized, it should be reviewed for effectiveness in the future once it is used.

4) The Legislature should continue the use tax exemption for use of machinery and equipment used in constructing, altering or updating equipment which is used in selling wood biomass fuel. Since this tax preference is not currently being utilized, it should be reviewed for effectiveness in the future once it is used.

5) The Legislature should continue the business and occupation tax deduction for sales or distribution of wood biomass fuel. Since this tax preference is not currently being utilized, it should be reviewed for effectiveness in the future once it is used.

Legislation Required: Yes, to modify the expiration dates.

Fiscal Impact: Currently $0.

ALCOHOL/BIODIESEL FUEL PRODUCTION FACILITIES – SUMMARY

Current Law

In 2003, the Legislature created three tax preferences enacted to promote the production of alcohol and biodiesel fuel:

- **A six-year property tax exemption** for all buildings, machinery and equipment, and other personal property used primarily in manufacturing alcohol fuel, biodiesel, or biodiesel feedstock;
- **A six-year exemption from the leasehold excise tax** for holders of leasehold interest in property used primarily for the manufacture of alcohol and biodiesel fuels as well as biodiesel feedstock; and
- **A business and occupation preferred tax rate** of 0.138 percent for manufacturers of alcohol fuel, biodiesel fuel, and biodiesel feedstock.

The property tax and leasehold excise tax preferences have filing deadlines of December 31, 2009. The preferred business and occupation tax rate expires on July 1, 2009. Because of the 2009 expiration dates, JLARC is including these tax preferences in its 2008 reviews. See Appendix 3 for current law statutes, RCW 84.36.635, 82.29A.135 and 82.04.260.

Findings and Recommendations

This review has evaluated the legal history, public policy objectives, and revenue impacts of the various tax preferences for production and manufacturing of alcohol and biodiesel fuels. The audit determined the following:

Legal History and Public Policy Objectives

- The Legislature created all three tax exemptions for manufacturers of biodiesel and alcohol fuels in 2003 in 2SHB 1240.
- There have been no major fundamental changes to these tax preferences since their enactment in 2003.
- One of the public policy objectives of these tax preferences is to encourage production of renewable fuels in Washington.
- Another objective of these tax preferences is to reduce air pollution and greenhouse gas emissions by encouraging the production of renewable energy fuel sources.
- Another objective of these tax preferences is to assist Washington farmers by developing alternative markets for oilseeds.

Beneficiaries

- *Property tax:* According to the Department of Revenue and county assessors' office staff, one biodiesel production facility in Washington has applied for the personal property tax exemption. There are four other oilseed crushing facilities which are either operational now, or will be in 2008, that could qualify for the property tax exemption.
- *Leasehold Excise tax:* According to data from the Department of Revenue, four biodiesel production facilities are claiming the leasehold excise tax.
- *Preferred B&O tax rate:* According to the excise tax return data in 2006, four businesses are claiming the reduced B&O tax rate.

Revenue Impacts

- *Property tax:* The revenue impact from the property tax exemption was $0 in fiscal year 2007. By 2008, the property tax savings for two oilseed crushers should be approximately $24,000. In future years, two other oilseed crushers will likely be operational and qualify for the property tax exemption. In future years, the value of this tax preference, if extended beyond 2009, could range from $122,000 to $139,000 per Biennium.
- *Leasehold excise tax:* In fiscal year 2008, the total taxpayer savings was approximately $27,500 in state leasehold excise tax savings and $24,000 in local leasehold excise taxes. In fiscal year 2009, the taxpayer savings will increase to approximately $138,000 in state leasehold excise tax and $121,000 in local leasehold excise tax.
- *Preferred B&O tax rate:* According to the excise tax return data in 2006, four businesses reported $22,000 in taxpayer savings in fiscal year 2008.

Recommendations

1) The Legislature should continue the property tax exemption for machinery and equipment used in producing alcohol fuel, biodiesel and biodiesel feedstock and review for effectiveness in the future once this industry is more developed.

2) The Legislature should continue the leasehold excise tax exemption for leasehold interests of machinery and equipment used in producing alcohol, biodiesel and biodiesel feedstock and review for effectiveness in the future once this industry is more developed.

3) The Legislature should continue the preferred business and occupation tax rate for manufacturers of alcohol and biodiesel fuel and feedstock and review for effectiveness in the future once this industry is more developed.

Legislation Required: Yes, to modify the expiration dates.

Fiscal Impact: See Revenue Impact section.

ALCOHOL/BIODIESEL FUEL PRODUCTION FACILITIES – REPORT DETAIL

Statutory History

The Legislature enacted these tax exemptions in 2003 in SSHB 1240. The Legislation included the following tax preferences for the biofuels producing industry in Washington:

- A six-year property tax exemption for all buildings, machinery and equipment, and other personal property used primarily in manufacturing alcohol fuels, biodiesel fuels, and biodiesel feedstock;
- A six-year exemption from the leasehold excise tax for holders of leasehold interest in property used primarily for the manufacture of alcohol and biodiesel fuels as well as biodiesel feedstock;
- A preferential business and occupation tax rate for income from manufacturing biodiesel and alcohol fuels; and
- A retail sales and use tax deferral for projects that manufacture biodiesel and alcohol fuels and biodiesel feedstock in certain counties with eligible areas (community empowerment zones).[126]

JLARC is reviewing the first three of these tax preferences because they all have expiration dates in 2009.

After the passage of SSHB 1240, the 2003 Legislature also passed EHB 2146. This legislation was very similar to HB 1240 except it created tax preferences for the manufacturing of wood biomass fuel. That is why in the business and occupation tax preferential tax rate section of law 82.04.260, there are two similar sections (subsections e and f) which provide a .138 tax rate for the manufacturers of both biodiesel fuel, alcohol fuel, biomass fuel and biodiesel feedstock. The preferential tax rate for biodiesel fuel and feedstock has an expiration date of July 1, 2009, but the preferential tax rate for the manufacturing of wood biomass fuel and alcohol fuels are permanently in law.

In 2008, the Legislature expanded these property tax and leasehold excise tax exemptions to include anaerobic digesters with a filing deadline of December 31, 2012.[127] There have been no other major changes to these tax preferences since 2003.

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[126]The retail sales and use tax deferral contained in SSHB 1240 for retail sales and use tax deferral had a null and void clause dependent on whether the expiration date on the regular distressed area's retail sales and use tax deferral program was extended beyond July 1, 2004. In 2004, the Legislature enacted SB 6240, which extended the expiration date on the general distressed area's retail sales and use tax deferral program to July 1, 2010. Because of the passage of SB 6240 in 2004, the retail sales and use tax deferral provisions of 2SHB 1240 did not take effect.

[127] SSB 6806.

Property Tax (RCW 84.36.635) and Leasehold Excise Tax Exemptions (RCW 82.29A.135)

Property taxes consist of annual payments by owners of real property (land, buildings, and other structures) and personal property. Property taxes are measured by the value of the property as determined by assessors applying standard appraisal methods. Property taxes in Washington are a levy-based system where the government entities determine the amount of taxes they need and impose those taxes on all property owners within their jurisdiction. There are legal limitations in place to restrict the amount of annual increase in property taxes. Real estate and personal property owned by a government entity are not subject to any property tax. Leasehold excise taxes are imposed when government-owned property is leased to a private owner. The leasehold interest in the public land or publicly-owned structures is subject to the leasehold tax, while the privately-owned improvements are subject to the property tax. The purpose of the leasehold excise tax is to compensate governmental entities for services rendered to lessees of public property. The leasehold excise tax is generally measured by contract rent, the amount for use of the public property.[128] However in certain circumstances the Department of Revenue can establish taxable rent that differs from contract rent.

The property tax exemption under review is for all real property including land, buildings, structures and improvements, and personal property including machinery and equipment used primarily in manufacturing biofuels. The leasehold excise tax exemption is for all leasehold interests in buildings, machinery, equipment, and other personal property used primarily for the manufacturing of biofuels. Both exemptions are for six years from the date when the facility becomes operational. The property tax claims must be filed with the county assessor, and the leasehold excise tax exemption is filed with the Department of Revenue. The property tax exemption is based on the county assessor's value of all real and personal property. The amount of the leasehold excise tax exemption depends on the value of the biofuels manufactured compared to the other manufactured products at the facility. If the facility only produces biofuels, then the value of the exemption is based on the value of the biofuels manufactured. Both the property tax and the leasehold excise tax exemptions have apportioning provisions for manufacturing facilities which manufacture additional products besides biofuels. If the company produces other products in addition to biofuels then the amount of the leasehold excise or property tax exemption is based on the annual percentage of total value of all products manufactured which is the value of the biofuels manufactured. Both tax exemptions have filing deadlines of December 31, 2009. No new claims for exemptions can be approved after that date but the property and leasehold excise tax exemptions will still apply for a six-year period following the date that a facility becomes operational.

[128]"2007 Tax Reference Manual – Information on State and Local Taxes in Washington State," Department of Revenue.

Business and Occupation Tax Preferred Tax Rate (RCW 82.04.260)

The Washington Legislature enacted the business and occupation tax in the Revenue Act of 1935. This tax is based on gross receipts. Initially the tax rates were 0.25 percent for all businesses except services, which were taxed at 0.5 percent. Over time, the Legislature has developed a number of specialized tax rates for particular types of businesses.[129] Under current law, for most companies, the business and occupation tax rates range from 0.13 percent to 1.5 percent. The retailing business and occupation tax rate is 0.471 percent, and the wholesaling and manufacturing tax rate is 0.484 percent. Those businesses which are not otherwise covered by another tax rate pay the B&O tax rate of 1.5 percent.[130] The B&O tax does not permit deductions for the costs of doing business, such as payments for raw materials and wages of employees. Any exemptions and deductions from the B&O tax are specified separately in law.

The business and occupation tax preferred tax rate under review is for manufacturers of alcohol fuel, biodiesel fuel, and biodiesel feedstock. This preferential tax rate expires on July 1, 2009.

Other Relevant Background

Other Tax Preferences for the Biofuels Industry

In addition to the three tax preferences under JLARC review for the biofuels industry this year, the Legislature also enacted three other tax preferences: two retail sales and use tax exemptions and a business and occupation tax deduction in 2003 in 2SHB 1241.[131] The additional retail sales and use tax exemptions are for machinery and equipment used directly for the retail sale and distribution of biodiesel blend or E85 motor fuel. In addition, services rendered in respect to constructing, repairing, decorating, installing, cleaning, altering, or improving structures or machinery and equipment used directly in the retail sale of biodiesel blend or E85 motor fuel are retail sales tax exempt. The use tax exemption is also for services rendered in respect to constructing, repairing, installing, cleaning, altering, or improving machinery and equipment used directly in the retail sale of biodiesel blend or E85 motor fuel. Both retail sales and use tax exemptions apply to not only machinery and equipment but also tangible personal property that become an ingredient or component of the structures or machinery and equipment. Fuel delivery vehicles may also be retail sales or use tax exempt if at least 75 percent of the fuel distributed by the vehicle is a biodiesel blend or E85 motor fuel.

The business and occupation tax deduction is for retail sales or distribution of biodiesel or E85 motor fuel. In 2007, the Legislature extended the expiration date of all three of these tax preferences to July 1, 2015. JLARC will review these three tax preferences for the biofuels industry later.

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[129] "2007 Tax Reference Manual – Information on State and Local Taxes in Washington State," Department of Revenue.

[130] Ibid.

[131] RCW 82.08.955, 82.12.955 and 82.04.4334.

Definitions of Terms: Bioenergy, Biomass, Biofuels, Biodiesel and Alcohol Fuels

Bioenergy is useful, renewable energy produced from organic matter. Biomass is any organic matter that is available on a renewable or recurring basis, including agricultural crops and trees, wood and wood residues, and other residue materials. Biofuels are fuels made from biomass resources. Biofuels include ethanol, biodiesel, and methanol.[132] Biodiesel is non-petroleum diesel fuel derived from waste oil and grease, and/or from oilseed crops. It is produced when a vegetable oil or animal fat is chemically reacted with an alcohol, and it can be used as a pure product or blended with petroleum diesel. The most common blend rate is 20 percent biodiesel, 80 percent petroleum diesel or "B20." Pure or neat biodiesel is called "B100." Biodiesel provides air quality benefits, including reductions in greenhouse gas emissions. Alcohol fuels are made from crops such as corn, sugar cane, and grasses, and from waste products such as waste paper or tree trimmings. Methanol and ethanol are two types of alcohol fuels used in vehicles. The most common blends of ethanol are either 15 percent ethanol and 85 percent gasoline or 10 percent ethanol and 90 percent unleaded gasoline. These fuel blends are sold to decrease air pollutants.

Washington Biodiesel Production and Distribution

As of May 2005, most of the biodiesel fuel sold in Washington was imported from the Midwest and has been produced from soybean oil.[133] Seattle Biodiesel, the first biodiesel facility in Washington, opened in March 2005. This facility has been importing soybean oil from out-of-state to make its biodiesel.[134] Since this first biodiesel plant opened in Washington, there have been efforts underway to switch from importing soybean oil to developing an oilseed market in the state. In 2007, there were about 18,000 acres in Washington planted with oilseeds crops. Two-thirds of the oilseeds were canola, and one third was mustard. It is anticipated that the acres in oilseed will triple in the next year.[135] Oilseeds, such as canola, rape, and mustard, are generally not grown as primary crops, but as a rotational crop in the cultivation of wheat or other grains. Farmers evaluate oilseeds profitability against other rotational crops. Growing oilseeds as a feedstock solely for biodiesel is not realistic at this point. Farmers will need to find a market for seed meal in order to make growing oilseed profitable in Washington.[136] University of Idaho researchers are studying new markets for seed meal of Washington's oilseeds.[137] Expansion of Washington's oilseed production is dependent on the creation of new markets.

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[132] Biomass Energy Data Book Edition 1, U.S. Department of Energy – Energy Efficiency and Renewable Energy September 2006.

[133] "Biodiesel in Washington: A Snapshot," by John Kim Lyons WSU – Energy Program May 2005 for CTED.

[134] Ibid.

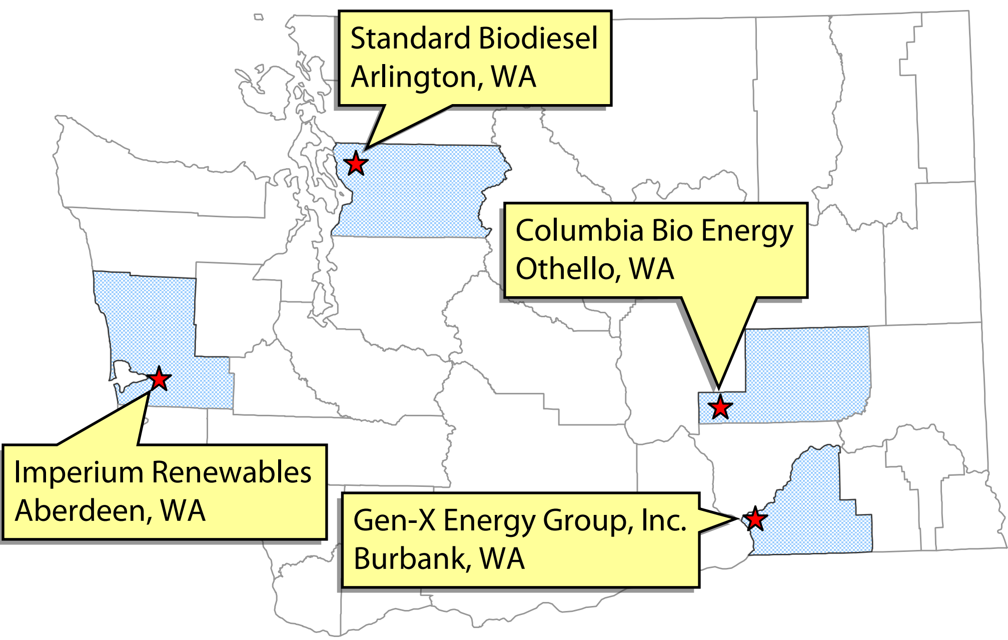
[135] Conversation with CTED Biofuels Coordinator Peter Moulton.

[136] "Biodiesel in Washington: A Snapshot," by John Kim Lyons WSU – Energy Program May 2005 for CTED.

[137] Ibid.

According to the National Biodiesel Board, in 2006, the U.S. produced 250 million gallons of biodiesel. That amount was triple the quantity produced in 2005. Washington has four biodiesel facilities in operation, and others are being proposed. The total capacity for all biodiesel plants in Washington was more than 100 million gallons per year. This list of operating biodiesel plants is from discussions with staff at the Washington Department of Community Trade and Economic Development, which updated the State BioEnergy Team report (January 2007).[138] The Washington map indicates the locations of the four operating biodiesel facilities in the state.

Exhibit 34 – Washington Biodiesel Producers



Source: CTED State Biofuels Coordinator and State BioEnergy Team. Report

Washington drivers use between 1.0 and 1.5 million gallons of blended biodiesel to fuel passenger cars and municipal vehicles. Some of the largest biodiesel users in Washington State in 2004 were the city of Seattle, city of Tacoma, state ferries, Dr. Dan's Alternative Fuel Works, intercity transit, King County metro, and Washington military bases.[139] In contrast, current consumption of petroleum diesel fuel in Washington is 700 million gallons per year.

According to the National Biodiesel Board, as of February 20, 2008, Washington has 29 distributors of biodiesel. As of February 6, 2008, the U.S. Department of Energy – Energy Efficiency and Renewable Energy reports there are 34 gas stations in Washington that sell biodiesel.

[138] Washington State BioEnergy Team 2006 Status Report - January 2007.

[139] "Biodiesel in Washington: A Snapshot," by John Kim Lyons WSU - Energy Program May 2005 for CTED.

Washington Ethanol Production and Distribution

The high cost of transportation and lack of pipelines has limited the expansion of traditional corn-fueled ethanol plants beyond the Midwest. According to the American Coalition for Ethanol, 121 ethanol production plants operated in the U.S. in 2007. Cellulosic ethanol breaks down that barrier by allowing almost any state to use its native agriculture. In 2008, Range Fuel started the first commercial-scale cellulosic ethanol plant in the United States in Georgia. This plant will be a 20-million gallon ethanol plant fueled by wood waste.[140] Several U.S. and foreign companies are experimenting with cellulosic systems.

According to the 2007 Status07 report by the American Coalition for Ethanol - A State by State Handbook, Washington State does not have any ethanol production facilities operating. Owners of a proposed new ethanol plant broke ground at the end of 2006 in Longview. The feedstock for this ethanol plant is to be corn from Washington and Oregon farmers as well as the Midwest. Due to slow progress in constructing this ethanol facility, it is unclear when or if this Northwest Renewables, LLC plant in Longview will be operational.[141]

Even though Washington currently does not produce any ethanol, it imports this fuel into the state. Some Washington residents have the option of purchasing ethanol-blended fuel. As of February 6, 2008, the U.S. Department of Energy – Energy Efficiency and Renewable Energy reported that seven stations in Washington sell ethanol-blended fuel (E85).

Federal Government Grants and Tax Incentives

The Commodity Credit Corporation of the U.S. Department of Agriculture provides grants for the expansion of biodiesel production. These grants reduce the cost of producing biodiesel, making it more cost-effective to produce. In addition to grant money, the federal government provides tax credits: a small agri-biodiesel or ethanol producer tax credit, and a volumetric ethanol or biodiesel 'blender' excise tax credit. The small agri-biodiesel producer tax credit is based on the amount of production of the agri-biodiesel made either from first-use vegetable oils or first-use animal fats. The tax credit is $0.10 per gallon up to 15 million gallons per year of new production. The biodiesel volumetric 'blender' tax credit is $1.00 per gallon for biodiesel made from virgin oils derived from agricultural commodities and animal fats. The tax credit is $0.50 per gallon for diesel fuel made from agricultural products and animal fats. The small ethanol producer tax credit is $0.10 per gallon up to 15 million gallons per year of new production. The volumetric ethanol tax credit is a tax refund of $0.51 per gallon of ethanol blended with gasoline.

[140] "Turning to chemistry for alternative fuel," by Matthew L. Ward International Herald Tribune, November 8, 2007.

[141] According to the Cowlitz County assessor, no buildings have been constructed yet at this future ethanol facility site.

State Government Loans: Washington Crushers

One element of Washington's bioenergy policy is the Energy Freedom Loan program. The Legislature established this loan program in 2006 in part to stimulate the construction of facilities in Washington to generate energy from farm sources or convert organic matter into fuels.[142] This program offers ten-year loans to public entities at an interest rate of 1 percent. The public entities team with private companies, farms, or agricultural cooperatives. In 2007, the Legislature appropriated $17 million to the Washington State Department of Agriculture (WSDA) for the Energy Freedom Loan Program. Of this, the Legislature earmarked $10.25 million for five specific projects to develop oilseed crushing capacity. The remaining loan amount was a competitive loan program. In 2007, the Legislature reduced the overall funding for the loan program to $14.5 million. The funding for targeted projects increased to $10.5 million. As of fiscal year 2007, WSDA has signed contracts with five public entities for bioenergy projects for a total of $10.5 million in loans.

All but one of the projects receiving a low-interest Energy Freedom loan have been for oilseed processing and three projects for both oilseed processing and biodiesel production. Oilseeds need to be crushed in order to produce biodiesel. In addition to biodiesel and ethanol production facilities, crushers can also qualify for the property tax or leasehold excise tax exemption under review. According to the Energy Freedom Loan Program Update, five owners of these crushers received these state low-interest loans: Spokane County Conservation District, Odessa Public Development Authority, Port of Warden, Port of Sunnyside, and South Yakima Conservation District. The South Yakima Conservation District project is an anaerobic digester. Two of these five projects are already operational: the Port of Sunnyside oilseed crushing facility and the South Yakima Conservation District anaerobic digester project. [143] The other three oilseed crushing projects plan to be operational sometime during 2008.

In 2007, legislative changes to the Energy Freedom program expanded the types of projects that could qualify for the loan program. Now, refueling projects as well as cellulosic ethanol production facilities and other alternative energy projects can qualify for the loan program. In addition to the changes to the loan eligibility requirements, the Legislature moved of the program to the Department of Community, Trade and Economic Development as of July 1, 2007.

Federal Renewable fuels mandate

The U.S. Energy Policy Act of 2005 (EPACT) legislation established a U.S. renewable fuels standard at 4 billion gallons in 2006, increasing to 7.5 billion gallons by 2012.[144] In his State of the Union address, President Bush proposed expanding the use of cellulosic ethanol. In his 2007 State of the Union address, President Bush proposed mandating 35 billion gallons of ethanol

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[142] "Energy Freedom Loan Program Update – Report to the Washington State Legislature," prepared by the Washington State Department of Agriculture, December 2007.

[143] RCW 82.08.900 (3)(a) defines anaerobic digester as a facility that processes manure from livestock into biogas and dried manure using microorganisms in a decomposition process within a closed, oxygen-free container.

[144] "Biofuels in the U.S. transportation sector," Energy Information Administration - February 2007.

production in the U.S. by 2017. According to studies on ethanol production in the U.S., the maximum amount of ethanol which can be produced from corn starch is 15 billion gallons per year, implying a proposed mandate for production of 20 billion gallons per year of cellulosic ethanol by 2017. Bush's 2007 proposed plan includes $2 billion in funding for cellulosic ethanol plants, with additional funding of $1.6 billion announced by USDA later in January 2007.[145]

Washington State Policy Encouraging Renewable Energy Source

In the January 2005, Governor Locke signed Executive Order 05-01 that created goals for state agencies to utilize renewable fuels. The Order directed state agencies to replace standard diesel with a 20 percent biodiesel blend by September 1, 2009. The order also directed state agencies to begin using a minimum 5 percent biodiesel blend as soon as possible.

Legislation in 2006 established minimum renewable fuel standards in ESSB 6508. The legislation mandated that, beginning December 1, 2008, all gasoline sold or offered for sale in Washington must contain at least 2 percent ethanol. In addition, certain special fuel licensees must provide that at least 2 percent of total annual diesel fuel sales are biodiesel fuel sales by no later than November 30, 2008.

In 2006, the Legislature also enacted HB 1010 that requires investor-owned and consumer–owned electric utilities with more than 25,000 customers to develop integrated resource plans (IRP) by September 1, 2008. Each plan must include, among other elements, a comparative evaluation of renewable and nonrenewable generating technologies. In addition, the plan must explain why renewable resources or conservation and efficiency resources were not selected.

On November 7, 2006, Washington voters approved Initiative 937, the Energy Independence Act. This initiative requires large utilities to obtain 15 percent of their electricity from new renewable resources such as solar and wind by 2020. The following statement is the initiative's declaration of Washington's intent to promote energy independence.[146]

> *Increasing energy conservation and the use of appropriately sited renewable energy facilities builds on the strong foundation of low-cost renewable hydroelectric generation in Washington State and will promote energy independence in the state and Pacific Northwest region. Making the most of our plentiful local resources will stabilize electricity prices for Washington residents, provide economic benefits for Washington counties and farmers, create high-quality jobs in Washington, provide opportunities for training apprentice workers in the renewable energy field, protect clean air and water and position Washington State as a national leader in clean energy technologies.*

[145] "Federal government programs to finance biodiesel production / oilseed crushing and ethanol venture," December 17, 2007.

[146] RCW 19.285.020.

In 2007, the Legislature established greenhouse gas emissions goals for Washington.[147] The legislation also requires the reporting of greenhouse gas emissions to the Legislature and directs the Governor to develop policy recommendations to the Legislature for consideration in the 2008 legislative session on how the state can achieve the greenhouse gas reduction goals.

Public Policy Objectives

What are the public policy objectives that provide a justification for the tax preference?

These three tax preferences lack any specific stated intent. There is legislative intent in other sections of the law on encouraging the production of renewable fuel sources in Washington. JLARC derived these three public policy objectives from general legislative intent on renewable energy sources and testimony on the bill enacted in 2003.

Promote Production of Biofuels

One of the public policy objectives of this property tax and leasehold excise tax exemption and preferential B&O tax rate is to attract alcohol and biodiesel fuel production to Washington. Due to the high costs of importing traditional biofuels feedstock from other parts of the U.S., producing biofuels has not been highly profitable in Washington. A public policy objective is to reduce the costs of building biofuel facilities in Washington and distributing biodiesel to consumers. Another public policy objective of these tax preferences is to lower the cost of ethanol and biodiesel fuel so the price of biofuels can be reduced and demand by consumers for alternative fuel can increase once more biofuel is produced in Washington.

Reduce Air Pollution and Greenhouse Gas Effect

Another objective of this tax preference is to encourage production of renewable fuels to reduce air pollution and greenhouse gas emissions.

New Markets for Washington Oilseeds

Another public policy objective of these tax preferences is to give Washington farmers another market for their oilseed crops by using them in producing biofuels. In order to have a successful biofuels industry in Washington, the biodiesel facilities will need to use local oilseed feedstock.

Is the purpose or intent of the tax preference clear?

These tax preferences lack any specific stated intent in the statute in which the exemptions are defined. There is legislative intent in other sections of the law on encouraging the production of renewable energy sources in Washington and at the federal level. The beneficiaries of these tax preferences are clear from the language in statute.

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[147] ESSB 6001.

Is there any readily available evidence related to the achievement of any of these public policy objectives?

Since enactment of these tax preferences in 2003, the number of biodiesel plants operating in Washington has increased. Having more biodiesel produced in Washington has coincided with increased consumption of biodiesel. There is no readily available evidence that these tax preferences were the instrumental factors that brought the businesses to Washington. However, the public policy objective of encouraging new production of biofuels has begun to be achieved. Having new biofuels production facilities in Washington has encouraged the expansion of oilseed production in the state, which assists farmers in finding new markets for oilseed crops. The public policy objective of helping Washington's agriculture industry has also begun to be achieved.

Beneficiaries

Who are the entities whose state tax and/or local tax liabilities are directly affected by the tax preference?

Property Tax Exemption

According to the Department of Revenue research staff and county assessors' staff, one biodiesel manufacturer has applied for the property tax exemption. The Longview Ethanol plant applied for the property tax exemption in 2007, but that request was denied due to the plant not being operational. No new property tax exemption application for the Longview ethanol plant has been completed.

Leasehold Excise Tax Exemption

According to the Department of Revenue research staff, four companies receive leasehold exemptions for manufacturing biodiesel fuel. These businesses have partnered with government entities that own the land where the biodiesel facilities are located. These private companies would be responsible for paying the leasehold excise tax without this tax preference.

Business and Occupation Preferential Tax Rate

According to the Department of Revenue excise tax returns for 2006, four companies report manufacturing biofuels. The number of beneficiaries may likely increase in the future as new biodiesel and ethanol plants become operational.

Revenue Impacts

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

Property Tax Exemption

During the time of this review, JLARC found that there was one potential biodiesel plant that could apply for a property tax exemption in the future. At the time of this review, the date of operation of the Longview ethanol plant is uncertain and is not included in these taxpayer savings estimates. There are also oilseed crushing machinery and equipment that would qualify for this property tax exemption. Two of those projects are currently operational, and the other three will likely be operational in 2008. One of the oilseed crushing facilities qualifies for the leasehold excise tax exemption. The following estimates of the property tax taxpayer savings if the tax preference is continued beyond 2009 assuming that two oilseed crushing facilities receive a property tax exemption in fiscal year 2008 and that the other two oilseed crushing facilities receive the property tax exemption beginning fiscal year 2009. This property tax exemption continues for six years after the facility is operational. The total local and state property tax savings is approximately $24,000 in fiscal year 2008, increasing to $145,000 by 2011.

Exhibit 35 – Local and State Property Tax Taxpayer Savings

Year	Local Property Taxpayer Savings ($ 000)	State Property Taxpayer Savings ($ 000)
2007	$18.6	$4.1
2008	$19.8	$4.3
2009	$100.0	$21.5
2010	$106.6	$22.7
2011	$111.5	$23.5

Source: JLARC projections.

The property tax taxpayer savings is not the same as government losses since this is a property tax exemption. If this tax preference is continued, there will continue to be a shifting of property tax liability among property owners. The owners of biodiesel facilities and oilseed crushing property will continue to pay no property tax, and other residential and business owners will pay slightly higher property taxes in the areas where those facilities are located because of this exemption.

Leasehold Excise Tax Exemption

According to Department of Revenue research staff, four companies receive leasehold exemptions for manufacturing biodiesel fuel. These businesses have partnered with government entities that own the land where the biodiesel facilities are located. These private companies

would be responsible for paying the leasehold excise tax without this tax preference. The following reveals the estimate for the leasehold excise tax exemption, assuming the tax preference exists beyond fiscal year 2009. The leasehold excise tax exemption continues for six years after a facility is operational.

Exhibit 36 – Leasehold Excise Taxpayer Savings

Year	State Leasehold Excise Taxpayer Savings ($ 000)	Local Leasehold Excise Taxpayer Savings ($ 000)
2007	$26.4	$23.2
2008	$27.5	$24.2
2009	$138.5	$121.5
2010	$145.3	$127.5
2011	$152.5	$133.8

Source: Department of Revenue and County Assessors data and JLARC projections.

The leasehold excise tax taxpayer savings is the same as the loss in state and local government revenue from having a leasehold excise tax exemption in place.

Business and Occupation Preferential Tax Rate

According to the Department of Revenue excise tax returns for 2006, four companies report manufacturing biofuels with approximately $5.5 million in gross income. This will likely increase in the future for 2007 as new biodiesel and ethanol plants become operational and will also have income from manufacturing of biofuels.

Exhibit 37 – Business and Occupation Taxpayer Savings

Year	B&O Taxpayer Savings ($ 000)
2007	$18
2008	$25
2009	$48
2010	$49
2011	$50

Source: JLARC projections based on DOR excise tax returns.

The B&O taxpayer savings is the same as the loss to state government revenue with this tax preference.

Recommendations

1) The Legislature should continue the property tax exemption for machinery and equipment used in producing alcohol fuel, biodiesel and biodiesel feedstock and review for effectiveness in the future once this industry is more developed.

2) The Legislature should continue the leasehold excise tax exemption for leasehold interests of machinery and equipment used in producing alcohol, biodiesel and biodiesel feedstock and review for effectiveness in the future once this industry is more developed.

3) The Legislature should continue the preferred business and occupation tax rate for manufacturers of alcohol and biodiesel fuel and feedstock and review for effectiveness in the future once this industry is more developed.

Legislation Required: Yes, to modify the expiration dates.

Fiscal Impact: See Revenue Impact section.

APPENDIX 1: SCOPE AND OBJECTIVES

2008 Expedited Tax Preference Performance Reviews

SCOPE AND OBJECTIVES

APRIL 2008

STATE OF WASHINGTON
JOINT LEGISLATIVE AUDIT AND REVIEW COMMITTEE

STUDY TEAM
Gary Benson
Lizbeth Martin-Mahar

PROJECT SUPERVISOR
Keenan Konopaski

LEGISLATIVE AUDITOR
Ruta Fanning

Joint Legislative Audit & Review Committee
1300 Quince St. SE
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(360) 786-5171
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Website:
www.jlarc.leg.wa.gov
e-mail: neff.barbara@leg.wa.gov

Mandate

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 550 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 may recommend an expedited review process for any tax preference that has an estimated biennial fiscal impact of $10 million or less.**

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.

Expedited Study Scope

This tax preference performance review will include the tax preferences identified by the Citizen Commission to be reviewed prior to August 30, 2008. These tax preferences were recommended by the Citizen Commission as being subject to an expedited review process:

Brief Description	RCW Citation	Year Enacted
1. Credit losses	82.16.050 (5)	1935
2. Processing horticultural products	82.04.4287	1935
3. Fraternal insurance	82.04.370	1935
4. Irrigation water	82.16.050 (7)	1935
5. Sales for resale	82.16.050 (2)	1935
6. Radio and TV broadcasting	82.04.280 (6)	1935
7. $2,000 monthly minimum	82.16.040; 82.32.030; 82.32.045	1935
8. Public utility property	82.08.0256; 82.12.0257	1935
9. Gas tax exemption for handling losses	82.36.029	1939

Expedited Study Scope (cont'd.)

Brief Description	RCW Citation	Year Enacted
10. Airports owned by cities in other states	84.36.130	1941
11. Farm auction sales	82.08.0257 82.12.0258	1943
12. Distribution of wood biomass fuel	82.08.960 82.12.960	2003
13. Wood biomass fuel production facilities	84.36.640 82.29A.135	2003
14. Sale of alternative fuel	82.04.260(1e)	2003
15. Sale of wood biomass fuel	82.04.4335	2003
16. Alcohol/biodiesel fuel production facilities	84.36.635 82.29A.135	2003

Expedited 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 preference review should be conducted as a full review or that the preference is determined to be de minimis, in which case it will not be reviewed):

Public Policy Objectives:

1. What are the public policy objectives that provide a justification for the tax preference? Is the purpose or intent of the tax preference clear?
2. Is there any readily available evidence related to the achievement of any of these public policy objectives?

Beneficiaries:

3. Who are the entities whose state and/or local tax liabilities are directly affected by the tax preference?

Revenue and Economic Impacts:

4. What are the past and future tax revenue impacts of the tax preference to the taxpayer and to the government if it is continued?

Timeframe for the Study

A preliminary audit report will be presented at the July 2008 JLARC meeting and at the August 2008 meeting of the commission. A final report will be presented to JLARC in November 2008.

JLARC Staff Contact for the Study

Gary Benson (360) 786-5618 benson.gary@leg.wa.gov
Lizbeth Martin-Mahar (360) 786-5123 martin-mahar.lizbeth@leg.wa.gov

Tax Preference Review Process

Commission develops and delivers to JLARC schedule of tax preferences for review
↓
JLARC staff conducts reviews of tax preferences
↓
Staff presents preliminary report to JLARC
↓
Staff requests comments from OFM and DOR
↓
JLARC presents preliminary report to commission
↓
Commission conducts public comment session and may provide comments
↓
Proposed Final Report *(with OFM, DOR, and commission comments)* to JLARC for approval to distribute
↓
Final Report transmitted to Legislative Fiscal Committees
↓
Legislative Fiscal Committees hold joint hearing on Final Report

APPENDIX 2: TAX PREFERENCE COMMISSION AND AGENCY RESPONSES

- Citizen Commission for Performance Measurement of Tax Preferences
- Office of Financial Management and Department of Revenue
- Department of Licensing

Citizen Commission for Performance Measurement of Tax Preferences

William A. Longbrake, *Commission Chair*

Lily Kahng, *Vice Chair*
Associate Professor
Seattle University Law School

Stephen Miller
Board Member
Washington Education Association

Paul Guppy
Vice President for Research
Washington Policy Center

Vacancy

Brian Sonntag
State Auditor

Senator **Phil Rockefeller**
Chair, Joint Legislative Audit and Review Committee

E-mail: hennessy.lisa@leg.wa.gov
www.citizentaxpref.wa.gov

December 5, 2008

To: Joint Legislative Audit and Review Committee

From: William A. Longbrake, Chair
Citizen Commission for Performance Measurement of Tax Preferences

Subject: **2008 Tax Preference Reviews**

Thank you for the opportunity to comment on the 2008 Tax Preference Preliminary Review Reports. The Commission has provided a forum for discussion and public comment on the recommendations included in the reviews. Our comments are as follows:

JLARC Recommendation	Commission Position and Adopted Comments
FULL REVIEWS:	
Intangibles Recommendation: The Legislature should continue the property tax exemption for intangible personal property.	Does not endorse and comments as follows: *Given the revenue impact of the exemption ($11 billion in 2008), the dramatic growth of intangible property in the New Economy, and the impact of such a large exemption on the adequacy, efficiency and fairness of the tax system, the Commission recommends that the Legislature study the exemption and consider how to appropriately treat intangible property.*
EXPEDITED REVIEWS:	
Wood biomass fuel: Production Facilities/Sale/Distribution Recommendations: 1) The Legislature should continue the property tax exemption for machinery and equipment used in producing wood biomass fuel. Since this tax preference is not currently being utilized, it should be reviewed for effectiveness in the future once it is used. 2) The Legislature should continue the leasehold excise tax exemption for leasehold interests of machinery and equipment used in producing wood biomass fuel. Since this tax preference is not currently being utilized, it should be reviewed for effectiveness in the future once it is used. 3) The Legislature should continue the retail sales tax exemption for sales of machinery and equipment used in constructing, altering or updating equipment which is used in selling wood biomass fuel. Since this tax preference is not	Does not endorse and comments as follows: *The Commission recommends that these preferences be allowed to expire in 2009 unless there is evidence that taxpayers plan to use them.*

Citizen Commission for Performance Measurement of Tax Preferences
Page 2
December 5, 2008

JLARC Recommendation	Commission Position and Adopted Comments
currently being utilized, it should be reviewed for effectiveness in the future once it is used. 4) The Legislature should continue the use tax exemption for use of machinery and equipment used in constructing, altering or updating equipment which is used in selling wood biomass fuel. Since this tax preference is not currently being utilized, it should be reviewed for effectiveness in the future once it is used. 5) The Legislature should continue the business and occupation tax deduction for sales or distribution of wood biomass fuel. Since this tax preference is not currently being utilized, it should be reviewed for effectiveness in the future once it is used.	
FULL REVIEWS:	
Exported and imported fuel Recommendation: The motor vehicle fuel tax and special fuel tax exemption for exported and imported fuel should be continued.	Endorse with the following comment: *The Commission recommends the Legislature consider whether to modify this exemption in light of US Supreme Court decisions subsequent to enactment of this exemption.*
Private K-12 schools Recommendation: The Legislature should continue the property tax exemption for private, nonprofit schools.	Endorse without comment
Private colleges Recommendation: The Legislature should continue the property tax exemption for private, nonprofit schools.	Endorse without comment
Commercial vessels Recommendation: The Legislature should continue the apportionment of commercial vessels for property tax purposes.	Endorse without comment
Other ships and vessels Recommendation: The property tax exemption for other ships and vessels should be continued.	Endorse without comment
Real estate sales/rental/leasing Recommendation: The Legislature should continue the business and occupation tax exemption for income derived from real estate sales, rental and leasing.	Endorse without comment
Business and occupation tax deduction for credit losses Recommendation: The Legislature should continue this business and occupation tax deduction for credit losses incurred by businesses.	Endorse without comment

Citizen Commission for Performance Measurement of Tax Preferences
Page 3
December 5, 2008

JLARC Recommendation	Commission Position and Adopted Comments
FULL REVIEWS (cont.):	
Agricultural producers Recommendation: Given the fact that incomes have increased significantly for some farms since the period of financial hardships when this tax exemption was enacted, the Legislature should consider establishing an income threshold in order to qualify for the business and occupation tax exemption for agricultural producers.	Endorse without comment
Insurance premiums Recommendation: The Legislature should continue the business and occupation tax exemption for income derived from insurance premiums.	Endorse without comment
Public utilities Recommendation: The Legislature should continue the business and occupation tax preference for public utility income.	Endorse without comment
Tax rate for urban trans. & vessels Recommendation: The Legislature should review the policy of taxing transportation related business activity at different public utility tax rates based on where a transportation service takes place or the size of a vessel in which the service is conducted.	Endorse without comment
Items used in interstate commerce Recommendation: The Legislature should clarify the public policy purpose for the retail sales tax exemption for sales of tangible personal property to air, rail, and water private or common carriers to be used in interstate or foreign commerce.	Endorse without comment
Electric generating equip.; renewable resources Recommendations: 1) Continue the retail sales and use tax preferences and reexamine these alternative energy tax preferences at a later date to determine their effectiveness in encouraging growth in this industry in Washington. 2) The Legislature should implement reporting requirements and criteria on which to evaluate the tax exemptions and reevaluate the wattage threshold limit to ensure there are not unintended beneficiaries.	Endorse without comment
EXPEDITED REVIEWS:	
Public utility tax credit losses Recommendation: The Legislature should continue this public utility tax deduction for credit losses incurred by businesses.	Endorse without comment

Citizen Commission for Performance Measurement of Tax Preferences
Page 4
December 5, 2008

JLARC Recommendation	Commission Position and Adopted Comments
EXPEDITED REVIEWS (cont.):	
Processing horticultural products Recommendations: The Legislature should continue the business and occupation tax preference for the income earned in receiving, washing, sorting, and packing of fresh horticultural products.	Endorse without comment
Fraternal insurance Recommendation: The Legislature should continue the business and occupation tax preference for fraternal beneficiary organizations.	Endorse without comment
Irrigation water Recommendation: Due to the lack of legislative intent and growth in beneficiaries of the public utility tax deduction for irrigation water, the Legislature should clarify if gross income derived from non-agricultural uses of irrigation water should be allowed for this tax deduction.	Endorse without comment
Sales for resale by water and gas utilities Recommendation: The Legislature should continue the public utility deduction for amounts derived from the sale for resale in Washington by water and gas utilities.	Endorse without comment
Radio and TV broadcasting Recommendations: (1) The Department of Revenue should conform its rule and practice on radio and television broadcasting advertising income to comply with the statute that allows two means for broadcasters to deduct income earned from the sale of network, national, and regional advertising. Since one of these means is no longer operative, broadcasters should deduct only actual sales of network, national, and regional advertising. (2) The Legislature should review the policy of exempting all network, national, and regional advertising from the B&O tax.	Endorse without comment
Minimum gross income filing threshold Recommendation: The Legislature should continue this public utility tax minimum income threshold exemption.	Endorse without comment
Public utility operating property Recommendation: The Legislature should continue these retail sales and use tax exemptions for sales of operating utility property to state and local political subdivisions.	Endorse without comment
Gas tax exemption for handling losses Recommendation: The Legislature should terminate the motor vehicle fuel handling loss deduction.	Endorse without comment

Citizen Commission for Performance Measurement of Tax Preferences
Page 5
December 5, 2008

JLARC Recommendation	Commission Position and Adopted Comments
EXPEDITED REVIEWS (cont.):	
Airports owned by cities in other states Recommendation: Given that there are no out-of-state municipalities owning airport property in Washington, the Legislature should terminate this property tax exemption.	Endorse without comment
Farm auction sales Recommendation: Due to the fact that Washington currently does not have uniform tax treatment for all purchases of used farm machinery and equipment regardless of location and method by which the property is acquired, the Legislature should require reporting information of on-farm auction sales and review the policy of these retail sales and use tax exemptions.	Endorse without comment
Alcohol/biodiesel fuel production facilities Recommendations: 1) The Legislature should continue the property tax exemption for machinery and equipment used in producing alcohol fuel, biodiesel and biodiesel feedstock and review for effectiveness in the future once this industry is more developed. 2) The Legislature should continue the leasehold excise tax exemption for leasehold interests of machinery and equipment used in producing alcohol, biodiesel and biodiesel feedstock and review for effectiveness in the future once this industry is more developed. 3) The Legislature should continue the preferred business and occupation tax rate for manufacturers of alcohol and biodiesel fuel and feedstock and review for effectiveness in the future once this industry is more developed.	Endorse without comment

STATE OF WASHINGTON
DEPARTMENT OF LICENSING
PO Box 9020 • Olympia, Washington 98507-9020

RECEIVED
AUG 12 2008
JLARC

August 8, 2008

Ms. Ruta Fanning
Legislative Auditor
Post Office Box 40910
Olympia, Washington 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 2008 Full Tax Preference Performance Reviews and 2008 Expedited Tax Preference Performance Reviews.

We appreciate the opportunity to respond to the recommendations in both reports. We support the recommendation on Exported and Imported Fuel that states the motor vehicle fuel tax and special fuel tax exemption for exported and imported fuel should be continued. We have no position on the recommendation on Gas Tax Exemption for Handling Losses that states the Legislature should terminate the motor vehicle handling loss deduction.

We appreciate your effort to continuously review and analyze the state's structure of tax liabilities and exemptions. Please let me know if you have any questions.

Sincerely,

FOR Liz Luce
Director

The department of Licensing has a policy of providing equal access to its services. If you need special accommodation, please call (360) 664-9492 or TTY (360) 664-8885.

RECEIVED
AUG 14 2008
JLARC

STATE OF WASHINGTON

August 8, 2008

TO: Ruta Fanning, Legislative Auditor
Joint Legislative Audit and Review Committee

FROM: Victor A. Moore, Director
Office of Financial Management

Cindi Holmstrom, Director
Department of Revenue

SUBJECT: JLARC PRELIMINARY REPORTS ON 2008 TAX PREFERENCE PERFORMANCE REVIEW

Thank you for the opportunity to review and comment on the Joint Legislative Audit and Review Committee's (JLARC) preliminary reports on 2008 Tax Preference Performance Reviews.

We appreciate your efforts and those of the Citizen 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 believe your work could improve the fairness of current tax preferences and add to our capacity to evaluate their impact on an ongoing basis. In examining these issues further, it may help to also look at the administrative burdens that result from a particular tax preference, burdens for both taxpayers and state agencies. We compliment your team for the thorough and thoughtful analysis of the tax preference items selected for review. We also offer the following two items of particular concern to the Department of Revenue.

Private, nonprofit K-12 Schools (Property Tax) pp 11-19 (Full Review)

The preliminary report indicates that the Department of Revenue's administrative rule is broader than the statute and, thus, there may be unintended beneficiaries. To the contrary, we believe the Department's rule controls the application of the K-12 private school exemption so that it stays within the statutory intent. The Department is continuing to work with your staff to address the conclusions in the report. We note, however, that the current rule reflects the pre-2006 statutes. The Legislature amended the applicable law (RCW 84.36.050) in 2006, and the Department continues to work with affected taxpayers on a draft rule reflecting the 2006 changes.

Ruta Fanning
August 8, 2008
Page 2

Radio and TV Broadcasting (B&O tax) pp 57-60 (Expedited review)

The preliminary report indicates that the Department of Revenue should conform its rule and practice on (apportioning) radio and television broadcasting advertising income to comply with the statute. We acknowledge that the statute provides for a standard deduction, based on information received from the Federal Communications Commission (FCC). In the alternative, individual broadcasting stations are required to itemize non-taxable revenues from network, national, and regional advertising. Since the FCC no longer provides this information, a portion of the statute is no longer operative. The Department's current rule allows a standard deduction for out-of-state revenues that relies on industry-provided data. This was adopted in agreement with the industry and we believe is in the spirit of the legislation. Nevertheless, as part of the Department's efforts to update its rules, it is planning to review its current rule and practice regarding the standard deduction.

Again, we appreciate your effort to continuously review and analyze the state's structure of tax liabilities and exemptions. Please continue to consult with the Office of Financial Management, Department of Revenue, and other agencies that would be affected by possible changes to tax preference legislation.

APPENDIX 3: CURRENT LAW

Public Utility Tax – Credit Losses

RCW 82.16.050(5)

In computing tax there may be deducted from the gross income the following items:

(5) The amount of bad debts, as that term is used in 26 U.S.C. Sec. 166, as amended or renumbered as of January 1, 2003, on which tax was previously paid under this chapter;

Processing Horticultural Products

RCW 82.04.4287

In computing tax there may be deducted from the measure of tax amounts derived by any person as compensation for the receiving, washing, sorting, and packing of fresh horticultural products and the material and supplies used therein when performed for the person exempted in RCW 82.04.330, either as agent or as independent contractor.

Fraternal Insurance

RCW 82.04.370

This chapter shall not apply to fraternal benefit societies or fraternal fire insurance associations, as described in Title 48 RCW; nor to beneficiary corporations or societies organized under and existing by virtue of Title 24 RCW, if such beneficiary corporations or societies provide in their bylaws for the payment of death benefits. Exemption is limited, however, to gross income from premiums, fees, assessments, dues or other charges directly attributable to the insurance or death benefits provided by such societies, associations, or corporations.

Irrigation Water

RCW 82.16.050(7)

In computing tax there may be deducted from the gross income the following items:

(7) Amounts derived from the distribution of water through an irrigation system, for irrigation purposes;

Sales for resale

RCW 82.16.050 (2)

In computing tax there may be deducted from the gross income the following items:

(2) Amounts derived from the sale of commodities to persons in the same public service business as the seller, for resale as such within this state. This deduction is allowed only with respect to water distribution, gas distribution or other public service businesses which furnish water, gas or any other commodity in the performance of public service businesses;

Radio and TV broadcasting

RCW 82.04.280(6)

Upon every person engaging within this state in the business of: …(6) radio and television broadcasting, excluding network, national and regional advertising computed as a standard deduction based on the national average thereof as annually reported by the Federal Communications Commission, or in lieu thereof by itemization by the individual broadcasting station, and excluding that portion of revenue represented by the out-of-state audience computed as a ratio to the station's total audience as measured by the 100 micro-volt signal strength and delivery by wire, if any; …as to such persons, the amount of tax on such business shall be equal to the gross income of the business multiplied by the rate of 0.484 percent.

Public Utility Tax - Minimum Income Threshold

RCW 82.16.040

The provisions of this chapter shall not apply to persons engaging in one or more businesses taxable under this chapter whose total gross income is less than two thousand dollars for a monthly period or portion thereof. Any person claiming exemption under this section may be required to file returns even though no tax may be due. If the total gross income for a taxable monthly period is two thousand dollars, or more, no exemption or deductions from the gross operating revenue is allowed by this provision.

RCW 82.32.030

(1) Except as provided in subsection (2) of this section, if any person engages in any business or performs any act upon which a tax is imposed by the preceding chapters, he or she shall, under such rules as the department of revenue shall prescribe, apply for and obtain from the department a registration certificate. Such registration certificate shall be personal and nontransferable and shall be valid as long as the taxpayer continues in business and pays the tax accrued to the state. In case business is transacted at two or more separate places by one taxpayer, a separate registration certificate for each place at which business is transacted with the public shall be required. Each certificate shall be numbered and shall show the name, residence, and place and character of business of the taxpayer and such other

information as the department of revenue deems necessary and shall be posted in a conspicuous place at the place of business for which it is issued. Where a place of business of the taxpayer is changed, the taxpayer must return to the department the existing certificate, and a new certificate will be issued for the new place of business. No person required to be registered under this section shall engage in any business taxable hereunder without first being so registered. The department, by rule, may provide for the issuance of certificates of registration to temporary places of business.

(2) Unless the person is a dealer as defined in RCW 9.41.010, registration under this section is not required if the following conditions are met:

(a) A person's value of products, gross proceeds of sales, or gross income of the business, from all business activities taxable under chapter 82.04 RCW, is less than twelve thousand dollars per year;

(b) The person's gross income of the business from all activities taxable under chapter 82.16 RCW is less than twelve thousand dollars per year;

(c) The person is not required to collect or pay to the department of revenue any other tax or fee which the department is authorized to collect; and

(d) The person is not otherwise required to obtain a license subject to the master application procedure provided in chapter 19.02 RCW.

RCW 82.32.045

(1) Except as otherwise provided in this chapter, payments of the taxes imposed under chapters 82.04, 82.08, 82.12, 82.14, and 82.16 RCW, along with reports and returns on forms prescribed by the department, are due monthly within twenty-five days after the end of the month in which the taxable activities occur.

(2) The department of revenue may relieve any taxpayer or class of taxpayers from the obligation of remitting monthly and may require the return to cover other longer reporting periods, but in no event may returns be filed for a period greater than one year. For these taxpayers, tax payments are due on or before the last day of the month next succeeding the end of the period covered by the return.

(3) The department of revenue may also require verified annual returns from any taxpayer, setting forth such additional information as it may deem necessary to correctly determine tax liability.

(4) Notwithstanding subsections (1) and (2) of this section, the department may relieve any person of the requirement to file returns if the following conditions are met:

(a) The person's value of products, gross proceeds of sales, or gross income of the business, from all business activities taxable under chapter 82.04 RCW, is less than twenty-eight thousand dollars per year;

(b) The person's gross income of the business from all activities taxable under chapter 82.16 RCW is less than twenty-four thousand dollars per year; and

(c) The person is not required to collect or pay to the department of revenue any other tax or fee which the department is authorized to collect.

Sales of Operating Utility Property

RCW 82.08.0256

The tax levied by RCW 82.08.020 shall not apply to sales (including transfers of title through decree of appropriation) heretofore or hereafter made of the entire operating property of a publicly or privately owned public utility, or of a complete operating integral section thereof, to the state or a political subdivision thereof for use in conducting any business defined in RCW 82.16.010 (1), (2), (3), (4), (5), (6), (7), (8), (9), (10) or (11).

RCW 82.12.0257

The provisions of this chapter shall not apply in respect to the use of any article of tangible personal property included within the transfer of the title to the entire operating property of a publicly or privately owned public utility, or of a complete operating integral section thereof, by the state or a political subdivision thereof in conducting any business defined in RCW 82.16.010 (1), (2), (3), (4), (5), (6), (7), (8), (9), (10), or (11).

Handling Losses

RCW 82.36.029

Upon the taxable removal of motor vehicle fuel, the licensee who acquired or removed the motor vehicle fuel, other than a motor vehicle fuel exporter, shall be entitled to a deduction from the tax liability on the gallonage of taxable motor vehicle fuel removed in order to account for handling losses, as follows: For a motor vehicle fuel supplier acting as a distributor, one-quarter of one percent; and for all other licensees, thirty one-hundredths of one percent. For those licensees required to file tax reports, the handling loss deduction shall be reported on tax reports filed with the department. For motor vehicle fuel distributors, the handling loss deduction shall be shown on the invoice provided to the motor vehicle fuel distributor by the seller.

Airports Owned by Cities in Other States

RCW 84.36.130

All property, whether real or personal, belonging exclusively to any municipal corporation in an adjoining state legally empowered by the laws of such adjoining state to acquire and hold property within this state, and which property is used primarily for airport purposes and other facilities for landing, terminals, housing, repair and care of dirigibles, airplanes and seaplanes for the aerial transportation of persons, property or mail, or in the armed forces of the United States, and upon which property there is expended funds by the federal, county or state agencies, or

upon which funds are allocated by the federal government agencies on national defense projects, is hereby exempted from ad valorem taxation. The exemption in this section applies only to airports five hundred acres or less in size.

Farm Auction Sales

RCW 82.08.0257

The tax levied by RCW 82.08.020 shall not apply to auction sales made by or through auctioneers of tangible personal property (including household goods) which have been used in conducting a farm activity, when the seller thereof is a farmer and the sale is held or conducted upon a farm and not otherwise.

RCW 82.12.0258

The provisions of this chapter shall not apply in respect to the use of tangible personal property (including household goods) which have been used in conducting a farm activity, if such property was purchased from a farmer at an auction sale held or conducted by an auctioneer upon a farm and not otherwise.

Wood Biomass Fuel Production

RCW 84.36.640

(1) For the purposes of this section, "wood biomass fuel" means a pyrolytic liquid fuel or synthesis gas-derived liquid fuel, used in internal combustion engines, and produced from wood, forest, or field residue, or dedicated energy crops that do not include wood pieces that have been treated with chemical preservatives such as creosote, pentachlorophenol, or copper-chroma-arsenic.

(2) (a) All buildings, machinery, equipment, and other personal property which is used primarily for the manufacturing of wood biomass fuel, the land upon which this property is located, and land that is reasonably necessary in the manufacturing of wood biomass fuel, but not land necessary for growing of crops, which together comprise a new manufacturing facility or an addition to an existing manufacturing facility, are exempt from property taxation for the six assessment years following the date on which the facility or the addition to the existing facility becomes operational.

(b) For manufacturing facilities which produce products in addition to wood biomass fuel, the amount of the property tax exemption shall be based upon the annual percentage of the total value of all products manufactured that is the value of the wood biomass fuel manufactured.

(3) Claims for exemptions authorized by this section shall be filed with the county assessor on forms prescribed by the department of revenue and furnished by the assessor. Once filed, the exemption is valid for six years and shall not be renewed. The assessor shall verify and

approve claims as the assessor determines to be justified and in accordance with this section. No claims may be filed after December 31, 2009.

The department of revenue may promulgate such rules, pursuant to chapter 34.05 RCW, as necessary to properly administer this section.

RCW 82.29A.135

(1) For the purposes of this section:

(a) "Alcohol fuel" means any alcohol made from a product other than petroleum or natural gas, which is used alone or in combination with gasoline or other petroleum products for use as a fuel for motor vehicles, farm implements, and machines or implements of husbandry.

(b) "Biodiesel feedstock" means oil that is produced from an agricultural crop for the sole purpose of ultimately producing biodiesel fuel.

(c) "Biodiesel fuel" means a mono alkyl ester of long chain fatty acids derived from vegetable oils or animal fats for use in compression-ignition engines and that meets the requirements of the American society of testing and materials specification D 6751 in effect as of January 1, 2003.

(d) "Wood biomass fuel" means a pyrolytic liquid fuel or synthesis gas-derived liquid fuel, used in internal combustion engines, and produced from wood, forest, or field residue, or dedicated energy crops that do not include wood pieces that have been treated with chemical preservatives such as creosote, pentachlorophenol, or copper-chroma-arsenic.

(2) (a) All leasehold interests in buildings, machinery, equipment, and other personal property which is used primarily for the manufacturing of alcohol fuel, wood biomass fuel, biodiesel fuel, or biodiesel feedstock, the land upon which this property is located, and land that is reasonably necessary in the manufacturing of alcohol fuel, wood biomass fuel, biodiesel fuel, or biodiesel feedstock, but not land necessary for growing of crops, which together comprise a new manufacturing facility or an addition to an existing manufacturing facility, are exempt from leasehold taxes for a period of six years from the date on which the facility or the addition to the existing facility becomes operational.

(b) For manufacturing facilities which produce products in addition to alcohol fuel, wood biomass fuel, biodiesel fuel, or biodiesel feedstock, the amount of the leasehold tax exemption shall be based upon the annual percentage of the total value of all products manufactured that is the value of the alcohol fuel, wood biomass fuel, biodiesel fuel, and biodiesel feedstock manufactured.

(3) Claims for exemptions authorized by this section shall be filed with the department of revenue on forms prescribed by the department of revenue and furnished by the department of revenue. Once filed, the exemption is valid for six years and shall not be renewed. The department of revenue shall verify and approve claims as the department of revenue

determines to be justified and in accordance with this section. No claims may be filed after December 31, 2009.

The department of revenue may promulgate such rules, pursuant to chapter 34.05 RCW, as are necessary to properly administer this section.

RCW 82.08.960

(1) The tax levied by RCW 82.08.020 does not apply to sales of machinery and equipment, or to services rendered in respect to constructing structures, installing, constructing, repairing, cleaning, decorating, altering, or improving of structures or machinery and equipment, or to sales of tangible personal property that becomes an ingredient or component of structures or machinery and equipment, if the machinery, equipment, or structure is used directly for the retail sale of a wood biomass fuel blend. Structures and machinery and equipment that are used for the retail sale of a wood biomass fuel blend and for other purposes are exempt only on the portion used directly for the retail sale of a wood biomass fuel blend.

(2) The tax levied by RCW 82.08.020 does not apply to sales of fuel delivery vehicles or to sales of or charges made for labor and services rendered in respect to installing, repairing, cleaning, altering, or improving the vehicles including repair parts and replacement parts if at least seventy-five percent of the fuel distributed by the vehicles is a wood biomass fuel blend.

(3) A person taking the exemption under this section must keep records necessary for the department to verify eligibility under this section. The exemption is available only when the buyer provides the seller with an exemption certificate in a form and manner prescribed by the department. The seller shall retain a copy of the certificate for the seller's files.

(4) For the purposes of this section, the definitions in *RCW 82.69.010 [2003 c 339 § 1] and this subsection apply.

(a) "Wood biomass fuel blend" means fuel that contains at least twenty percent wood biomass fuel by volume.

(b) "Machinery and equipment" means industrial fixtures, devices, and support facilities and tangible personal property that becomes an ingredient or component thereof, including repair parts and replacement parts that are integral and necessary for the delivery of a wood biomass fuel blend into the fuel tank of a motor vehicle.

(5) This section expires July 1, 2009.

RCW 82.12.960

(1) The provisions of this chapter do not apply in respect to the use of machinery and equipment, or to services rendered in respect to installing, repairing, cleaning, altering, or improving of eligible machinery and equipment, or tangible personal property that becomes

an ingredient or component of machinery and equipment used directly for the retail sale of a wood biomass fuel blend.

(2) The provisions of this chapter do not apply in respect to the use of fuel delivery vehicles including repair parts and replacement parts and to services rendered in respect to installing, repairing, cleaning, altering, or improving the vehicles if at least seventy-five percent of the fuel distributed by the vehicles is a wood biomass fuel blend.

(3) For the purposes of this section, the definitions in RCW 82.08.960 apply.

(4) This section expires July 1, 2009.

RCW 82.04.4335

(1) In computing tax there may be deducted from the measure of tax amounts received from the retail sale, or for the distribution, of wood biomass fuel.

(2) For the purposes of this act [section], the following definitions apply:

(a) "Wood biomass fuel" means a pyrolytic liquid fuel or synthesis gas-derived liquid fuel, used in internal combustion engines, and produced from wood, forest, or field residue, or dedicated energy crops that do not include wood pieces that have been treated with chemical preservatives such as creosote, pentachlorophenol, or copper-chroma-arsenic.

(b) "Distribution" means any of the actions specified in RCW 82.36.020(2).

(3) This section expires July 1, 2009.

Biomass Fuel Production, Distribution and Sales

RCW 84.36.640

(1) For the purposes of this section, "wood biomass fuel" means a pyrolytic liquid fuel or synthesis gas-derived liquid fuel, used in internal combustion engines, and produced from wood, forest, or field residue, or dedicated energy crops that do not include wood pieces that have been treated with chemical preservatives such as creosote, pentachlorophenol, or copper-chroma-arsenic.

(2) (a) All buildings, machinery, equipment, and other personal property which is used primarily for the manufacturing of wood biomass fuel, the land upon which this property is located, and land that is reasonably necessary in the manufacturing of wood biomass fuel, but not land necessary for growing of crops, which together comprise a new manufacturing facility or an addition to an existing manufacturing facility, are exempt from property taxation for the six assessment years following the date on which the facility or the addition to the existing facility becomes operational.

(b) For manufacturing facilities which produce products in addition to wood biomass fuel, the amount of the property tax exemption shall be based upon the annual percentage of

the total value of all products manufactured that is the value of the wood biomass fuel manufactured.

(3) Claims for exemptions authorized by this section shall be filed with the county assessor on forms prescribed by the department of revenue and furnished by the assessor. Once filed, the exemption is valid for six years and shall not be renewed. The assessor shall verify and approve claims as the assessor determines to be justified and in accordance with this section. No claims may be filed after December 31, 2009.

The department of revenue may promulgate such rules, pursuant to chapter 34.05 RCW, as necessary to properly administer this section.

RCW 82.29A.135

(1) For the purposes of this section:

(a) "Alcohol fuel" means any alcohol made from a product other than petroleum or natural gas, which is used alone or in combination with gasoline or other petroleum products for use as a fuel for motor vehicles, farm implements, and machines or implements of husbandry.

(b) "Biodiesel feedstock" means oil that is produced from an agricultural crop for the sole purpose of ultimately producing biodiesel fuel.

(c) "Biodiesel fuel" means a mono alkyl ester of long chain fatty acids derived from vegetable oils or animal fats for use in compression-ignition engines and that meets the requirements of the American society of testing and materials specification D 6751 in effect as of January 1, 2003.

(d) "Wood biomass fuel" means a pyrolytic liquid fuel or synthesis gas-derived liquid fuel, used in internal combustion engines, and produced from wood, forest, or field residue, or dedicated energy crops that do not include wood pieces that have been treated with chemical preservatives such as creosote, pentachlorophenol, or copper-chroma-arsenic.

(2) (a) All leasehold interests in buildings, machinery, equipment, and other personal property which is used primarily for the manufacturing of alcohol fuel, wood biomass fuel, biodiesel fuel, or biodiesel feedstock, the land upon which this property is located, and land that is reasonably necessary in the manufacturing of alcohol fuel, wood biomass fuel, biodiesel fuel, or biodiesel feedstock, but not land necessary for growing of crops, which together comprise a new manufacturing facility or an addition to an existing manufacturing facility, are exempt from leasehold taxes for a period of six years from the date on which the facility or the addition to the existing facility becomes operational.

(b) For manufacturing facilities which produce products in addition to alcohol fuel, wood biomass fuel, biodiesel fuel, or biodiesel feedstock, the amount of the leasehold tax exemption shall be based upon the annual percentage of the total value of all products manufactured that is the value of the alcohol fuel, wood biomass fuel, biodiesel fuel, and biodiesel feedstock manufactured.

(3) Claims for exemptions authorized by this section shall be filed with the department of revenue on forms prescribed by the department of revenue and furnished by the department of revenue. Once filed, the exemption is valid for six years and shall not be renewed. The department of revenue shall verify and approve claims as the department of revenue determines to be justified and in accordance with this section. No claims may be filed after December 31, 2009.

The department of revenue may promulgate such rules, pursuant to chapter 34.05 RCW, as are necessary to properly administer this section.

RCW 82.08.960

(1) The tax levied by RCW 82.08.020 does not apply to sales of machinery and equipment, or to services rendered in respect to constructing structures, installing, constructing, repairing, cleaning, decorating, altering, or improving of structures or machinery and equipment, or to sales of tangible personal property that becomes an ingredient or component of structures or machinery and equipment, if the machinery, equipment, or structure is used directly for the retail sale of a wood biomass fuel blend. Structures and machinery and equipment that are used for the retail sale of a wood biomass fuel blend and for other purposes are exempt only on the portion used directly for the retail sale of a wood biomass fuel blend.

(2) The tax levied by RCW 82.08.020 does not apply to sales of fuel delivery vehicles or to sales of or charges made for labor and services rendered in respect to installing, repairing, cleaning, altering, or improving the vehicles including repair parts and replacement parts if at least seventy-five percent of the fuel distributed by the vehicles is a wood biomass fuel blend.

(3) A person taking the exemption under this section must keep records necessary for the department to verify eligibility under this section. The exemption is available only when the buyer provides the seller with an exemption certificate in a form and manner prescribed by the department. The seller shall retain a copy of the certificate for the seller's files.

(4) For the purposes of this section, the definitions in *RCW 82.69.010 [2003 c 339 § 1] and this subsection apply.

  (a) "Wood biomass fuel blend" means fuel that contains at least twenty percent wood biomass fuel by volume.

  (b) "Machinery and equipment" means industrial fixtures, devices, and support facilities and tangible personal property that becomes an ingredient or component thereof, including repair parts and replacement parts that are integral and necessary for the delivery of a wood biomass fuel blend into the fuel tank of a motor vehicle.

(5) This section expires July 1, 2009.

RCW 82.12.960

(1) The provisions of this chapter do not apply in respect to the use of machinery and equipment, or to services rendered in respect to installing, repairing, cleaning, altering, or improving of eligible machinery and equipment, or tangible personal property that becomes an ingredient or component of machinery and equipment used directly for the retail sale of a wood biomass fuel blend.

(2) The provisions of this chapter do not apply in respect to the use of fuel delivery vehicles including repair parts and replacement parts and to services rendered in respect to installing, repairing, cleaning, altering, or improving the vehicles if at least seventy-five percent of the fuel distributed by the vehicles is a wood biomass fuel blend.

(3) For the purposes of this section, the definitions in RCW 82.08.960 apply.

(4) This section expires July 1, 2009.

RCW 82.04.4335

(1) In computing tax there may be deducted from the measure of tax amounts received from the retail sale, or for the distribution, of wood biomass fuel.

(2) For the purposes of this act [section], the following definitions apply:

(a) "Wood biomass fuel" means a pyrolytic liquid fuel or synthesis gas-derived liquid fuel, used in internal combustion engines, and produced from wood, forest, or field residue, or dedicated energy crops that do not include wood pieces that have been treated with chemical preservatives such as creosote, pentachlorophenol, or copper-chroma-arsenic.

(b) "Distribution" means any of the actions specified in RCW 82.36.020(2).

(3) This section expires July 1, 2009.

Alcohol Fuel and Biodiesel Fuel Production and Sales

RCW 82.36.635

(1) For the purposes of this section:

(a) "Alcohol fuel" means any alcohol made from a product other than petroleum or natural gas, which is used alone or in combination with gasoline or other petroleum products for use as a fuel for motor vehicles, farm implements, and machines or implements of husbandry.

(b) "Biodiesel feedstock" means oil that is produced from an agricultural crop for the sole purpose of ultimately producing biodiesel fuel.

(c) "Biodiesel fuel" means a mono alkyl ester of long chain fatty acids derived from vegetable oils or animal fats for use in compression-ignition engines and that meets the requirements of the American society of testing and materials specification D 6751 in effect as of January 1, 2003.

(2)(a) All buildings, machinery, equipment, and other personal property which is used primarily for the manufacturing of alcohol fuel, biodiesel fuel, or biodiesel feedstock, the land upon which this property is located, and land that is reasonably necessary in the manufacturing of alcohol fuel, biodiesel fuel, or biodiesel feedstock, but not land necessary for growing of crops, which together comprise a new manufacturing facility or an addition to an existing manufacturing facility, are exempt from property taxation for the six assessment years following the date on which the facility or the addition to the existing facility becomes operational.

(b) For manufacturing facilities which produce products in addition to alcohol fuel, biodiesel fuel, or biodiesel feedstock, the amount of the property tax exemption shall be based upon the annual percentage of the total value of all products manufactured that is the value of the alcohol fuel, biodiesel fuel, and biodiesel feedstock manufactured.

(3) Claims for exemptions authorized by this section shall be filed with the county assessor on forms prescribed by the department of revenue and furnished by the assessor. Once filed, the exemption is valid for six years and shall not be renewed. The assessor shall verify and approve claims as the assessor determines to be justified and in accordance with this section. No claims may be filed after December 31, 2009.

The department of revenue may promulgate such rules, pursuant to chapter 34.05 RCW, as necessary to properly administer this section.

RCW 82.29A.135

(1) For the purposes of this section:

(a) "Alcohol fuel" means any alcohol made from a product other than petroleum or natural gas, which is used alone or in combination with gasoline or other petroleum products for use as a fuel for motor vehicles, farm implements, and machines or implements of husbandry.

(b) "Biodiesel feedstock" means oil that is produced from an agricultural crop for the sole purpose of ultimately producing biodiesel fuel.

(c) "Biodiesel fuel" means a mono alkyl ester of long chain fatty acids derived from vegetable oils or animal fats for use in compression-ignition engines and that meets the requirements of the American society of testing and materials specification D 6751 in effect as of January 1, 2003.

(d) "Wood biomass fuel" means a pyrolytic liquid fuel or synthesis gas-derived liquid fuel, used in internal combustion engines, and produced from wood, forest, or field residue, or dedicated energy crops that do not include wood pieces that have been treated with chemical preservatives such as creosote, pentachlorophenol, or copper-chroma-arsenic.

(2)(a) All leasehold interests in buildings, machinery, equipment, and other personal property which is used primarily for the manufacturing of alcohol fuel, wood biomass fuel, biodiesel fuel, or biodiesel feedstock, the land upon which this property is located, and

land that is reasonably necessary in the manufacturing of alcohol fuel, wood biomass fuel, biodiesel fuel, or biodiesel feedstock, but not land necessary for growing of crops, which together comprise a new manufacturing facility or an addition to an existing manufacturing facility, are exempt from leasehold taxes for a period of six years from the date on which the facility or the addition to the existing facility becomes operational.

(b) For manufacturing facilities which produce products in addition to alcohol fuel, wood biomass fuel, biodiesel fuel, or biodiesel feedstock, the amount of the leasehold tax exemption shall be based upon the annual percentage of the total value of all products manufactured that is the value of the alcohol fuel, wood biomass fuel, biodiesel fuel, and biodiesel feedstock manufactured.

(3) Claims for exemptions authorized by this section shall be filed with the department of revenue on forms prescribed by the department of revenue and furnished by the department of revenue. Once filed, the exemption is valid for six years and shall not be renewed. The department of revenue shall verify and approve claims as the department of revenue determines to be justified and in accordance with this section. No claims may be filed after December 31, 2009.

The department of revenue may promulgate such rules, pursuant to chapter 34.05 RCW, as are necessary to properly administer this section.

RCW 82.04.260(1e & f)

(1) Upon every person engaging within this state in the business of manufacturing:

(e) Until July 1, 2009, alcohol fuel, biodiesel fuel, or biodiesel feedstock, as those terms are defined in RCW 82.29A.135; as to such persons the amount of tax with respect to the business shall be equal to the value of alcohol fuel, biodiesel fuel, or biodiesel feedstock manufactured, multiplied by the rate of 0.138 percent; and

(f) Alcohol fuel or wood biomass fuel, as those terms are defined in RCW 82.29A.135; as to such persons the amount of tax with respect to the business shall be equal to the value of alcohol fuel or wood biomass fuel manufactured, multiplied by the rate of 0.138 percent.