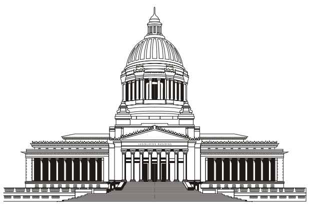
# 2010 Full Tax Preference Performance Reviews

**Report 11-4**

**January 5, 2011**

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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 nearly 590 tax preferences.

## Why a JLARC Review of Tax Preferences?

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

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

### *Citizen Commission Sets the Schedule*

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

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

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

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

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

In October 2009, the Commission adopted its fourth ten-year schedule for the tax preference reviews. The schedule for 2010 includes a total of 58 tax preferences under the business and occupation tax, public utility tax, sales tax, use tax, property tax, motor vehicle fuel tax, special fuel tax, litter tax, real estate excise tax, leasehold excise tax, and the insurance premiums tax. Of these 58 tax preferences, the law required 10 tax preferences to have a full review process, which are included in this report.

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

JLARC's assignment from EHB 1069 is to conduct the reviews of tax preferences according to the schedule developed by the Commission and consistent with the guidelines set forth in statute. This report presents JLARC's reviews of the 10 tax preferences scheduled by the Commission for full review. Ten expedited tax preference reviews are included in a separate report. A third report contains information on the remaining 38 preferences with a biennial fiscal impact of less than $2 million.

## JLARC's Approach to the Tax Preference Reviews

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

- **Public Policy Objectives:**
  1. What are the public policy objectives that provide a justification for the tax preference? Is there any documentation on the purpose or intent of the tax preference? (RCW 43.136.055(b))
  2. What evidence exists to show that the tax preference has contributed to the achievement of any of these public policy objectives? (RCW 43.136.055(c))
  3. To what extent will continuation of the tax preference contribute to these public policy objectives? (RCW 43.136.055(d))
  4. If the public policy objectives are not being fulfilled, what is the feasibility of modifying the tax preference for adjustment of the tax benefits? (RCW 43.136.055(g))
- **Beneficiaries:**
  5. Who are the entities whose state tax liabilities are directly affected by the tax preference? (RCW 43.136.055(a))
  6. To what extent is the tax preference providing unintended benefits to entities other than those the Legislature intended? (RCW 43.136.055(e))
- **Revenue and Economic Impacts:**
  7. What are the past and future tax revenue and economic impacts of the tax preference to the taxpayer and to the government if it is continued? (This includes an analysis of the general effects of the tax preference on the overall state economy, including the effects on

consumption and expenditures of persons and businesses within the state.) (RCW 43.136.055(h))

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

### *Other States:*

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

## Methodology

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

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

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

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

## Summary of the Results from JLARC's Reviews

The table beginning on page 5 provides a summary of the recommendations from JLARC's analysis of the tax preferences scheduled for full review in 2010. JLARC provides analysis of tax preferences scheduled for expedited review and expedited light review in 2010 in additional volumes. Of the ten tax preferences included in this volume, this report recommends that the Legislature continue seven tax preferences as they are. The full report raises issues for the Legislature's consideration for one tax preference, and recommends that the Legislature terminate two tax preferences.

## Organization of This Report

This report includes ten separate chapters. Each chapter consists of a review of one or more related tax preferences. 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 provide the Scope and Objectives and the text of current law for each preference.

## 2010 Full Reviews

| Year Enacted | # of Claimants ($ amount) | JLARC Recommendation | Comments by Citizen Commission for Performance Measurement of Tax Preferences | Related Legislation as of 2010 |
|---|---|---|---|---|
| **JLARC recommendation: Legislature should continue the tax preference** | | | | |
| Nonresidents' Personal Property / RCW 82.12.0251 | | | | |
| 1935 | Unknown<br>$4.2 billion | Continue | Endorses without comment | Unknown until after 2011 session |
| Vehicles Sold to Nonresidents / RCW 82.08.0264 | | | | |
| 1935 | Unknown<br>$26.7 million | Continue | Endorses without comment | Unknown until after 2011 session |
| Interstate Transportation Equipment / RCW 82.08.0262; RCW 82.08.0263; RCW 82.12.0254 | | | | |
| 1935 | Unknown<br>$2.5 billion | Continue | Endorses with comment: The Commission recommends that the Legislature consider whether to increase the qualifying threshold for motor vehicles by reviewing whether "in substantial part" should be replaced by the language "primarily used."<br>Rationale: The Legislature considered such a change in 2010. Adoption of "primarily used" language would provide the same 50 percent interstate use threshold for both motor vehicles and other transportation equipment. | Unknown until after 2011 session |
| Fertilizer, Spray Materials, and Chemical Sprays and Washes / RCW 82.04.050(11) | | | | |
| 1943 | 17,500<br>$65.7 million | Continue | Endorses without comment | Unknown until after 2011 session |
| Labor and Services Used in Construction and Repair of Public Roads/ RCW 82.04.050(10); RCW 82.04.190(3) | | | | |
| 1943 | Unknown<br>$60.8 million | Continue | Endorses with comment: The Commission endorses the recommendations and notes that the circumstances have changed regarding the exclusion of state-owned roads from this tax preference and that the exclusion may no longer serve its original purpose. The Commission recommends that the Legislature consider revising the relevant statute to extend the tax preference to apply to labor and services for construction and repair of state-owned roads. | Unknown until after 2011 session |

| 2010 Full Reviews | | | | |
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| **Year Enacted** | **# of Claimants ($ amount)** | **JLARC Recommendation** | **Comments by Citizen Commission for Performance Measurement of Tax Preferences** | **Related Legislation as of 2010** |
| Sales of Breeding Livestock, Cattle, and Milk Cows / RCW 82.08.0259; RCW 82.12.0261 | | | | |
| 1945 | 4,300<br>$9.3 million | Continue | Endorses without comment | Unknown until after 2011 session |
| Title Insurance Premiums / RCW48.14.020(1); RCW48.14.020(4) | | | | |
| 1947 | Unknown<br>$3.5 million | Continue | Endorses without comment | Unknown until after 2011 session |
| **JLARC recommendation: Legislature should re-examine or clarify the intent of the tax preference** | | | | |
| Shipments to Ports For Interstate or Foreign Transportation / RCW 82.16.050(9) | | | | |
| 1937 | Unknown<br>$7.6 million | Since this tax preference providing a public utility tax deduction for shipments to ports is no longer required by the Constitution, the original public policy objective is no longer applicable. Statutory changes in 1949 and 1967, however, imply that the Legislature may have had additional policy objectives. Because the Legislature did not identify its objectives at those times, the Legislature should reexamine and clarify this preference to identify what, if any, public policy objectives still exist. | Endorses with comment: The Commission endorses the recommendation but suggests the Legislature conduct its reexamination of the intent of this preference in conjunction with the economic impact study that the Commission recommends for the 'Through Freight in Interstate Transportation Public Utility Tax Deduction' and 'Instate Portion of Interstate Transportation' tax preferences.<br><br>The Legislature should specify that the study should be completed by December 31, 2011, to inform a decision during the 2012 Legislative Session. After the 2012 session, if the Legislature has taken no action, the Commission intends to determine whether it should schedule this preference for another review. | Unknown until after 2011 session |

## 2010 Full Reviews

| Year Enacted | # of Claimants ($ amount) | JLARC Recommendation | Comments by Citizen Commission for Performance Measurement of Tax Preferences | Related Legislation as of 2010 |
|---|---|---|---|---|
| **JLARC recommendation: Legislature should impose the public utility tax** | | | | |
| Instate Portion of Interstate Transportation / RCW 82.16.050(6) | | | | |
| 1935 | Unknown<br>$24.6 million | Because the U.S. Constitution no longer prohibits the instate portion of interstate transportation from being taxed, the public utility tax should be imposed on these activities. In order to implement this, the Legislature should provide specific authorization to the Department of Revenue to develop a method of apportioning transportation income generated from activities within the state. | Does not endorse and comments as follows: The Commission does not endorse the recommendation because it believes it is premature to authorize the Department of Revenue to develop an apportionment methodology. Although the existing preference is no longer constitutionally necessary, affected taxpayers have structured competitive activities in reliance on continuation of the preference. Because termination of the preference may have unintended deleterious consequences for taxpayers and more generally for the state, the Commission recommends that the Legislature direct either the Office of Financial Management, the Department of Revenue, or the Economic and Revenue Forecast Council conduct an economic impact study of the effects of termination on the competitiveness of affected taxpayers and the primary and secondary tax revenue impacts of termination. The Commission also recommends that the Legislature consider whether the economic impact study should identify policy options such as defining the tax base, and the revenue impacts of such options, for restructuring the public utility tax for affected taxpayers. The study should also include recommendations for how to structure an apportionment methodology that complies with the guidelines established by the U.S. Supreme Court.<br><br>The Legislature should specify that the study should be completed by December 31, 2011, to inform a decision during the 2012 Legislative Session. After the 2012 session, if the Legislature has taken no action, the Commission intends to determine whether it should schedule this preference for another review. | Unknown until after 2011 session |

| 2010 Full Reviews | | | | |
|---|---|---|---|---|
| **Year Enacted** | **# of Claimants ($ amount)** | **JLARC Recommendation** | **Comments by Citizen Commission for Performance Measurement of Tax Preferences** | **Related Legislation as of 2010** |
| Instate Portion of Interstate Transportation / RCW 82.16.050(6) (continued from previous page) | | | | |
| | | | Rationale for non-endorsement and recommendation for economic impact study. Public testimony identified the potential for significant unintended adverse economic consequences for taxpayers and possibly for the state if the preference is terminated. Although very limited factual evidence was presented, there is a possibility that termination could result in loss of employment and other sources of state tax revenue that could exceed the amount of revenue raised by the public utility tax as a result of termination. While this possibility is uncertain, public testimony indicated a high likelihood that termination could lead to potentially serious disruptive consequences. Because of the uncertainty and absence of substantial factual information about potential impacts, the Commission believes that it would be prudent to conduct an economic impact study. The Commission believes the current tax preference is outdated, but rather than terminating the preference, consideration should be given to structuring the public utility tax for the affected taxpayers in ways that are tax efficient and enable tax payers to be competitive on an interstate basis. If the Legislature prefers to have an economic impact study conducted by a neutral party, it should direct the Economic and Revenue Forecast Council to conduct the study; otherwise the study could be conducted by the Office of Financial Management or the Department of Revenue. | |

| 2010 Full Reviews | | | | |
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| **Year Enacted** | **# of Claimants ($ amount)** | **JLARC Recommendation** | **Comments by Citizen Commission for Performance Measurement of Tax Preferences** | **Related Legislation as of 2010** |
| **JLARC recommendation: Legislature should terminate the tax preference** | | | | |
| Through Freight in Interstate Transportation / RCW 82.16.050(8) | | | | |
| 1937 | Unknown<br>Indeterminate | Because this preference is no longer constitutionally necessary, the Legislature should terminate the preference providing a public utility tax deduction tax for intrastate portions of interstate shipments of goods under a through freight rate where the shipment is stopped in Washington to store, manufacture, or process the goods, then continues to the final destination. | Does not endorse and comments as follows: The Commission does not endorse the recommendation. Although the existing preference is no longer constitutionally necessary, affected taxpayers have structured competitive activities in reliance on continuation of the preference. Because termination of the preference may have unintended deleterious consequences for taxpayers and more generally for the State, the Commission recommends that the Legislature direct either the Office of Financial Management, the Department of Revenue, or the Economic and Revenue Forecast Council to conduct an economic impact study of the effects of termination on the competitiveness of affected taxpayers and the primary and secondary tax revenue impacts of termination. The Commission also recommends that the Legislature consider whether the economic impact study should identify policy options such as defining the tax base, and the revenue impacts of such options, for restructuring the public utility tax for affected taxpayers.<br><br>The Legislature should specify that the study should be completed by December 31, 2011, to inform a decision during the 2012 Legislative Session. After the 2012 session, if the Legislature has taken no action, the Commission intends to determine whether it should schedule this preference for another review. | Unknown until after 2011 session |

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| | | | Rationale for non-endorsement and recommendation for economic impact study. Public testimony identified the potential for significant unintended adverse economic consequences for taxpayers and possibly for the state if the preference is terminated. Although very limited factual evidence was presented, there is a possibility that termination could result in loss of employment and other sources of state tax revenue that could exceed the amount of revenue raised by the public utility tax as a result of termination. While this possibility is uncertain, public testimony indicated a high likelihood that termination could lead to potentially serious disruptive consequences. Because of the uncertainty and absence of substantial factual information about potential impacts, the Commission believes that it would be prudent to conduct an economic impact study. The Commission believes the current tax preference is outdated, but rather than terminating the preference, consideration should be given to structuring the public utility tax for the affected taxpayers in ways that are tax efficient and enable tax payers to be competitive on an interstate basis. If the Legislature prefers to have an economic impact study conducted by a neutral party, it should direct the Economic and Revenue Forecast Council to conduct the study; otherwise the study could be conducted by the Office of Financial Management or the Department of Revenue. | |