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

2012 Tax Preference Performance Reviews

Report 13-1

February 20, 2013

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Joint Legislative Audit and Review Committee

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

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

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

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Committee Approval

On February 20, 2013, this report was approved for distribution by the Joint Legislative Audit and Review Committee.

2012 Tax Preference Performance Reviews

Report 13-1

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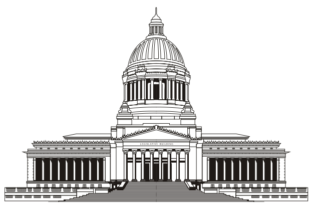

STATE OF WASHINGTON

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REPORT SUMMARY

What Is a Tax Preference?

Tax preferences are defined in statute as 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 total number of tax preferences changes as they are added or expire: currently there are 619.

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 (now found in Chapter 43.136, Revised Code of Washington). The legislation assigns specific roles in the process to two different entities.

- The Citizen Commission for Performance Measurement of Tax Preferences creates a schedule for reviews, holds public hearings, and comments on the reviews.
- The Joint Legislative Audit and Review Committee (JLARC) conducts the reviews.

Citizen Commission Sets the Schedule

The Legislature directed the Citizen Commission for Performance Measurement of Tax Preferences to develop a schedule to accomplish an orderly review of most tax preferences over ten years. The Commission is directed to omit certain tax preferences from the schedule, such as those required by constitutional law.

The Commission conducts its reviews based on analysis prepared by JLARC. In addition, the Commission may elect to rely on information supplied by the Department of Revenue. This volume includes 20 chapters covering 23 preferences (similar preferences may be combined in one chapter) completed by JLARC in 2012. Analysis of preferences completed in previous years is found on the Commission's website: http://www.citizentaxpref.wa.gov/

JLARC's Approach to the Tax Preference Reviews

The statute directs the type of questions to be addressed in JLARC's reviews. The 11 questions typically covered in the reviews, along with their statutory reference, are stated below:

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))
10. For those preferences enacted for economic development purposes, what are the economic impacts of the tax preference compared to the economic impacts of government activities funded by the tax? (RCW 43.136.055(j))

Other States:

11. 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(k))

Depending on the tax preference, certain questions may be excluded. For instance, question #4 relates to modifying a preference if the public policy is not being fulfilled. If the preference is fulfilling its public policy, this question is skipped.

Questions related to economic impacts may be skipped for preferences whose purpose is not economic development.

JLARC's Analysis Process

JLARC staff carefully analyze a variety of evidence in conducting these reviews: 1) the legal and public policy history of the tax preferences; 2) the beneficiaries of the tax preferences; 3) government data pertaining to the utilization of these tax preferences and other relevant data; 4) available information on the economic and revenue impact of the tax preferences; and 5) other states' laws to identify similar tax preferences.

When a preference's public policy objective is identified in statute, staff are able to affirmatively state the public policy objective. This is sometimes found in intent statements or in other parts of statute.

However, for many of the preferences, the Legislature did not state the public policy objective. In such instances, staff may be able to infer what the public policy objective might be.

To arrive at this inferred policy objective we go through the following step-by-step process:

- Review final bills and bill reports for any statements on the intent or public policy objectives.
- Review bills prior to the final version and legislative action on bills related to the same topic.
- Review bill reports and testimony from various versions of the bill.
- Review records of floor debate, when available.
- Review whether there were court cases that provide information on the objective.
- Review any information available through the Department of Revenue's files on the history of tax preferences, including rules, determinations, appeals, audits, and taxpayer communication.
- Review any press reports during the time of the passage of the bill which may indicate the intention of the preference.
- Review any other historic documents that may address the issue addressed by the tax preference.

If there is sufficient information in this evidence to identify an inferred policy objective, we state that in our reviews. In these instances, though, the purpose may be a more generalized statement than can be made compared to instances that have explicit statutory language. And in many cases, there simply is not sufficient evidence to identify any policy purpose.

JLARC staff also interview the agencies that administer the tax preferences or are knowledgeable of the industries affected by the tax such as the Department of Revenue, the Department of Licensing, the Department of Transportation, and the Department of Financial Institutions. These parties provide data on the value and usage of the tax preference and the beneficiaries. If the beneficiaries of the tax are required to report to other state or federal agencies, JLARC staff will also obtain data from those agencies.

In addition, for the preference related to a business and occupation tax credit for high technology businesses, JLARC contracted with expert econometricians to evaluate the preference's impact on job creation. The econometricians' report is incorporated into the review, and can be found in Appendix 4.

Summary of the Results from JLARC's Reviews

The table beginning on page 5 provides a summary of auditor recommendations. These are:

- Terminate one preference.
- Review and clarify the intent of twelve preferences.
- Continue ten preferences.

Organization of This Report

This report summary is followed by two report addenda, added by the Joint Legislative Audit and Review Committee. These addenda are followed by a letter from the chair of the Citizen Commission, noting the adoption of the Commission's comments on the reviews. The letter is followed by a summary of the preferences, including the full text of Commission's comments, presented in alphabetical order. More detailed information is then presented for each preference. The appendices provide the Scope and Objectives and the text of current law for each preference.

In addition to the preferences reviewed in this report, information on 33 other preferences considered by the Commission in 2012 can be found in the 2012 Expedited Tax Preferences. Information on these preferences was provided by the Department of Revenue.

COMMITTEE ADDENDA

At the February 20, 2013 JLARC meeting the Committee approved this report for distribution and adopted two addenda to the report.

NOTE: Addendum #2 reflects the views of the individual sponsors listed below. It does not reflect the views of all members of the Committee.

Committee Addendum #1

The Committee notes that its action to distribute the **2012 Tax Preference Performance Reviews: Proposed Final Report** does not imply the Committee agrees or disagrees with auditor recommendations or the recommendations of the Citizen Commission for Performance Measurement of Tax Preferences.

Statute directs the auditors and the Citizen Commission to make recommendations on tax preferences. Action to pursue or not pursue the auditor and Citizen Commission recommendations takes place in the policy-making forum outside of JLARC. The role of performance audit reviews and recommendations is to help inform the Legislature's decisions.

Committee Addendum #2

Sponsors:

Rep. Cathy Dahlquist
Rep. Gary Alexander
Rep. Kathy Haigh
Sen. Mike Hewitt
Sen. Janéa Holmquist Newbry
Rep. Ed Orcutt
Rep. Hans Zeiger

While we respect the work performed by the Auditor and the Tax Preference Commission, we reach different conclusions and would make different recommendations as to certain policies. Specifically:

1. With respect to the B&O Tax Rate for Stevedoring and International Charter and Freight Brokers we recommend that the rate **CONTINUE WITHOUT MODIFICATION**. These preferences lower costs and are one tool for increasing the competitiveness of our ports, which are major sources of jobs and economic growth.
2. With respect to the B&O Tax Rate for Insurance Producers, Title Insurance Agents, and Surplus Line Brokers we recommend that the rate **CONTINUE WITHOUT MODIFICATION**. This preference a) offsets the impact of pyramiding taxation on insurance producer commissions paid by locally owned and operated insurance businesses and b) minimizes the competitive disadvantages faced by Washington insurance producers who compete with out-of-state, non-commissioned direct selling insurance companies.

SUMMARY OF AUDIT RESULTS AND CITIZEN COMMISSION COMMENTS

State of Washington

Citizen Commission for Performance Measurement of Tax Preferences

William A. Longbrake, Chair
Governor's Council of Economic Advisors

Stephen B. Miller, Vice Chair
Washington Education Association

James Bobst
Pacific Fibre Products, Inc.

Ruta Fanning
Retired Legislative Auditor

Paul Guppy
Washington Policy Center

NON-VOTING MEMBERS:

Senator **Craig Pridemore**
Chair, Joint Legislative Audit & Review Committee

Brian Sonntag
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October 31, 2012

The Honorable Representative Ross Hunter
The Honorable Representative Gary Alexander
The Honorable Senator Ed Murray

2012 Tax Preference Reviews

I am pleased to report that the Citizen Commission for Performance Measurement of Tax Preferences (Citizen Commission) has unanimously adopted its comments for this year's review of tax preferences.

The attached comments are the consensus of all Commissioners. Commissioners encouraged me, in my capacity as Chair, to emphasize to you the importance of the Legislature considering this year's and previous years recommendations and comments on tax preference statutes, which have undergone rigorous review by the Joint Legislative Audit and Review Committee (JLARC) staff, pursuant to legislatively-mandated criteria and government auditing standards.

As the chairs and ranking minority members of the fiscal committees, I urge your action on these recommendations during the upcoming legislative session.

This is the sixth year that tax preferences have been reviewed at the direction of the Legislature. Legislation enacted in 2006 established the Citizen Commission and directed it to develop a schedule for an orderly review of tax preferences over ten years.

Tax preference reviews provide a valuable evaluation tool at a time when the Legislature is grappling with difficult fiscal issues. Terminating tax preferences that do not appear to be meeting their intended purposes provides the Legislature with the option of using resources for alternative revenue or program purposes. Similarly, continuing effective preferences provides an assurance that the state is getting the value it expects.

After reviewing JLARC's report and taking public testimony, the Commission has unanimously recommended the expiration of eight of the twenty-three preferences reviewed this year. The Commission recommends the Legislature should continue nine other preferences, and clarify the purpose for the remaining six preferences. Summaries of the analysis, JLARC recommendations, and Commission comments are attached to this letter.

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Washington's legislatively-mandated process for reviewing tax preferences over a ten-year period was cited in a recent report by the Pew Center for the States as one of thirteen states "leading the way" in efforts to evaluate tax incentives for jobs and growth, including *informing policy choices*, *reviewing all tax incentives* and *drawing clear conclusions*. The report indicated that only one state (Oregon) met a fourth criterion of *measuring economic impact*. I am pleased to report that this year Washington joined Oregon in measuring economic impact of certain tax preferences.

With respect to the Pew Center report, I asked the Legislative Auditor the following questions: *"Do JLARC staff feel the Pew Center's characterization of Washington State's efforts to evaluate tax preferences is accurate?" and "What are the Legislative Auditor's office's views on the six key questions the Pew Center posed for measuring economic impact?"* By unanimous agreement the Commission requested that the Legislative Auditor include his responses in the 2012 report to the Legislature.

Some tax preferences are established with the goal of stimulating economic development. As the recent report by the Pew Center for the States found, these types of preferences are typically difficult to evaluate, and very few states across the nation have done so in a credible fashion.

Our state is an exception and is among a few that are making progress in evaluating such economic impacts. This year's report by JLARC includes a rigorous economic analysis of the B&O tax credit for high technology research and development. The JLARC analysis provided credible and unbiased information about the performance of this preference. Based on this analysis from JLARC, the Commission unanimously concluded the Legislature should allow this preference to expire because the cost of this preference greatly exceeds the estimated benefits. The Commission concluded that the Legislature's objective of creating "quality" employment opportunities in the state might be achieved more cost effectively in other ways.

This type of analysis by JLARC is critical to helping the Legislature determine whether an economic development tax preference should continue, be modified or be terminated. However, making informed recommendations requires rigorous analysis that depends upon the availability of financial resources for contracting with economic experts. The Legislature's support of JLARC's efforts will help ensure JLARC can sustain and apply these analytical techniques to other tax preferences in the upcoming biennia. This year the Commission has specifically recommended the Legislature provide funds for JLARC to study the economic impact of three preferences related to freight and shipping industries. While the Commission is cognizant of the state's limited financial resources, it believes that only a very small amount will be required to conduct rigorous economic analysis. The benefits of better structured tax preferences, which promote more effective economic development and employment, will repay the small amount invested many times over.

I believe the work of JLARC staff and the Citizen Commission has provided a thoughtful and deliberative forum for highlighting many important performance and policy issues associated with

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evaluating tax preferences. I encourage you to consider the recommendations of JLARC staff and Citizen Commission comments covering the entire six years of tax preference reviews during the upcoming legislative session.

As Chair of the Citizen Commission for Performance Measurement of Tax Preferences, I would be pleased to discuss the Commission's position and comments with you and any interested legislators. I can be contacted via email at bill@tlff.org.

If you have questions about JLARC's performance audits, please feel free to contact the Legislative Auditor, Keenan Konopaski, at 360-786-5187 or keenan.konopaski@leg.wa.gov. Additional information on all six years of tax preference reviews can be found at: www.citizentaxpref.wa.gov/reports.htm.

Sincerely,

William A. Longbrake

William A. Longbrake, Chair
Citizen Commission for Performance Measurement of Tax Preferences

cc: All Legislators
Keenan Konopaski, Legislative Auditor
Stan Marshburn, Director, Office of Financial Management
Brad Flaherty, Director, Department of Revenue

attachment

<table>
<tr><th colspan="4">Summary of 2012 Tax Preference Performance Reviews</th></tr>
<tr><th>What the Preference Does</th><th>Public Policy Objective</th><th>Estimated Beneficiary Savings</th><th>Auditor Recommendation</th></tr>
<tr><td colspan="4">Annuities (Insurance Premiums Tax)/ RCW 48.14.020(1) Detail on page 21</td></tr>
<tr><td>Exempts life insurance companies from insurance premiums tax on payments received on “qualifying” and “non-qualifying” annuity contracts.
“Qualifying” annuities qualify for federal tax deferrals on contributions.</td><td>The Legislature did not state the public policy objectives of the preference.
JLARC infers that the public policy objective is to encourage individuals to save toward retirement, and to treat “qualifying” and “non-qualifying” annuities the same.</td><td>$188.7 million in 2013-15 Biennium</td><td>Continue: Because payments to “qualifying” and “non-qualifying” annuities are receiving the same tax treatment, and to the extent tax savings are passed on, the exemptions are encouraging individuals to save for retirement.</td></tr>
<tr><td colspan="4">Commission Comment: Commission endorses the auditor recommendation.</td></tr>
<tr><td colspan="4">Biotechnology Manufacturing Deferral/Waiver (Sales and Use Tax) / RCWs 82.75.010; 82.75.030 Detail on page 27</td></tr>
<tr><td>Provides a deferral and eventual waiver of state and local sales and use taxes on construction of facilities and purchases of machinery and equipment by firms engaged in manufacturing of biotechnology related products.
Expires January 1, 2017.</td><td>The Legislature stated the public policy objectives of this deferral:
1) To encourage expenditures in commercial biotechnology operations; and
2) To develop employment opportunities in biotechnology manufacturing.</td><td>$1.4 million in 2013-15 Biennium</td><td>Review and clarify: To determine if progress toward its biotechnology manufacturing objectives is sufficient and to consider identifying targets for investment and employment.</td></tr>
<tr><td colspan="4">Commission Comment: The Commission does not endorse the recommendation that the Legislature should review and clarify this tax preference and recommends that the Legislature take no action and allow this preference to expire in 2017, as scheduled.
Rationale: The JLARC audit staff was unable to determine the impact, if any, this preference has had on encouraging investment and creating jobs. Additionally, there is no evidence that this industry needs this preference for unique competitive conditions. No testimony was provided by beneficiaries in support of continuing this tax preference.</td></tr>
<tr><td colspan="4">Business Inventories (Property Tax) / RCWs 84.36.477; 84.36.510 Detail on page 39</td></tr>
<tr><td>Exempts business inventories from property tax.</td><td>The Legislature stated that the public policy objective for exempting business inventories from the property tax is to stimulate the economy and, thereby, increase revenues to the state and local governments.</td><td>$1.4 billion in 2013-15 Biennium</td><td>Continue: Because it has removed a competitive disadvantage relative to states where inventories are exempt.</td></tr>
<tr><td colspan="4">Commission Comment: Commission endorses the auditor recommendation.</td></tr>
</table>

Summary of 2012 Tax Preference Performance Reviews

What the Preference Does	Public Policy Objective	Estimated Beneficiary Savings	Auditor Recommendation
Commuting Programs (B&O Tax, PUT) / RCW 82.70.020			Detail on page 49
Provides a credit against either B&O tax or public utility tax to employers and property managers for amounts they pay to or on behalf of employees that use commuting programs. Expires June 30, 2013.	The Legislature did not state the public policy objective of the preference. JLARC infers the public policy objective is to encourage businesses to provide financial incentives to their employees who participate in commute trip reduction programs that reduce single occupancy vehicle travel in Washington.	$0 in 2013-15 Biennium (The preference is scheduled to expire at the end of the 2013-15 Biennium.)	**Review and clarify:** Because while it is providing a credit to businesses that provide financial incentives to their employees who participate in commute trip reduction activities, it is unclear whether the preference is meeting the broader public policy objective of increasing participation in commute reduction programs.
Commission Comment: The Commission does not endorse the recommendation that the Legislature should review and clarify the public policy objective of the preference and determine whether it is necessary any longer to encourage trip reduction activities. The Commission recommends that the Legislature allow the preference to expire as scheduled on June 30, 2013. **Rationale**: The Legislature did not specify a public policy purpose for this preference. JLARC staff inferred from the record that the implied public policy purpose is to encourage businesses to provide financial incentives to their employees who participate in commute trip reduction programs. This preference may no longer be essential to achieve the implied public policy objective because many businesses offer trip reduction financial incentives to employees as a standard component of their employee benefit programs. In 1994, the Department of Revenue stated that many firms already had commute trip reduction programs in place and tax credits were not expected to generate significantly higher participation in such programs. The Commission believes that expiration of this preference would be unlikely to result in a material reduction in businesses' provision of trip reduction financial incentives to employees.			
Condominium and Homeowner Maintenance Fees (B&O Tax) / RCW 82.04.4298			Detail on page 61
Provides condominium, apartment, and homeowners' associations with a deduction for fees paid by owners to cover costs of repair, maintenance, replacement, management, or improvement of residential structures and "commonly held property."	The Legislature did not state a public policy objective for the preference. JLARC infers that the public policy objective is to provide equal tax treatment between homeowners who pay directly for their home maintenance and homeowners who pay maintenance fees to an association.	$20 million in 2013-15 Biennium	**Continue:** Because it is providing equal tax treatment between homeowners who pay directly for their home maintenance and homeowners who pay maintenance fees to an association.
Commission Comment: Commission endorses the auditor recommendation.			

<table>
<tr><th colspan="4">Summary of 2012 Tax Preference Performance Reviews</th></tr>
<tr><th>What the Preference Does</th><th>Public Policy Objective</th><th>Estimated Beneficiary Savings</th><th>Auditor Recommendation</th></tr>
<tr><td colspan="4">Ferry Boats (Sales and Use Tax) / RCWs 82.08.0285; 82.12.0279 — Detail on page 67</td></tr>
<tr><td>Exempts from sales/use tax purchases by state and local governments of ferry boats and component parts, as well as labor and services to build, repair, or maintain such vessels.</td><td>The Legislature did not state the public policy objective of the preference.

JLARC infers the public policy objective is to support state and local governments by reducing the cost of building and repairing ferry vessels owned and operated by state and local government entities.</td><td>$26.1 million in 2013-15 Biennium</td><td>Continue: Because it is meeting the inferred public policy objective of reducing the cost to state and local government entities of building, maintaining, and repairing ferry vessels they own and operate.</td></tr>
<tr><td colspan="4">Commission Comment: The Commission does not endorse the recommendation to continue the preference and encourages the Legislature to review and clarify the public policy intent of the preference.

Rationale: The JLARC staff study infers the public policy objective is to support state and local governments by reducing the cost of building and repairing ferry vessels owned and operated by state or local government entities. The principal beneficiary of this preference is Washington State Ferries. If the preference were terminated, state and local government entities that operate ferries in Washington would have to pay sales and use tax, which presumably would be a burden on state and local entities' finances. However, because state and local entities that operate ferries charge fees to users of ferries, it would be possible for those entities to raise user fees to recover the amount of sales and use tax. Thus, in effect, this preference is a subsidy that reduces the fees paid by users of ferries. The Commission recommends that the Legislature review and clarify the public policy objective of this preference and determine whether the intent of the preference is to subsidize public use of ferries. If that is not the public policy intent, the Legislature should consider terminating this preference.</td></tr>
<tr><td colspan="4">Fish Tax Differential Rates (Enhanced Food Fish Tax) / RCW 82.27.020(4) — Detail on page 75</td></tr>
<tr><td>Provides five differential fish tax rates for different species of enhanced food fish. The tax applies to the first commercial possession by an owner of the fish in Washington.</td><td>The Legislature did not state the public policy objective of the preference.

JLARC infers the public policy objective is to set fish tax rates so that those that most benefited from state expenditures for hatcheries and fisheries management paid at a higher rate to fund them.

It is unclear why the Legislature set the differential tax rates at the level at which they were established.</td><td>$7.5 million in 2013-15 Biennium</td><td>Review and clarify: Because it is unclear:
1) Why the differential rates were set at the levels they were; and
2) Whether the Legislature seeks a rate structure that reflects the relative levels of state expenditures for maintaining and enhancing the different fish and shellfish species.</td></tr>
<tr><td colspan="4">Commission Comment: Commission endorses the auditor recommendation.</td></tr>
</table>

Summary of 2012 Tax Preference Performance Reviews

<table>
<tr><th>What the Preference Does</th><th>Public Policy Objective</th><th>Estimated Beneficiary Savings</th><th>Auditor Recommendation</th></tr>
<tr><td colspan="4">Health Insurance by State Pool (Insurance Premiums Tax) / RCW 48.14.022 Detail on page 85</td></tr>
<tr><td>Allows health insurance carriers to deduct from their insurance premium income the fees they are required to pay to the Washington State Health Insurance Pool (WSHIP) before calculating their insurance premiums tax.</td><td>The Legislature did not state the public policy objective of the tax preference.
JLARC infers that the public policy objective is to define the insurance premiums tax base.</td><td>$2.9 million in 2013-15 Biennium</td><td>Continue: Because the tax deduction for fees paid to WSHIP is defining the base for the insurance premiums tax.</td></tr>
<tr><td colspan="4">Commission Comment: Commission endorses the auditor recommendation.</td></tr>
<tr><td colspan="4">High Technology R&D Deferral/Waiver (Sales and Use Tax) and Credit (B&O Tax) / RCWs 82.04.4452; 82.63.010; 82.63.030 Detail on page 91</td></tr>
<tr><td>Provides: 1) a deferral/waiver of state and local sales and use taxes on investment in facilities, and machinery and equipment by firms engaged in high technology R&D and pilot scale manufacturing; and 2) a B&O tax credit for qualified research and development spending.
Expires January 1, 2015.</td><td>The Legislature stated the public policy objectives of the high technology R&D tax preferences are to:
1) Create “quality” employment opportunities in this state; and
2) Encourage expenditures in research and development, supporting, and sustaining the high technology sector as it develops new technologies and products.</td><td>$114 million in 2013-15 Biennium</td><td>Review and clarify: To determine if progress toward its high technology R&D objectives is sufficient and to consider identifying targets for investment and employment.</td></tr>
</table>

Summary of 2012 Tax Preference Performance Reviews

What the Preference Does	Public Policy Objective	Estimated Beneficiary Savings	Auditor Recommendation
High Technology R&D Deferral/Waiver *(continued from previous page)*			
Commission Comment: The Commission does not endorse the recommendation that the Legislature review and clarify this tax preference and recommends that the Legislature allow the B&O tax credit and sales and use tax deferral/waiver to expire in 2015, as scheduled. **Rationale**: The JLARC audit staff study provided substantive evidence that these tax preferences created approximately 454 new jobs between 2004 and 2009 at an overall cost in terms of foregone tax revenue of approximately $20.5 million per year or $45,000 per job. However, new earnings per job were estimated to amount to $25,000. Even allowing for measurement errors, it is clear that the cost of these preferences greatly exceeds the estimated benefits. Industry representatives provided general information in support of these tax preferences. However, they did not provide tangible evidence to refute the findings of the JLARC staff study nor did they provide alternative evidence of a direct link between these tax preferences and significant job creation. Industry representatives testified that competition from other states to attract high technology R&D companies is intense, but provided no evidence that investment in high technology R&D would decline meaningfully if this tax preference were terminated. An industry representative testified that these preferences are important for industry profitability. However, since most participants in this industry are neither fledgling nor facing unique short-term competitive pressures, financially supporting the industry through these tax preferences appears to be of little or no value. The Legislature's objective to create "quality" employment opportunities in the state might be achieved more cost effectively in other ways such as partnering with the high technology R&D industry to provide educational and training programs that develop human resources skills needed by the industry.			
Insurance Guaranty Funds (Insurance Premiums Tax) / RCWs 48.32.145; 48.32A.125			Detail on page 107
Allows insurance companies to credit guaranty fund assessments against their insurance premiums taxes in 20 percent increments annually, fully recouping the assessment after five years.	The Legislature did not state the public policy objective of the tax preference. JLARC infers that the public policy objective is to allow insurers to re coup assessments paid to the guaranty funds.	$480,000 in 2013-15 Biennium	**Continue**: Because insurers are being allowed to recoup assessments to the guaranty funds.
Commission Comment: Commission endorses the auditor recommendation.			

Summary of 2012 Tax Preference Performance Reviews

What the Preference Does	Public Policy Objective	Estimated Beneficiary Savings	Auditor Recommendation
Insurance Producers, Title Insurance Agents, and Surplus Line Brokers (B&O Tax) / RCW 82.04.260(9)			Detail on page 113
Provides a lower B&O tax rate of 0.484 percent to insurance producers, title insurance agents, and surplus line brokers. The current general service rate is 1.8 percent.	The Legislature did not state the public policy objective of the tax preference. JLARC infers that the public policy objectives are: 1) To reduce the impact of B&O surtaxes on insurance contractors because they are unable to raise commissions to cover tax increases in the short term (1983); 2) To provide some equity for insurance businesses following the removal of pyramiding for real estate businesses (1983 and 1995); and 3) To simplify the tax code by consolidating B&O tax rates (1998).	$35.6 million in 2013-15 Biennium	**Review and clarify:** Because it is unclear why the Legislature is providing different tax treatment to businesses with similar agent/sub agent relationships; and because the inferred objectives related to the inability of passing on rate increases and of consolidating rates may no longer apply.

Commission Comment: The Commission endorses the recommendation that the Legislature should review and clarify the public policy purpose of the preference and unless there is a compelling reason for a differential rate, the Legislature should increase the tax rate to provide equivalent tax treatment with businesses with similar agent/sub-agent relationships.

Rationale: The JLARC staff study documents numerous changes in this tax preference between its initiation in 1935 and the most recent change in 2009. Beginning in 1995 the Legislature has reduced the tax rate on insurance commissions from 1.172% of insurance commissions to 0.484%. The Legislature provided no economic or competitive rationale for the reductions in the tax rate. Over the same time period, the Legislature has reduced the tax rate on real estate commissions from 2.13% to 1.80%. It should be noted that pyramiding of B&O taxes applies to insurance agents but not to real estate agents, pursuant to a 1992 state Supreme Court case that ruled that insurance agents are not entitled to the same exemption that removed tax pyramiding for real estate agents. Adjusting the current insurance commissions tax rate for pyramiding results in a combined B&O tax rate of 0.726% compared to 1.80% for real estate services. In public testimony, representatives of insurance agents pointed out that commission rates are established by insurance companies. Thus, there are limitations on how agents can recover costs directly from policyholders if there is an increase in the insurance commissions B&O tax rate. However, no evidence was provided for why a lower tax rate relative to similar agent/sub-agent relationships in other industries is appropriate.

Summary of 2012 Tax Preference Performance Reviews

What the Preference Does	Public Policy Objective	Estimated Beneficiary Savings	Auditor Recommendation
Leases Under $250 Per Year and Short Term Leases (Leasehold Excise Tax) / RCW 82.29A.130(8)-(9)			Detail on page 123
Exempts private leases of publicly owned property from leasehold excise tax where: • The taxable rent is less than $250 per year, or • The possession or use is less than 30 days.	The Legislature did not state the public policy objective of the preferences. JLARC infers the public policy objective is to define the leasehold excise tax base by avoiding double taxation and by easing administration of the tax.	$5.6 million in 2013-15 Biennium	**Continue**: Because the preference is meeting the inferred public policy objectives of avoiding double taxation and easing administration of the leasehold excise tax.
Commission Comment: Commission endorses the auditor recommendation.			
Minor Final Assembly Completed in Washington (B&O Tax) / RCW 82.04.4295			Detail on page 131
Provides a B&O tax deduction to manufacturers that perform minor final assembly in Washington on components that have been imported from outside the United States.	The Legislature did not state the public policy objective of the tax preference. JLARC infers that the public policy objective is to address the specific circumstance of the assembly of Chevrolet LUV trucks at the Port of Seattle in order to retain that operation.	None	**Terminate**: Because of changes in federal import regulations, imported truck components are no longer being assembled at Washington ports, and there are no known beneficiaries of this deduction for minor final assembly.
Commission Comment: Commission endorses the auditor recommendation.			

Summary of 2012 Tax Preference Performance Reviews

What the Preference Does	Public Policy Objective	Estimated Beneficiary Savings	Auditor Recommendation
Natural and Manufactured Gas (Sales and Use Tax) / RCWs 82.08.026; 82.12.023; 82.14.030(1)			Detail on page 139
Provides a sales/use tax exemption for natural and manufactured gas purchased by consumers when the consumer pays Washington's brokered natural gas use tax.	The Legislature did not state a public policy objective for the preference. JLARC infers the public policy objectives of the preference, working in conjunction with the brokered natural gas use tax, are to: 1) Ensure equitable taxation by avoiding double taxation of natural or manufactured gas purchased from outside the state; 2) Provide local governments with a continued source of local tax revenue; and 3) Comply with the federal Constitution.	$193.7 million in 2013-15 Biennium	**Continue:** Because it is meeting the inferred public policy objectives of: 1) Ensuring equitable taxation by avoiding double taxation; 2) Providing local governments with a continued source of local tax revenue; and 3) Complying with the federal Constitution.
Commission Comment: Commission endorses the auditor recommendation.			
Precious Metals and Bullion (Sales and Use Tax, B&O Tax) / RCW 82.04.062			Detail on page 149
The two preferences: • Exempt sales or use of precious metal and bullion from sales/use tax; and • Subject sellers of precious metal and bullion to B&O tax on commissions on transactions for third parties, not on gross receipts.	The Legislature did not state the public policy objective of the tax preferences. JLARC infers the public policy objective is to make Washington coin and bullion dealers more competitive with out-of-state competitors by treating precious metal and bullion sales like sales of investments rather than sales of tangible personal property.	$42.2 million in 2013-15 Biennium	**Review and clarify**: Because implementation of the statute may not be achieving the inferred public policy objective of treating precious metal and bullion sales like sales of investments.
Commission Comment: Commission endorses the auditor recommendation.			

Summary of 2012 Tax Preference Performance Reviews

What the Preference Does	Public Policy Objective	Estimated Beneficiary Savings	Auditor Recommendation
Solar Energy and Silicon Product Manufacturers (B&O Tax) / RCW 82.04.294			Detail on page 161
Provides a preferential B&O tax rate of 0.275 to: • Manufacturers of certain solar energy systems; • Manufacturers of solar grade silicon and other products used as components of solar energy systems; and • Wholesalers of solar energy systems or component products they manufactured Expires June 30, 2014.	The Legislature stated the public policy objectives of the solar energy and silicon product manufacturers B&O tax preferences are to: 1) Retain and expand existing solar industry manufacturing businesses in Washington; 2) Attract new solar energy manufacturers/wholesalers to the state; and 3) Create jobs in Washington.	$1.6 million in 2013-15 Biennium	**Review and clarify**: To determine if progress toward solar industry objectives is sufficient and to consider identifying targets for solar business retention, attraction, and job creation.
Commission Comment: Commission endorses the auditor recommendation.			
Special Fuel Use Exemptions (Fuel Tax) / RCW 82.38.080			Detail on page 171
Provides a number of exemptions from the special fuel tax for specific uses of fuel.	The Legislature did not state the public policy objective of the tax preference. JLARC infers the public policy objectives are: 1) To establish the tax base for special fuel tax; and 2) To exempt fuel used for public purposes.	$36.4 million in 2013-15 Biennium	**Continue**: Because they are achieving the inferred public policy objective of: 1) Establishing the tax base for special fuel tax; and 2) Exempting fuel used for public purposes from the special fuel tax.
Commission Comment: Commission endorses the auditor recommendation.			

Summary of 2012 Tax Preference Performance Reviews

What the Preference Does	Public Policy Objective	Estimated Beneficiary Savings	Auditor Recommendation
Stevedoring and International Charter and Freight Brokers (B&O Tax) / RCWs 82.04.260(6); 82.04.260(7)			Detail on page 181
These two preferences provide a preferential B&O tax rate of 0.275 percent to stevedoring and associated activities and to international charter and freight brokers.	The Legislature did not state the initial public policy objective of the tax preferences. JLARC infers the public policy objective for the preferential tax rate for stevedoring activities is to keep Washington's ports and port-related businesses competitive. JLARC could not determine the public policy objective for the preferential tax rate for international charter and freight brokers. The stated public policy objective in 1998 for reducing the tax rates for both stevedoring and international charter and freight brokers was to simplify the tax code by consolidating B&O tax rates.	**Stevedoring:** $17.9 million in 2013-15 Biennium **International Charter and Freight Brokers:** $8.5 million in 2013-15 Biennium	**Review and clarify**: Because: 1) The public policy objective for why the Legislature chose the particular current preferential tax rate for stevedoring activities is unclear; 2) The objective for providing the preferential tax rate for international charter and freight brokers is unclear; and 3) The objective to consolidate B&O tax rates and classifications may no longer apply.

Commission Comment: The Commission does not endorse the auditor recommendation to review and clarify these two preferences and recommends that the Legislature should terminate both of these preferential tax rates.

Rationale: The apparent original intent of providing a preferential tax rate in 1979 was to maintain an equivalent tax burden after a U.S. Supreme Court decision eliminated the tax exemption of certain stevedoring activities. While the industry has argued that the preferential rate is justified for competitive reasons, the industry has never provided substantiation for this claim. In testimony provided to the Commission by a representative of these industries, no substantive evidence was provided that elimination of this preference would harm the competitiveness of Washington's ports materially. In response to a question during public testimony, an industry representative acknowledged no competing west coast ports in the U.S. receive a similar tax break. The JLARC staff study indicated that it is unclear that the preferential B&O tax rate has had any role in making Washington's ports more competitive. Therefore, the Commission recommends that the Legislature stop supporting these industries financially by terminating the preferential tax rates.

Summary of 2012 Tax Preference Performance Reviews

<table>
<tr><th>What the Preference Does</th><th>Public Policy Objective</th><th>Estimated Beneficiary Savings</th><th>Auditor Recommendation</th></tr>
<tr><td colspan="3">Travel Agents and Tour Operators (B&O Tax) / RCW 82.04.260(5)</td><td>Detail on page 193</td></tr>
<tr><td>Provides a preferential B&O tax rate of 0.275 percent to travel agents and tour operators.</td><td>The Legislature did not state the initial public policy objective of the tax preferences.
JLARC infers the public policy objectives for this preference are to:
1) Reduce the financial impact of DOR's 1975 rule change on travel agents by reducing their tax rate in proportion to the commissions earned from arranging interstate air travel;
2) Provide equitable tax treatment between travel agents and air carriers; and
3) Achieve administrative simplicity by taxing tour operators at the same rate as travel agents.</td><td>$10.2 million in 2013-15 Biennium</td><td>Review and clarify: Because it is unclear whether the inferred public policy objectives of reducing the financial impact of DOR's 1975 rule change, providing equitable tax treatment with air carriers, and achieving administrative simplicity still apply in light of the changes to the industry since the time of enactment.</td></tr>
<tr><td colspan="4">Commission Comment: The Commission does not endorse the auditor recommendation and recommends that the Legislature terminate the preferential tax rate for travel agents and tour operators.
Rationale: JLARC audit staff documented that circumstances in the travel industry have changed since this preference was established. Based on the JLARC staff analysis, it appears there are no longer competitive reasons to continue the preference and thus retention of the preference simply increases commissions for travel agents. Moreover, administrative considerations, which prompted the Department of Revenue to request the Legislature extend the preference to tour operators, no longer exist. Because there is no apparent compelling reason any longer for preferential tax treatment, the Legislature should terminate this preference.</td></tr>
</table>

Summary of 2012 Tax Preference Performance Reviews

What the Preference Does	Public Policy Objective	Estimated Beneficiary Savings	Auditor Recommendation
Urban Passenger Transit Fuel (Sales and Use Tax) / RCWs 82.08.0255(1)(a), (c); 82.12.0256(2)(a)			Detail on page 201
Provides a sales/use tax exemption for fuel purchased for: • Urban passenger public transportation by an urban passenger transportation system; or • Use in passenger-only ferries by public transportation benefit areas, counties, or county ferry districts.	The Legislature did not state the public policy objective of the tax preference. JLARC infers that the public policy objective is to reduce operating costs for public transportation providers and thus improve public transportation and reduce transportation costs for urban transit users.	$22 million in 2013-15 Biennium	**Continue**: Because it is meeting the inferred public policy objective of reducing the costs for providers of urban passenger transportation services.
Commission Comment: Commission endorses the auditor recommendation.			

The Citizen Commission also updated comments on three preferences reviewed in 2010.

<table>
<tr><th colspan="4">Updated Comments on Select 2010 Tax Preference Performance Reviews</th></tr>
<tr><th>What the Preference Does</th><th>Public Policy Objective</th><th>Estimated Beneficiary Savings</th><th>Auditor Recommendation</th></tr>
<tr><td colspan="4">Interstate Transportation, Instate Portion (PUT) / RCW 82.16.050(6)</td></tr>
<tr><td>Provides a deduction from the public utility tax for income the state is constitutionally prohibited from taxing. Generally, wholly instate trips (from one point in Washington to another) are fully subject to public utility tax. However, under current practice, interstate carriers are not subject to public utility tax on the instate portion of their transportation activities. The preference applies to the instate portion of interstate transportation of goods and passengers by truck, rail, and some water transportation.</td><td>The Legislature did not state its intent when the statute was enacted as part of the Revenue Act of 1935. However, the statute recognizes that the state cannot tax amounts derived from activities it is prohibited from taxing by the federal or state Constitution. Washington's practice of not collecting public utility tax on the instate portion of interstate transportation activities is no longer necessary to comply with Supreme Court doctrine.</td><td>$59.7 million in 2011-13 Biennium</td><td>Terminate: Because the U.S. Constitution no longer prohibits the instate portion of interstate transportation from being taxed. 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.</td></tr>
<tr><td colspan="4">Commission Comment (2010): 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.

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.

Legislative Action: No action taken.</td></tr>
<tr><td colspan="4">Additional Commission Comment (2012): The Commission notes that the Legislature took no action on the Commission's recommendation, and notes that the fiscal impact of these preferences exceeds $100 million per biennium. The Commission therefore recommends that the Legislature mandate JLARC to conduct an economic impact study of the preferences and appropriate sufficient resources to conduct this study. After the 2013 session, if the Legislature has taken no action the Commission will consider whether to schedule these preferences for further review.</td></tr>
</table>

Updated Comments on Select 2010 Tax Preference Performance Reviews

What the Preference Does	Public Policy Objective	Estimated Beneficiary Savings	Auditor Recommendation
Transportation, Through Freight (PUT) / RCW 82.16.050(8)			
Provides a deduction from the public utility tax for instate portions of interstate shipments of goods where the carrier authorizes the shipper to stop the shipment in Washington to store, manufacture, or process the goods, then continues to transport the same goods or their equivalent, in the same or a converted form, to the final destination noted under a through freight rate (also known as a through bill of lading). The preference applies to transportation of goods by truck, rail, and certain water transportation.	The Legislature did not state its intent when the preference was enacted in 1937. However, the implied intent appears to be based on the 1930s-era U.S. Supreme Court's analysis and interpretation of federal Commerce Clause prohibitions. This interpretation held that taxing any portion of interstate transportation activities, even instate portions, was a burden on interstate commerce and unconstitutional. However, this interpretation is outdated and no longer compatible with current Commerce Clause interstate taxation doctrine.	$32.2 million in 2011-13 Biennium	**Terminate:** Because this preference is no longer constitutionally necessary.

Commission Comment (2010): 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.

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.

Legislative Action: No action taken.

Additional Commission Comment (2012): The Commission notes that the Legislature took no action on the Commission's recommendation, and notes that the fiscal impact of these preferences exceeds $100 million per biennium. The Commission therefore recommends that the Legislature mandate JLARC to conduct an economic impact study of the preferences and appropriate sufficient resources to conduct this study. After the 2013 session, if the Legislature has taken no action the Commission will consider whether to schedule these preferences for further review.

Updated Comments on Select 2010 Tax Preference Performance Reviews

What the Preference Does	Public Policy Objective	Estimated Beneficiary Savings	Auditor Recommendation
Shipments to Ports (PUT) / RCW 82.16.050(9)			
Provides a deduction from public utility tax for transportation of commodities from a point in Washington directly to an instate port, dock, wharf, export elevator, or shipside for direct shipment by vessel outside the state. The preference is not available when the origin and point of delivery are within the same city. The preference applies to transportation of commodities by truck, rail, and certain water transportation.	The Legislature did not state its intent when the preference was enacted in 1937. However, the implied intent appears to be based on the 1930s-era U.S. Supreme Court's analysis and interpretation of federal Commerce Clause prohibitions. This interpretation held that taxing any portion of interstate transportation activities, even instate portions, was a burden on interstate commerce and unconstitutional. However, this interpretation is outdated and no longer compatible with current Commerce Clause interstate taxation doctrine.	$15.2 million in 2009-11 Biennium	**Review and clarify:** Since this tax preference 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.

Commission Comment (2010): 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.

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.

Legislative Action: No action taken.

Additional Commission Comment (2012): The Commission notes that the Legislature took no action on the Commission's recommendation, and notes that the fiscal impact of these preferences exceeds $100 million per biennium. The Commission therefore recommends that the Legislature mandate JLARC to conduct an economic impact study of the preferences and appropriate sufficient resources to conduct this study. After the 2013 session, if the Legislature has taken no action the Commission will consider whether to schedule these preferences for further review.

Commission Comments on Auditor Recommendations to DOR and OFM

In a supplement to the 2012 preference reviews, JLARC staff noted difficulties with two tools related to evaluating preferences: 1) the annual survey that the Department of Revenue uses to collect and report beneficiary information; and 2) the current version of the Office of Financial Management's Washington Input-Output Model.

The auditor made two recommendations:

1. The Department of Revenue should convene a work group to address how to improve the reliability and the accuracy of the information collected in the annual survey and reported to the Legislature and the public. The Department of Revenue concurred with the recommendation.
2. The Office of Financial Management should estimate the cost of including state government and local government as separate sectors within the Washington Input-Output model. The Office of Financial Management concurred with the recommendation.

The Commission endorsed the auditor recommendations.

ANNUITIES (INSURANCE PREMIUMS TAX)

Report Summary

What the Preference Does	Public Policy Objectives	Estimated Beneficiary Savings	Auditor Recommendation
Exempts life insurance companies from insurance premiums tax on payments received on "qualifying" and "non-qualifying" annuity contracts. "Qualifying" annuities qualify for federal tax deferrals on contributions.	The Legislature did not state the public policy objectives of the preference. JLARC infers that the public policy objective is to encourage individuals to save toward retirement, and to treat "qualifying" and "non-qualifying" annuities the same.	$188.7 million in 2013-15 Biennium	**Continue**: Because payments to "qualifying" and "non-qualifying" annuities are receiving the same tax treatment, and, to the extent tax savings are passed on, the exemptions are encouraging individuals to save for retirement.

ANNUITIES (INSURANCE PREMIUMS TAX)

Current Law

Current law exempts life insurance companies from insurance premiums tax on payments received on annuity contracts. Companies offering annuities receive a series of payments, called premiums, made at regular intervals over a period of more than a year. Two types of annuities receive this exemption:

1) "Qualifying" annuities that qualify for federal tax deferrals on contributions, such as 401(k)s, individual retirement accounts, and deferred compensation plans; and
2) "Non-qualifying" annuities that do not qualify for federal tax deferrals on contributions.

Typically, an employee contributes to a "qualifying" retirement plan through regular payroll deductions. The plan may, in turn, purchase annuities that make payments to employees when they are eligible to receive retirement benefits. Persons who invest in "non-qualifying" annuities may be already retired or may be employees that have exceeded limits for annual payroll contributions to a "qualifying" retirement plan. These individuals may invest in annuities and pay the premiums themselves.

See Appendix 3 for the current statutes, RCWs 48.14.020(1) and 48.14.021.

Legal History

1891 The Legislature imposed a tax on all insurance companies at a rate of 2 percent of gross premiums collected minus insurance company losses.

1926 Congress first allowed federal income tax deferrals for employee contributions to pension plans. This began a long history of Congress granting tax-deferred status for various types of retirement plans such as Individual Retirement Accounts (IRAs) and employer-sponsored salary reduction plans. These plans became known as "qualifying" retirement plans.

1947 The Legislature specifically applied the insurance premiums tax to premiums on annuities.

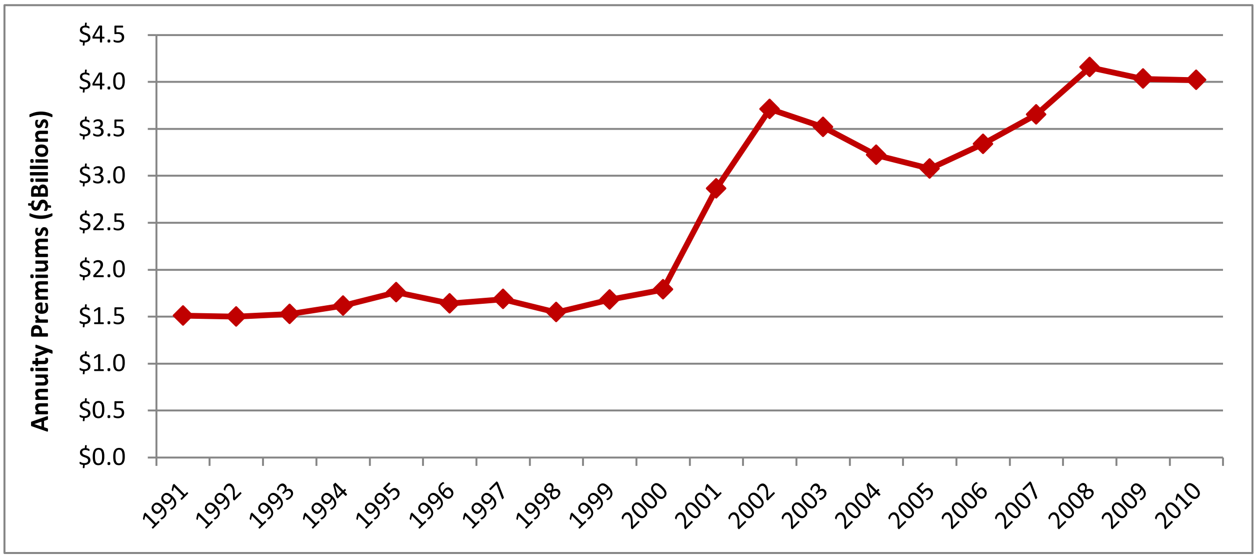
1963-1971 The Legislature began to phase out the insurance premiums tax on annuity premiums qualifying for federal income tax-deferred status. The Legislature fully eliminated the premiums tax on qualifying plans by 1971.

1979 The Legislature also exempted "non-qualifying" annuity premiums from the insurance premiums tax.

Other Relevant Background

Annual annuity premiums in Washington have grown by 166 percent over the last 20 years, suggesting that annuities have grown in popularity as a means of saving for retirement. Data on annuity premiums is not readily available prior to 1991. See Exhibit 1.

Exhibit 1 – Annuity premiums grew 166% between 1991 and 2010



Source: Annual Reports, Office of the Insurance Commissioner.

Public Policy Objectives

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

The Legislature did not state the public policy objective of the exemption for *qualifying* annuities. JLARC infers that the Legislature, like the federal government, wanted to encourage individuals to save toward retirement in "qualifying" retirement plans.

The Legislature stated that the public policy objective of the 1979 exemption for *non-qualifying* annuities is to provide equitable tax treatment for both types of annuities:

> *It is the intent of the Legislature to eliminate existing tax discrimination between qualified and nonqualified pension plans which are effectuated by annuity contracts, by excluding the consideration paid for such contracts from premiums subject to the premium tax.*

JLARC infers that the overarching policy objective of both tax preferences is to encourage Washingtonians to save toward retirement in both "qualifying" retirement plans and in "non-qualifying" individual annuities.

What evidence exists to show that the tax preferences have contributed to the achievement of any of these public policy objectives?

The tax preferences are achieving their inferred public policy objective to the extent that tax savings are passed on to purchasers of annuities, which may encourage individuals to save for retirement. Also, the exemptions for qualified and nonqualified annuities are meeting the stated objective of providing the same tax treatment under the insurance premiums tax.

To what extent will continuation of the tax preferences contribute to these public policy objectives?

To the extent that savings are passed on to the investor, continuation of the preference may encourage individuals to save for retirement and will continue to provide qualified and nonqualified annuities with the same tax treatment under the insurance premiums tax.

Beneficiaries

Who are the entities whose state tax liabilities are directly affected by the tax preferences?

Currently, 195 insurance companies sell annuity contracts in Washington with annual premiums of $4 billion.

Revenue and Economic Impacts

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

Exhibit 2, below, shows that life insurance companies saved $80.4 million in insurance premiums tax in 2010 and are estimated to save $188.7 million in the 2013-15 Biennium from the exemptions.

Exhibit 2 – Estimated 2013-15 Beneficiary Savings for Annuity Exemption from Insurance Premiums Tax

Year	Life Insurance Annuity Premiums	Insurance Premiums Tax Rate	Beneficiary Savings
2010	$4,018,800,000	2%	$80,400,000
2011	$4,089,700,000	2%	$81,800,000
2012	$4,282,300,000	2%	$85,600,000
2013	$4,448,500,000	2%	$89,000,000
2014	$4,626,400,000	2%	$92,500,000
2015	$4,811,500,000	2%	$96,200,000
		2013-15 Biennium	**$188,700,000**

Source: JLARC analysis of OIC Annual Reports and Economic and Revenue Forecast Council's February 2012 forecast of insurance premiums tax. Amounts for 2010 are based on actual premiums; amounts in the remaining years are estimates.

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

If the tax preferences were terminated, insurance businesses would pay premiums tax on payments they receive from annuity contracts. The insurance businesses might try to pass some or all of the 2 percent insurance premiums tax on to their customers. The Office of the Insurance Commissioner regulates premium rates and reports that it approves rates that are reasonable in relation to benefits, with allowances for expenses, profits, and sufficient reserves.

Other States

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

All states except California and West Virginia provide premiums tax exemptions for payments to qualified annuities. All states except California, Maine, Nevada, South Dakota, West Virginia, and Wyoming exempt payments to non-qualified annuities.

Auditor Recommendation:

The Legislature should continue the insurance premiums tax exemptions for payments on annuities because 1) payments to qualified and non-qualifying annuities are receiving the same tax treatment under the insurance premiums tax, and 2) to the extent tax savings are passed on, the exemptions are meeting the inferred public policy objective of encouraging individuals to save for retirement.

Legislation Required: No.

Fiscal Impact: None.

Biotechnology Manufacturing Deferral/Waiver (Sales and Use Tax)

Report Summary			
What the Preference Does	**Public Policy Objectives**	**Estimated Beneficiary Savings**	**Auditor Recommendation**
Provides a deferral and eventual waiver of state and local sales and use taxes on construction of facilities and purchases of machinery and equipment by firms engaged in manufacturing of biotechnology related products. Expires January 1, 2017.	The Legislature stated the public policy objectives of this deferral: 1) To encourage expenditures in commercial biotechnology operations, and 2) To develop employment opportunities in biotechnology manufacturing.	$1.4 million in 2013-15 Biennium	**Review and clarify**: To determine if progress toward biotechnology manufacturing objectives is sufficient and to consider identifying targets for investment and employment.

BIOTECHNOLOGY MANUFACTURING DEFERRAL/WAIVER (SALES AND USE TAX)

Current Law

Current law provides a deferral and eventual waiver of state and local sales and use taxes on construction of facilities and purchases of machinery and equipment by firms engaged in manufacturing biotechnology related products. Two types of products qualify:

1) **Biotechnology products:** Any virus, therapeutic serum, toxin, antitoxin, vaccine, blood, and certain other products used in the prevention, treatment, or cure of diseases or injuries to humans; and
2) **Medical devices:** Devices recognized in the national formulary or the U.S. pharmacopeia; intended for prevention, diagnosis, or treatment; or intended to affect the structure or function of the body.

Beneficiaries are required to submit an application to and receive approval from the Department of Revenue (DOR) prior to beginning construction or acquiring equipment. As long as the facility or machinery and equipment continues to qualify for the intended purpose, the deferred sales and use taxes do not need to be repaid. Beneficiaries must submit an annual survey by April 30 each year and continue the qualified use of the facility for eight years. Twelve and a half percent of the deferred tax is waived each year these criteria are met so at the end of eight years, taxes have been completely waived.

The sales and use tax deferral/waiver became effective July 1, 2006, and expires on January 1, 2017.

Current law also requires DOR to collect and report information to the Legislature and the public on the performance of this preference.

Depending on type of purchases and location of the manufacturing facilities, biotechnology manufacturers qualify for other sales and use tax preferences. All manufacturers statewide qualify for an exemption for certain machinery and equipment and related services. All manufacturers in high unemployment counties or community empowerment zones (areas within cities that are eligible for federal, state, and local assistance due to high unemployment and low household income) qualify for deferral and eventual waiver of sales and use taxes on both structures and equipment.

See Appendix 3 for the current statutes, RCWs 82.75.010 and 82.75.030.

Legal History

In the years leading up to enactment of the biotechnology manufacturing sales and use tax deferral/waiver in 2006, legislative and executive branch studies recommended that the state address startup costs of the emerging biotechnology manufacturing sector.

1991 The Biotechnology Advisory Committee recommended that the Legislature expand the existing sales and use tax deferral for rural manufacturers to apply to biotechnology manufacturers.

2001 The Governor convened the Washington State Competitiveness Council which recommended that the state provide more support for research, development, and commercialization of technology products in key industrial clusters such as biotechnology.

2004 At the request of the Governor, the Technology Alliance released a strategic plan for biotechnology. The Technology Alliance is a nonprofit organization whose members are representatives of high technology businesses and institutions. The plan called for "increasing the rate at which scientific discoveries and technological advancements are turned into commercial success." The plan recommended reducing the B&O tax rate for biotechnology manufacturing.

2006 The Legislature established this sales and use tax deferral/waiver program for commercial biotechnology manufacturers.

Public Policy Objectives

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

The Legislature expressly stated the public policy objectives of this deferral:

1) To encourage expenditures in commercial biotechnology operations, and
2) To develop employment opportunities in biotechnology manufacturing.

The Legislature did not identify specific targets associated with these objectives, for example, how many new employment positions it wanted and at what wage level.

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

The available evidence shows that the two public policy objectives are being fulfilled to a certain extent. However, it is unknown the extent to which this preference has encouraged this investment and employment growth. Beneficiaries of the biotechnology deferral reported that they have invested in manufacturing plant and equipment and that they have created new jobs for those facilities. The Legislature did not identify specific targets for these objectives.

1) Investment in Commercial Biotechnology Operations

Biotechnology manufacturers invested an estimated $21 million in manufacturing facilities and equipment between 2007 and 2010 based on $1.9 million in deferred sales and use taxes. Exhibit 3, below, illustrates that a total of six firms have completed ten projects in King and Snohomish counties. All of the projects have been expansions of previously existing facilities with structures comprising an estimated two-thirds of the costs and machinery and equipment comprising one-third of the costs. No new businesses established since 2006 have received the deferral. Applications have been approved for an additional two projects that have not yet been completed.

Exhibit 3 – Qualified Investment by Biotech Deferral Claimants 2007-2010

Name	# Projects	Project Cost	Location	New or Expanded Facility
Bio-Rad Laboratories Inc.	3	$9,910,000	King & Sno.	Expanded facility
Bayer Pharmaceuticals	1	$6,180,000	Snohomish	Expanded facility
Light Sciences Oncology	1	$2,200,000	King	Expanded facility
CMC ICOS Biologics Inc.	3	$1,420,000	Snohomish	Expanded facility
Nanostring Technologies	1	$740,000	King	Expanded facility
Oligoco Inc. (Blue Heron)	1	$320,000	Snohomish	Expanded facility
Total:	**10**	**$20,770,000**		

Source: JLARC analyses of DOR application and invoice data.

JLARC is unable to isolate what impact, if any, this tax preference had on investment in the ten projects. As noted earlier, the Legislature did not specify how many projects or what level of investment it intended to achieve with the tax deferral.

2) Employment Opportunities in Biotechnology

As shown in Exhibit 4 below, beneficiaries of the tax preference reported hiring 147 new employees since 2007, including 14 employees for new facilities. JLARC is unable to isolate what impact, if any, this tax preference had in creating these jobs, and the Legislature did not identify how many jobs it intended to create with the preference.

Exhibit 4 – Reported New and Existing Washington Employees of Biotechnology Deferral Claimants

Year	Number of Businesses Reporting	All Washington Employees	New Employees	New Employees Located in Expanded Facilities
2008	4	478	58	0
2009	4	475	19	0
2010	6	661	70	14
		Total:	**147**	**14**

Source: JLARC analysis of Department of Revenue survey data.

It is difficult to gain a clear picture of the overall employment performance for this tax preference based on the job information DOR is collecting. It is not clear how to reconcile the reported changes in the total number of employees with the reported number of new employees. For example, for years 2008 to 2009 the same four taxpayers reported **reducing** total employment and, at the same time, **creating** new employment positions. For further discussion, see the Supplement to this review, following this review.

It is also not clear whether the quality of the jobs offered by beneficiaries is being maintained. The percentage of employees earning wages of $60,000 or more remained stable over the period for which annual survey information is available. The percentage of employees with medical and dental benefits and the percentage enrolled in retirement plans fluctuate. In 2010, beneficiaries paid wages of $60,000 or more to 60 percent of their employees. They provided 87 percent of their employees with medical and dental benefits and 79 percent of their employees with retirement benefits. See Exhibit 5, below.

Exhibit 5 – Pay and Benefits Reported for All Employees by Biotechnology Deferral Claimants

Year	% Earning $60,000 or More	% Enrollees Medical	% Enrollees Retirement
2008	57%	93%	71%
2009	62%	86%	85%
2010	60%	87%	79%

Source: JLARC analysis of Department of Revenue survey data.

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

Continuation of the tax preference would continue to defer and eventually waive sales and use taxes for businesses investing in biotechnology manufacturing facilities in Washington. JLARC is not able to determine if the new investment and employees reported by beneficiaries are a direct result of the tax preference.

Beneficiaries

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

In the six years since enactment of the deferral, six firms have benefited from the biotechnology deferral for a lifetime total of $1.9 million in beneficiary savings. All deferrals have been taken by existing firms that are expanding their operations rather than by new businesses established since 2006 or businesses that are constructing new facilities. Projects have been located in King and Snohomish Counties.

Revenue and Economic Impacts

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

Exhibit 6, below, shows that beneficiaries of the sales and use tax deferral for investment in biotechnology manufacturing facilities and machinery and equipment saved an estimated $631,000 in state and local sales taxes in Fiscal Year 2010. Beneficiaries are estimated to save $1.41 million in the 2013-15 Biennium. These estimates are derived from DOR audit data. Because the amount of capital investment is volatile, JLARC adjusted the forecast in Fiscal Year 2010 to reflect a three-year average of deferrals.

Exhibit 6 – Estimated 2013-15 Beneficiary Savings for the Biotechnology Sales and Use Tax Deferral

Year	State	Local	Total
2010	$443,000	$188,000	$631,000
2011	$447,000	$190,000	$637,000
2012	$449,000	$191,000	$640,000
2013	$461,000	$196,000	$657,000
2014	$481,000	$204,000	$685,000
2015	$508,000	$216,000	$724,000
2013-15 Biennium	**$989,000**	**$420,000**	**$1,409,000**

Source: All amounts are estimates based on DOR invoice data and the February 2012 Revenue and Economic Forecast.

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

If the tax preference were terminated, some biotechnology manufacturers could qualify for certain other sales and use tax preferences. Manufacturers throughout the state qualify for the manufacturing machinery and equipment exemption. Biotechnology manufacturers in high unemployment counties or community empowerment zones qualify for a sales and use tax deferral/waiver on construction of facilities.

Without the tax preference, some beneficiaries would pay sales and use taxes on construction or expansion of facilities because they are located outside these counties or empowerment zones. The effect on employment and the economy would depend on the ability of these businesses to either absorb these additional costs or pass them on to their customers.

Other States

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

Few states provide sales and use tax preferences directly for constructing and equipping biotechnology facilities. Thirty states offer income tax credits for capital investments generally. Similarly, 32 states provide general sales and use tax exemptions for manufacturing machinery and equipment.

Louisiana and Minnesota provide sales and use tax exemptions specifically for construction of biotechnology facilities.

Auditor Recommendation:

The Legislature identified the public policy objectives for this tax preference for biotechnology manufacturers: 1) to encourage investment in commercial biotechnology operations, and 2) to create biotechnology jobs. However, the Legislature did not identify specific targets for these objectives. This JLARC review finds that, between 2007 and 2010, six existing biotechnology manufacturers invested in ten projects. These businesses reported on the annual survey that they hired 147 new employees in total, including 14 new employees located in the expanded facilities qualifying for the preference. Improvements are needed to strengthen the reliability of jobs data in the annual survey. (See the Supplement to this review for further discussion.) No new businesses created since 2006 are receiving the biotechnology deferral. If the Legislature takes no action on this preference, it will expire on January 1, 2017.

The Legislature should review and clarify this tax preference to determine if progress toward its biotechnology manufacturing objectives is sufficient and to consider identifying targets for investment and employment.

Legislation Required:	Yes.
Fiscal Impact:	Depends on legislative action.

Supplement to the Tax Preference Review of the Biotechnology Manufacturing Deferral/Waiver:

Improvements Are Needed in the Annual Taxpayer Survey

The Legislature stated in reference to the biotechnology manufacturing tax preference that "accountability and effectiveness are important aspects of setting tax policy," and that information on the tax preference is needed in order make decisions on the "best use of limited state resources." To allow for an on-going evaluation of the preference, the Legislature put in place mechanisms for DOR to collect and report information on the tax preference.

Mechanisms for collecting information from beneficiaries are:

- The **application** for deferred sales and use taxes, which businesses must file before initiating construction of facilities or purchasing machinery and equipment. The application provides estimates of employment and wages, project costs, and schedule for completing the project. DOR has to approve the application, and approved applications may be disclosed.
- Beneficiaries of the B&O tax credit and the sales and use tax deferral must file an **annual survey** with DOR that provides information on the amount of tax deferral claimed in the previous year, and employment, wages, and benefits for the preceding year. DOR may request additional information to measure results of the tax preference. The amount of the tax preference claimed may be disclosed. Other survey information must be aggregated by three or more beneficiaries.

The Legislature established three different mechanisms for DOR to report on the performance of this tax preference:

1) DOR is to provide **annual descriptive statistics** to the Legislature every October. DOR uses information collected in the annual survey in its descriptive statistics. The descriptive statistics include information on the amount of tax preference claimed as well as information about jobs, wages, and benefits. Information is summarized to protect confidential employment and wage data.
2) The Legislature originally directed DOR to complete two **evaluations** of this preference, one in 2009 and a second in 2015. The Legislature eliminated the 2015 DOR study requirement and transferred responsibility for the evaluation to JLARC as part of the tax preference review process.
3) **DOR is to provide** information to the public **on the amount of the sales and use tax deferral claimed in the previous year for each beneficiary. If the amount on the survey is incorrect, DOR may disclose the correct amount using other sources.**

DOR has completed the required annual descriptive statistics and the 2009 evaluation of the tax preference. DOR provides information to the public by posting deferral amounts on its website and in response to public requests. However, all three reporting mechanisms rely on survey information which overstates the amount of tax preference claimed.

Annual Surveys Do Not Provide the Information Needed by the Legislature to Evaluate the Preference

JLARC found inconsistencies between the tax preference information needed to evaluate the preferences and the information that DOR is collecting in the annual survey and providing to the Legislature and the public. This section provides two examples of this problem, one about the reported tax deferral amounts and one about reporting on job performance.

Reported sales and use tax deferral amounts

DOR is instructing the beneficiaries of the biotechnology manufacturing tax preference to report taxes deferred in a way that results in misleading reporting about the preference. To illustrate this problem, consider a business that builds a qualifying new facility, accumulating a $100,000 sales tax bill that it can defer under this preference if it maintains the qualifying use and submits its required annual surveys. If it does so for eight years, the sales tax is waived.

The biotechnology manufacturing business is exempt from $100,000 in sales tax one time, as it makes the necessary purchases to build its facility. DOR, however, is directing the business to report that one-time sales tax saving every year for eight years. Exhibit 7, below, illustrates the reporting that results from this practice. This reporting leaves the impression that the state is foregoing $100,000 in sales tax every year for this one project and that the amounts in each column could be added for an eight-year total.

Exhibit 7 – Example of How DOR's Reporting of the Annual Biotechnology Deferral Would Not Match Actual Sales Tax Deferred

1 Biotech Project	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8
Actual sales tax deferred	$100,000	$0	$0	$0	$0	$0	$0	$0
What DOR directs beneficiaries to report in the annual survey	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000
Deferral amount reported to the public by DOR	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000

Source: JLARC analysis of DOR annual survey instructions.

This JLARC review used actual sales and use tax amounts determined from audits of qualifying biotechnology manufacturing projects to overcome this problem.

Reported performance in creating jobs

The annual survey yields employment information that does not provide the Legislature with a clear picture of job performance among the beneficiaries of the biotechnology manufacturing tax preference. To illustrate this problem, Exhibit 8, below, shows the employment information on the annual survey for a two-year period for the same four beneficiaries of the tax preference that filed surveys in both years. These same beneficiaries reported **creating** 19 new positions between 2008 and 2009. They also reported **reducing** total employment by 3 employees. It is not clear what this means for overall employment performance for the taxpayer beneficiaries.

Exhibit 8 – Annual Survey Gives No Clear Picture of Job Performance

Year	Number of Biotechnology Business Beneficiaries	Reported Washington Employees of the Four Biotech Beneficiaries	Reported New Employees of the Four Biotech Beneficiaries
2008	4	478	58
2009	4	475	**19**
Change in total number of jobs between 2008 & 2009		**(3)**	

Source: JLARC Analysis of DOR Annual Surveys.

As a result of these and other problems, the surveys are not providing the Legislature or the public with reliable annual information on the performance of this tax preference as required by statute.

Auditor Recommendation:

The Department of Revenue should convene a work group to address how to improve the reliability and the accuracy of the information collected in the annual taxpayer survey and reported to the Legislature and the public.

Legislation Required: No.

Fiscal Impact: JLARC assumes that this can be completed within existing resources.

Implementation Date: In time for the 2013 annual survey.

BUSINESS INVENTORIES (PROPERTY TAX)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**Auditor Recommendation**
Exempts business inventories from property tax.	The Legislature stated that the public policy objective for exempting business inventories from the property tax is to stimulate the economy and, thereby increase revenues to the state and local governments.	$1.4 billion in 2013-15 Biennium	**Continue**: Because it has removed a competitive disadvantage relative to states where inventories are exempt.

BUSINESS INVENTORIES (PROPERTY TAX)

Current Law

Current law exempts business inventories from property tax. Business inventories include livestock and agricultural products, goods for resale, mobile homes that are part of dealers' inventories, and ingredients or components of articles manufactured for sale. Exempt business inventories do not include supplies, timber on public land sold under contract, and leased or rented property.

See Appendix 3 for the current statutes, RCWs 84.36.477 and. 84.36.510.

Legal History

Early exemptions for specific types of inventory

Business inventories had been taxed since 1881 when the Territorial Legislature imposed property taxes on all real and personal property. Over a period of years beginning in 1925, the Legislature extended personal property tax exemptions to certain goods being transported through Washington or being held temporarily in public or private warehouses in Washington. Later, the Legislature began extending the exemption to agricultural and forestry products before fully exempting business inventories in 1984.

The Legislature granted exemptions for certain types of business inventories under specific circumstances as follows:

1925 Ore or metal shipped from outside the state to a smelter or refining works inside the state and up to 30 days after being refined or reduced.

1927 Goods shipped from a U.S. territory or possession while being transported or held in storage for a limited time before being transported out of state.

1933 Agricultural and horticultural products if the producer owned the products.

1937 Grains, fruit, fish, and certain related products while being transported or held in storage for a limited time before being transported out of state.

1939 Vegetables and vegetable products while being transported or held in storage for a limited time before being transported out of state.

1961 Goods shipped from other states while being transported or stored for a limited time before being transported out of state.

1972 Unprocessed timber while being transported or stored for a limited time before being transported out of state.

Numerous attempts to exempt business inventories

Over a period of years, a number of legislative proposals attempted to eliminate or phase out the property tax on business inventories in response to studies of the impact of the tax on Washington's economy.

1969 A bill adopted by the Legislature would have phased out the property tax on business inventories over a period of ten years. However, the Governor vetoed the bill.

1973 As a part of a major tax restructuring that included a constitutional amendment creating an income tax, the Legislature provided for a phase-out of property tax on business inventories over a five-year period. In the next general election, voters rejected the constitutional amendment and, with it, the tax phase-out on business inventories.

A report prepared by legislative staff in the same year asserted that a tax on business inventories "adversely affected the business climate in Washington relative to its neighbors." The report noted that, at the time, California allowed a 50 percent reduction in the assessed value of inventory; Oregon had begun a phase-out that would fully exempt inventories in 1980, and Idaho fully exempted inventories. Also in 1973, the Governor appointed a citizen advisory group that recommended elimination of the property tax on business inventories.

1974 A bill enacted by the Legislature and signed by the Governor phased out the inventory tax by means of a credit against the business and occupation (B&O) tax over a ten-year period. The legislation scheduled the credit to end in 1984, at which time business inventories became fully exempt from property tax.

The bill also required the Department of Revenue (DOR) to report biennially to the Legislature on economic impacts of the phase-out and provide recommendations to ensure that the amount of incentive is "balanced" by increased revenues. DOR reported in subsequent biennia that the effect of the inventory tax phase-out could not be distinguished from other factors affecting the economy.

Efforts to address local property tax shifts and losses

The Legislature was aware that exempting inventories would shift the property tax burden onto other property owners and also result in tax losses to taxing districts because of the magnitude of the exemption. Generally, small property tax exemptions result in shifts in tax burden to other property owners. But there are limits to how much tax can be shifted before a property tax exemption results in losses to taxing districts. By law, taxing districts can increase levy rates until they reach statutory rate maximums. For example, cities can levy up to $3.60 per $1,000 of assessed valuation, thereby shifting the tax burden. Once a city reaches a levy rate of $3.60, it can no longer increase taxes, and any further exemption from the assessment roll results in revenue losses to the city. After passing the inventory exemption, the Legislature took steps to mitigate for local taxing district property tax shifts and losses as follows:

1975 Specified that leased or rented property did not qualify for the B&O tax credit and the exemption.

1982 Enacted an additional local option sales tax of up to 0.5 percent partly to compensate local governments for the anticipated loss in tax revenues from the exemption of business inventories.

1983 Provided $14 million over a four-year period to reduce the impact of tax shifts on property owners in districts severely affected by the inventory exemption.

Public Policy Objectives

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

The Legislature stated that the public policy objective for exempting business inventories from the property tax was to stimulate the economy and, thereby increase revenues to the state and local governments. In 1969 and 1973, Legislative leaders called for eliminating the tax on business inventories. Most western states had begun reducing or eliminating the tax and, according to reports, a number of warehouse and storage businesses had already moved to Oregon to take advantage of its more favorable property taxes. By the time Washington implemented the exemption for inventories in 1984, 35 states including all western states except Alaska had provided similar exemptions.

Testimony and reports suggested that eliminating a tax disadvantage for businesses that store goods for sale or transport, and for those that maintain inventories of ingredients and components would improve the economy by attracting and retaining businesses and by encouraging existing businesses to expand. The Legislature expected that this improvement in the economy would result in increased revenues to both the state and local governments.

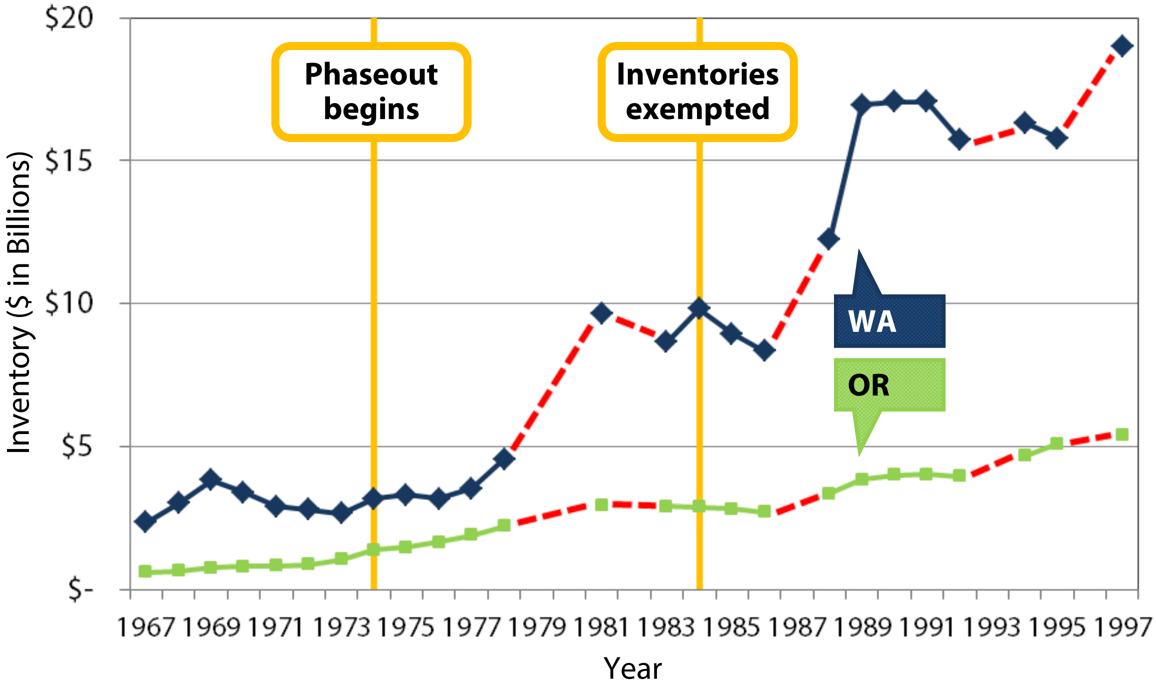
What evidence exists to show that the tax preference has contributed to the achievement of any of these public policy objectives?

Following implementation of the exemption, evidence shows that the value of Washington's business inventories increased and that state revenues increased, but local revenues lagged behind state revenue growth. However, it is not clear whether these inventory and revenue improvements can be attributed to the exemption.

Increased value of inventories

After the inventory exemption, Washington manufacturing inventories increased in dollar amount and increased more rapidly in relation to Oregon, a neighboring competitor. The U.S. Census has maintained data on manufacturing inventories at the state level for most years going back to the 1960s, and manufacturing inventories make up 50 percent of total Washington inventories. See Exhibit 9, on the following page.

Exhibit 9 – WA Manufacturing Inventory Growth Increased Relative to Oregon over 30 Years



Note: Inventories are interpolated – indicated by dashes – when Census data is not available.

Source: American Survey of Manufacturers and Economic Census of Manufacturing, U.S. Census.

Growth in manufacturing inventories could be explained by a number of other factors. After the conclusion of the phaseout of the tax on inventories in 1985, the Department of Revenue reported that "there were simply too many other economic changes occuring at the same time of the inventory [phaseout] both at the state and national level to permit an objective appraisal of the impact of the inventory tax [phaseout]." These factors included the general growth in the economy and the fact that inventories also rose for the U.S. as a whole.

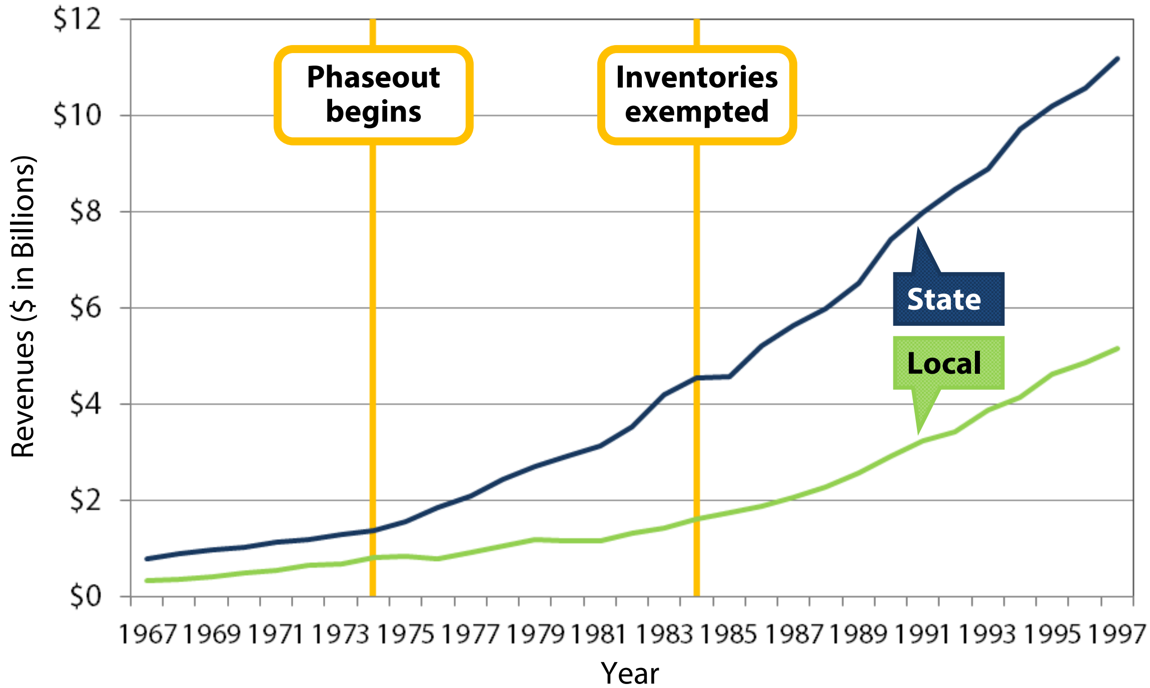
Another factor is that personal property is self-reported, and, according to a DOR study, businesses under-reported inventories until 1974 when they were required to report in order to claim the B&O tax credit for the tax on inventories.

For the same reasons, JLARC cannot conclude from this evidence whether the tax preference had an effect on the economy.

Increased state and local revenues

State and local revenues, including property tax and sales and use taxes, increased after inventories became exempt. JLARC is unable to isolate what impact, if any, this tax preference had on the increase in revenues. State revenues increased more rapidly than local revenues. Local taxing districts experienced greater difficulty absorbing the inventory tax exemption because their rates are more restricted than the state levy rate. The Legislature attempted to compensate local governments for the impact of the inventory exemption starting in 1982 by adopting an optional local sales tax of 0.5 percent. See Exhibit 10, below.

Exhibit 10 – State Revenue Growth Outpaced Local Revenue Growth



Source: State and Local Government Finances, U.S. Census.

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

Continuation of the tax preference allows businesses to maintain inventories in Washington without owing property tax. Because most states exempt business inventories from property tax, a tax on an estimated $43 billion in inventories in Washington would likely put the state at a competitive disadvantage.

Beneficiaries

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

Beneficiaries are businesses in Washington that hold inventories. According to 2007 Census reports, Washington manufacturers and construction businesses are the largest group of beneficiaries. Manufacturing businesses held about 50 percent of all inventories in Washington for the last period in which data are available. Inventories held by construction businesses amounted to 32 percent of all inventories.

Revenue and Economic Impacts

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

Beneficiaries saved an estimated $191 million in property taxes in Fiscal Year 2010 and are estimated to save $1.4 billion in the 2013-15 Biennium. See Exhibit 11, below.

Exhibit 11 – Estimated 2013-15 Beneficiary Savings from Business Inventory Property Tax Exemption

Year	State Property Tax	Local Property Tax	Total Beneficiary Savings
2010	$77,930,000	$113,060,000	$190,990,000
2011	$99,650,000	$125,270,000	$224,920,000
2012	$127,780,000	$334,650,000	$462,430,000
2013	$132,110,000	$534,740,000	$666,850,000
2014	$126,940,000	$554,580,000	$681,520,000
2015	$121,260,000	$567,780,000	$689,040,000
2013-15 Biennium	**$248,200,000**	**$1,122,360,000**	**$1,370,560,000**

Source: Annual Survey of Manufacturers and Economic Census, U.S. Census; national inventory growth provided by the Economic and Revenue Forecast Council, and DOR property tax estimation model. All amounts are estimates.

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

If the tax preference were terminated, businesses would be liable for the property tax on their inventories. The increase in taxes for businesses that hold stocks of inventory would likely result in some decline in the economy. However, there is not enough evidence to determine the magnitude.

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

The manufacturing and construction sectors hold the most value of inventory and would be the most severely impacted. Other property owners, particularly homeowners, would benefit because property taxes would shift from them to business property.

Other States

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

Nine states exempt all tangible personal property from property tax and, therefore, also exempt business inventory. An additional 30 states, including Washington, tax tangible personal property but specifically exempt business inventory. Business inventory is subject to property tax in the remaining 11 states.

Auditor Recommendation:

The Legislature should continue the property tax exemption for business inventories because it has removed a competitive disadvantage relative to states where inventories are exempt.

Legislation Required:	No.
Fiscal Impact:	None.

COMMUTING PROGRAMS (B&O TAX, PUBLIC UTILITY TAX)

Report Summary

What the Preference Does	Public Policy Objectives	Estimated Beneficiary Savings	Auditor Recommendation
Provides a credit against either B&O tax or public utility tax to employers and property managers for amounts they pay to or on behalf of employees that use commuting programs. Expires June 30, 2013.	The Legislature did not state the public policy objective of the preference. JLARC infers the public policy objective is to encourage businesses to provide financial incentives to their employees who participate in commute trip reduction programs that reduce single occupancy vehicle travel in Washington.	$0 in 2013-15 Biennium (The preference is scheduled to expire at the start of the 2013-15 Biennium.)	**Review and clarify:** Because while it is providing a credit to businesses that provide financial incentives to their employees who participate in commute trip reduction activities, it is unclear whether the preference is meeting the broader public policy objective of increasing participation in commute reduction programs.

COMMUTING PROGRAMS (B&O TAX, PUBLIC UTILITY TAX)

Current Law

This preference provides a tax credit against either business and occupation (B&O) tax or public utility tax (PUT) to employers and property managers in Washington for amounts they pay as financial incentives, either directly to employees or on their behalf, for using commuting programs. Eligible commuting programs include: car sharing, ride sharing, using public transportation, and using non-motorized commuting.

Each January, employers seeking the credit must apply to the Department of Revenue. The credit is:

- One-half of the amount paid to or on behalf of each participating employee, capped at $60 per employee per fiscal year;
- Limited to a $200,000 credit each fiscal year per employer; and
- Capped for the total statewide credit at $2.75 million per fiscal year.

If the total amount of applicants in any year exceeds the cap, the Department prorates the credits allowed for all applicants so the limit is not exceeded.

The tax credit is scheduled to expire June 30, 2013.

See Appendix 3 for the current statute, RCW 82.70.020.

Legal History

1963 Congress enacted the federal Clean Air Act to control air pollution on a national level.

1967 The Legislature passed the Washington Clean Air Act, the basis for state and local air pollution rules in Washington. Regulations at the state level must be as or more protective of human health and the environment than those of the federal Clean Air Act.

1991 The Legislature enacted legislation for "traffic demand management" – which would become the Commute Trip Reduction (CTR) law. The legislation's stated intent was "to require local governments in those counties experiencing the greatest automobile-related air pollution and traffic congestion to develop and implement plans to reduce single occupant vehicle commute trips." The legislation also aimed to reduce dependence on imported petroleum.

The legislation required each county with a population over 150,000 and each city within such a county that contained a "major employer" (one with at least 100 full-time employees at a specific business location in Washington, including state agencies) to implement a program to reduce single occupant vehicle commuting in order to meet specific reduction goals provided in the statute. Local governments in counties with less severe pollution and traffic congestion could voluntarily implement such plans. The 1991 legislation did not provide any B&O or PUT credits.

1993 A bill was introduced to provide incentives to encourage ride sharing. The bill called for providing a motor vehicle excise tax (MVET) exemption for private vehicles used for ride-sharing involving at least four persons (including the driver). Testimony by the prime sponsor and others noted that additional incentives were needed to reduce single occupancy vehicles and help businesses meet CTR goals. The bill was not enacted.

1994 The Legislature passed a revised version of the 1993 bill, establishing new credits against B&O tax and PUT for employers in the eight largest counties (King, Pierce, Snohomish, Spokane, Clark, Kitsap, Yakima, and Thurston). The credits began June 9, 1994, and were set to expire December 31, 1996. The reduction in B&O tax and PUT collections was offset by a transfer from the air pollution control account (APCA).

Eligible employers had to have at least 100 employees at a specific business location and had to provide financial incentives to employees participating in a CTR ride-sharing program for vehicles carrying four or more people. Participants applied to the Department of Revenue (DOR), the agency administering the credit program. The credit was limited to 50 percent of the amount paid to each qualified employee and capped at $60 per employee per year. Total credits for the program could not exceed $2 million per calendar year, with a maximum credit for any employer of $200,000.

At the time, the State Energy Office estimated 980 business sites representing 550 businesses were eligible for the credits. Many of these firms already had commute trip reduction programs in place. According to the DOR, the credits were not expected to generate significantly higher participation in such programs. The projected amounts were $29,700 for Fiscal Year 1995 and $35,610 for Fiscal Year 1996.

1996 The Legislature extended the expiration date for the Commute Trip Reduction B&O and PUT credits to December 31, 2000, and made the following changes:

- Extended the credit to any county, not just the eight largest;
- Allowed the credit to be used by any employer, not just "major" employers;
- Extended the credit beyond ride-sharing to public transportation and non-motorized commuting;
- Lowered the minimum number of passengers for ride-sharing vehicles from four to two, but lowered the credit for vehicles carrying two people to 30 percent from 50 percent;
- Reduced the annual state cap from $2 million to $1.5 million/calendar year; and
- Reduced the maximum credit per business from $200,000 to $100,000.

1999 The Legislature enhanced the CTR credit program to:

- Raise the credit's annual state cap to the lower of $2.25 million or the amount provided from the air pollution control account transportation account (APCA) and public transportation systems account appropriations to offset reductions in B&O tax and PUT.
- Extend the credits to property managers that pay B&O tax or PUT and provide commute trip reduction financial incentives to employees. Property managers are companies operating shopping centers or office buildings where a number of businesses with less than 100 employees are located.

The bill passed by the Legislature extended the expiration date to December 31, 2006.

The Governor, however, vetoed extending the expiration date, citing concerns over the financial impact to the APCA. His veto message noted:

> *Sections 6 and 7 of the bill would extend the entire CTR tax credit program to December 31, 2006. Based upon the last proposed legislative transportation budget, this bill as drafted, combined with the operating budget for the 1999-2001 biennium, creates a shortfall in the APCA of between $1.3 million and $2.4 million in the next biennium.*
>
> *I support extension of the CTR tax credit as a means of reducing traffic congestion. However, I cannot in good faith support the long-term implementation of the statutory changes contained in sections 1 through 5 of this bill unless the legislature also provides a solution to the projected deficit in the APCA.*
>
> *. . . I am directing the Office of Financial Management to work with the Department of Ecology, Department of Transportation, Legislative Transportation Committee, Senate Ways and Means Committee, and House Appropriations Committee to develop a workable proposal for funding the APCA and the CTR tax credit program, for implementation during the 2000 regular legislative session.*[1]

2000 The Legislature repealed the motor vehicle excise tax (MVET) effective January 1, 2000. Because the MVET largely funded the APCA and transportation account, the repeal eliminated the credits' funding sources. Various bills to extend the CTR tax credits, including a proposal by the Governor to fund the credits directly through the General Fund, were not enacted. Thus, the Commute Trip Reduction B&O tax and PUT credits were not funded during 2000, and the credits expired on December 31, 2000.

2001 An Office of Financial Management-request bill was introduced that would reinstate the credit, increase the credit cap, and expand program eligibility by providing funding through the multimodal transportation account. Proponents testified that reinstating the CTR credit demonstrated that the state valued employers' investments, would ease the burden on employers required to comply with CTR requirements, and would create a public/private partnership to provide additional assistance to businesses providing financial incentives to employees. The bill was not enacted.

2002 The Legislature reinstated the CTR tax credits with funds provided through a multimodal transportation account whose funding was dependent on passage of State Referendum 51 (transportation funding plan). When Referendum 51 was rejected by the state's voters on November 5, 2002, the legislation to reinstate the CTR credits became null and void.

2003 The Legislature again reinstated the CTR tax credits beginning July 1, 2003. Funding for the credits was provided by the multimodal transportation account, enacted in the 2003 transportation revenue bill. The credits were scheduled to expire June 30, 2013. Employers and property managers had to apply to DOR and were allowed a credit of up to $60 per employee per year, or up to 50 percent of the paid CTR incentives, whichever was less.

[1] Governor's veto message for SSB 5781, May 18, 1999.

Credits could be carried forward up to three years. Credits were limited to $200,000 per employer per year and were capped at $2.25 million per fiscal year.

2005 The Legislature changed the CTR tax credit program to:

- Require employers/property managers to apply to DOR annually in January;
- Allow any unused credits to be carried forward and used later (up to June 30, 2013); and
- Increase the CTR program credit cap from $2.25 to $2.75 million per fiscal year.

The January application period allowed DOR to receive all employer applications and to equitably distribute the available credit amount between all of the applicants, based on the detail provided in the application. Previously, the credit funds were available to applicants on a first-come, first-served basis.

Other Relevant Background

What is the Commute Trip Reduction Program?

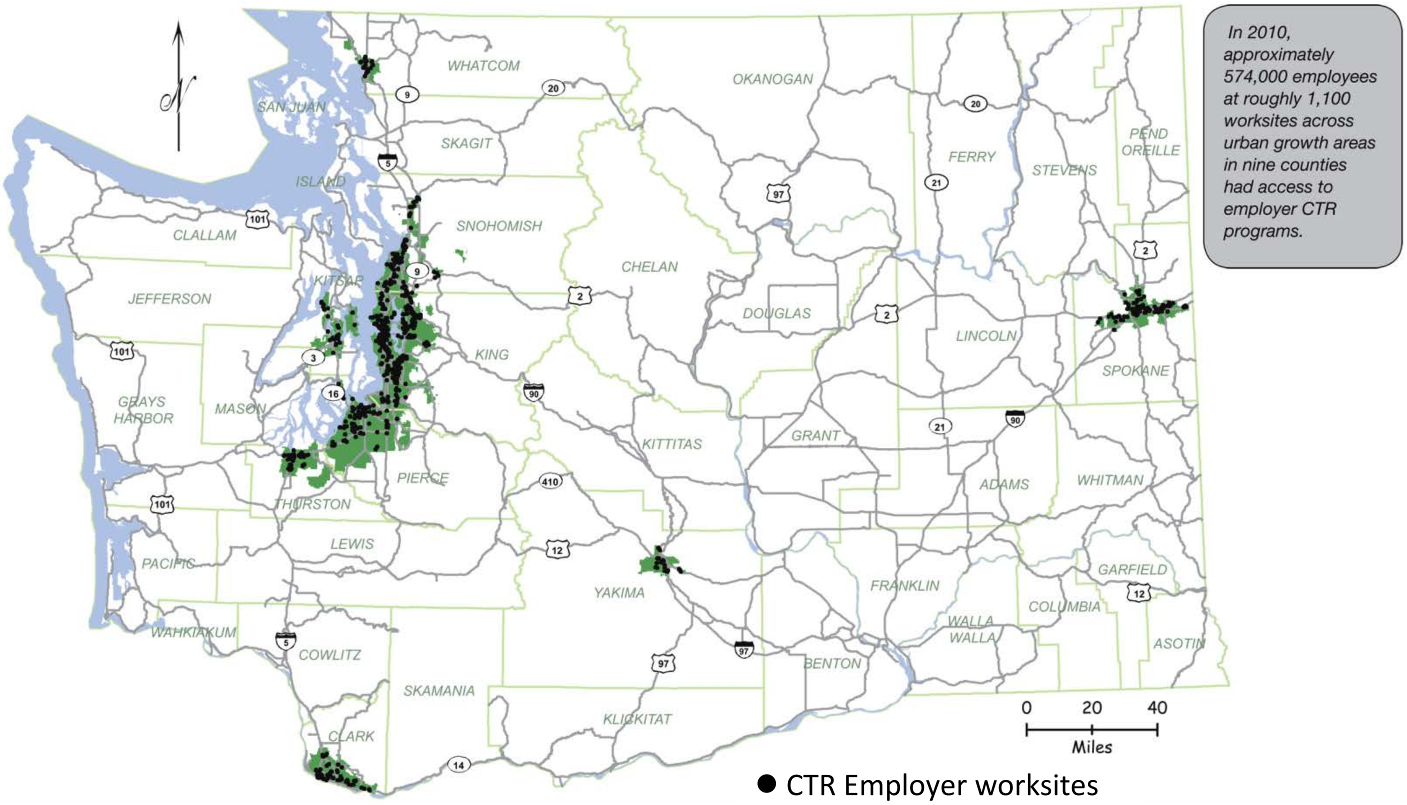
Washington's Commute Trip Reduction program was created by the Legislature in 1991 and incorporated into the state's Clean Air Act. The program's goals are to reduce traffic congestion, air pollution, and gasoline consumption through employer-based programs that reduce the number of commute trips made by solo drivers.

The CTR program focuses on commuters traveling to large worksites and dense employment centers through congested areas during the morning peak travel period. The program directs "major employers" in urban growth areas with the most traffic congestion to implement programs to reduce the proportion of employees who drive alone to work. Major employers are defined in the law as private or public employers (including state agencies) with 100 or more full-time employees at a single worksite who start their regular workday between 6 and 9 a.m. on weekdays for at least 12 consecutive months.

WSDOT has adopted rules that set the program's goals and targets. The first goal is to reduce drive-alone travel by CTR commuters in urban growth areas, and the target based on that goal is a 10 percent reduction in single occupancy vehicle trips by 2012. The second goal is to reduce greenhouse gases and air pollution by a 13 percent reduction in vehicle miles traveled (VMT) per employee by 2012. According to the Washington State Commute Trip Reduction Board, CTR worksites achieved reductions of about 4.8 percent in the drive-alone rate and about 5.6 percent in VMT per employee from the 2007-08 baseline survey to the 2009-10 progress survey – a reduction of nearly 16,000 vehicle trips. It is too early to tell whether the program will meet its 2012 goals.

In 2010, approximately 574,000 employees at roughly 1,100 worksites across urban growth areas in nine counties have employer CTR programs available to them. See Exhibit 12, on the following page.

Exhibit 12 – CTR Employer Worksites are Concentrated in Urban Areas



Source: CTR 2011 Report to the Washington State Legislature.

Public Policy Objectives

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

This discussion of public policy objectives has two components: the broad public policy objective for the commute trip reduction program itself and a more specific inferred public policy objective of establishing the tax credits.

Although the Legislature did not state a public policy objective specifically for the tax credits, the Legislature did state a broad public policy objective for the commute trip reduction program. In 1994, when it first provided B&O tax and PUT credits to major employers providing financial incentives to employees for participating in ride-sharing, the Legislature stated:

> *It is the intent of the Legislature to revise those portions of state law that inhibit the application of imaginative solutions to the state's transportation mobility problems and to encourage many more public and private employers to adopt effective transportation demand management strategies.*

Based on this statement, JLARC infers that the public policy objective of the credits is to encourage businesses to provide financial incentives to their employees who participate in CTR programs that reduce single occupancy vehicle travel in Washington.

Testimony by the prime sponsor and others in 1993 and 1994 stated that major employers implementing CTR programs needed financial incentives to help them meet the goals of the 1991 CTR law. They noted such incentives would help businesses convince employees to stop using single occupancy vehicles and participate in ride-sharing. A 1994 House bill report noted testimony stated that the credits send "... a message to the business community that the state wants to be a partner in dealing with air pollution, traffic congestion, and reducing dependency on foreign oil – all laudable goals of the act."

When the credits were reinstated July 1, 2003, no public policy objective was provided in the legislation. The prime sponsor of the bill testified in House and Senate Transportation Committee hearings that providing the tax credits was part of an effort to move transportation forward, that the CTR program was very successful in taking single occupancy cars off the roads, and that the program was supported by both business and environmental groups. Other testimony noted the credits could make a difference to smaller employees that were not required to participate in CTR programs but wanted to provide incentives to employees participating in CTR activities.

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

Encouraging businesses to provide CTR financial incentives to their employees: Department of Revenue CTR credit data reveals that the number of employers applying for and taking the B&O tax and PUT credits continues to grow each year, as does the amount of credit requested. CTR credit applications from 2006 (the first year that the law allowed DOR to prorate the credit among all applicants depending on their request, rather than providing the credit on a first-come, first-served basis) show the total requests for credits have consistently grown from the prior year, even though the statutory limit has remained at $2.75 million since 2006. DOR provides credits to each applicant, based on the information provided in their applications. Of the total credits used in Fiscal Year 2011, 96 percent were for B&O tax. See Exhibit 13, below, for a summary of the CTR credits awarded from 2006 through 2011.

Exhibit 13 – Number of Employers Taking CTR Credit Continues to Grow

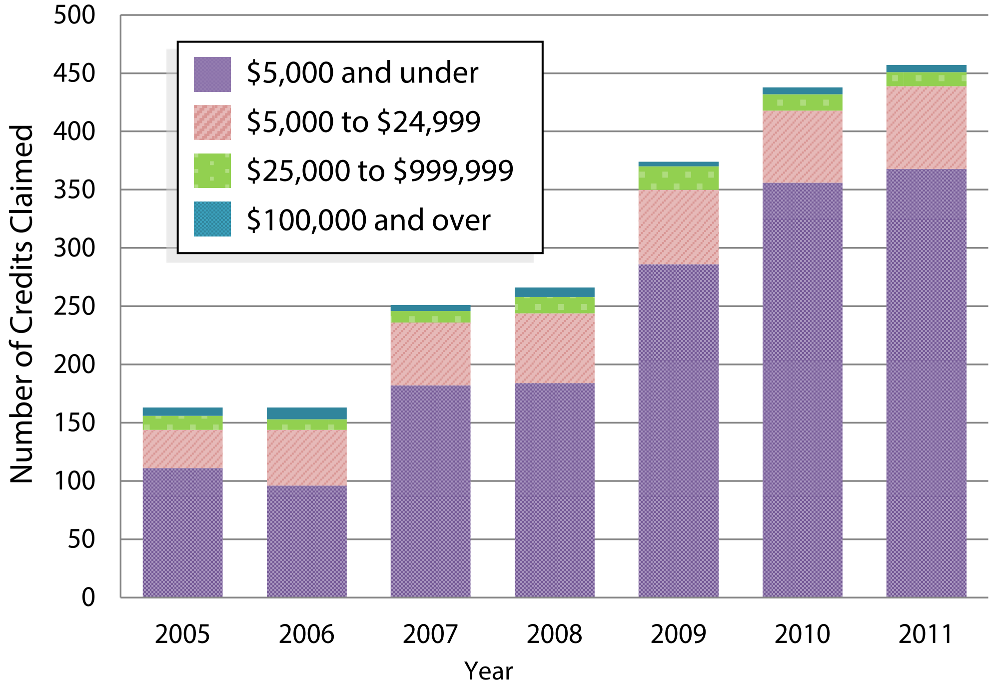
FY	Number of Employers Taking Credits	Total Credit Requests by Employers	Total CTR Credits Used	Statutory Credit Limit
2006	163	\$3,311,013	\$2,220,179	\$2,750,000
2007	251	\$3,959,163	\$2,029,179	\$2,750,000
2008	266	\$4,090,719	\$2,510,880	\$2,750,000
2009	374	\$4,759,259	\$2,528,217	\$2,750,000
2010	438	\$4,802,684	\$2,526,750	\$2,750,000
2011	457	\$6,343,310	\$2,290,633	\$2,750,000

Note: The statutory credit cap is reached every year; however, the amount of credit claimed may be less than the credit cap due to businesses not having enough tax liability to use all of their available credits. Such credits are carried over and may be used in future years through June 30, 2013.

Source: DOR CTR form data, FY 2006-2011.

In addition, the 2005 change requiring all applicants to apply annually in January allowed DOR to distribute the available credit among all applicants rather than providing the credit on a first-come, first-served basis. This has resulted in more small employers who receive total credits of less than $5,000 to participate in the program. See Exhibit 14, below.

Exhibit 14 – 2005 Change Allows More Small Employers to Participate in the Program



Source: DOR CTR application data, 2005-2011.

Encouraging more public and private employers to adopt effective transportation demand management strategies: JLARC is unable to determine whether the preference has had any impact on the broader public policy objective of encouraging people to reduce use of single occupancy vehicles. We found two seemingly conflicting statements regarding the effect on CTR program participation for the 3 ½ year period between January 1, 2000, and June 30, 2003, when the CTR B&O tax and PUT credits were not funded or had expired.

The Washington State Commute Trip Reduction Board provides reports to the Legislature on the CTR Program. In its 2001 report, the Board stated that when the B&O tax and PUT credits were discontinued effective January 1, 2000, the number of businesses participating in the CTR program dropped and stated:

> The Task Force recommends that the Legislature reinstate a rideshare tax credit for private sector employers that was discontinued in 1999. Between 1994 and 1999 employers that provided direct subsidies to employees for commuting without driving alone were able to receive a credit . . . against their business and occupation or public utility taxes. Employers who took advantage of the tax credit were more than five times as effective in reducing the drive-alone rate to their worksites than other CTR employers. The tax credit was very

successful in encouraging sites not participating in CTR to provide commute programs to their employees.

However, data compiled by WSDOT reflects that, during the period when the B&O/PUT credit was not provided (January 1, 2000, through June 30, 2003), the number of worksites and employees participating in the CTR program grew more than they did after the credit was reenacted. See Exhibit 15, below. In addition, testimony in 2003 by a representative for the Washington Transit Association noted that the number of employers participating in the CTR program grew by 12 percent from 1999 to 2001. The credit was not funded during either 2000 or 2001.

Exhibit 15 – Participating Worksites and Employees Increased Without a B&O or PUT Credit

FY Biennium	Participating Worksites	Participating Employees	Growth in Employees from Prior Year
1997-99	981	401,356	
1999-01	1,008	445,453	10%
2001-03	1,051	483,104	8%
2003-05	1,054	516,332	6%
2005-07	1,056	527,665	2%
2007-09 *	841	546,921	4%
2009-11	912	575,967	5%

CTR B&O/PUT credit not in effect from 1/01/2000 through 6/30/2003. Growth in participation was greater during this period than after the credit was reinstated.

*Change in program baseline and other elements altered how worksites and employees are counted, beginning in FY2007.

Source: WSDOT CTR participation data provided by Kathy Johnson, WSDOT CTR coordinator.

Overall, data shows the number of participating employers and employees in the CTR program has grown steadily since 1996. Growth did not stop when the credit was not in effect from January 1, 2000, through June 30, 2003.

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

Continuation of the preference would continue to provide a credit to businesses that provide financial incentives to their employees who participate in CTR programs. It is unclear whether the B&O tax and PUT credits contribute to the broader public policy objective of encouraging employers and employees to participate in the CTR program. As reflected in Exhibit 15, above, during the time period the credits were discontinued, participating worksites and employees grew at a greater rate than at any time since the credits were reinstated (July 1, 2003).

Beneficiaries

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

In Fiscal Year 2011, the 457 employers and property managers that took the credit were the direct beneficiaries of the preference. These employers/property managers were able to reduce their B&O taxes or public utility taxes by 50 percent of the amount they paid as financial incentives to or on behalf of employees that participated in ride-sharing, using public transportation or car-sharing, or using nonmotorized commuting.

Revenue and Economic Impacts

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

Assuming current law is not changed, JLARC estimates there will be no beneficiary savings realized by participants in the 2013-15 Biennium, as the credit is scheduled to expire June 30, 2013. See Exhibit 16, below. JLARC based estimates for Fiscal Years 2012 and 2013 on credit amounts taken by beneficiaries since 2006, which have averaged $2,350,973 since the cap was set at $2.75 million in 2005.

Exhibit 16 – Estimated 2013-15 Beneficiary Savings for Commute Trip Reduction B&O Tax and PUT Credits

Fiscal Year	Total CTR Credits Taken
2010	$2,528,000
2011	$2,291,000
2012	$2,351,000
2013	$2,351,000
2014	$0
2015	$0
2013-15 Biennium	**$0**

Source: FY 10-11 from DOR CTR data; 2012-2013 is average credit amount taken by participants since $2.75 M cap enacted. Credits expire June 30, 2013.

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

If the tax preference was terminated, current beneficiaries would not be provided B&O tax credits or PUT credits for 50 percent of the amounts they provide as financial incentives to employees for participating in various commute trip reduction activities, such as ride-sharing, carpooling, biking, walking, or using public transportation services. It is unknown whether the loss of the credit would affect participation rates by businesses or their employees.

Other States

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

In addition to Washington, JLARC found five other states that provide employers with a credit from applicable business taxes for employee commuting programs (Colorado, Delaware, Georgia, Maryland, and Minnesota).

Auditor Recommendation:

If the Legislature takes no action on this preference, it will expire on June 30, 2013.

The Legislature should review and clarify this preference, because while it is providing a credit to businesses that provide financial incentives to their employees who participate in Commute Trip Reduction activities, it is unclear whether the preference is meeting the broader public policy objective of increasing participation in commute reduction programs.

Legislation Required:	Yes.
Fiscal Impact:	Depends on legislative action.

CONDOMINIUM AND HOMEOWNER MAINTENANCE FEES (B&O TAX)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**Auditor Recommendation**
Provides condominium, apartment, and homeowners' associations with a deduction for fees paid by owners to cover costs of repair, maintenance, replacement, management, or improvement of residential structures and "commonly held property."	The Legislature did not state a public policy objective for the preference. JLARC infers that the public policy objective is to provide equal tax treatment between homeowners who pay directly for their home maintenance and homeowners who pay maintenance fees to an association.	$20 million in 2013-15 Biennium	**Continue:** Because it is providing equal tax treatment between homeowners who pay directly for their home maintenance and homeowners who pay maintenance fees to an association.

CONDOMINIUM AND HOMEOWNER MAINTENANCE FEES (B&O TAX)

Current Law

Condominium, apartment, and homeowners' associations may deduct from their business and occupation (B&O) tax base the fees paid by owners to cover costs of repair, maintenance, replacement, management, or improvement of residential structures and "commonly held property."

The deduction is not allowed for fees or charges made for use of property by the public unless they are guests accompanied by a member.

"Commonly held property" includes areas required for common access such as reception areas, halls, stairways, and parking; it may also include recreation rooms, swimming pools, and small parks or recreation areas. "Commonly held property" does not include more grounds than are normally required in a residential area or include such extensive areas as required for golf courses, campgrounds, hiking, and riding areas, and boating areas.

To receive the deduction, the association must meet these qualifications:

- The salary or compensation paid to officers, managers, or employees must be only for actual services they performed and at levels comparable to similar positions within the county;
- Dues, fees, or assessments more than needed for the eligible purposes must be rebated to the members of the association; and
- Assets of the association or organization must be distributable to all members and must not benefit any single member or group of members.

See Appendix 3 for the current statute, RCW 82.04.4298.

Legal History

1947 In *North Pacific Coast Freight Bureau v. WA,* the Washington Supreme Court established that member-funded organizations must pay B&O tax on their gross income. The case involved a freight bureau operating for the benefit of member railroads.[2]

1979 Using the argument in *North Pacific*, Department of Revenue (DOR) auditors assessed back taxes on a Seattle condominium association. The association appealed the assessment in Thurston County Superior Court.

In the 1979 session, the Legislature established this deduction in statute for condominium and homeowner association fees used for repair, maintenance, and management of residential structures, and commonly held property.

[2] *North Pacific Coast Freight Bureau v. WA, 12 Wn.2d 563 (1942).*

1987 DOR determined that fees collected from the members of a commonly owned tennis club, not involving residential property, are not entitled to this deduction. The deduction only applies to property that is held in common by an association of owners of residential property.

1995 DOR ruled that fees assessed by a homeowner association for the operation and improvement of a common water distribution system are not entitled to the deduction.

Other Relevant Background

The federal Internal Revenue Service allows condominium, timeshare, and homeowner associations to deduct membership fees, dues, or assessments for making principal and interest payments, and maintaining the association property. Washington's B&O tax deduction does not apply to timeshare associations or to fees collected for making principal and interest payments.

Public Policy Objectives

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

The Legislature did not state a public policy objective for the preference.

JLARC infers from the public record that the Legislature intended to provide equal tax treatment between homeowners who pay directly for their home maintenance and homeowners who pay maintenance fees to an association. The Senate sponsor speaking on behalf of the tax preference on the Senate floor stated that the policy objective is to exempt fees for ordinary homeowner activities like "maintenance, mowing the grass, taking out the garbage" for which DOR had recently begun asserting the tax.

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

The inferred public policy objective is being achieved because it is providing equitable treatment between members of condominium and homeowner associations and residential property owners who are not members of associations. A homeowner association collects fees from members to pay for costs of repairing, maintaining, replacing, managing, or improving commonly held property. Residential property owners must pay for these services from household income. With this deduction, neither forms of income are taxed under the B&O tax.

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

Continuing the preference will continue to provide equal tax treatment between homeowners who pay directly for their home maintenance and homeowners who pay maintenance fees to an association.

Beneficiaries

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

The beneficiaries of the tax preference are the estimated 12,000 condominium and homeowner associations in Washington. There are an estimated 500,000 residential property owners who are association members.

Revenue and Economic Impacts

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

Condominium and homeowner associations saved an estimated $7.1 million in B&O taxes in Fiscal Year 2011. For the two-year period of the 2013-15 Biennium, beneficiaries are estimated to save $20 million. See Exhibit 17, below.

Exhibit 17 – Estimated 2013-15 Beneficiary Savings for the Condominium and Homeowner Association Fee B&O Tax Deduction

Fiscal Year	Total Fees	Rate	Beneficiary Savings
2010	$404,860,000	1.55%	$6,280,000
2011	$395,480,000	1.80%	$7,120,000
2012	$407,740,000	1.80%	$7,340,000
2013	$486,390,000	1.80%	$8,760,000
2014	$615,660,000	1.50%	$9,240,000
2015	$714,320,000	1.50%	$10,720,000
		2013-15 Biennium	**$19,950,000**

Note: Higher service rate in effect from May 1, 2010 to June 30, 2013, 2ESSB 6143 §1101 (1st sp. sess., 2010).

Source: 2009 American Community Survey; Dawn Bauman, Executive Director, National Board of Certification for Community Association Managers; and OFM Population Survey.

Statewide data on homeowner fees is not available. JLARC estimated the beneficiary savings by estimating that 112,000 condominium and 404,000 homeowners paid fees to associations. Data used for this purpose came from the National Board of Certification for Community Association Managers, the OFM Population Survey, and the American Community Survey (ACS) conducted by the U.S. Census. Median fees paid to condominium associations are $250 a month for Seattle, Snohomish, and Pierce County according to the ACS. Homeowner association fees average $150 annually, according to the DOR.

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

If the tax preference were terminated, some condominium and homeowner associations would still not pay B&O tax, for two reasons. First, there is a minimum annual income threshold of $12,000 for reporting B&O tax. While the average income for homeowner associations is $33,000 a year, the income of smaller associations could fall below the reporting threshold. Second, there is a B&O tax credit for small businesses. The average monthly tax on association income is $49, which would be eliminated by the small business credit.

Other States

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

A total of 33 states exempt condominium and homeowner associations from tax, most by linking their policy to federal tax laws, which specifically exempt income of homeowner associations. California specifically exempts condominium associations from tax.

Auditor Recommendation:

The Legislature should continue the deduction for condominium and homeowner maintenance fees because it is meeting the inferred public policy objective of providing equal tax treatment between homeowners who pay directly for their home maintenance and homeowners who pay maintenance fees to an association.

Legislation Required:	No.
Fiscal Impact:	None.

Ferry Boats (Sales and Use Tax)

Report Summary

What the Preference Does	Public Policy Objectives	Estimated Beneficiary Savings	Auditor Recommendation
Exempts from sales/use tax purchases by state and local governments of ferry boats and component parts, as well as labor and services to build, repair, or maintain such vessels.	The Legislature did not state the public policy objective of the preference. JLARC infers the public policy objective is to support state and local governments by reducing the cost of building and repairing ferry vessels owned and operated by state and local government entities.	$26.1 million in 2013-15 Biennium	**Continue:** Because it is meeting the inferred public policy objective of reducing the cost to state and local government entities of building, maintaining, and repairing ferry vessels they own and operate.

FERRY BOATS (SALES AND USE TAX)

Current Law

State and local government entities are exempt from sales tax on purchases of ferry vessels and purchases of labor and services to construct, repair, or maintain ferry vessels. In addition, use of ferry vessels, tangible personal property that becomes a component part of a ferry, or labor and/or services performed to repair or improve ferries by state or local governmental entities is exempt from use tax.

In 2011, the Legislature enacted a related sales and use tax exemption for fuel purchased for use in ferry vessels by the Washington State Ferry System or a county-owned ferry system. The exemption takes effect on July 1, 2013, and is not yet scheduled for JLARC review.

See Appendix 3 for the current statutes, RCWs 82.08.0285 and 82.12.0279.

Legal History

1800s	Beginning in the mid-1800s, Puget Sound was served by a number of private ferry operators often referred to as "the Mosquito Fleet." Their numbers peaked after the Yukon gold rush in the 1890s.
Early 1900s	With improved and expanded rail and highway systems, the number of private ferry passengers and operators decreased. By 1936, only one private operator, Puget Sound Navigation Company (PSNC), operating the "Black Ball" ferry fleet, remained.
1944	Washington adopted the 18th amendment to the state constitution, creating a state highway fund, funded by vehicle license fees and excise taxes on motor vehicle fuel. The amendment declared the highway fund could only be used for "highway purposes." The state recognized ferry routes as a continuation of the highway system, and thus state ferries were eligible for this funding. However, the law stipulated that highway fund money could not be used for passenger-only ferry services.
Late 1940s	Citing increased labor and operating costs, PSNC petitioned the State Highway Department for a 30 percent fare increase, but the Legislature repeatedly rejected the request.
1951	PSNC sold all of its terminal facilities and ferries (except the Seattle/Port Angeles/Victoria B.C. route) to the newly created Washington Toll Bridge Authority, now Washington State Ferries (WSF). The state ferry system was originally intended to provide temporary service until an anticipated network of bridges could be built connecting the west and east sides of Puget Sound.
1959	The Legislature rejected plans to build cross-sound bridges, making the state ferry system a permanent part of the state transportation system.

1977 The Legislature adopted a new state ferry procurement/construction process which included a sales/use tax exemption for purchases or construction of state ferries and for items that became component parts of ferries. The preference also included a sales tax exemption for associated labor or service charges for constructing or repairing state ferry vessels.

1979 The Legislature expanded the state ferry sales and use tax exemptions to apply to Washington local governments operating ferries.

2003 The Legislature provided a use tax exemption for labor and services for repairing or improving ferry vessels to serve as a companion for the existing sales tax exemption on such services.

2006 The Legislature directed WSF to end its passenger-only ferry operations and focus its resources on auto ferry routes. The Legislature simultaneously enabled local cities, counties, and transit agencies to form new ferry districts and public transportation benefit areas with expanded tax-collecting authority to fund passenger-only ferry service. Also, the Legislature reduced regulatory barriers for new passenger ferry services.

Public Policy Objectives

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

The Legislature did not state a public policy objective when it initially enacted the tax preferences for state ferries or when it expanded the exemptions to local government entities.

From historical records, JLARC infers the public policy objective is to support state and local governments by reducing the cost of building and repairing ferry vessels owned and operated by the state or local government entities.

According to documents and newspaper articles from the time, the state was struggling with how to finance and pay for needed new ferries. In 1977, the *Seattle Times* reported the bid to build three new ferry boats, expected to cost about $36 million, came in at $59.2 million.

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

The preference does reduce state and local governments' costs for construction, repair, and maintenance of ferry vessels, as it reduces the expenses for such activities by the combined state and local sales/use tax rates (currently between 7.0 and 9.5 percent).

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

Continuation of the preference would continue to reduce state and local governments' costs to construct, repair, and maintain ferry vessels.

Beneficiaries

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

The biggest beneficiary of this preference is Washington State Ferries. Additional beneficiaries include various local government entities that operate ferry systems. See Exhibit 18 on the following page.

Washington State Ferry Operations and Vessels

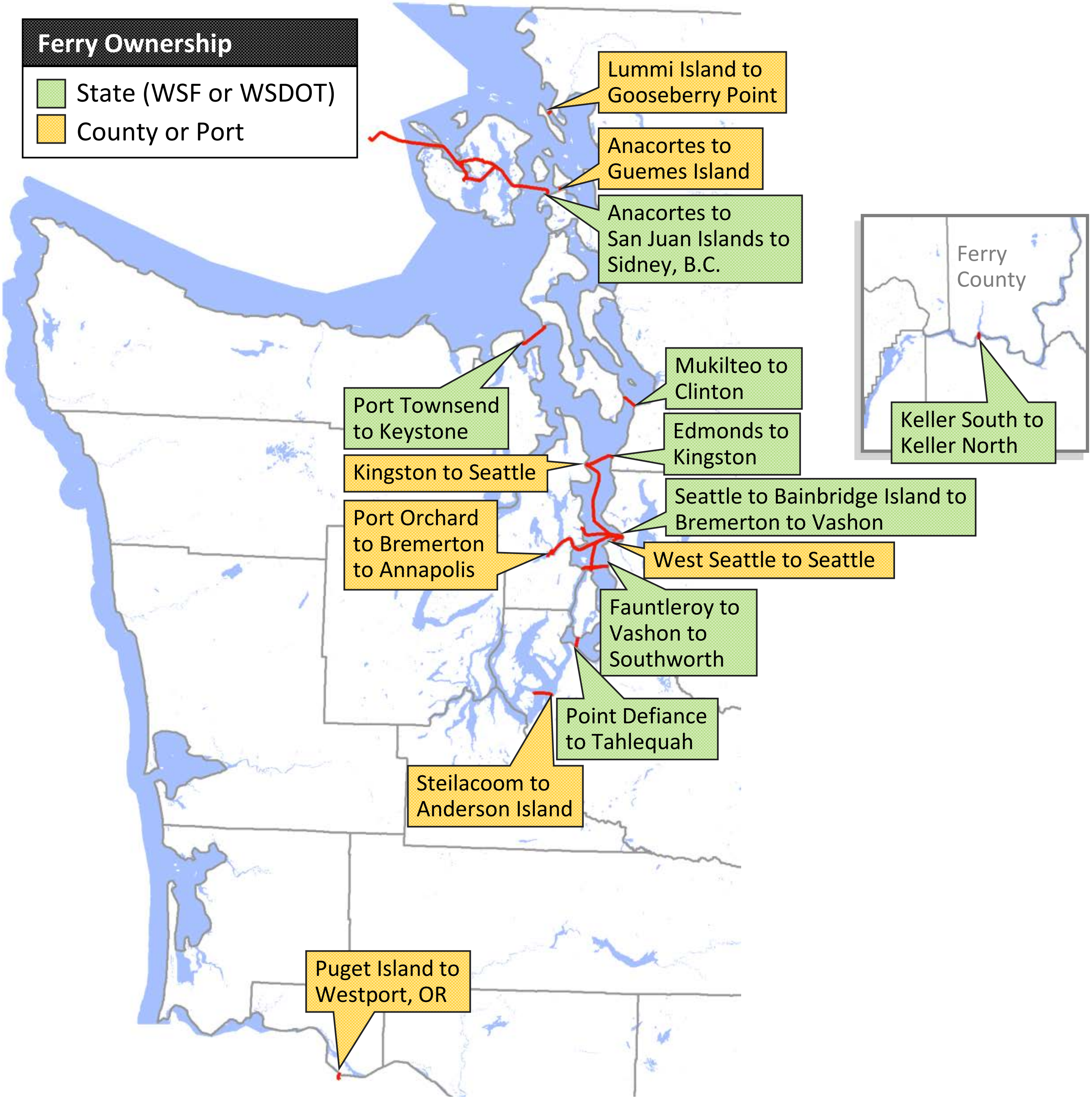
With a fleet of 22 auto/passenger ferries as of February 2012, Washington State Ferries reports that it operates the largest ferry system in the U.S. and fourth largest in the world. The ferries range in size from the Jumbo Mark II class that carries up to 2,500 passengers and 202 vehicles to the Hiyu, which carries 200 passengers and 34 vehicles. WSF operates 20 terminals on nine routes, making approximately 450 trips a day and carrying approximately 22 million riders a year.

Ferries in Washington Operated by Local Governments

In addition to the state-operated ferries, a number of local government entities operate ferries, including:

- King County Ferry District (two passenger-only ferries);
- Kitsap Transit (one passenger-only ferry);
- Pierce County (two passenger/vehicle ferries);
- Port of Kingston (two passenger-only ferries);
- Skagit County Public Works (one passenger/vehicle ferry);
- Wahkiakum County (one passenger/vehicle ferry); and
- Whatcom County Public Works (one passenger/vehicle ferry).

Exhibit 18 – State and County-Operated Ferries in Washington



Source: WSDOT GIS data.

Revenue and Economic Impacts

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

Beneficiaries are estimated to save $26 million in the 2013-15 Biennium due to this sales and use tax exemption. In Fiscal Years 2010 and 2011, WSF expenditures accounted for 97 percent of the total. See Exhibit 19, below.

Exhibit 19 – Estimated 2013-15 Beneficiary Savings for Ferry Boat Sales/Use Tax Exemption

Fiscal Year	Total expenditures for ferry vessel purchases, repair, maintenance	State Sales/Use Tax	Local Sales/Use Tax	Total Sales/Use Tax
2010	$147,185,000	$9,567,000	$3,550,000	$13,117, 000
2011	$151,405,000	$9,841,000	$3,652,000	$13,493,000
2012	$126,158,000	$8,200,000	$3,043,000	$11,243,000
2013	$134,374,000	$8,734,000	$3,241,000	$11,975,000
2014	$146,691,000	$9,535,000	$3,538,000	$13,073,000
2015	$146,045,000	$9,493,000	$3,523,000	$13,016,000
			2013-15 Biennium	**$26,089,000**

Source: Expenditure and projected cost data for FY10-15 provided by WSF, WSDOT, King Co Ferry District, Kitsap Transit, Pierce, Skagit and Wahkiakum Counties. JLARC estimate for Port of Kingston and Whatcom Co. public ferry systems based on similar sized boats. Sales tax rates projected from 2012-15 at 6.5% for state; 2.412% for local.

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

If the tax preference were terminated, state and local government entities that operate ferries in Washington would have to pay sales or use tax on ferry vessels they purchased or acquired, as well as sales or use tax on component replacement or repair parts and repair, and charges for maintenance labor and services.

Other States

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

Four other states exempt sales of ferry boats from sales/use tax: New Jersey, New York, Vermont, and California. Additionally, four other states exempt personal property purchased for public transportation, including water transportation: Ohio, Missouri, Massachusetts, and Indiana.

Auditor Recommendation:

The Legislature should continue the preference because it is meeting the inferred public policy objective of reducing the cost to state and local government entities of building, maintaining, and repairing ferry vessels they own and operate.

Legislation Required:	No.
Fiscal Impact:	None.

FISH TAX DIFFERENTIAL RATES (ENHANCED FOOD FISH TAX)

Report Summary			
What the Preference Does	**Public Policy Objectives**	**Estimated Beneficiary Savings**	**Auditor Recommendation**
Provides five differential fish tax rates for different species of enhanced food fish. The tax applies to the first commercial possession by an owner of the fish or shellfish in Washington.	The Legislature did not state the public policy objective of the preference. JLARC infers the public policy objective is to set fish tax rates so that those that most benefit from state expenditures for hatcheries and fisheries management pay at a higher rate to fund them. It is unclear why the Legislature set the differential tax rates at the level at which they were established.	$7.5 million in 2013-15 Biennium	**Review and clarify**: Because it is unclear: 1) Why the differential rates were set at the levels they were; and 2) Whether the Legislature seeks a rate structure that reflects the relative levels of state expenditures for maintaining and enhancing the different fish and shellfish species.

FISH TAX DIFFERENTIAL RATES (ENHANCED FOOD FISH TAX)

Current Law

Washington's tax on enhanced food fish (commonly known as the "fish tax") applies to the first commercial possession in Washington by an owner of a variety of fish, shellfish, or other seafood. "Enhanced food fish" includes species of fish and shellfish that are developed by the state through various hatchery and other programs of the Department of Fish and Wildlife (WDFW).

Taxable fish and shellfish include those originating in territorial or adjacent waters of Washington, salmon originating from Washington, Oregon, and British Columbia, and Chinook salmon originating from southeast Alaska waters that are caught by trolling.

The fish tax is measured by the value of the fish and shellfish when first landed. The fish and shellfish are "landed" when they are brought to land, including wharves or piers or when they are physically placed on a tender in Washington territorial waters. The fish tax is usually paid by the licensed dealer that buys the fish/shellfish, rather than by the commercial harvester. The tax is collected and administered by the Department of Revenue (DOR).

The statute provides five differential fish tax rates for different species of enhanced food fish. The current applicable fish tax rates are noted in Exhibit 20, below.

Exhibit 20 - Food Fish Subject to Washington's Fish Tax and Current Rates

Food Fish Type	Fish Tax Rate
Chinook, coho, chum salmon or eggs; anadromous game fish (e.g., steelhead or cutthroat trout, Dolly Varden char)	5.62%
Pink and sockeye salmon fish or eggs	3.37%
Other food fish or eggs; shellfish	2.25%
Oysters	0.09%
Sea urchins and sea cucumbers	4.92%*

* Through 12/31/2013 or until Department of Fish and Wildlife determines the number of sea urchin or sea cucumber licenses has been reduced to 20, whichever occurs first. The rate will return to 2.25% thereafter.

Source: JLARC analysis of RCW 82.27.020(4), (5), and RCW 82.02.030.

See Appendix 3 for the current statute, RCW 82.27.020(4).

Legal History

Washington has a long history of requiring commercial harvesters and processors of fish and shellfish to be licensed and pay taxes, beginning in 1854 for oysters, clams, and shellfish and in 1877 for salmon. In addition, the state has been applying different tax rates to various types of fish and shellfish since 1915.

1915 The Legislature enacted the Fisheries Code, establishing laws to regulate fishing and harvesting in the state. Among other things, the Code established:

- A "tonnage tax" of $1 per gross ton annually on commercial wholesale sales of salmon and other food fish caught in Washington waters, and
- A "royalty tax" on all commercial harvester/processors in Puget Sound, Willapa Harbor, Grays Harbor, and the Columbia River district, set at various designated rates per different levels of volume (e.g., per pound, per hundred pounds, per gross, or per ton), depending on the species of fish or shellfish. The tax applied to most species of fish or shellfish harvested or processed in Washington, except oysters.

1949 The Legislature repealed the royalty and tonnage taxes, replacing them with new privilege and catch fees.

- The "privilege fee" was on wholesale and retail fish/shellfish dealers and manufacturers. For those operating in the Columbia River district, there were seven differential rates, ranging from 3/16th of a cent to 3.34 cents per pound, per hundred pounds, or per dozen (for crabs). For all other areas, the fee was 1 percent of the value of the fish/shellfish.
- The "catch fee" was a 1 percent tax on commercial harvesters/processors based on the value of the fish/shellfish harvested. It did not apply to food fish or shellfish from concurrent waters of the Columbia River or to oysters or clams from licensed farms.

1955 The Legislature created the "Food Fish and Shellfish Fisheries Code." The new Code increased the privilege fee for some processers/dealers, increased the catch fee for Chinook and silver (coho) salmon, and extended the privilege tax to oysters at a rate of 1 cent per gallon/bushel for Pacific oysters and 6.5 cents per gallon on all others.

1963 The Legislature changed the method of assessing privilege taxes by basing the tax on the primary value of the fish. Two rates were provided: one for Chinook and silver (coho) salmon, and another for all other food fish species. The Legislature also removed the distinction between districts, making the tax application uniform statewide.

1977 The Legislature established a salmon enhancement program intended to provide funds for planning, acquiring, constructing, improving, and operating salmon enhancement facilities in Washington. As part of the program funding, they amended and increased the privilege fees on food fish and shellfish for processors and wholesale/retail dealers as follows:

- Chinook, coho, and chum salmon - 5 percent of value;
- Pink and sockeye salmon - 3 percent of value; and
- Other food fish and shellfish - 2 percent of value.

Oyster taxation remained unchanged at 1 cent per gallon/bushel for Pacific oysters and 6.5 cents per gallon on all other oysters.

1979 A State Auditor's Office report on the Department of Fisheries (DOF) found a lack of procedures to ensure the privilege and catch fees were being paid. The audit recommended transferring the responsibility for administering and collecting the fees to the Department of Revenue.

1980 The Legislature repealed the privilege and catch fees under Chapter 75.32 RCW and replaced them with a new excise tax on commercial possession of food fish and shellfish in Washington, collected and administered by DOR. The new tax maintained the 1977 tax rates and classifications, except that the basis of taxing oysters was changed from volume to value and a standard .07 percent rate was imposed.

1982 The Legislature enacted a surtax on a number of different excise taxes, including the fish tax.

1983 The Legislature imposed the food fish tax on anadromous game fish at the same rate as Chinook, coho, and chum salmon. "Anadromous game fish" was defined to mean steelhead and cutthroat trout, and Dolly Varden char. Tax receipts from anadromous game fish were to be deposited in the Game Fund, rather than the state's General Fund. The Legislature's stated intent was to ensure that commercial fishing operations that benefit from the commercial harvest of these fish should pay a tax to assist in funding the fisheries.

1999 The Legislature increased the tax rate for sea urchins and sea cucumbers, setting the rate at 4.6 percent through December 31, 2005, and reducing it to 2.1 percent thereafter. The increased amount was to be deposited in the sea urchin dive and the sea cucumber dive accounts. Previously, sea urchins and sea cucumbers were subject to the "other food fish" rate of 2.1 percent.

2005 The Legislature extended the higher rate for sea urchins and sea cucumbers from December 31, 2005, to December 31, 2010.

2010 The Legislature again extended the higher rate for sea urchins and sea cucumbers to December 31, 2013, or until the WDFW notifies DOR that the number of sea urchin and cucumber licenses has been reduced to 20, whichever occurs first.

Other Relevant Background

Exemptions from the enhanced food fish tax are provided for:

- Tuna, mackerel, and jack fish (scheduled for JLARC review in 2013).
- Commercially grown fish or shellfish raised from eggs or larvae that are under the control of the grower until harvested or sold (scheduled for JLARC review in 2015).
- Food fish shipped into Washington that is already processed (frozen or packaged for retail sale) (scheduled for JLARC review in 2021).
- Food fish shipped from out-of-state when documentation of origin is provided (scheduled for JLARC review in 2021).

In addition, businesses are subject to business and occupation (B&O) tax on fish they catch in Washington waters (under the extracting classification) and for fish caught outside of Washington waters but sold within Washington (under either the wholesaling or retailing classification).

Public Policy Objectives

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

The Legislature did not state a public policy objective for the differential enhanced food fish rates. The historic record provides some evidence for why this tax was established, which provides insight into why rates vary by species.

Enhanced food fish tax

The Legislature stated its intent in establishing the food fish and shellfish tax as part of the state's salmon enhancement program in 1977:

> *The long range economic development goals for the state . . . include the restoration of salmon runs to provide an increased supply of this valuable renewable resource for the benefit of commercial and recreational users and the economic well-being of the state.* ***For the purpose of providing funds for the planning, acquisition, construction, improvement, and operation of salmon enhancement facilities within the state, it is the intent of the legislature that the revenues received from . . . (a variety of fees and licenses) . . . and all moneys received from all privilege fees . . . collected on fresh or frozen salmon or parts thereof be utilized to fund such costs.***

A 1978 newspaper article quoting the DOF assistant director provides additional information:

> *To raise the funds . . . taxes paid by processors and commercial fishermen were increased substantially. All the funds collected as a result of these increases are to be utilized for salmon enhancement. . . It was the Legislature's judgment that* ***people who benefit most from the resource should help pay for that resource,*** *hence the change in the tax structure. . .*

Archival legislative documents also noted the tax's purpose in 1980 when the Legislature changed the privilege tax to an excise tax on possession and transferred its administration and collection to the Department of Revenue, noting "Legislative intent when enacting the original law imposing this tax was that the proceeds be applied toward servicing state debt incurred to finance construction of improved and expanded hatcheries and to pay a portion of the state's cost of regulating these fisheries."

Different rates for different species

It is unclear why the Legislature set the differential tax rates at the levels at which they were established.

Historical analysis shows that certain salmon species have been taxed at a higher rate than other salmon species or other fish since the 1915 royalty fee; this rate stratification was continued when the privilege tax was imposed in 1949. A possible justification for different rates is that certain salmon species required more state revenue/resources to support, maintain, improve, and enhance the species at the time the tax rates were enacted. For example, fish and shellfish given lower rates may not have utilized hatcheries to the extent that Chinook, coho, and chum salmon species did.

It is unclear why the fish tax rate for oysters was set lower than the other food fish and shellfish. One possibility is that commercial oysters were historically produced on leased or privately owned property and did not require the same level of state resources to maintain or enhance the species.

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

The differential fish tax rates do function to ensure that the tax rate applied to commercial harvesters, processors, and dealers of Chinook, coho, or chum salmon, or anadromous game fish is higher than the rate applied to other types of food fish or shellfish.

The differential rates may have been set so that in 1977 and 1980 those that most benefited from state expenditures for hatcheries and fisheries management (the commercial possessors of certain salmon and game fish) paid a higher fish tax rate to contribute more than commercial possessors of other fish in order to pay more toward hatchery and fishery management programs.

However, the specific rates enacted in 1977 and reestablished in 1980 may not currently meet the inferred public policy objective of reflecting the relative cost to maintain or enhance various species. WDFW indicates that some fisheries with lower fish tax rates now require more state resources and management than they did at the time the rates were set.

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

Continuation of the current differential fish tax rates would ensure that commercial harvesters, processors, and dealers of certain types of salmon and game fish pay a higher rate than the rates applied to other food fish and shellfish. However, as noted above, it is not clear that maintaining the current rate structure would accomplish the implied public policy objective of linking the differential rate structure to relative levels of state management expenditures for the different fish and shellfish species.

Beneficiaries

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

The beneficiaries are businesses that commercially harvest, process, and sell certain fish and shellfish in Washington. Generally, the processor is the first commercial possessor in Washington and responsible for paying the tax. In Fiscal Year 2011, 236 businesses filed fish tax returns and paid $3.14 million in food fish tax. Per WDFW, crab is the biggest revenue generator of all the fish and shellfish species.

Department of Revenue fish tax returns for Fiscal Years 2007 through 2011 reflect the number of businesses reporting taxable events under the various differential tax categories during the last five fiscal years. See Exhibit 21, on the following page.

Exhibit 21 – Number of Businesses Reporting Under Various Fish Tax Species Classifications

Differential Fish Tax Classifications	FY07	FY08	FY09	FY10	FY11
Shellfish	127	121	118	126	133
Chinook salmon fish/eggs	87	75	69	72	70
Coho salmon fish/eggs	68	69	59	81	65
Other fish/eggs	73	70	66	70	62
Sockeye salmon fish/eggs	46	7	24	12	42
Chum salmon fish/eggs	48	45	46	39	36
Oysters	15	18	21	17	18
Sea cucumber	8	7	6	8	15
Pink salmon fish/eggs	6	19	5	25	14
Sea urchin	6	7	6	7	8
Anadromous game fish	12	13	8	5	6

Note: The same taxpayers may report under multiple categories, so numbers are likely duplicated.

Source: DOR fish tax data; FY07-10 (DOR Research); FY11 (DOR TAA).

Revenue and Economic Impacts

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

JLARC estimates the beneficiary savings for the 2013-15 Biennium to be $7.5 million. See Exhibit 22, below.

Exhibit 22 – Estimated 2013-15 Beneficiary Savings for Differential Fish Tax Rates

FY	Food fish species and current differential tax rates lower than 5.62%				Combined Beneficiary Savings
	Pink/sockeye salmon fish or eggs	Other food fish or eggs; shellfish	Oysters	Sea Urchins, Sea Cucumbers*	
	3.37%	2.25%	0.09%	2.25%	
2009	$5,000	$2,015,000	$92,000	$39,000	$2,151,000
2010	$62,000	$2,538,000	$82,000	$36,000	$2,718,000
2011	$152,000	$3,442,000	$114,000	$43,000	$3,751,000
2012	$152,000	$3,442,000	$114,000	$43,000	$3,751,000
2013	$152,000	$3,442,000	$114,000	$43,000	$3,751,000
2014	$152,000	$3,442,000	$114,000	$43,000	$3,751,000
2015	$152,000	$3,442,000	$114,000	$43,000	$3,751,000
2013-15 Biennium		**$6,884,000**	**$228,000**	**$86,000**	**$7,502,000**

*Additional 2.67% surcharge currently in effect not included in differential rate calculation, as it goes directly to dive accounts for these fisheries.

JLARC determined the beneficiary savings by calculating the difference between the highest rate (5.62 percent) and the four lower rates. Due to the volatility of the fish tax, JLARC maintained the FY 2011 savings estimate for subsequent years.

Source: DOR Fish Tax Addendum data FY 2009-2011; JLARC estimate FY 2012-2015.

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

If the differential tax rates were eliminated, and if all businesses subject to the fish tax paid under the highest rate (currently 5.62 percent), the tax burden on harvesters, processors, and dealers of species that have lower rates would increase. These businesses would either have to absorb the additional tax burden or increase the price of the food fish to their customers to cover the additional tax.

Other States

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

Alaska, Oregon, and California all impose fish and shellfish landing taxes on commercial fish landings and wholesale sales, similar to Washington. Each state uses different categories of fish and shellfish species and different rates.

- Alaska taxes fish based on the unprocessed weight, but multiplied by the statewide average price for that species, as determined by the Alaska Department of Fish and Game each year.
- Oregon taxes fish based on the value at the point of landing.
- California taxes fish based on its unprocessed weight rather than its value.

Auditor Recommendation:

The Legislature should review and clarify the differential fish tax rates provided in statute, because it is unclear: 1) why the differential rates were set at the levels they were; and 2) whether the Legislature seeks a rate structure that reflects the relative levels of state expenditures for maintaining and enhancing the different fish and shellfish species.

Legislation Required:	Yes.
Fiscal Impact:	Depends on legislative action.

Health Insurance by State Pool (Insurance Premiums Tax)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**Auditor Recommendation**
Allows health insurance carriers to deduct from their insurance premium income the assessments they are required to pay to the Washington State Health Insurance Pool (WSHIP) before calculating their insurance premiums tax.	The Legislature did not state the public policy objective of the tax preference. JLARC infers that the public policy objective is to define the insurance premiums tax base.	$2.9 million in 2013-15 Biennium	**Continue**: Because the tax deduction for assessments paid to WSHIP is defining the base for the insurance premiums tax.

HEALTH INSURANCE BY STATE POOL (INSURANCE PREMIUMS TAX)

Current Law

Heath insurance carriers are allowed to deduct from their insurance premium income the assessments they are required to pay to the Washington State Health Insurance Pool (WSHIP) before calculating their insurance premiums tax. WSHIP is a nonprofit organization established by the Legislature that provides health insurance to individuals who have been denied coverage because of pre-existing medical conditions.

Enrollees in WSHIP pay premiums at rates between 110 and 150 percent of standard insurance rates in the individual insurance market. However, the premiums cover only a portion of expenses, and the remaining expenses are funded primarily by assessments on WSHIP members based on their share of covered state residents.

The entities that pay WSHIP assessments include health insurance carriers that offer group and individual policies, carriers that offer Medicare supplemental policies, and coverage under Healthy Options or the Basic Health program. In addition, stop loss insurers and the state's Public Employees Benefits Board's Uniform Medical Plan pay assessments at one-tenth the rate of health insurance carriers. Carriers that do not pay the fee include self-funded plans, federal employee and military plans, and Medicare.

See Appendix 3 for the current statute, RCW48.14.022.

Legal History

1986 The Washington Health Care Project Commission recommended that the Legislature provide basic health coverage to families with incomes below 200 percent of the federal poverty level. Also, the Commission recommended an insurance pool to cover medically uninsurable individuals with incomes above 200 percent of the federal poverty level.

1987 The Legislature followed the Commission's recommendations by establishing two mechanisms to provide health insurance coverage for uninsured residents:

1) The WSHIP to provide an insurance pool for individuals that had been denied health insurance; and

2) The Washington Basic Health Plan to provide subsidized insurance to low-income Washington residents.

In 1987, most health insurance carriers paid the business and occupations (B&O) tax rather than the insurance premiums tax. The new law provided a deduction from the B&O tax for WSHIP assessments paid by most insurance carriers and a premiums tax deduction for others that paid the insurance premiums tax.

1993 The Legislature passed the Health Services Act, a comprehensive overhaul of the individual health insurance market. In the same act, the Legislature shifted the taxation of health insurance carriers from the B&O tax to the insurance premiums tax. With this shift in taxation, the B&O deduction became obsolete, and the Legislature repealed it in 2005. The deduction of WSHIP assessments from the insurance premiums tax remained in law.

2010 As part of the federal Affordable Care Act, Congress approved funding for a temporary program to make coverage available to individuals with pre-existing conditions who have been uninsured for at least six months. Rates offered under this program cannot exceed standard insurance rates. In Washington State, this program is operated by the same third-party contractors as WSHIP to provide insurance. How the Affordable Care Act provisions will effect WSHIP enrollment in the future is uncertain.

Public Policy Objectives

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

The Legislature did not state the public policy objective of the tax preference.

JLARC infers that the public policy objective of the tax preference is to define the insurance premiums tax base. The Legislature by its action has determined that mandatory WSHIP assessments should be excluded from taxable premiums and should not be subject to insurance premiums tax.

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

The tax preference is achieving its public policy objective by excluding WSHIP assessments from the base of the insurance premiums tax.

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

Continuation of the preference will continue to define the tax base for the insurance premiums tax by excluding WSHIP assessments from the tax calculation.

Beneficiaries

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

The direct beneficiaries of the tax preference are the health insurance carriers that pay the WSHIP fee and are members of the high risk pool. Members include all group and individual health insurance carriers, carriers that offer Medicare supplemental policies, stop loss insurers, carriers that participate in Healthy Options and Basic Health, and the Public Employees Benefits Board's Uniform Medical Plan.

Revenue and Economic Impacts

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

Exhibit 23, below, shows that WSHIP member insurance carriers saved an estimated $1.2 million in insurance premiums taxes in Fiscal Year 2011. These savings are estimated at $2.9 million in the 2013-15 Biennium.

Exhibit 23 – Estimated 2013-15 Beneficiary Savings from the Insurance Premiums Tax Exemption for WSHIP Assessments

Fiscal Year	Member Assessments	Beneficiary Tax Savings
2010	$53,100,000	$1,100,000
2011	$61,900,000	$1,200,000
2012	$64,800,000	$1,300,000
2013	$67,300,000	$1,300,000
2014	$70,000,000	$1,400,000
2015	$72,800,000	$1,500,000
	2013-15 Biennium	**$2,900,000**

Notes: 2011 is based on WSHIP projections, and 2012-2015 is forecast by JLARC based on Economic Revenue and Forecast Council growth in insurance premiums taxes, February 2011.

Source: WSHIP Annual Report, 2010.

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

If the tax preference were terminated, WSHIP member insurers would pay insurance premiums tax on the assessments they are required to pay to WSHIP. These insurance carriers might try to pass some or all of the increased insurance premiums tax on to their customers. The Office of the Insurance Commissioner (OIC) allows rates that are reasonable in relation to benefits, with allowances for expenses, profits, and sufficient reserves. OIC reports it would generally allow premium rate increases to cover fee costs.

Other States

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

High risk health insurance pools operate in 35 states including Washington, and, like Washington, 29 states charge assessments to members to supplement the pool. At least nine states allow the insurer to offset the amount of the fee as a credit against insurance premiums or other taxes.

Auditor Recommendation:

The Legislature should continue the tax preference because the tax deduction for assessments paid to the Washington State Health Insurance Pool is fulfilling the inferred public policy objective of defining the base for the insurance premiums tax.

Legislation Required:	No.
Fiscal Impact:	None.

HIGH TECHNOLOGY R&D DEFERRAL/WAIVER (SALES AND USE TAX) AND CREDIT (B&O TAX)

Report Summary

What the Preference Does	Public Policy Objectives	Estimated Beneficiary Savings	Auditor Recommendation
Provides: 1) A deferral/waiver of state and local sales and use taxes on investment in facilities, and machinery and equipment by firms engaged in high technology R&D and pilot scale manufacturing; and 2) A B&O tax credit for qualified research and development spending. Expires January 1, 2015.	The Legislature stated the public policy objectives of the high technology R&D tax preferences are to: 1) Create "quality" employment opportunities in this state; and 2) Encourage expenditures in research and development, supporting, and sustaining the high technology sector as it develops new technologies and products.	$114 million in 2013-15 Biennium	**Review and clarify**: To determine if progress toward its high technology R&D objectives is sufficient and to consider identifying targets for investment and employment.

HIGH TECHNOLOGY R&D DEFERRAL/WAIVER (SALES AND USE TAX) AND CREDIT (B&O TAX)

Current Law

Current law provides two tax preferences to businesses that perform high technology research and development (R&D):

1) A deferral and eventual waiver of state and local sales and use taxes on investment in facilities, and machinery and equipment by firms engaged in qualified high technology R&D and pilot scale manufacturing; and
2) A business and occupation (B&O) tax credit for businesses that meet a certain threshold of qualified research and development spending.

To qualify, research and development must be conducted in the fields of:

- Advanced computing;
- Advanced materials;
- Biotechnology;
- Electronic device technology; or
- Environmental technology.

Exhibit 24, below, shows high technology R&D that qualifies and does not qualify for these tax preferences.

Exhibit 24 – R&D that Qualifies and Does Not Qualify for Tax Incentives

Qualifying R&D	Non-Qualifying R&D
Discovering and translating technological information into new or improved products, processes, techniques, formulas, inventions, or software, including exploring a new use for an existing drug, device, or biological product if the new use requires separate licensing by the federal Food and Drug Administration.	Adaptation or duplication of existing products without improving by means of technology
	Surveys and studies
	Social science and humanities research
	Market research or testing and quality control
	Sale promotion and service
	Computer software developed for internal use
	Research in such areas such as style, taste, and seasonal design

Source: JLARC analysis of tax law.

Both the B&O tax credit and the sales and use tax deferral/waiver became effective January 1, 1995 and expire on January 1, 2015.

Sales and Use Tax Deferral/Waiver

In order to qualify for the high technology R&D sales and use tax deferral/waiver, a business or nonprofit must invest in a new R&D facility or expand, renovate, or equip an existing facility.

Beneficiaries are required to submit an application to the Department of Revenue (DOR) prior to beginning construction of a facility or acquiring machinery and equipment. As long as the facility or machinery and equipment continues to qualify for the intended purpose, the deferred sales and use taxes do not need to be repaid. Beneficiaries must submit an annual survey by April 30 each year and continue the qualified use of the facility for eight years. Twelve and a half percent of the deferred tax is waived each year these criteria are met so at the end of eight years, the deferred taxes have been completely waived.

Business and Occupation (B&O) Tax Credit

In order to qualify for the high technology R&D B&O tax credit, a business must spend more than 0.92 percent of its taxable income on qualified R&D in Washington. The credit is calculated by:

1) Determining the amount of qualified R&D expenditures. This amount is either 100 percent of expenditures on in-house R&D or 80 percent of compensation received to perform R&D for others.
2) Subtracting 0.92 percent of the taxpayer's taxable income from the qualified R&D spending.
3) Multiplying the remainder by 1.5 percent.

Exhibit 25, below, provides an example of how this B&O tax credit is calculated.

Exhibit 25 – Calculation of the B&O Tax Credit for High Tech R&D Spending
Assume $75,000 R&D Spending and $100,000 Taxable Income

	Taxpayer's R&D Spending	**$75,000**
–	**Taxpayer's Taxable Income ($100,000) X 0.92%**	**$920**
=	**Remainder**	**$74,080**
X	**1.5% (B&O Tax Credit Rate)**	**$1,111**

Source: JLARC analysis of tax law.

The credit for each taxpayer may not exceed $2 million or the amount of tax liability for the calendar year, whichever is less. Qualified expenditures can include operating expenses such as wages, compensation of a proprietor or a partner, and benefits, supplies, and computer expenses, but may not include capital and overhead costs.

See Appendix 3 for the current statutes for the deferral/waiver, RCWs 82.63.010, and 82.63.030 and for the tax credit, RCW 82.04.4452.

Legal History

In the years leading up to enactment of these tax preferences, legislative and executive branch studies recommended that the state address the startup costs of persons conducting high technology research and development. The Legislature responded with two forms of tax relief: one for capital investment and another for operating expenditures.

1994 The Legislature enacted the high technology R&D sales and use tax deferral, and required the deferral to be repaid over a five-year period beginning after the third year of operation. The deferral applied to capital investment in facilities and machinery and equipment.

In the same bill, the Legislature enacted the B&O tax credit for high technology R&D operating expenditures. Originally, the statute required R&D spending to exceed a threshold of 0.92 percent of taxable income in order to qualify. The credit was equal to the amount of qualified expenditures multiplied by 2.5 percent for for-profit businesses and 0.515 percent for nonprofit organizations.

The statute required DOR to evaluate the high technology incentives in 1997, 2000, and 2003. Both the credit and deferral became effective on January 1, 1995, and were set to expire on July 1, 2004.

1995 Legislation converted the 1994 sales and use tax deferral to an eventual waiver if the beneficiary used the facility for its qualifying use for eight years.

1997 The Legislature reduced the rate of the B&O tax credit from 2.5 percent to 1.5 percent for for-profit businesses and from 0.515 percent to 0.484 percent for nonprofit organizations.

2004 The Legislature changed the B&O tax credit rate (the rate to be multiplied by qualified R&D spending) to the taxpayer's average tax rate beginning in June 2004. In addition, the Legislature changed the method of determining the amount of spending qualifying for the B&O tax credit. Originally, the law required R&D spending to exceed a threshold of 0.92 percent of the beneficiary's taxable income and, if so, calculated the credit by multiplying the full amount of R&D spending by the credit rate. In 2004, the calculation of the credit was done by subtracting 0.92 percent of taxable income before multiplying by the tax rate. This change reduced the benefit of the credit because it reduced the amount of qualified spending to be multiplied by the credit rate.

Also in the 2004 bill, the Legislature expanded the deferral/waiver to state universities and extended the expiration date for both preferences to January 1, 2015.

A new provision required that beneficiaries of the tax preferences file annual surveys reporting on the number of positions created, wages and benefits by wage bands, and information related to product development. Stating that "accountability and effectiveness are important aspects of setting tax policy" and that information on the tax preference is needed in order to make decisions on the "best use of limited state resources," the Legislature required that DOR prepare annual descriptive statistics and analytical reports due in 2009 and 2013 based on information reported in the annual survey.

2005 The Legislature again changed the credit rate to the higher of the taxpayer's average tax rate or 0.75 percent effective in Calendar Year 2007, the higher of the taxpayer's average tax rate or 1 percent in Calendar Year 2008, and the higher of the taxpayer' average tax rate or 1.25 percent in Calendar Year 2009. The credit rate became 1.5 percent beginning in Calendar Year 2010. See Exhibit 26, below, for the credit rate history.

Exhibit 26 – Rate History of High Technology R&D B&O Tax Credit

Year Enacted	For-Profit Credit Rate	Nonprofit Credit Rate
1995-1997	2.5%	0.515%
1998-2003	1.5%	0.484%
2004	Taxpayer's average rate	0.484%
2005-2006	Taxpayer's average rate	
2007	Higher of average rate or 0.75%	
2008	Higher of average rate or 1.0%	
2009	Higher of average rate or 1.25%	
2010-2014	1.5%	

Source: JLARC analysis of tax law.

2009 The Legislature clarified that the tax deferral/waiver applied to multiple qualified buildings leased to the same person if the structures are located within a five mile radius and construction of the buildings is initiated within a 60-month period.

Public Policy Objectives

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

The Legislature expressly stated the public policy objectives of the high technology R&D tax preferences are to:

1) Create "quality" employment opportunities in this state; and
2) Encourage expenditures in research and development, supporting, and sustaining the high technology sector as it develops new technologies and products.

The Legislature did not identify specific targets associated with the employment objectives. The Legislature did not specify how many jobs it required to meet objectives and what wage and benefit levels it considered to be "quality" employment. The amount of R&D spending required to meet objectives was also not specified.

What evidence exists to show that the tax preferences have contributed to the achievement of any of these public policy objectives?

The information provided in DOR tax returns, surveys, and other records indicates that the two public policy objectives are being fulfilled to a certain extent. However, there are problems with DOR's collecting and reporting of information on the annual survey. Beneficiaries reported that they have created jobs and have claimed the sales and use tax deferral/waiver and B&O tax credit for R&D spending. It is not clear from the survey how much tax incentive has been claimed and how many new jobs have been added. It is also not clear from the survey whether an increase in jobs and how much of an increase in R&D spending has occurred as a result of the tax preferences. (For further discussion, see the Supplement to this review following this report.)

To determine whether employment and R&D spending increased **as a result of** the tax preferences, JLARC contracted with economists who are experts in econometric modeling. JLARC obtained confidential tax return data from DOR and employment and wage data from the Employment Security Department (ESD) to overcome the problems we identified with the self-reported taxpayer survey data. However, the survey is the only source of information on the "quality" of jobs provided by beneficiaries.

This review will first present results of the econometric analysis on the increase in employment and R&D spending as a result of the B&O tax credit. The consultants did not include the sales and use tax deferral/waiver in the analysis because the low number of beneficiaries would have provided insufficient data to measure a statistical impact. Next, the review will provide information on the "quality" of jobs such as wages and benefits that is only available from the annual survey. The survey information relates to the quality of <u>all</u> jobs provided by the beneficiaries, not just the quality of the new jobs.

B&O Tax Preference Estimated to Create an Average 454 New High Tech Jobs

Our consulting economists were able to estimate the increase in employment that occurred **as a result of** the B&O tax credit for the study period 2004 to 2009. Their analyses indicate that employment growth of 454 new jobs (or between 0.5 and 0.6 percent) at the firms that claimed the B&O tax credit is attributable to the credit. The economists calculated a range of estimates with a low of 84 jobs and a high of 907 jobs, but preferred the estimate of 454 jobs. The economists caution that the 454 jobs should not be added for each year but are a "once-and-for-all permanent change in the number of jobs in the state." The full report is in Appendix 4.

In contrast, high technology businesses taking the B&O tax credit reported creating between 3,223 and 16,885 new jobs during this same time period. There are two caveats to remember when comparing these numbers: 1) as discussed in the Supplement to this tax preference review, JLARC identified problems with the job numbers reported in DOR's annual survey; and 2) in the survey, the businesses are directed to report the number of new jobs created regardless of the reason, while the economists estimated the number of new jobs that were **the result of** the B&O tax credit.

Our consulting economists suggested another measure the Legislature might find useful to gauge the impact of the B&O tax credit: a comparison of the **taxpayer savings per job** created by the B&O tax credit to the **new earnings per job** resulting from the tax credit. For the first part of this calculation, the amount of tax credit claimed over the study period averaged $20.5 million per year or approximately $45,000 per job.

The calculation to reach the amount of new earnings per job begins with estimating earnings associated with the tax preference. Estimated earnings associated with the new jobs averaged $19.6 million per year over the study period or approximately $43,000 per job.

However, as our consulting economists explain, only a portion of the earnings from these new jobs directly increase earnings for existing state residents. This is due to two factors:

1) A portion of all new jobs in the state will be reflected in a higher population over time rather than higher state employment rates as new workers move into the state to take some of the new jobs.
2) A portion of the earnings result from existing state residents moving up to better-paying jobs than would have occurred otherwise.

Therefore, estimated earnings must be adjusted downward in order to reflect only the new earnings per job. As our consulting economists explain, their previous research on these effects indicate about 40 percent of the earnings from the new jobs are likely to lead to higher earnings for the original state residents.

Taking 40 percent of the estimated average earnings of $43,000 per new job yields a figure of $17,200 in new earnings per job.

JLARC then used OFM's Washington Input-Output Model to identify the total direct, indirect, and induced change in total economy-wide earnings associated with each $17,200 in increased earnings. The result is a final estimate of an increase of $25,000 in new earnings in the state for each new job created by the high technology B&O tax credit. The Legislature can then compare this to the taxpayer savings of $45,000 for each job created by the B&O tax credit.

Unclear What R&D Spending May Have Occurred Because of the Credit

Beneficiaries of the high technology R&D incentives have invested an estimated $2.9 billion in facilities and equipment and spent $93.8 billion on R&D operating expenses over the lifetime of the tax preferences (from 1995 through 2010). It is not clear how much of this R&D spending may have occurred because of the tax credit.

Our consulting economists found that about 30 percent of the 672 firms included in the analysis have a reduced incentive to increase R&D spending. Firms with this reduced incentive are those that that cannot take the credit to the full extent because they have either reached the $2 million cap for the amount of annual allowable credit (two firms) or are limited by the amount of their tax liability (an additional 198 firms).

"Quality" of Employment

While, the previous analysis covered the effect of the B&O tax credit on new employment positions, the following analysis uses information from the DOR annual survey that includes all employees working for the beneficiaries, not just new employees.

Beneficiaries report that the percent of employees earning $60,000 or more a year has fluctuated over the seven-year period since the survey information became available. The percentage of full-time employees and the percentage of employees enrolled in medical, dental, and retirement plans have declined over the same years. In 2010, 67 percent of all employees earned $60,000 or more; 76 percent of beneficiaries' employees worked full time, 76 percent were enrolled in medical and dental plans; and 68 percent were enrolled in retirement plans. Exhibit 27, below, provides additional detail.

Exhibit 27 – Percent of Beneficiary Employees Earning $60,000 or More Unchanged; Percent Enrolled in Medical, Dental, and Retirement Plans Declined

Year	% Earning $60,000 or More	% Full Time	% Enrollees Medical & Dental	% Enrollees Retirement
2004	66%	92%	89%	77%
2005	72%	91%	90%	77%
2006	60%	78%	79%	70%
2007	60%	76%	78%	71%
2008	65%	76%	77%	69%
2009	66%	77%	78%	71%
2010	67%	76%	76%	68%

Source: JLARC analysis of Department of Revenue survey data.

The information is self-reported by the beneficiaries on the DOR's annual survey and is the only source of information on factors that relate to the "quality" of employment.

For those preferences enacted for economic development purposes, what are the economic impacts of the tax preferences compared to the economic impact of government activities funded by the tax?

Legislation enacted in 2011 specifically directed JLARC to determine the economic impacts using the Washington Input-Output Model as constructed and maintained by the Office of Financial Management. However, JLARC learned in the course of our analysis that the current version of the Washington Input-Output Model does not include information on how the state and local government sectors relate to other sectors of the economy. Absent this information in the input-output model, JLARC cannot accurately compare private sector and government impacts. (For further discussion, see the Supplement to this review beginning on page 97.)

To what extent will continuation of the tax preferences contribute to these public policy objectives?

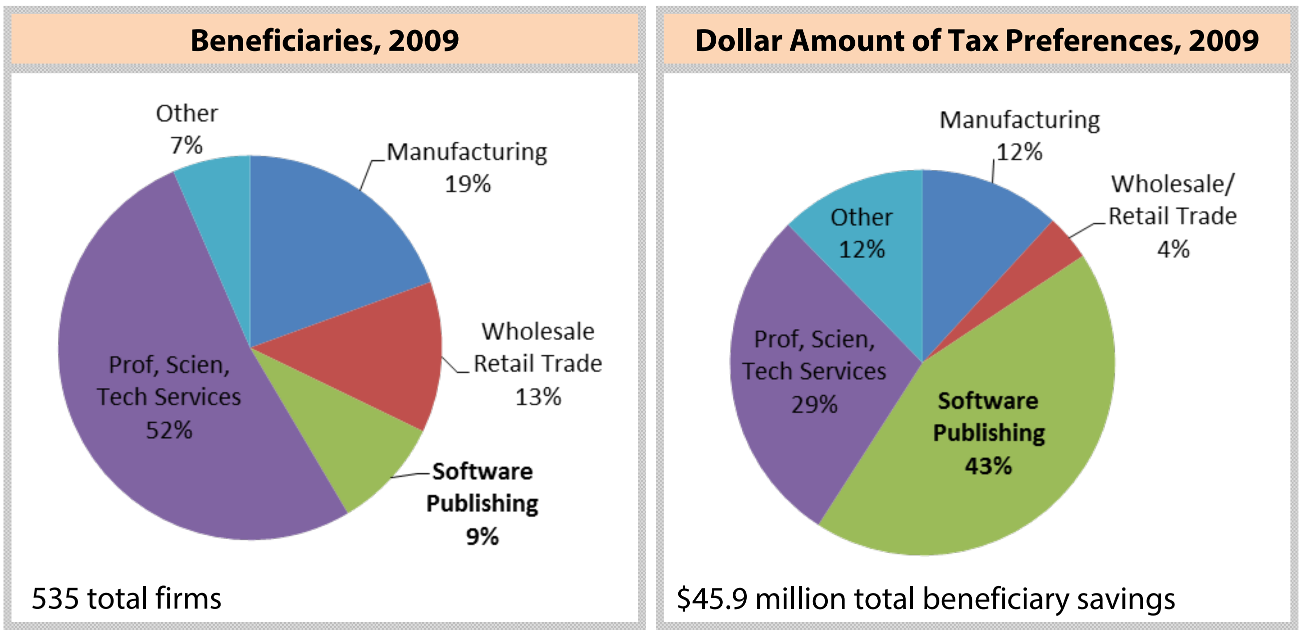
Continuation of the tax preference would continue to defer and eventually waive sales and use taxes for businesses and organizations investing in high technology R&D projects in Washington. Businesses that conduct high technology R&D would continue to receive a B&O tax credit for a portion of their operating expenses if their qualified R&D expenditures exceed 0.92 percent of their taxable income.

Beneficiaries

Who are the entities whose state tax liabilities are directly affected by the tax preferences?

In 2009, a total of 507 businesses took the B&O tax credit and 25 businesses and nonprofits claimed the sales and use tax deferral/waiver for investments in 31 projects. Exhibit 28, below, shows that professional, scientific, and technical services are the primary beneficiaries in terms of the number of firms and software publishers are the primary beneficiaries in terms of the dollar amount of tax preferences claimed in 2009.

Exhibit 28 – Software Publishing Firms Make Up 9 Percent of all Beneficiaries and Claim 43 Percent of all Dollar Amount of Tax Preferences in 2009



Source: JLARC analysis of DOR taxpayer data.

Revenue and Economic Impacts

What are the past and future tax revenue and economic impacts of the tax preferences to the taxpayer and to the government if they are continued?

Beneficiaries of the high technology sales and use tax deferral/waiver and B&O tax credits saved an estimated $77.6 million in Fiscal Year 2010. Savings are estimated to be $114 million in the 2013-15 Biennium. See Exhibit 29, below.

Exhibit 29 – Estimated 2013-15 Beneficiary Savings from High Technology B&O Tax Credit and Sales and Use Tax Deferral/Waiver

Fiscal Year	Sales & Use Tax Deferral	B&O Tax Credit	Total Beneficiary Savings
2010	$54,000,000	$23,550,000	$77,550,000
2011	$28,700,000	$28,700,000	$57,400,000
2012	$29,300,000	$29,200,000	$58,500,000
2013	$30,000,000	$30,000,000	$60,000,000
2014	$30,700,000	$25,600,000	$56,300,000
2015	$31,500,000	$26,200,000	$57,700,000
2013-15 Biennium	**$62,200,000**	**$54,200,000**	**$114,000,000**

Note: Beneficiary tax savings for Fiscal Year 2010 are based on actuals; the deferral amount for 2011 is a three year average because high technology investments are volatile. Fiscal Years 2011 through 2015 amounts are estimates.

Source: JLARC analysis of DOR data and the February 2012 forecast of U.S. R&D spending.

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

If the tax preferences were terminated, high technology R&D businesses and nonprofits located in high unemployment counties or community empowerment zones (areas within cities that are eligible for federal, state, and local assistance due to high unemployment and low household income) could qualify for deferral/waiver of sales and use taxes on facilities and machinery and equipment. However, most of the R&D activity is located outside these counties or empowerment zones.

Economic analysis indicates that the B&O tax credit is attributable to employment growth of 454 new jobs (or between 0.5 and 0.6 percent) at the firms that claimed the B&O tax credit It can be assumed that in the absence of the credit this job growth would not occur.

Other States

JLARC found that six states **do not** offer a tax credit for R&D operating expenses (Kentucky, Nevada, Oklahoma, South Dakota, Wyoming, and Texas). The remaining 44 states offer various forms of R&D tax credits, including 23 states that provide income tax credits based on the federal credit for research and development spending. The federal credit requires that firms increase their R&D spending over previous years.

Thirty-two states provide sales and use tax exemptions for R&D machinery and equipment. Six states provide sales and use tax exemptions for R&D facilities.

Auditor Recommendation:

The Legislature identified the public policy objectives for this tax preference for high technology R&D: to encourage investment in high technology R&D and to create "quality" jobs. However, the Legislature did not identify specific targets for these objectives, or what is meant by "quality" jobs.

This JLARC review finds results of the two tax incentives are mixed. The B&O tax resulted in an estimated one-time employment growth of 454 jobs with an average cost per new job of $45,000 and an estimated increase of new earnings per job of $25,000.

In addition, while beneficiaries made R&D expenditures in Washington, it is not clear how much of this spending occurred as a result of the tax credit. Thirty percent of the beneficiaries received reduced benefit from the B&O tax credit because of limitations on the amount of credit that could be taken.

The Legislature should review and clarify this tax preference to determine if progress toward its high technology R&D objectives is sufficient and to consider identifying targets for investment and employment.

Legislation Required:	Yes.
Fiscal Impact:	Depends on legislative action.

Supplement to the Tax Preference Review:

Enhancements are Needed in the Annual Taxpayer Survey and OFM's Input-Output Model

In the course of conducting this tax preference review, JLARC staff encountered difficulties with two tools related to evaluating preferences: 1) the annual survey that DOR uses to collect and report beneficiary information, and 2) the current version of the Office of Financial Management's Washington Input-Output Model. This Supplement to the tax preference review contains two recommendations to improve these tools for evaluating other tax preferences.

The Annual Taxpayer Survey

The Legislature stated in reference to the high technology preferences that "accountability and effectiveness are important aspects of setting tax policy," and that information on the tax preference is needed in order make decisions on the "best use of limited state resources." To allow for an on-going evaluation of the preference, the Legislature put in place mechanisms for DOR to collect and report information on the tax preference.

Mechanisms for **collecting** information from beneficiaries are:

- The **application** for deferred sales and use taxes, which businesses must file before initiation of construction of facilities or purchase of machinery and equipment. The application provides estimates of employment and wages, project costs, and schedule for completion of the project. DOR has to approve the application, and approved applications may be disclosed.
- Beneficiaries of the B&O tax credit and the sales and use tax deferral must file an **annual survey** with DOR that provides information on the amount of tax deferral claimed in the previous year, and employment, wages, and benefits for the preceding year. DOR may request additional information to measure results of the tax preference. The amount of the tax preference claimed may be disclosed. Other survey information must be aggregated by three or more beneficiaries.

The Legislature established three different mechanisms for DOR to **report** on the performance of these tax preferences:

1) DOR is to provide **annual descriptive statistics** to the Legislature every October. DOR uses information collected in the annual survey in its descriptive statistics. The descriptive statistics include information on the amount of tax preference claimed as well as information about jobs, wages, and benefits. Information is summarized to protect confidential employment and wage data.

2) The Legislature directed DOR to complete five **evaluations** of these preferences, in 1997, 2000, 2003, 2009, and in 2013 using information from the annual survey. The Legislature eliminated the 2013 DOR study requirement for the B&O tax credit and transferred responsibility to JLARC as part of the tax preference review process. However, DOR is still responsible for the study of the high technology sales and use tax deferral in 2013.
3) DOR is to provide information to the public on the amount of the tax credit and deferral claimed in the previous year for each beneficiary. If the amount on the survey is incorrect, DOR may disclose the correct amount using other sources.

DOR has completed annual descriptive statistics every year since 2004 when survey data became available. DOR submitted all of the evaluations by the prescribed due dates but did not submit the 2009 evaluation until April 2012. In addition, DOR provides information to the public by posting credit and deferral amounts specific to each type of tax preference on its website and in response to public requests. However, all three reporting mechanisms rely on survey information which overstates the amount of tax preference claimed.

Annual Surveys Do Not Provide the Information Needed by the Legislature to Evaluate the Preference

JLARC found inconsistencies between the tax preference information needed to evaluate the preferences and the information that DOR is collecting in the annual survey and providing to the Legislature and the public. This section provides two examples of this problem, one about the reported tax deferral amounts and one about reporting on job performance.

Reported sales and use tax deferral amounts – DOR is instructing the beneficiaries of the high technology R&D sales and use tax deferral to report taxes deferred in a way that results in misleading reporting about the preference. To illustrate this problem, consider a business that builds a qualifying new facility, accumulating a $100,000 sales tax bill that it can defer under this preference if it maintains the qualifying use and submits its required annual surveys. If it does so for eight years, the sales tax is waived.

The high technology R&D business is exempt from $100,000 in sales tax one time, as it makes the necessary purchases to build its facility. DOR, however, is directing the business to report that one-time sales tax saving every year for eight years. Exhibit 30, on the following page, illustrates the reporting that results from this practice. This reporting leaves the impression that the state is foregoing $100,000 in sales tax every year for this one project and that the amounts in each column could be added for an eight-year total.

Exhibit 30 – Example of How DOR's Reporting of the Annual R&D Sales Tax Deferral Would Not Match Actual Sales Tax Deferred

1 R&D Project	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8
Actual sales tax deferred	$100,000	$0	$0	$0	$0	$0	$0	$0
What DOR directs beneficiaries to report in the annual survey	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000
Deferral amount reported to the public by DOR	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000

Source: JLARC analysis of DOR annual survey instructions.

This JLARC review used actual sales and use tax amounts determined from audits of high technology R&D projects to overcome this problem.

Reported performance in creating jobs – The annual survey yields employment information that does not provide the Legislature with a clear picture of job performance among the beneficiaries of the high technology R&D tax preferences. To illustrate this problem, Exhibit 31, below, shows the employment information on the annual survey for a two-year period for the same 392 beneficiaries of the tax preferences that filed surveys in both years. These same beneficiaries reported **creating** 7,176 new positions between 2008 and 2009. They also reported **reducing** total employment by 4,699 employees. It is not clear what this means for overall employment performance for the taxpayer beneficiaries.

Exhibit 31 – Reporting on Annual Survey Gives No Clear Picture of Job Performance for Beneficiaries of the High Technology R&D Credit and Deferral

Year	Number of High Technology R&D Beneficiaries	Reported Washington Employees of the Beneficiaries	Reported New Employees of the Beneficiaries
2008	392	129,781	15,568
2009	392	125,082	**7,176**
Change in number of jobs between 2008 & 2009		**(4,699)**	

Source: JLARC Analysis of DOR Annual Surveys.

The economic analyses for this review used more reliable employment data from the Employment Security Department and statistical analysis to overcome this problem.

Auditor Recommendation 1:

The Department of Revenue should convene a work group to address how to improve the reliability and the accuracy of the information collected in the annual survey and reported to the Legislature and the public.

Legislation Required:	No.
Fiscal Impact:	JLARC assumes that this can be completed within existing resources.
Implementation Date:	In time for the 2013 annual survey.

Improvements Are Needed in OFM's Input-Output Model

Legislation in 2011 (SB 5044) directed JLARC to provide information on the economic impact of a tax preference compared to the economic impact of government activities funded at the same level of expenditure as the tax preference.

The 2011 legislation specifically directed JLARC to determine these economic impacts using the Washington Input-Output Model as constructed and maintained by the Office of Financial Management. This review of the two high technology tax preferences offered JLARC its first opportunity to conduct this kind of assessment of the potential opportunity costs associated with taking the tax preference amounts out of public sector spending. However, JLARC learned in the course of our analysis that the current version of the Washington Input-Output Model is not constructed to evaluate how the state and local government sectors relate to other sectors of the economy.

Recommendation 2 below would provide the Legislature with information on the estimated cost to enhance the input-output model.

Auditor Recommendation 2:

The Office of Financial Management should estimate the cost of including state government and local government as separate sectors within the Washington input-output model.

Legislation Required:	No.
Fiscal Impact:	JLARC assumes OFM can complete a cost estimate for this task within existing resources. The results of the OFM analysis will provide an estimate of the fiscal impact to improve the model.
Implementation Date:	In time for the Governor's 2013-15 budget submittal.

INSURANCE GUARANTY FUNDS (INSURANCE PREMIUMS TAX)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**Auditor Recommendation**
Allows insurance companies to credit guaranty fund assessments against their insurance premiums taxes in 20 percent increments annually, fully recouping the assessment after five years.	The Legislature did not state the public policy objective of the tax preference. JLARC infers the public policy objective is to allow insurers to recoup assessments paid to the guaranty funds.	$480,000 in 2013-15 Biennium	**Continue**: Because insurers are being allowed to recoup assessments to the guaranty funds.

INSURANCE GUARANTY FUNDS (INSURANCE PREMIUMS TAX)

Current Law

Washington insurance guaranty associations assess fees on insurance companies when required to cover claims against insolvent insurers. This tax preference allows insurance companies to credit this assessment against their insurance premiums taxes in 20 percent increments annually, fully recouping the assessment after five years.

When assessments are made, they are based on each insurer's share of Washington premiums and are deposited in two insurance guaranty funds operated by nonprofit Washington associations:

1) The Property and Casualty Insurance Guaranty Association, and
2) The Life and Disability Insurance Guaranty Association.

Fraternal insurance, health care service contractors, health maintenance organizations, and certain insurers not subject to the insurance code such as title, surety, and mortgage guaranty insurance companies are not members of insurance guaranty associations.

See Appendix 3 for the current statutes, RCWs 48.32.145 and 48.32A.125.

Legal History

1971 The Legislature created the two guaranty associations to pay claims of insolvent insurers. The acts required all companies doing business as property, casualty, life, and disability insurers in Washington to be members of a guaranty association.

1972 The life and disability guaranty association assessed insurance companies $2.6 million to pay claims of an insolvent insurer, Federal Old Line Insurance Company.

1974 In *Aetna Life Insurance Company*, nine insurance companies appealed the 1972 assessment to the state Supreme Court. The court ruled in favor of the guaranty association, thereby keeping the assessment in place.[3]

1975 The Life and Disability Guaranty Association informed the Legislature of a pending additional assessment to cover remaining policyholders of Federal Old Line, bringing the total assessment to $5 million. The Legislature enacted this preference for life and disability insurers, allowing them to credit 10 percent of the assessment against their insurance premiums tax annually for ten years. The preference allowed these insurers to fully recoup their assessments after ten years.

1976 The Legislature enacted a similar tax preference for property and casualty insurers, except that the assessment could be offset (or credited) over a five-year period.

[3] *Aetna Life Insurance Company et al. v. Washington Life and Disability Insurance Guaranty Association, 83 Wn.2d 523 (1974).*

1990 The Legislature gave the same treatment to life and disability insurers by allowing them to offset assessments over a five-year period rather than the original ten-year period.

1993 As part of a larger revenue enhancement package, the Legislature ended the 20 percent credit effective April 1993 for life and disability insurers and effective January 1999 for property and casualty insurers.

1997 The Legislature re-enacted credits for both associations, again offsetting the assessments over five years.

Public Policy Objectives

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

The Legislature did not state the public policy objective for the tax preference. However, the Legislature did state that the policy objective of the guaranty associations was to protect claimants and policy holders in case their insurers became insolvent.

JLARC infers from historic records that the Legislature intended to allow insurers to recoup assessments paid to the guaranty funds. The Legislature adopted the tax preference after the court approved the original assessment to cover Federal Old Line's policy claims and the guaranty association made known an additional assessment would be required.

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

The credit against the insurance premiums tax has allowed insurers to recoup their assessments within five years, thus reducing the impact of the assessments on the insurers. In total, the guaranty funds have paid $28.4 million in net expenses to Washington policyholders of 452 insolvent companies in the U.S. The assessments on insurance companies to cover these expenses have been recovered by reduced tax liabilities.

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

Continuing the tax preference will continue to allow insurers to recoup their assessments.

Beneficiaries

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

Beneficiaries are all authorized insurance companies doing business in Washington that take credits against the insurance premiums tax for guaranty fund assessments. Currently, 695 companies are members of the life and disability association and 513 companies are members of the property and casualty association. Some property and casualty insurers with disability lines of insurance are members of both associations.

Revenue and Economic Impacts

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

Exhibit 32, below, shows that beneficiaries saved an estimated $820,000 in Fiscal Year 2011 and are estimated to save a minimum of $480,000 in the 2013-15 Biennium. Beneficiary savings beyond the current year are minimum estimates because they do not include assessments for future insolvencies. It is difficult to predict if and when insurance companies will become insolvent. The Life and Disability Guaranty Association last issued an assessment in 2010, and the Property and Casualty Association last issued an assessment in 2006.

Exhibit 32 – Estimated 2013-15 Beneficiary Savings for Insurance Guaranty Fund Credit Against Insurance Premiums Tax

Fiscal Year	Credit for Life & Disability Assessments	Credit for Property & Casualty Assessments	Total Beneficiary Savings
2010	$1,570,000	$200,000	$1,770,000
2011	$780,000	$40,000	$820,000
2012	$780,000	$0	$780,000
2013	$480,000	$0	$480,000
2014	$480,000	$0	$480,000
2015	$0	$0	$0
2013-15 Biennium	**$480,000**	**$0**	**$480,000**

Source: Fiscal note on PSSB 6299 (2012); Figures are based on actual guaranty fund assessments.

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?

The beneficiaries would not be able to recover the amount of their assessments and could attempt to pass on any increases to their customers. The Office of the Insurance Commissioner (OIC) reports that it allows rates that are reasonable in relation to benefits, with allowances for expenses, profits, and sufficient reserves. The OIC has allowed increases in premium rates if premium taxes increase.

Other States

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

All but four states allow insurers that pay assessments to guaranty funds to offset their assessment against other taxes owed. In most cases, the offset is taken against the insurance premiums tax. Most states (33) allow insurers to offset assessments over five years, while other states (five) allow offsets over ten years. Massachusetts and New Jersey allow only 50 percent of the assessment to be offset. Four states — Alaska, Illinois, Maryland, and Maryland — have no offset provisions.

Auditor Recommendation:

The Legislature should continue the tax preference because the inferred public policy objective of allowing insurers to recoup assessments to the guaranty funds is being achieved.

Legislation Required: No.

Fiscal Impact: None.

Insurance Producers, Title Insurance Agents, and Surplus Line Brokers (B&O Tax)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**Auditor Recommendation**
Provides a lower B&O tax rate of 0.484 percent to insurance producers, title insurance agents, and surplus line brokers. The current general service rate is 1.8 percent.	The Legislature did not state the public policy objective of the tax preference. JLARC infers that the public policy objectives are: 1) To reduce the impact of B&O surtaxes on insurance contractors because they are unable to raise commissions to cover tax increases in the short term (1983); 2) To provide some equity for insurance businesses following the removal of pyramiding for real estate businesses (1983 and 1995); and 3) To simplify the tax code by consolidating B&O tax rates (1998).	$35.6 million in 2013-15 Biennium	**Review and Clarify:** Because it is unclear why the Legislature is providing different tax treatment to businesses with similar agent/sub-agent relationships; and because the inferred objectives related to the inability of passing on rate increases and of consolidating rates may no longer apply.

INSURANCE PRODUCERS, TITLE INSURANCE AGENTS, AND SURPLUS LINE BROKERS (B&O TAX)

Current Law

Insurance producers, title insurance agents, and surplus line brokers pay a lower business and occupation (B&O) tax rate of 0.484 percent. The current general service rate is 1.8 percent.

Insurance producer is a statutory term to describe all insurance agents, brokers, and solicitors. **Title insurance agents** sell policies for title companies. **Surplus line brokers** sell insurance to cover unique or unusual risks from insurance companies outside Washington for which coverage is not available in state. These insurance businesses are referred to collectively in this review as "contractors." Also in this review, the contractor who owns or manages the agency is referred to as an "agent," and the contractor who sells insurance is referred to as the "sub-agent."

Contractors are paid commissions by insurance companies to sell their products. If the contractor works out of an agency, the agent pays B&O tax on the full commission, and the sub-agent pays tax on his or her share of the commission. The shared portion of the commission is taxed twice. This is by design in the B&O tax and is known as "pyramiding."

See Appendix 3 for the current statute RCW 82.04.260(9).

Legal History

This legal history includes information on the B&O tax treatment of insurance businesses as well as real estate businesses. JLARC reviewed the tax preference on shared real estate commissions in 2011. Insurance businesses and real estate businesses have similar operations where sub-agents may work out of an agency and receive a share of the commission from the agent.

Between 1947 and 1969, insurance and real estate businesses received consistent B&O tax treatment on their commission income. That changed in 1970 when the Legislature began taxing the two differently. This divergence in their tax treatment continues today with the pyramiding removed for real estate commissions while insurance commissions are taxed at a preferential B&O tax rate.

1935 The Legislature created the B&O tax that imposed a tax on the privilege of engaging in business activities in Washington. In general, insurance contractors owed tax on their gross commissions at the 0.5 percent service rate. Legislators designed the B&O tax system to tax gross receipts or the value of products at each stage of producing a product or service. This is known as "pyramiding."

Without any statutory direction to do so, the Washington State Tax Commission issued a rule that removed the pyramiding effect of the tax on insurance commission income.

1947 Again with no statutory direction to do so, the Tax Commission issued a rule granting the same exemption to real estate businesses as it did to insurance businesses.

1969 Acknowledging that its rule of exempting real estate and insurance shared commissions had no basis in law, the Tax Commission reversed itself and began a program of registering and taxing real estate and insurance agents and sub-agents on their gross commissions.

1970 The Legislature reversed the Tax Commission with regard to real estate businesses but not insurance businesses. The Legislature removed the pyramiding for real estate commissions by exempting the sub-agent portion of the commission if the agent paid tax on the gross commission. Insurance businesses did not receive the same B&O tax treatment on their commission income. Both real estate and insurance commission income was taxed at the rate of 1.0 percent, the rate for most service activities at that time.

1983 The Legislature increased B&O tax rates for general services, but it established a new preferential rate for insurance commissions including a temporary surtax for a total tax rate of 1.1 percent. The real estate and general services rate increased to 1.5 percent.

1991 To conform to federal law, the Legislature defined persons selling life insurance full-time for a single insurance company as employees. Employees are exempt from paying B&O tax. Life insurance contractors selling insurance for multiple insurance companies and contractors selling other kinds of insurance continued to pay B&O tax.

1992 The state Supreme Court in *Impecoven v. Department of Revenue* ruled that insurance agents are not entitled to the same exemption that removed tax pyramiding for real estate agents. The court reasoned that the Legislature gave evidence of its intent to provide special tax treatment to real estate sales businesses and had rejected proposals to give consistent treatment to insurance businesses.[4]

1995 The Legislature again reduced insurance commission rates and reduced the overall surtax resulting in a 0.575 percent insurance rate and a 2.09 percent real estate and general service rate. The original bill would have removed tax pyramiding on insurance commissions, but this provision was removed before final passage.

1998 In a bill that consolidated several B&O tax rates, the Legislature reduced the rate on insurance commissions to the same 0.484 percent rate charged manufacturers, wholesalers, and radio and TV broadcasting, among others.

2007 The Legislature replaced the terms insurance agent, broker, and solicitor with "producer" to conform to licensing standards in other states. The term did not include title insurance agents and surplus line brokers.

2008 The Legislature updated the B&O tax statutes to recognize that the preferential insurance tax rate applied to the newly termed insurance "producers" and to title insurance agents.

2009 The Legislature again updated the statute to recognize that the tax preference also applied to surplus line brokers.

[4] *Impecoven v. The Department of Revenue*, 120 Wn2d 357 (1992).

In addition to these changes specific to insurance contractors, the Legislature applied broad tax increases to many businesses four times between 1951 and 1970. By 1970, service businesses paid B&O tax at the rate of 1.0 percent. The subsequent rate history of taxes on insurance, real estate, and general service activities is shown in Exhibit 33, below. Insurance services were provided a lower B&O tax rate than rates on other services in 1983, 1995, and 1998, while the Legislature removed the pyramiding for real estate agents and sub-agents in 1970. Temporary surtaxes are included in the rates.

Exhibit 33 – B&O Tax Rate on Insurance Reduced Relative to Service Rates

Year	Legislative Action	Insurance Commissions RCW 82.04.260(9)	Real Estate Commissions RCW 82.04.255	General Service RCW 82.04.290(2)
1970	Pyramiding removed from tax on real estate commissions	1.0%	1.0% (no pyramiding)	1.0%
1983	Overall B&O rates increased Insurance taxed at special rate	1.1%	1.5% (no pyramiding)	1.5%
1993	Service B&O rate increased Overall surtax applied	1.172%	2.13% (no pyramiding)	2.13%
1994-1995	Insurance rates and overall surtax reduced	0.575%	2.09% (no pyramiding)	2.09%
1997	Surtax expired; service rate reduced	0.55%	2.09% (no pyramiding)	2.09%
1998	Insurance B&O rates reduced	0.484%	2.09% (no pyramiding)	2.09%
2010	Real estate and general service rates increased through FY 2013	0.484%	1.8% (no pyramiding)	1.8%

Source: JLARC analysis of tax law. Excludes temporary surtaxes that applied equally to all services.

Other Relevant Background

Salespersons in other types of professional businesses are also paid on commissions, such as stock brokers and real estate agents and sub-agents. As with insurance contractors, these brokers, agents, and sub-agents are required to have professional licenses, and are typically independent contractors rather than employees.

However, insurance agencies and stock brokerages pay B&O tax on gross commissions without deduction for commissions shared with sub-agents, while real estate sub-agents are exempt if the tax on the commission is paid by the agent. Real estate businesses and stock brokers pay B&O tax at the same rate as the general service rate, while insurance businesses pay at a lower rate. Exhibit 34, below, illustrates the different tax rates and measure of the tax base that apply to professional businesses with similar agent and sub-subagent relationships and that share commission income.

Exhibit 34 – Businesses With Shared Commissions Are Taxed Differently

Type of Business	Tax Rate	Gross Commissions Paid to Agent	Shared Commissions Received by Sub Agents
Stockbrokers	1.8%	Taxable on gross	Taxable on share
Real estate agents	1.8%	Taxable on gross	Not taxable
Insurance, title & surplus line contractors	0.484%	Taxable on gross	Taxable on share

Source: JLARC analysis of tax law.

Note: Rates paid by stockbrokers and real estate agents become 1.5 percent on July 1, 2013.

Public Policy Objective

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

The Legislature did not specifically state the public policy objective for this preference.

From public records, JLARC infers that there may be three public policy objectives for the tax preference depending on the year in which the Legislature provided a lower B&O tax rate to insurance services relative to real estate and general services:

1) To reduce the impact of B&O surtaxes on insurance contractors because they are unable to raise commissions to cover tax increases in the short term (1983);
2) To provide some equity for insurance businesses following the removal of pyramiding for real estate businesses (1983 and 1995); and
3) To simplify the tax code by consolidating B&O tax rates (1998).

Inability to increase commissions to cover tax increases: The 1983 preferential rate was attached as an amendment to an overall rate increase on major taxes such as liquor, insurance premiums, and B&O taxes. The amendment allowed for an increase in the B&O tax rate on insurance services but at lower rates than real estate and general services. Testimony by sponsors suggested that the Legislature provided the preferential insurance rate because the industry operated on fixed commission contracts and could not immediately pass on tax increases to their customers.

Equity for insurance businesses following removal of pyramiding for real estate businesses: In 1995, the Legislature reduced the tax rate on insurance commissions because, as a bill sponsor indicated, insurance contractors were "taxed twice" on the same commission income. The Washington Supreme Court had ruled in 1992 that insurance contractors were not entitled to the same exemption that removed tax pyramiding on shared real estate commissions.

Rate consolidation: In 1998, the Legislature reduced the insurance services rate relative to real estate and general service rates as part of an effort to consolidate ten B&O tax rates into six rates in order to simplify the tax code.

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

One of the inferred public policy objectives is unclear, and it is also unclear whether two of these inferred public policy objectives still apply.

1) **Ability to increase commissions to cover tax increases:** Insurance contractors may have difficulty increasing commissions to cover tax increases in the short term but not in the long term. According to the Office of the Insurance Commissioner, insurance contractors have the ability to pass on tax increases to their customers by negotiating future commission rates to include B&O tax increases. The Office of the Insurance Commissioner reports that it allows insurance companies to increase premium rates to reflect tax increases as long as the rates are reasonable in relation to benefits and reserves are sufficient but not excessive. This ability to increase commissions to cover tax increases implies that the public policy objective may not be applicable in the long term.

2) **Equity for insurance businesses following removal of pyramiding for real estate businesses:** If the Legislature reduced insurance tax rates seeking to equalize tax burdens for insurance and real estate businesses following the removal of pyramiding for real estate businesses, this is not being achieved. Instead, insurance contractors are receiving a lower tax burden than real estate agents. Exhibit 35, below, shows an example where B&O taxes on a $1,000 commission shared evenly with a sub-agent participating in the sale are lower for insurance services than real estate services even though taxes on insurance commissions pyramid.

Exhibit 35 – Lower Insurance Commissions Rates Result in Lower Overall B&O Taxes
(Assumes $1,000 agent commission shared evenly with sub-agent)

	Agent Tax on Gross Commission	Sub-agent Tax on Shared Commission	Total Taxes Owed
Real estate services	$1,000 × 1.8% **$18.00**	$500 × 0% **$0.00**	**$18.00**
Insurance services	$1,000 × 0.484% **$4.84**	$500 × 0.484% **$2.42**	**$7.26**

Source: JLARC analysis of tax law and rules.

The Legislature has also not provided equivalent tax treatment for other professional businesses with agent/sub-agent relationships such as stock brokerages. It is not clear why the Legislature is providing different tax treatment to professions with similar relationships.

3) **Rate consolidation:** The B&O rate consolidation in 1998 reduced the number of rates from ten to six in an effort to "simplify" tax reporting. This reduced the insurance commission rate to 0.484 percent. However, today taxpayers may pay B&O tax at any of 12 different B&O tax rates and under 51 separate tax classifications. This evidence suggests that the objective of setting the rate at 0.484 percent for purposes of consolidating and simplifying B&O tax rates is no longer relevant, as the Legislature has continued to add more B&O tax classifications and rates through the years.

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

It is unclear why the Legislature is providing different tax treatment to businesses with similar agent/sub-agent relationships. It is also unclear whether two of the policy objectives still apply: to reduce the impact of surtax on life insurance contractors due to their inability to increase commissions and to simplify taxes by consolidating rates.

Beneficiaries

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

The beneficiaries of this tax preference are the insurance producers, title agents, and surplus line brokers who pay a reduced B&O tax rate.

In 2011, 5,000 taxpayers reported on the DOR tax return at the preferential B&O tax rate on insurance commissions. While this is much lower than the total number of licensees (120,000), there are a number of reasons. Some licensees are employees of insurance companies, and so they pay no B&O tax. Some licensees are not currently in business, and some insurance contractors earn commissions below the minimum threshold for reporting and paying tax on commissions.

The combined insurance commission income reported by taxpayers was $1.8 billion in Fiscal Year 2011.

Revenue and Economic Impacts

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

Beneficiaries saved an estimated $19.2 million in B&O taxes in Fiscal Year 2010 due to the preferential rate. Savings are calculated based on the difference between the general service rate and the insurance service rate. The B&O service rate is 1.8 percent effective May 1, 2010, but it will revert to 1.5 percent on July 1, 2013. Beneficiaries are estimated to save $35.6 million in the 2013-15 Biennium. See Exhibit 36, below.

Exhibit 36 – Estimated 2013-15 Beneficiary Savings from Preferential B&O Rate for Insurance Producers

FY	Gross Commissions	Insurance Rate	Service Rate	Beneficiary Savings
2010	$1,842,500,000	0.484%	1.525%	$19,200,000
2011	$1,790,300,000	0.484%	1.8%	$23,600,000
2012	$1,851,200,000	0.484%	1.8%	$24,400,000
2013	$1,802,600,000	0.484%	1.8%	$23,700,000
2014	$1,761,200,000	0.484%	1.5%	$17,900,000
2015	$1,742,600,000	0.484%	1.5%	$17,700,000
			2013-15 Biennium	**$35,600,000**

Note: The service rate in effect in 2010 assumes 1 month of collections at the 1.8% rate and 11 months at 1.5%.

Source: Amounts for 2010 and 2011 are estimates based on actual DOR tax returns; amounts for subsequent years are projections of these estimates using the Economic and Revenue Forecast Council's November 2012 forecast of the insurance premiums tax.

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

If the tax preference were terminated, insurance producers, title insurance agents, and surplus line brokers would pay higher taxes on their commissions. According to the Office of the Insurance Commissioner, while insurance contractors may have difficulty passing on a tax increase in the short term, future commissions could be negotiated at higher rates, and tax increases could ultimately be passed on to the insured in the form of higher insurance premium rates.

Other States

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

Most states impose a net income tax rather than a gross receipts tax like Washington's B&O tax. Net income taxes do not have a pyramiding effect on shared commission income because they are based on profits (income minus costs of doing business). In general, net income taxes provide specific credits and deductions instead of preferential rates for specific industries.

Auditor Recommendation:

The Legislature should review and clarify the preferential tax rate for insurance commissions because it is unclear why the Legislature is providing different tax treatment to businesses with similar agent/sub agent relationships; and because the inferred objectives related to the inability of passing on rate increases and of consolidating rates may no longer apply.

Legislation Required:	Yes.
Fiscal Impact:	Depends on legislative action.

Leases Under $250 per Year and Short Term Leases (Leasehold Excise Tax)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**Auditor Recommendation**
Exempts private leases of publicly owned property from leasehold excise tax where: • The taxable rent is less than $250 per year, or • The possession or use is less than 30 days.	The Legislature did not state the public policy objective of the preferences. JLARC infers the public policy objective is to define the leasehold excise tax base by avoiding double taxation and by easing administration of the tax.	$5.6 million in 2013-15 Biennium	**Continue**: Because the preferences are meeting the inferred public policy objectives of avoiding double taxation and easing administration of the leasehold excise tax.

LEASES UNDER $250 PER YEAR AND SHORT TERM LEASES (LEASEHOLD EXCISE TAX)

Current Law

These preferences provide exemptions from leasehold excise tax for private leases of publicly owned property in two cases:

- Where the taxable rent is less than $250 per year; or
- Where the possession or use is short term (less than 30 days).

The leasehold excise tax (LET) is a tax in-lieu-of property tax, paid for private uses or leases of publicly owned real or personal property. Examples include municipal docks, port properties, moorages and landing fields, and recreational cabins on publicly owned lands. A "leasehold interest" is the right to possess and occupy and use publicly owned property that is exempt from property tax. "Publicly owned" means owned by the federal, state, or city governments, school districts, or other municipal organizations.

The tax is applied to the lease, rent, fee, or other value attached to the leasehold interest which is generally in the public land or publicly owned structures. It is not based on the value of the property itself.

See Appendix 3 for the current statutes, RCW 82.29A.130 (8)-(9).

Legal History

Historically, the Washington State Constitution exempted all publicly owned property from property taxation. Private leasehold interests in public property were taxed inconsistently under property tax. When leasehold interests were taxed, the tax was based on a valuation standard established by the State Supreme Court in the *Metropolitan Building Company* cases in the early 1900s. The Court's valuation standard based the tax on the lessee's equity in the lease rather than on the lease's fair market value.

Late 1960s The King County Assessor attempted to assess property tax on the value of public property leased to private businesses based on the fair market value of the lease, which was not the established standard at the time. This resulted in litigation involving property owned by the Port of Seattle that was leased to a private corporation (the Edgewater Inn on Seattle's Pier 67).

1969 The Legislature considered a bill that would have nullified the old valuation standard established by the earlier *Metropolitan Building* cases. The bill received strong opposition, particularly from the Washington Public Ports Association and the University of Washington and was not enacted.

1970 The Port of Seattle and the private lessor of port property appealed the King County Assessor's tax assessment from the late 1960s. In *Pier 67, Inc., v. King County*,[5] the State Supreme Court ruled that a leasehold interest in publicly owned property could be valued using the lease's fair market value over the lease period.

In revising the valuation method and overturning 60 years of precedent, the Court declared "the standards of valuation for assessing leaseholds are the same standards for valuing and assessing taxable property in general."[6] This imposed a tax burden for many leaseholds on publicly owned property that had escaped taxation under the Court's earlier decisions.

1971 The next year, the Legislature enacted a "leasehold moratorium act" that suspended applying the *Pier 67* decision for assessment years before 1973. The Legislature adopted an interim method of assessing the fair market value of leasehold property that allowed deduction for rent or consideration for the unexpired lease term but did not allow a deduction for indebtedness.

1973 The Legislature ended the moratorium and enacted a 14 percent in-lieu excise tax based on the value of leases on private lessors of public property.

1975-1976 The Legislature enacted a new leasehold excise tax (LET) at a rate of 12 percent based on the value of the leases, repealing the tax passed in 1973. Cities and counties were allowed to impose a local option LET at a rate of 4 and 6 percent, respectively. The local option taxes were allowed as credits against the state tax, so the combined state/local tax rate remained at 12 percent. The enacting legislation included 11 exemptions from the LET, including the two under JLARC review here: one for leaseholds with an annual taxable rent less than $250, and another for leases for a period less than 30 days.

1977 The Washington State Supreme Court issued the *Japan Line v. McCaffrey*[7] decision, noting the Legislature enacted the LET to resolve "a 6-year controversy over the best and most equitable manner of taxing benefits received by (private) lessees of publicly owned property." The Court stated the Legislature's intent in enacting the new tax law was "that the excise tax was intended to replace the [property] tax.

1982 The Legislature added a temporary surcharge to the 12 percent tax rate. The surcharge became permanent on July 1, 1983, resulting in the current combined LET rate of 12.84 percent.

Other Relevant Background

Leasehold Excise Tax Basics

Since publicly owned property is not subject to regular property tax, LET allows taxation of all property so that private users of government-owned property do not realize an economic benefit over privately owned property. Examples include airline facilities at public airports, use of state

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[5] *Pier 67, Inc., v. King County, et.al.*, 78 Wn.2d 48; 469 P.2d902 (1970).

[6] *Pier 67, Inc., v. King County, et.al.*, 78 Wn.2d 48; 469 P.2d902 (1970) pg. 52.

[7] *Japan Line v. McCaffrey,* 88 Wn.2d 93 (1977).

owned tidelands managed by the Department of Natural Resources, businesses leasing properties owned by the University of Washington in Seattle's downtown core, and national forest land leased for recreational cabins.

The leasehold excise tax is paid by the person or business that uses/leases government-owned real or personal property. The lessor of the property collects the tax from the lessee, then reports and pays the tax to the Department of Revenue on a quarterly basis. In 2010, there were 1,679 registered leasehold excise tax accounts. Usually, buildings or other improvements have been added to the property. In such cases, the leasehold interest is in the public land or publicly owned structures, while any privately owned improvements are subject to regular property tax.

The LET tax rate is 12.84 percent. Cities and counties may levy a local LET on leasehold interests in public property within their jurisdictions up to a maximum rate of 6 percent, reducing the state rate on such property to 6.84 percent. The maximum city rate is 4 percent and is credited against the county rate. The maximum county rate is 6 percent in unincorporated areas and 2 percent in cities that levy the maximum rate. As of January 2012, there are 156 cities and counties that levy a local LET.

Public Policy Objectives

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

The Legislature did not expressly state the public policy objectives when it enacted the two preferences.

It did, however, state its intent in enacting the leasehold excise tax: to provide uniformity in taxation and to compensate government entities for services and benefits enjoyed by private lessees of public properties that are exempt from property tax under the State Constitution. Thus, the LET was intended to ensure that lessees of publicly owned properties paid their "fair share" of the cost of government services when that property is rented or leased to people or businesses that would be subject to property tax if they owned the property.

JLARC infers from a thorough review of various historical documents, histories, and legal and legislative analyses that the preferences were intended to define the leasehold excise tax base by avoiding double taxation and by easing administration of the tax:

- The exemption for uses less than 30 days may be to avoid taxing such uses twice. Generally, a lease/use of real property for a period of less than 30 days is subject to either B&O tax (for licenses to use real property) or retail sales tax (for short-term lodging services). The LET exemption prevents government-owned properties used for short timeframes from being subject to both B&O tax or retail sales tax and LET on the property use.
- A Department of Revenue report notes the $250 threshold provides administrative convenience to lessees, lessors, and the Department of Revenue.

What evidence exists to show that the tax preferences have contributed to the achievement of any of these public policy objectives?

The preferences for leasehold interests under $250 per year and for periods of less than 30 days function to define the tax base for LET by specifically excluding leases fitting these two scenarios from taxation. JLARC could find no situations where these exemptions were specifically discussed in documents, either at the time of enactment or thereafter. They appear to be achieving the implied public policy objective of establishing the LET's base.

The exemption for leasehold interests of less than 30 days is achieving its inferred public policy objective of establishing the taxable base by ensuring that such uses, which are generally subject to retail sales tax, are not also subject to LET.

The Department of Revenue indicates it is unusual to find any leasehold interests less than $250 per year. However, the Department does not suggest revisiting the threshold amount, noting the administrative savings by increasing the $250 threshold would be minimal, due to the small number of leasehold excise tax taxpayers.

To what extent will continuation of the tax preferences contribute to these public policy objectives?

Continuation of these preferences will continue to define the tax base for the leasehold excise tax.

Beneficiaries

Who are the entities whose state tax liabilities are directly affected by the tax preferences?

Beneficiaries of the preferences include private persons, businesses, corporations, or other organizations that lease government-owned property for either annual leases of $250 or less or for periods of less than 30 days.

Examples of short-term leases include:

- Renting a public hospital exam room to a doctor for his or her business use;
- A county-owned fairground renting space to a group for a party or a weekend event; and
- A city renting a parcel to a vendor to set up a vending stand for a 3-week period during the year.

Examples of annual leases less than $250 include:

- A rural airport leasing a long-term parking space;
- A rural port providing space to dry-dock a boat during the winter; and
- Leasing a tie down at a rural airport.

Revenue and Economic Impacts

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

Since the leasehold excise tax exemptions provided by these preferences do not require beneficiaries to report, file, deduct, or otherwise document their use of the preferences, it is difficult to determine the beneficiary savings realized.

The Department of Revenue's 2012 Tax Exemption Study estimated the 2013-15 Biennial beneficiary savings for these preferences at $5.6 million. See Exhibit 37, below. JLARC could not determine an alternative method for estimating the beneficiary savings.

Exhibit 37 – DOR Estimated 2013-15 Beneficiary Savings - Leasehold Excise Tax Exemptions for Short Term Leases and Annual Leases Less Than $250

Fiscal Year	Estimated Base Value	State Portion (6.84%)	Local Portion (6.00%)	Combined Estimated Savings
2010	$17,346,000	$1,186,000	$1,041,000	$2,227,000
2011	$18,229,000	$1,247,000	$1,094,000	$2,341,000
2012	$19,157,000	$1,310,000	$1,149,000	$2,459,000
2013	$20,132,000	$1,377,000	$1,208,000	$2,585,000
2014	$21,158,000	$1,447,000	$1,270,000	$2,717,000
2015	$22,235,000	$1,521,000	$1,334,000	$2,855,000
2013-15 Biennium		**$2,968,000**	**$2,604,000**	**$5,572,000**

Source: Department of Revenue 2012 Tax Exemption Study workpaper. Growth in estimated base calculated on average LET collections increase, 2004-2010.

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

If the preferences were terminated, lessees of publicly owned property for uses less than 30 days may be subject to both retail sales tax and leasehold excise tax. Lessees of publicly owned property for less than $250 per year would be required to pay LET, and the Department of Revenue would have to identify them for taxation purposes. Any effect on employment and the economy would depend on lessees' ability to absorb the higher cost or pass it on to others.

Other States

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

JLARC did not address this question due to the unique structure of Washington's leasehold excise tax.

Auditor Recommendation:

The Legislature should continue the tax preferences because they are meeting their inferred public policy objectives of avoiding double taxation and easing administration of the leasehold excise tax.

Legislation Required:	No.
Fiscal Impact:	None.

MINOR FINAL ASSEMBLY COMPLETED IN WASHINGTON (B&O TAX)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**Auditor Recommendation**
Provides a business and occupation (B&O) tax deduction to manufacturers that perform minor final assembly in Washington on components that have been imported from outside the United States.	The Legislature did not state the public policy objective of the tax preference. JLARC infers that the public policy objective is to address the specific circumstance of the assembly of Chevrolet LUV trucks at the Port of Seattle in order to retain that operation.	None	**Terminate**: Because of changes in federal import regulations, imported truck components are no longer being assembled at Washington ports, and there are no known beneficiaries of this deduction for minor final assembly.

MINOR FINAL ASSEMBLY COMPLETED IN WASHINGTON (B&O TAX)

Current Law

Current law provides a business and occupation (B&O) tax deduction to manufacturers that perform minor final assembly in Washington on components that have been imported from outside the United States.

Minor final assembly is defined as costing 2 percent or less of the value of the completed product. Manufacturers do not receive the preference and pay B&O tax on the full value of the finished product if the value of the additional in-state manufacturing is greater than 2 percent of the value of the completed product.

Under this tax preference, the amount of the deduction is the value of the article manufactured outside the U.S. Exhibit 38, below, shows an example of the tax on a cab chassis and truck bed with a combined value of $10,000 manufactured in Japan and shipped to Washington to be assembled into a pickup. In the first scenario, the in-state manufacturing cost is $1,000; in the second scenario, the in-state manufacturing cost is $150.

- In the first scenario, B&O tax is due on the full truck value of $11,000 because the in-state manufacturing costs are 10 percent of the value of the finished truck; and
- In the second scenario, B&O tax is due on only the $150 in-state manufacturing costs because the in-state costs are less than 2 percent of the value of the finished truck.

Exhibit 38 – Tax Preference Applies Only If Value of In-State Manufacturing Is 2% or Less of Finished Value

	Manufacturing done outside U.S.	$10,000	
		Scenario 1	Scenario 2
+	In-state manufacturing	$1,000	$150
=	Finished truck's value	$11,000	$10,150
	Is in-state manufacturing greater than 2% of finished truck's value?	Yes	No
	Manufacturing B&O tax of 0.484% due on:	Finished truck's value ($11,000)	In-state manufacturing ($150)
	Tax Due	$53.25 ($11,000 X 0.484%)	$0.73 ($150 X 0.484%)

Source: JLARC analysis of tax law.

Businesses are eligible for this deduction if:

1) The activity is otherwise taxable under manufacturing B&O tax;
2) The minor final assembly is normally done at the place of initial manufacture if the product were manufactured domestically;
3) The total cost of the minor final assembly does not exceed 2 percent of the value of the product sold; and
4) The articles are subsequently sold and shipped outside the state.

There are few circumstances in which this deduction would apply. The legislative history suggests that the deduction was originally intended to apply to manufacturers that shipped cab chassis and truck beds to be assembled into pickup trucks at Washington ports.

Final assembly of imported trucks no longer takes place at Washington ports. Although some finishing of imported products takes place in this state, the Department of Revenue (DOR) does not consider it manufacturing for tax purposes. Manufacturing is defined in tax law as activities where labor and skill are applied to a producer's own materials to make a "new, different, or useful product." The definition excludes activities that are merely incidental to manufacturing such as altering or improving.

See Appendix 3 for the current statute, RCW 82.04.4295.

Legal History

1963 President Lyndon Johnson signed a proclamation imposing a 25 percent duty on foreign imported trucks valued at $1,000 or more. This duty became known as the "chicken tax" because the European Economic Community had earlier imposed a protective tariff on frozen chickens from the United States. The U.S. duty was originally intended to retaliate against the tariff on chickens by imposing a duty on German-made Volkswagen vans which were classified as trucks.

1966 In response to a 1965 state Supreme Court decision, the Washington Department of Revenue (DOR) ruled that manufacturers importing articles for further manufacturing owed B&O tax on the gross value of the product. The Court had decided in *Reynolds Metals v. Washington*[8] that the value of ore shipped into this state for manufacture into aluminum ingots could not be deducted from the value of the manufactured product for purposes of the B&O tax.

1970s Although originally intended for European imported trucks, the federal 25 percent duty began to apply to pickup trucks imported from Asia as their values started to exceed the $1,000 federal limit threshold. Japanese manufacturers began importing cab chassis and rear beds as separate components for assembly in the U.S. rather than paying the 25 percent duty on the finished product. At that time, U.S. Customs assessed a lower duty of 4 percent on separate truck components.

[8] *Reynolds Metals v. Washington, 65 Wn. (2d) 882 (1965).*

During the 1970s, two automobile manufacturers assembled trucks in Washington—Toyota at the Port of Tacoma and Isuzu (partly owned by General Motors) at the Port of Seattle. DOR had allowed small changes to vehicles upon entry without imposing the manufacturing B&O tax, but the agency determined that assembly of trucks constituted manufacturing and that manufacturers owed tax on the full value of the vehicle.

1976 DOR began asserting tax on the full value of trucks assembled in Washington. Following this action, Toyota moved its truck assembly operation to the Port of Portland.

1977 The next year, the Legislature enacted this B&O deduction for the value of articles manufactured outside the U.S. if minor final assembly takes place in this state.

The original bill would have excluded all manufacturing from tax if the final assembly in Washington cost less than 5 percent of the value of the article, and the preference would have applied to all manufacturers shipping into Washington. As adopted, the bill reduced the limit on final assembly to 2 percent and more narrowly applied the deduction to components manufactured in foreign countries.

1980 U.S. Customs redefined imported cab chassis as trucks and imposed the federal 25 percent duty. This change at the federal level removed the incentive for overseas manufacturers to ship component parts for minor assembly in Washington or any other state. After the change in definition, Asian truck vehicle manufacturers that had previously assembled pickup trucks in Washington opened manufacturing plants elsewhere in the U.S.

The lone known beneficiary of the deduction, General Motors/Isuzu which assembled Chevy LUV trucks at the Port of Seattle, ended its operations in the 1980s.

Public Policy Objectives

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

The Legislature did not state the public policy objective of the tax preference.

From the legislative record, JLARC infers that the Legislature intended to address the specific circumstance of the assembly of Chevrolet LUV trucks at the Port of Seattle in order to retain that operation.

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

The preference may have contributed to the inferred public policy objective before 1980, prior to when U.S. Customs began imposing the federal 25 percent duty on imported truck chassis. Overseas manufacturers can no longer avoid the higher federal duty by doing minor assembly of trucks in Washington or in any other state.

There is no evidence that truck assembly currently takes place in Washington. In the 1980s, the Port of Seattle converted the terminal that housed General Motors/Isuzu truck assembly into cold storage warehouses for Washington food product exports.

Currently, ports at Grays Harbor, Vancouver, and Tacoma receive shipments of automobiles that require some finishing, such as attaching side view mirrors, installing air conditioners, or customizing to appeal to specific markets. DOR considers this work to be altering and improving rather than manufacturing.

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

Because there are no known instances of taxpayers benefiting from the tax preference, continuation of the tax preferences would have no effect.

Beneficiaries

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

JLARC could not find any beneficiaries currently claiming this tax preference. At the request of JLARC, the Washington Public Port Association polled their member ports and DOR polled its auditors. Neither the ports nor DOR could find any current activity that would be eligible for the deduction.

Revenue and Economic Impacts

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

There is no revenue and economic impact because there are no known beneficiaries.

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?

There would be no negative effects because no known taxpayers are using the preference.

Other States

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

JLARC could not find any other state that imposes a broad-based gross receipts tax on manufacturing activity similar to Washington and provides an exemption for minor final assembly.

Auditor Recommendation:

The Legislature should terminate the tax preference because it is no longer meeting its inferred public policy objective: in part because of changes in federal import regulations, imported truck components are no longer being assembled at Washington ports, and there are no known beneficiaries of this deduction for minor final assembly.

Legislation Required:	Yes.
Fiscal Impact:	No impact.

NATURAL AND MANUFACTURED GAS (SALES AND USE TAX)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**Auditor Recommendation**
Provides a sales/use tax exemption for natural and manufactured gas purchased by consumers when the consumer pays Washington's brokered natural gas use tax.	The Legislature did not state a public policy objective for the preference. JLARC infers the public policy objectives of the preference, working in conjunction with the brokered natural gas use tax, are to: 1) Ensure equitable taxation by avoiding double taxation of natural or manufactured gas purchased from outside the state; 2) Provide local governments with a continued source of local tax revenue; and 3) Comply with the federal Constitution.	$193.7 million in 2013-15 Biennium	**Continue:** Because it is meeting the inferred public policy objectives of: 1) Ensuring equitable taxation by avoiding double taxation; 2) Providing local governments with a continued source of local tax revenue; and 3) Complying with the federal Constitution.

NATURAL AND MANUFACTURED GAS (SALES AND USE TAXES)

Current Law

This preference provides an exemption from state and local retail sales or use taxes for natural and manufactured gas purchased by consumers when the consumer pays Washington's brokered natural gas use tax.

"Brokered natural gas" is natural or manufactured gas purchased by a consumer from a source outside the state that is delivered to the consumer instate. Throughout this discussion, the terms "brokered natural gas (BNG)" and "natural and manufactured gas" are used interchangeably. For this preference, the consumers are generally large, in-state commercial or industrial users of natural or manufactured gas.

Current brokered natural gas use tax rates are:

- **State rate:** 3.852 percent
- **Local rate:** From 0 to a maximum of 14.75 percent, as set by local municipalities. Six percent is the most common rate and the maximum authorized without requiring local voter approval.

Natural or manufactured gas used in cities that do not impose a local brokered natural gas tax is only subject to the state rate.

See Appendix 3 for the current statutes, RCW 82.08.026; 82.12.023; and 82.14.030(1).

Legal History

Beginning in the mid-1800s, sales to consumers of natural and manufactured gas were regulated by local and federal governments. Natural gas distribution was deemed, first by local and then by the federal government, as a business that affected the public interest to a sufficient extent to merit regulation. Before the natural gas industry was deregulated, commercial and industrial consumers were required to purchase their natural gas from local distributors or local gas companies. Natural gas sellers paid state and local natural gas distribution public utility taxes on their sales.

1935 The Legislature enacted the public utility tax (PUT), with a special reporting classification for gas distribution. "Gas distribution business" was defined as "the business of operating a plant or system for the production or distribution for hire or sale of gas, whether manufactured or natural."

1985 The federal government deregulated natural gas sales, following deregulation in the airline, trucking, and telephone industries. In the natural gas industry, the price of the commodity supply was opened up to competition.

1986-1988 Following federal deregulation, large industrial and institutional users of natural gas increasingly purchased gas through brokers from sellers in other states. Although the gas may have been delivered through a local gas company's pipeline, the sale/purchase was considered to occur outside the state. Such purchases of brokered natural gas (BNG) were not subject to PUT; instead they were subject to sales or use tax.

Some utilities collected and reported sales tax on such sales and some purchasers reported use tax on their purchases. However, there was confusion about the tax liability of such transactions. In addition, cities that imposed a natural gas PUT saw a significant loss in revenue after federal deregulation.

1989 The Legislature enacted a new use tax on the use of BNG in Washington. The tax had a state and potential local tax component, with the rates for each matching the PUT rate for gas distribution. In the same bill that established the new BNG tax, the Legislature specifically exempted natural and manufactured gas from state and local sales/use taxes when BNG use tax had been paid by the consumer.

2010 The Legislature passed a bill clarifying that local BNG use tax is imposed where a taxpayer burns or stores natural or manufactured gas. The law went into effect June 10, 2010, and applied to natural gas used on or after that date.

In July, the Washington State Supreme Court upheld a Department of Revenue interpretation that local BNG use tax is imposed where the gas is burned, regardless of where it was first received by the taxpayer.[9] In finding for the Department, the court stated, "the legislature expressed its clear purpose to authorize municipalities to tax entities for the use of natural gas within city limits."

Other Relevant Background

Brokered Natural Gas Use Tax

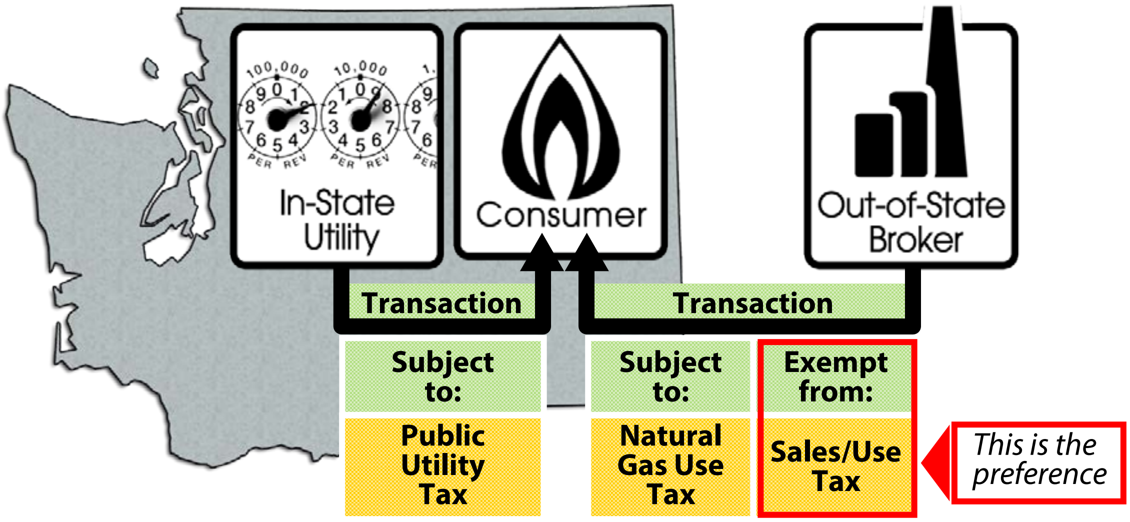
Generally, natural gas distribution and sales are subject to public utility tax in Washington. However, for natural and manufactured gas that is purchased through an out-of-state broker and delivered into the state via a pipeline, PUT does not apply. Such purchases would generally be subject to state and local sales or use tax. This preference provides an exemption from state and local sales/use tax when consumers directly pay BNG use tax on their natural/manufactured gas purchases from out-of-state brokers. See Exhibit 39, on the following page.

BNG use tax is paid by the in-state user and is measured by the value of the gas when delivered to the customer. The Department of Revenue administers the state tax, and cities contract with the Department to collect the local tax for them. The state BNG tax goes to the state's General Fund; the local BNG goes to the city for general purposes.

[9] *G-P Gypsum Corp. v. State Department of Revenue*, 169 Wn.2d 304 (2010).

Exhibit 39 – Consumers That Pay Natural/Manufactured Gas Use Tax Exempt from Sales/Use Tax

Natural or manufactured gas purchased from an out-of-state broker is exempt from sales/use tax when natural gas use tax is paid by the consumer.



Source: JLARC analysis of RCWs 82.08.026; 82.12.023; 82.14.030(1).

The BNG use tax rate is the same as gas distribution PUT. Since the state's BNG rate is about one half of the state sales/use tax rate, the state collects less in tax money under the BNG than it would have collected under sales/use tax.

However, some cities that impose a local BNG use tax collect more than they would have under local sales/use taxes. Cities that impose BNG use tax can charge rates up to 6 percent without voter approval, a rate higher than the current average local sales tax rate of 2.412 percent. Tax rates in excess of 6 percent must be approved by local voters. Seven municipalities currently impose a rate higher than 6 percent.

As of January 1, 2012, 56 cities assess a local BNG tax – 37 in western Washington and 19 in eastern Washington. Eight cities impose graduated rates based on the volume of natural/manufactured gas used. A higher rate applies to gas used up to a certain dollar amount annually or monthly (each city varies); once the dollar amount is reached, either a lower rate or no tax applies.

Public Policy Objectives

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

The Legislature did not state the public policy objective for providing an exemption from sales/use tax on natural and manufactured gas upon which BNG use tax is paid.

JLARC infers the public policy objectives of the preference, working in conjunction with the brokered natural gas use tax, are to: 1) ensure equitable taxation by avoiding double taxation of natural or manufactured gas purchased from outside the state; 2) provide local governments with a continued source of local tax revenue; and 3) comply with the federal Constitution.

The exemptions were part of the same bill that implemented the BNG use tax. The Legislature stated its intent for implementing the brokered natural gas use tax in the enacting statute:

> *Due to a change in the federal regulations governing the sale of brokered natural gas, cities have lost significant revenues from the utility tax on natural gas. It is therefore the intent of the legislature to adjust the utility and use tax authority of the state and cities to maintain this revenue source for the municipalities and provide equality of taxation between intrastate and interstate transactions.*

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

The tax preference appears to be achieving its three inferred public policy purposes:

1) It avoids double taxation, ensuring that a consumer does not pay both BNG and sales/use tax on the same purchase.

2) The preferences ensure a means for cities to maintain a revenue source from consumers that purchase gas from outside the state.

   In the 2010 *G-P Gypsum Corp.* case, the Washington State Supreme Court noted that session law included a statement of legislative purpose and also stated that after federal deregulation, consumers began to buy gas directly from producers rather than from local distribution companies. This resulted in cities losing revenue on natural gas sales because when consumers stopped buying gas from local distributors, their purchases were no longer subject to either state or local PUT. The court noted the Legislature sought to remedy the situation by giving cities the authority to tax natural gas **use** rather than its **sale**, thus allowing them to generate tax revenues even when gas was purchased from outside the state.

   The Court further noted the factual situation the Legislature sought to address: a manufacturer (consumer) who before deregulation would have purchased natural gas from a local distribution company may now purchase gas from an out-of-state broker and thus avoid the local utility tax. The Court stated:

   > *When we properly consider the legislative intent behind the local BNG tax in construing the plain meaning of the statutes at issue, it is clear that the local BNG gas tax holds a special position within the universe of Washington use tax provisions. It is a tax that is designed to mimic a locality's public utility tax.*[10]

   As of January 1, 2012, 56 cities impose a local BNG tax. These cities are collecting more under the BNG than they would under local sales tax.

3) Finally, the preferences ensure Washington complies with the federal Constitution and does not discriminate against interstate commerce by taxing interstate transactions such as purchases of natural or manufactured gas from an out-of-state broker at a higher rate than

[10] *G-P Gypsum Corp. v. State Department of Revenue*, 169 Wn.2d 304 (2010).

in-state sellers. Natural and manufactured gas sold through in-state utilities and through out-of-state brokers is taxed similarly and at the same rates, whether under public utility tax or under natural/manufactured gas use tax.

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

Continuation of the preference would continue to allow consumers to avoid double taxation on natural and manufactured gas purchased from outside the state, to provide local governments with a source of local tax revenue, and to comply with the federal Constitution.

Beneficiaries

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

The beneficiaries of this preference are consumers of brokered natural gas that pay BNG use tax, which exempts them from having to pay retail sales/use taxes. In Fiscal Year 2011, 287 taxpayers reported BNG use tax to the Department of Revenue. The beneficiaries include:

- Public and private hospitals
- Public and private colleges
- Gas distributors
- Construction businesses
- Food product and industrial manufacturers
- Food distributors and grocery chains
- Refineries
- State agencies

Revenue and Economic Impacts

What are the past and future tax revenue and economic impacts of the tax preferences to the taxpayer and to the government if they are continued?

JLARC estimates the beneficiary savings for the 2013-15 Biennium to be $193.7 million. See Exhibit 40, on the following page.

To determine the beneficiary savings for this preference, JLARC assumed that without these preferences, beneficiaries would pay state and local sales/use taxes on their purchases of BNG from out-of-state brokers, in addition to state and local BNG use tax.

Exhibit 40 – Estimated 2013-15 Beneficiary Savings for Natural/Manufactured Gas Upon Which BNG Use Tax is Paid

FY	State Sales/Use Tax (6.5%)	Local Sales/ Use Tax (2.412%)	Total Combined State & Local Sales Tax
2010	$79,518,000	$29,563,000	$109,081,000
2011	$61,694,000	$22,931,000	$84,625,000
2012	$70,606,000	$26,244,000	$96,850,000
2013	$70,606,000	$26,244,000	$96,850,000
2014	$70,606,000	$26,244,000	$96,850,000
2015	$70,606,000	$26,244,000	$96,850,000
2013-15 Biennium	**$141,212,000**	**$52,488,000**	**$193,700,000**

Source: 2010 & 2011 – DOR BNG Tax Return data; 2012-2015 - estimated by JLARC. JLARC did not calculate any growth in the tax in future years, due to the unpredictable nature of the tax.

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

If the tax preference were to be terminated, consumers who currently purchase brokered natural or manufactured gas through out-of-state brokers might have to pay not only the brokered natural gas use tax on their purchases but also state/local sales or use tax on the value of the gas used. This would increase their tax on such gas purchases/uses by between 7 percent and 9.5 percent (depending on the location where the gas is used or stored).

A repeal of the preference may raise constitutional questions, based on possible discrimination against interstate commerce. If challenged for constitutional reasons, it is questionable whether repealing the preference would ultimately result in revenue collections from both the BNG use tax and retail sales/use taxes.

Other States

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

JLARC did not address this question because the brokered natural gas use tax is unique to Washington. This preference addresses issues of tax equity within Washington's tax structure and ensures conformity to federal Constitutional requirements.

Auditor Recommendation:

The Legislature should continue this tax preference because it is meeting the inferred public policy objectives of: 1) ensuring equitable taxation by avoiding double taxation; 2) providing local governments with a continued source of local tax revenue; and 3) complying with the federal Constitution.

Legislation Required:	No.
Fiscal Impact:	None.

PRECIOUS METAL AND BULLION (SALES AND USE, B&O TAX)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**Auditor Recommendation**
The two preferences: • Exempt sales or use of precious metal and bullion from sales/use tax; and • Subjects sellers of precious metal and bullion to B&O tax on commissions on transactions for third parties, not on gross receipts.	The Legislature did not state the public policy objective of the tax preferences. JLARC infers the public policy objective is to make Washington coin and bullion dealers more competitive with out-of-state competitors by treating precious metal and bullion sales like sales of investments rather than sales of tangible personal property.	$42.2 million in 2013-15 Biennium	**Review and clarify**: Because implementation of the statute may not be achieving the inferred public policy objective of treating precious metal and bullion sales like sales of investments.

PRECIOUS METAL AND BULLION (SALES AND USE TAX, B&O TAX)

Current Law

This review covers two tax preferences that work together related to purchases of precious metal, coin, and monetized bullion in Washington. We will use the term "precious metal and bullion" to refer to these products throughout this review. The preferences work together as follows:

- **Sales and use tax exemptions – Buyers** are exempt from sales or use taxes on their purchases or use of precious metal and bullion.
- **Special B&O tax treatment** – Rather than paying business and occupation (B&O) tax on their gross receipts at the lower retailing or wholesaling B&O rates, **sellers** of precious metal and bullion pay tax at the higher service and other activities B&O tax rate **but only on amounts they receive as commissions on the transactions.**

Absent these two preferences, **buyers** of precious metal and bullion would be subject to state and local sales taxes ranging between 7.0 and 9.5 percent, and **sellers'** gross receipts from such sales would be subject to either retailing or wholesaling B&O tax (0.471 and 0.484 percent, respectively). The service and other activities B&O tax rate is higher (currently at 1.8 percent), but the sellers pay only on commissions they receive from certain transactions rather than on their gross receipts from a sale.

The Department of Revenue (DOR) interprets the statutory language to not tax income from precious metal and bullion sales unless the seller makes a sale on behalf of another party and earns a commission on the sale transaction. The Department indicates that its interpretation is based on RCW 82.04.062(2), which states that commissions upon transactions for the accounts of customers are subject to tax. Under the Department's interpretation, if a seller owns the precious metal or bullion and marks up the price to make a profit, the seller does not pay B&O tax on that mark-up. In this regard, the preferences provide treatment that is different from other investment products, as sellers of other investments do pay B&O tax on such mark-ups.

See Appendix 3 for the current statute, RCW 82.04.062(1) and (2).

Legal History

Pre 1983 Precious metal and bullion sold or used in Washington was subject to sales or use tax, in the same manner as any other tangible personal property. The tax was calculated on the full sale/purchase price, with no exclusion for brokerage or service fees. Income earned from such sales was subject to B&O tax under either the retailing or wholesaling classification, again in the same manner as income from other sales of tangible personal property.

1983, 1984 The Legislature considered bills to exempt the sale or use of precious metal and bullion from sales/use tax. The bills continued to treat precious metal and bullion as tangible personal property for tax purposes. Proponents claimed such an exemption would encourage residents to buy from in-state retailers rather than from out-of-state sellers or from mail order establishments who did not charge sales tax on such sales. Newspaper articles at the time noted that for every sale made in-state, two were made out-of-state.

Out-of-state dealer newspaper ads offered toll free numbers and promised “no sales tax.” None of the bills included a B&O tax exemption or special treatment. None of the bills were enacted.

1985 The Legislature enacted the tax preferences. The legislation excluded sales of precious metal and bullion from the definition of “retail sale,” effectively exempting such sales from sales/use tax and from retailing or wholesaling B&O tax. The legislation also subjected the “commissions” received on “transactions for the accounts of customers over and above the amount paid to other dealers associates with such transactions” to B&O tax under the service and other activities classification, rather than requiring sellers to pay B&O tax under the retailing or wholesaling classification on their gross sales.

The legislation changed how precious metals and bullion were treated for tax purposes. Instead of treating these sales like tangible personal property, they would be treated more like investments. The primary sponsor of the measure testified to a House Ways and Means Committee that his plan consisted of : 1) a sales/use tax exemption and retailing/wholesaling B&O tax exemption by means of an exclusion from the definition of “retail sale” for sales of precious metal and bullion, and 2) taxation of only the profit/markup amount charged by sellers under the service B&O tax classification, rather than taxing the gross receipts under the lower retailing or wholesaling B&O tax rates. He testified:

> *I would like to reclassify (precious metal and bullion) and put it at the same rate as securities investments, at 1.5 percent, rather than the lower (B&O tax) rate it’s at now. I believe firmly that this will increase sales of local dealers beyond the loss in sales tax and that the increase in B&O tax will be greater than the loss in retail sales tax.*

The Governor partially vetoed items unrelated to the precious metal/bullion preferences in the bill. His veto message stated:

> *This measure contains several changes to business taxes. . . It also includes adjustments in taxes for several industries which have clearly demonstrated that present taxes place them at a significant competitive disadvantage to similar businesses in other states. In each of these cases, Washington industries made convincing cases that continuing the current taxes would result in actual loss of existing business within the state with a resulting loss of jobs.*

The statute has not been altered since its enactment.

2005-2006 Bills were introduced to repeal the sales/use and B&O tax preferences, but were not enacted.

2007-2008 Bills were introduced to exempt melting and re-forming precious metal/bullion from manufacturing B&O tax and to clarify that service and other activities B&O tax applied to amounts earned from sales of precious metal and bullion in excess of the market price of the metal on the markup, whether referred to as a commission, premium, spread, or some other term. The bills were not enacted.

2009-2010 Several bills associated with the preferences were introduced with differing aims, including bills to:

- Exempt melting and re-forming precious metal/bullion from manufacturing B&O tax, clarify that service and other activities B&O tax applied to income earned from sales in excess of the market price of the metal (on the markup, whether called a commission, premium, spread, or some other term) by persons owning the precious metal as well as on commissions, and extend the same tax treatment to sales of rare earth metals;
- Eliminate all preferential sales/use and B&O tax treatment for the industry (DOR-request bill); and
- Change the status of precious metal/bullion back to tangible personal property as it had been prior to 1985. The bill would have maintained a sales and use tax exemption for precious metal and bullion, and changed the B&O taxation back to how it was before 1985 so that the gross sales of precious metal and bullion would be subject to either retailing or wholesaling B&O tax.

None of the bills were enacted.

2012 Two bills to repeal the sales/use and B&O tax preferences and change the taxability of precious metal and bullion back to how it was prior to 1985 were introduced, but were not enacted.

Other Relevant Information

Relevant definitions:

"Precious metal bullion" is defined as any precious metal that has been smelted or refined, including, but not limited to, gold, silver, platinum, rhodium, and palladium, and that is valued on its content, not its form.

"Monetized bullion" is defined as coins or other forms of money manufactured from gold, silver, or other metals and used as a medium of exchange under Washington, United States, or foreign nation laws, not including coins or money sold to be manufactured into jewelry or art.

What determines the selling price of precious metal and bullion?

According to industry sources, the selling price for precious metal and bullion is based on "spot prices" for metal that are controlled by the international metals market and change constantly throughout the day. Sellers of precious metal and bullion charge buyers a price that includes the amount they paid for the metal (the spot price) and an additional amount that represents the seller's profit on the sale (commonly referred to as a "spread," "mark-up," or "commission").

There is no set amount or percentage for the spread. Industry sources state that the industry average is generally between 2 and 3 percent of the transaction amount.

How does Washington tax sellers of securities and investments?

Stock and securities sellers differ in their tax treatment from precious metal and bullion sellers in that various amounts received from sales of stocks or securities over and above the purchase price of the products are taxed. Such amounts are not currently taxed for precious metal and bullion sellers, except for commissions. See Exhibit 41, below.

Exhibit 41 – B&O Taxes on Precious Metal and Bullion Sales Not Comparable With Securities and Investment Sales

Gross Income from	Sellers of	
	Securities & Investments	Precious Metal & Bullion
Commissions earned on sales made on behalf of third parties	1.8%	1.8%
Amounts received over and above the cost or purchase price of the products	1.8%	Not Taxed

Source: JLARC interpretation of WACs 458-20-162 and 458-20-248.

Public Policy Objectives

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

The Legislature did not state a public policy objective when it enacted the preferences in 1985.

However, JLARC found evidence from several sources supporting an inferred public policy objective for the preferences. The inferred objective is to make Washington coin and bullion dealers more competitive with out-of-state competitors by treating precious metal and bullion sales like sales of investments rather than sales of tangible personal property. This inferred public policy objective is supported by the following:

- Testimony by the prime sponsor at a 1985 House committee public hearing stated the preferences were intended to treat such goods as securities and tax them similarly to insurance and other investment-type income (which were not subject to sales/use tax). He also indicated the intent to treat the selling of precious metal and bullion as securities and tax such sales only on the "commissions" earned at a higher B&O tax rate, like other types of securities or investments, rather than on gross sales at a lower rate.
- At the same 1985 hearing, a representative for the Washington Coin and Bullion Association noted the legislation would provide equity with other investment sales and parity with other states as to how precious metal, coins, and bullion are taxed. He testified that the industry wanted to be taxed in the same manner as other forms of investment and that "we don't want something anyone else doesn't have." He noted the industry supported being taxed as a service business and that they were "willing to compromise on B&O tax by paying at a

higher rate," stating the industry thought the greater volume of business brought by the sales/use tax exemption would make up for the increase in B&O tax sellers would pay.

- Various newspaper articles from 1983 through 1985 discussed the competitive problems and lost sales in-state precious metal and bullion sellers experienced due to other states exempting precious metal and bullion sales from sales tax.
- A 2008 Department of Revenue report noted the public policy objective for the sales/use tax exemption was to provide tax relief to coin and bullion dealers who were competing with dealers in states without a sales tax on precious metals or bullion.
- Intent sections of bills introduced in 2008 and 2009 noted: "When the legislature enacted Chapter 471, laws of 1985, it intended to tax the business of making sales of precious metal (and) bullion the same as sales of other investment products."
- Testimony by Department of Revenue representatives at a 2010 public hearing for a DOR-request bill to repeal the sales/use tax exemption stated that the exemption's original purpose was primarily to provide relief for in-state sellers competing with sellers from other states.
- Testimony by industry representatives during the 2008 and 2010 legislative sessions stated the preferences were enacted to create a Washington-grown coin and bullion sales industry. Testimony noted there were very few businesses selling these items prior to 1985 because they could not readily compete with businesses from neighboring states that did not tax such sales.

What evidence exists to show that the tax preferences have contributed to the achievement of any of these public policy objectives?

The available evidence shows that achievement of the inferred public policy objective of the two tax preferences is mixed. While the sales/use tax mechanism appears to be achieving its objective of treating sales of precious metal and bullion like other investment transactions, DOR's interpretation of the B&O statute results in taxation of sellers of precious metal and bullion that is not consistent with taxation of other sellers of investments.

Sales and Use Tax Exemptions

The sales and use tax exemption appears to be achieving the inferred public policy objective by not subjecting these products to sales/use tax, in the same manner as other investments are not subject to sales/use tax. According to the industry, this makes them more competitive with sellers in other states. JLARC was unable to isolate what, if any, impact the sales/use tax exemption has had on overall precious metal and bullion sales by Washington retailers.

In 1985, industry representatives stated that industry jobs in Washington were down 70 percent and in-state sales down 80 percent compared to 1980. More recently, in 2010, industry representatives testified that prior to the preferences' enactment in 1985, there were about 25 precious metal and bullion sellers in Washington but in 2010, there were over 100. JLARC could not identify reliable data to verify these statements.

Using DOR tax reporting data, JLARC was able to identify 77 registered businesses that may have made qualifying sales in Fiscal Year 2010 or Fiscal Year 2011. In reviewing the tax reporting data, JLARC found that about half of those businesses reported qualifying tax exempt sales. The limited data available reflected combined retail and wholesale sales of precious metal and bullion of about $250 million in Fiscal Year 2010 and $330 million in Fiscal Year 2011. These sales totals may be attributable not only to the number of sales of precious metal and bullion in Washington, but also to the increased value of precious metal and bullion during this period, which increased from approximately $950 an ounce in July 2009 to approximately $1,580 an ounce in May 2012.

B&O Tax Treatment

If the public policy objective was to subject the industry to B&O tax in the same manner as income from sale of other investments—on the markup above the market price, whether it is called a commission, premium, spread, or some other term—then the public policy objective **is not being achieved.** While prime sponsor and industry testimony in 1985 implied that the industry anticipated paying B&O tax on the amounts added above the market price of precious metal and bullion sold, the Department of Revenue has not interpreted or administered the statute in that manner.

According to the Department's interpretation, only "commission" income earned from sales of precious metal and bullion owned by a third party is subject to B&O tax.

The term "commissions" was frequently used in the 1985 testimony, but the term was never defined in the statute. However, the testimony implied that "commission" referred to the difference between the dealer's buy and sell price (**e.g., the spread or mark-up**). The interpretation used by the Department of Revenue is more restrictive. The Department's interpretation results in no B&O tax being paid on sales made by persons owning precious metal and bullion on amounts attributable to the markup, spread, etc., between the market price of precious metal and bullion and the selling price. Other sellers of investment products, such as stockbrokers, security houses, and real estate agents do pay B&O tax on income earned above the market price of the products they sell.

Bills introduced in 2008 and 2009 would have made changes to the preferences that would have resulted in B&O tax treatment that is more consistent with that of other sellers of investment products. The bills clarified that B&O tax applied to the mark-up above the market price, whether it is called a commission, premium, spread, or some other term. These bills were not enacted.

To what extent will continuation of the tax preferences contribute to these public policy objectives?

Continuation of the preferences would continue to exempt sales of precious metal and bullion from sales and use tax, treating such sales like other investment transactions. However, if the Department of Revenue continues its current interpretation of the B&O statute, B&O tax treatment for sellers of precious metal and bullion will continue to differ from that of other sellers of investments.

Beneficiaries

Who are the entities whose state tax liabilities are directly affected by the tax preferences?

Beneficiaries of the **sales and use tax exemption** are Washington consumers who are exempted from paying sales/use tax on their purchases of precious metal and bullion.

Beneficiaries of the **special B&O tax treatment** are Washington businesses that sell bullion, coins, or precious metal in two ways: either selling products that they own or selling on behalf of a third party.

Because there are no reporting or accountability standards required of businesses using the preference, JLARC could not determine the exact number of businesses that may be making qualifying tax-exempt sales or not paying B&O tax due to the preference. Some of these businesses sell precious metal and bullion as their main activity. Others make only occasional sales of qualifying products, such as estate liquidators, collectible shops, or jewelry stores.

Revenue and Economic Impacts

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

Since the sales, use, and B&O tax exemptions provided by these preferences do not require beneficiaries to report, file, deduct, or otherwise document their use of the preferences, it is difficult to determine the beneficiary savings realized.

The Department of Revenue's 2012 Tax Exemption Study estimated the beneficiary savings for the sales/use tax exemption preference at $39 million for the 2013-15 Biennium. See Exhibit 42, below. JLARC could not determine an alternative method for estimating the beneficiary savings.

Exhibit 42 – DOR Estimated 2013-15 Beneficiary Savings for Precious Metal and Monetized Bullion Sales/Use Tax Exemption

Fiscal Year	State Sales Tax	Local Sales Tax	Combined Sales Tax
2012	$12,513,000	$4,813,000	$17,326,000
2013	$13,137,000	$5,053,000	$18,190,000
2014	$13,793,000	$5,305,000	$19,098,000
2015	$14,482,000	$5,570,000	$20,052,000
2013-15 Biennium	**$28,275,000**	**$10,875,000**	**$39,150,000**

Source: DOR 2012 Tax Exemption Report, page 220.

The Department of Revenue estimated the beneficiary savings for the special B&O tax treatment preference at $3 million for the 2013-15 Biennium. See Exhibit 43, on the following page. JLARC could not determine an alternative method for estimating the beneficiary savings.

Exhibit 43 – DOR Estimated 2013-15 Beneficiary Savings for Precious Metal and Monetized Bullion B&O Tax Treatment

Fiscal Year	Business & Occupation Tax
2012	$1,356,000
2013	$1,424,000
2014	$1,496,000
2015	$1,570,000
2013-15 Biennium	**$3,066,000**

Source: DOR 2012 Tax Exemption Report, page 41.

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

If the preferences were terminated, persons purchasing precious metal and bullion from Washington businesses would be subject to sales/use tax on those purchases, as they were prior to 1985. It is unclear what effect the imposition of sales/use tax would have on the amount of purchases of precious metal and bullion.

In addition, businesses making retail or wholesale sales of precious metal and bullion would be required to report and pay B&O tax under the retailing or wholesaling classification on their gross sales at a rate of 0.471 and 0.484 percent, respectively. The effect of the increased B&O tax obligation on employment and the economy would depend on the extent to which these industries could absorb the increased costs or pass them along to their customers.

Other States

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

Of the 45 states and the District of Columbia that impose a sales tax, 25 (including Washington and Idaho) provide some form of sales and use tax exemption for sales of precious metal or bullion. The sales/use tax exemptions differ by state. For example:

- Michigan requires bullion be 900 parts per thousand to be exempt, while North Dakota requires 99 parts per thousand;
- Florida requires the selling price be greater than $500;
- California exempts purchases of over $1,500 and charges no sales tax on California gold bullion coins; and
- Louisiana, Maryland, Massachusetts, and New York require the sales price be greater than $1,000 for the transaction to be exempt from sales or use tax.

JLARC was unable to find preferential treatment provided to sellers along the lines of the preferential B&O tax treatment provided to Washington sellers.

Auditor Recommendation:

The Legislature should review and clarify the sales and use and B&O tax preferences provided for the precious metal and bullion industry because implementation of the statute may not be achieving the inferred public policy objective of treating precious metal and bullion sales like sales of investments.

Legislation Required:	Yes.
Fiscal Impact:	Depends on legislative action.

SOLAR ENERGY AND SILICON PRODUCT MANUFACTURERS (B&O TAX)

Report Summary

What the Preference Does	Public Policy Objectives	Estimated Beneficiary Savings	Auditor Recommendation
Provides a preferential B&O tax rate of 0.275 percent to: • Manufacturers of certain solar energy systems; • Manufacturers of solar grade silicon and other products used as components of solar energy systems; and • Wholesalers of solar energy systems or component products they manufacture. Expires June 30, 2014.	The Legislature stated the public policy objectives of the solar energy and silicon product manufacturers B&O tax preferences are to: 1) Retain and expand existing solar industry manufacturing businesses in Washington; 2) Attract new solar energy manufacturers/wholesalers to the state; and 3) Create jobs in Washington.	$1.6 million in 2013-15 Biennium	**Review and clarify**: To determine if progress toward solar industry objectives is sufficient and to consider identifying targets for solar business retention, attraction, and job creation.

SOLAR ENERGY & SILICON PRODUCT MANUFACTURERS (B&O TAX)

Current Law

This preference provides a preferential business and occupation (B&O) tax rate of 0.275 percent to:

- Manufacturers of solar energy systems using photovoltaic modules or stirling converters;
- Manufacturers of solar grade silicon, silicon solar wafer, silicon solar cells, thin film solar devices, or compound semiconductor solar wafers for use exclusively in components of such solar energy systems; and
- Wholesalers of solar energy systems or component products that they have manufactured.

Absent this preference, these manufacturers and wholesalers would pay the general B&O tax rates for manufacturing and wholesaling activities, which are both currently 0.484 percent.

The tax preference expires June 30, 2014.

Businesses do not need to apply to take the preferential B&O tax rate. Businesses are required to file an annual report by April 30th following the year they take the preferential B&O tax rate. The annual reports identify the number of jobs provided in Washington as well as information related to hourly wage ranges and types of benefits the businesses offer their employees.

The Legislature has provided several other tax preferences for various aspects of the solar industry, including:

- Sales and use tax exemptions for solar hot water equipment enacted in 2006 and allowed to expire June 30, 2009;
- Sales and use tax exemptions for renewable energy machinery and equipment, including solar energy, enacted in 2009, reviewed by JLARC in 2011, and scheduled to expire June 30, 2013; and
- A cost recovery program for individuals, businesses, and local governments that produce energy using solar, methane, and wind power enacted in 2005. JLARC is scheduled to review the program in 2018, and it is scheduled to expire in 2020.

See Appendix 3 for the current statute, RCW 82.04.294.

Legal History

2004 The Legislature considered two bills that provided several incentives to manufacturers of photovoltaic (PV) solar modules, including a reduced B&O tax rate, a B&O tax exemption if the manufacturer is located in a county with an unemployment rate of more than 12 percent, and sales, use, and property tax exemptions. According to testimony at a public hearing, the legislation was intended to secure a qualifying manufacturer to locate in Ferry County. The bills were not enacted.

2005 The Legislature enacted two bills to encourage in-state production and use of solar energy. The bill that enacted this preference dealt with the **production** end. The Legislature provided a reduced B&O tax rate of 0.2904 percent for businesses that manufacture solar energy systems using PV modules or silicon components and for businesses that make wholesale sales of solar energy systems using PV modules or silicon components that they manufactured. Taxpayers that use the preference must submit annual reports to the Department of Revenue. The Legislature set a June 30, 2014, expiration date.

Again, testimony noted that manufacturers were waiting to locate in Ferry or Garfield Counties and that others would locate and begin manufacturing in Washington, provided these incentives were passed.

The other bill passed by the Legislature dealt with the **consumption** end, creating a cost-recovery incentive program to promote renewable energy systems using solar, wind, or anaerobic digesters. The cost recovery program was set to expire June 30, 2015.

2007 The Legislature clarified that the preferential B&O tax rate applied to manufacturing, processing for hire, and wholesale sales of "solar grade silicon," rather than "silicon."

2009 As part of a bill that provided a number of tax incentives to various renewable or "green" industries, the Legislature made the following changes to this preference:

1) Reduced the B&O tax rate from 0.2904 to 0.275 percent for qualifying manufacturers or wholesalers, beginning October 1, 2009, matching the rate provided to other solar technology preferences; and
2) Added a number of materials to the list of qualifying items manufactured or sold at wholesale, including: silicon solar wafers, silicon solar cells, thin film solar devices, or compound semiconductor solar wafers to be used exclusively in components of such systems.

Additionally, the Legislature extended the expiration date for the consumption-oriented renewable energy cost recovery program from June 30, 2015, to June 30, 2020.

2010 The Legislature added a requirement that wholesale sales qualifying for the preferential B&O tax rate must be made by the manufacturer of qualifying solar and silicon systems or components.

2011 The Legislature added manufacturing or wholesale sales of stirling converters to the list of qualifying activities for the preferential B&O tax rate, effective July 22, 2011. Testimony by a representative for a company at a Senate Ways & Means public hearing noted that stirling converters are newly developed technology not covered under the existing tax preference.

Public Policy Objectives

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

The Legislature provided a public policy objective for this preference when it was enacted in 2005.

The Legislature further finds that targeting tax incentives to focus on key growth industries is an important strategy to enhance the state's business climate.

> *A recent report by the Washington State University energy program recognized the solar electric industry as one of the state's important growth industries. It is of great concern that businesses in this industry have been increasingly expanding and relocating their operations elsewhere. The report indicates that additional incentives for the solar electric industry are needed in recognition of the unique forces and issues involved in business decisions in this industry.*
>
> *Therefore, the legislature intends to enact comprehensive tax incentives for the solar electric industry that address activities of the manufacture of these products and to encourage these industries to locate in Washington. Tax incentives for the solar electric industry are important in both retention and expansion of existing business and attraction of new businesses, all of which will strengthen this growth industry within our state, will create jobs, and will bring many indirect benefits to the state.*

Thus, the Legislature had three public policy objectives with this preference: 1) to retain and expand existing solar industry manufacturing businesses in Washington; 2) to attract new solar energy manufacturers/wholesalers to the state, and 3) to create jobs in Washington. The Legislature did not identify specific targets associated with these objectives, for example, how many new solar energy businesses it intended to attract.

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

1) Retaining and Expanding Existing Solar Manufacturing Industry in Washington

JLARC reviewed all annual reports filed by beneficiaries of the preference. Reports were available for Calendar Years 2006 through 2010. For Calendar Year 2006, two businesses filed an annual report. One of the businesses reported operating in Washington since 1994; the other reflected a 2006 open date. Those two businesses are still conducting solar manufacturing or wholesaling activities in the state. JLARC is not able to isolate what, if any, impact this preference had on these two businesses remaining in operation.

2) Attracting New Solar Manufacturing Businesses into Washington

The businesses identified in newspaper articles and legislative hearings at the time the preference was enacted did not start solar businesses in Washington. In addition, the preference was expanded in 2011 to include manufacturing stirling converters, specifically because one company noted it planned to begin such manufacturing operations in Washington in 2011. However, in June 2011, the company announced it had decided to instead conduct its manufacturing in Utah.

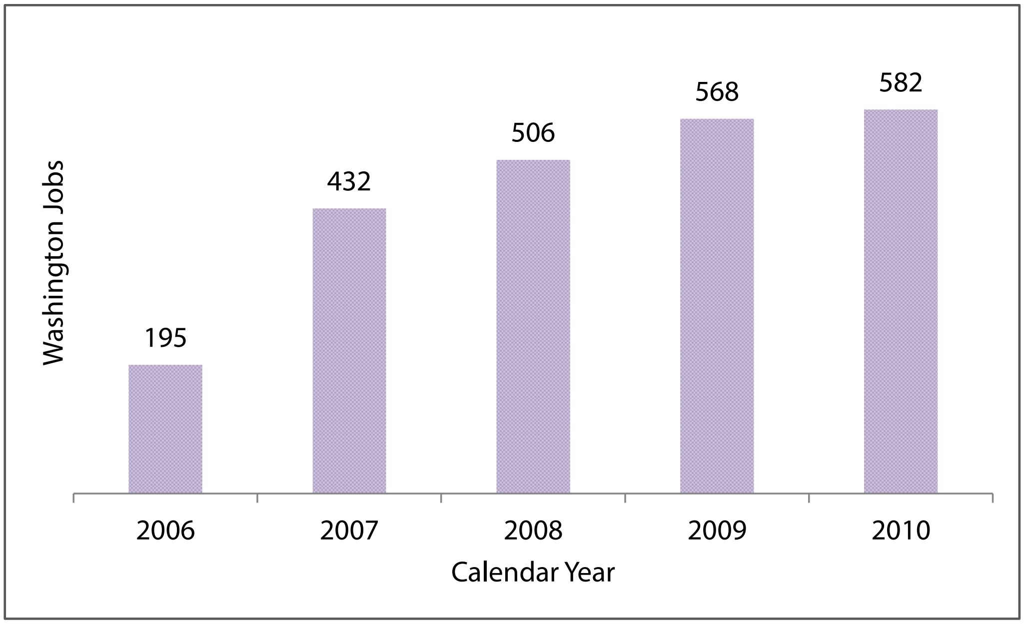
Between Calendar Years 2006 and 2010, three new beneficiaries began taking the preference. Two remain in business while one closed its Vancouver, Washington, operation in February 2010 and shifted production to Oregon and California.

JLARC is aware of two new solar module manufacturers that began operations in Washington after January 2011. Annual reports for these businesses are not yet available.

3) Creating Jobs

The number of industry-reported in-state solar and silicon manufacturing jobs increased from 194 jobs in 2006 (the first year after the preference was enacted) to 582 jobs in 2010. See Exhibit 44, below. JLARC is not able to isolate what, if any, impact the preference had in creating these jobs.

Exhibit 44 – Washington Solar Industry Reported Manufacturing Jobs Increase from 2006 -2010



Source: JLARC analysis of DOR Annual Reports, CY2006 – CY 2010.

Most of these jobs were full time, with very few part-time or temporary positions reported throughout the five years of data. The Legislature did not specify whether it was looking for a definitive number or percentage increase in jobs.

While the total number of jobs and beneficiaries of the preference have increased, the increase in jobs is predominantly in one business, REC Solar Grade Silicon LLC, in Moses Lake. See Exhibit 45, below.

Exhibit 45 – Annual Reports Show Most Job Growth Realized by One Company

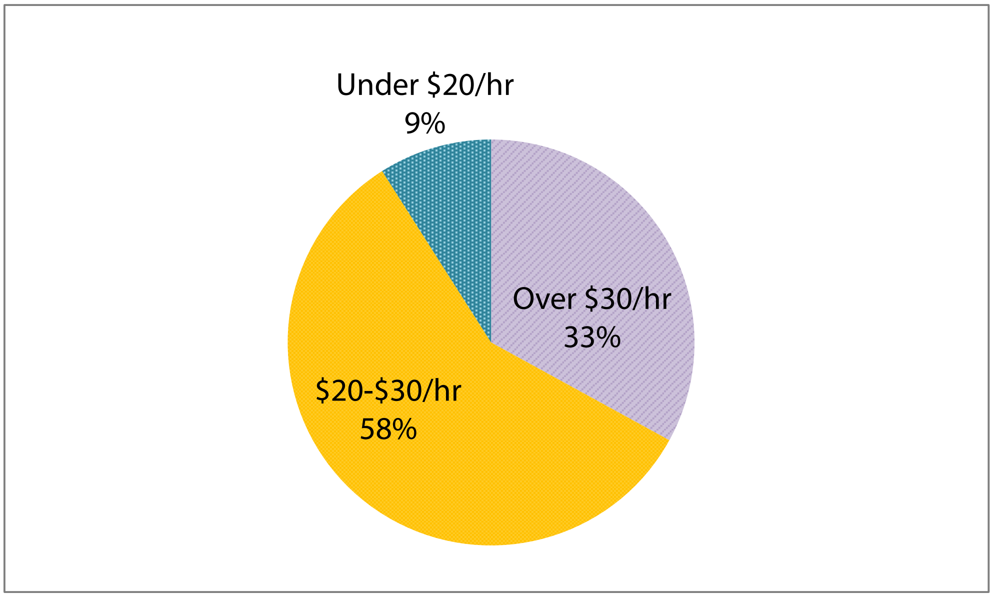
Company	2006	2007	2008	2009	2010
REC Solar Grade Silicon LLC	194	339	413	470	558
Shell Solar Industries LP	*	92	92	92	0 **
Eco Depot Inc.	1	1	1	1	2
JX Crystals Inc.	*	*	*	5	5
Silicon Energy LLC	*	*	*	*	17
Percent of jobs provided by REC Solar	**99%**	**73%**	**77%**	**79%**	**96%**

* No Annual Report filed because business had not opened or was not operative. ** Closed 2/28/2010.

Source: JLARC analysis of DOR Annual Reports, 2006 – 2010.

Annual report detail shows that 91 percent of the jobs pay over $20 an hour. See Exhibit 46, below. Ninety-nine percent of the jobs provided medical and dental benefits, and all but one position had a retirement plan.

Exhibit 46 – 91% of Solar Manufacturer/ Wholesaler Employees Earn at Least $20 per Hour in 2010



Source: JLARC analysis of DOR 2010 Annual Report wage data.

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

If continued, the preference will provide existing and any new solar and silicon manufacturers in Washington with a reduced B&O tax rate. JLARC is not able to isolate what, if any, impact continuation of the preference would have on solar business retention, business attraction, and job creation.

Beneficiaries

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

According to the required annual reports submitted by taxpayers, five companies were beneficiaries of the preference during the five years that report data is available. Exhibit 47, on the following page, provides detail on those companies.

Exhibit 47 – 5 Businesses Have Used the Preferential B&O Tax Rate

Company	2006	2007	2008	2009	2010
REC Solar Grade Silicon LLC	Yes	Yes	Yes	Yes	Yes
Shell Solar Industries, LP	*	Yes	Yes	Yes	No, closed 2/28/2010
Eco Depot Inc.	Yes	Yes	Yes	Yes	Yes
JX Crystals Inc.	*	*	*	Yes	Yes
Silicon Energy LLC	*	*	*	*	Yes

*Did not claim the preference.

Source: JLARC review of DOR Annual Reports, publicly available business data.

Revenue and Economic Impacts

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

JLARC estimates the beneficiary savings for this preference in the 2013-15 Biennium at $1.6 million. See Exhibit 48, below. The estimate assumes current law will continue and the preference will expire at the date currently specified, June 30, 2014.

Exhibit 48 – Estimated 2013-15 Beneficiary Savings for Solar Energy/Silicon Manufacturing Preferential B&O Tax Rate

Fiscal Year	Taxable Income	B&O Tax Due With Preference	B&O Tax Due Without Preference	Beneficiary Savings
2010	$327,919,000	$911,000	$1,587,000	$676,000
2011	$693,225,000	$1,906,000	$3,355,000	$1,449,000
2012	$721,646,000	$1,985,000	$3,493,000	$1,508,000
2013	$737,523,000	$2,028,000	$3,570,000	$1,542,000
2014	$744,161,000	$2,047,000	$3,602,000	$1,555,000
2015	$754,579,000	**Expires 6/30/2014**	$3,652,000	$-
2013-15 Biennium	**$1,498,740,000**	**$2,047,000**	**$7,254,000**	**$1,555,000**

Source: DOR tax return data FY2010, 2011; growth rates based on manufacturing growth rates from ERFC Forecast, February 2012. The preference is scheduled to expire June 30, 2014.

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?

The businesses currently taking advantage of the preferential tax rate (four in 2010) would be subject to the general manufacturing or the wholesaling B&O tax rate, both of which are currently 0.484 percent. The effect on employment and the economy would depend on the ability of these businesses to either absorb those higher costs or pass them on to their customers.

Other States

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

Twelve other states provide a tax preference for solar energy manufacturing. Most of these states use a state income tax credit. However, Virginia provides an incentive grant, while California allows a municipal property tax rebate at the discretion of local governments. Florida requires businesses to generate 400 new jobs within six months to be eligible for its credit. North Carolina offers only a credit for construction costs incurred prior to 2006.

Auditor Recommendation:

The Legislature identified the public policy objectives for this preference: solar business retention, business attraction, and job creation. However, the Legislature did not identify specific targets for these objectives. This JLARC review shows that: 1) two solar manufacturing businesses in existence at the time the preference was enacted continue to operate in the state; 2) three new solar businesses located in Washington between 2006 and 2010, one of which then relocated out-of-state; and 3) industry-reported jobs in solar manufacturing and wholesaling increased from 194 in 2006 to 582 jobs in 2010, with almost all of the growth attributable to one company. If the Legislature takes no action on this preference, it will expire on June 30, 2014.

The Legislature should review and clarify this preference to determine if the progress toward its solar industry objectives is sufficient and to consider identifying targets for solar business retention, attraction, and job creation.

Legislation Required: Yes.

Fiscal Impact: Depends on legislative action.

SPECIAL FUEL USE EXEMPTIONS (FUEL TAX)

Report Summary

What the Preference Does	Public Policy Objectives	Estimated Beneficiary Savings	Auditor Recommendation
Provides a number of exemptions from the special fuel tax for specific uses of fuel.	The Legislature did not state the public policy objective of the tax preference. JLARC infers the public policy objectives are: 1) To establish the tax base for special fuel tax; and 2) To exempt fuel used for public purposes.	$36.4 million in 2013-15 Biennium	**Continue**: Because they are achieving the inferred public policy objective of: 1) Establishing the tax base for special fuel tax; and 2) Exempting fuel used for public purposes from the special fuel tax.

SPECIAL FUEL USE EXEMPTIONS (FUEL TAX)

Current Law

This preference provides a number of exemptions from the special fuel tax. Special fuel tax is a complementary tax to the motor vehicle fuel tax and is imposed on all combustible gases and liquids used to propel motor vehicles on public roads, except for fuel that fits under the definition of "motor vehicle fuel" (predominately gasoline). Diesel is the most common special fuel. However, special fuel can also include biodiesel, natural gas, butane, and propane. The special fuel tax rate is the same as the motor vehicle fuel tax rate, currently 37.5 cents per gallon.

The specific exemptions for certain uses or users under this review are detailed in Exhibit 49, below:

Exhibit 49 – Special Fuel Tax Exemptions Provided in RCW 82.38.080(1) and (3)

Exemption	Year Enacted
State and local government road construction/maintenance vehicles	1971
Publicly owned firefighting equipment	1971
Special mobile equipment (e.g., ditch diggers, asphalt spreaders, etc.)	1971
Powering auxiliary equipment on motor vehicles (e.g., cement mixers, garbage trucks, dairy delivery trucks, self-loading log trucks)	1971
U.S. government-owned and operated motor vehicles	1971
Heating purposes	1971
Publicly or privately owned urban passenger transportation systems	1971
Incidental use of a motor vehicle on public roads between private properties	1979
Transportation of persons with special transportation needs by private, nonprofit transportation providers	1983
Vehicle refrigeration, mixing, etc., units powered by separate motors from separate fuel tanks	1998
Motor vehicles used in logging operations on federal land	1998
Waste vegetable oil used to manufacture biodiesel	2008

Source: JLARC analysis of RCW 82.38.080(1) and (3).

JLARC has previously reviewed related special fuel use exemptions. In 2007, JLARC reviewed a preference providing refunds of motor vehicle and special fuel taxes for exported fuel. In 2008, JLARC reviewed four preferences exempting exported and imported fuel from motor vehicle and special fuel taxes. That review included RCW 82.38.080(2). This review focuses on the 12 other special fuel tax exemptions provided under RCW 82.38.080(1) and (3).

See Appendix 3 for the current statute, RCW 82.38.080(1) and (3).

Legal History

1921 The Legislature adopted a 1 cent per gallon tax on sales of liquid fuel gasoline or other fuel used in internal combustion engines.

1923 The Legislature increased the liquid fuel tax to 2 cents per gallon and narrowed the tax base to liquid fuel used to operate motor vehicles on public highways. Liquid fuel used for non-highway use was eligible for a refund of the tax paid.

1933 The Legislature enacted a petroleum products excise tax of 5 cents per gallon on motor vehicle fuel sold, distributed, or used in Washington, replacing the liquid fuel tax. The legislation defined "motor vehicle fuel" as gasoline or any other flammable liquid used chiefly as fuel to propel motor vehicles, motor boats, or airplanes.

Petroleum products other than motor vehicle fuel (e.g., diesel) were also subject to a 5 cent per gallon tax.

1941 The Legislature repealed the portion of the 1933 petroleum products excise tax that subjected fuels other than motor vehicle fuel to the petroleum products tax and replaced it with a 5 cent per gallon "Use Fuel Tax." The tax applied to fuels other than motor vehicle fuel that were used to propel a motor vehicle. Tax proceeds were deposited into the motor vehicle fund. The legislation defined "fuel" as any combustible gas, liquid, or material used in an internal combustion engine to generate power to propel a motor vehicle, except for motor vehicle fuel. This new tax was intended primarily for diesel fuel.

1971 The Legislature repealed the "Use Fuel Tax" and enacted a "Special Fuel Tax Act," creating a special fuel tax at a rate of 9 cents per gallon. The stated purpose of the tax was to "supplement the Motor Vehicle Fuel Tax Act . . . by imposing a tax upon the use, within this state, of all fuels not taxed under said Motor Vehicle Fuel Tax Act. . ." The legislation defined "special fuel" as all combustible gases and liquids suitable to generate power to propel motor vehicles, except for motor vehicle fuel as defined in Chapter 82.36 RCW.

The Legislature provided six exemptions from the special fuel tax: (1) state or local government motor vehicles used in road construction and maintenance; (2) publicly owned firefighting equipment; (3) special mobile equipment; (4) auxiliary power equipment on motor vehicles; (5) U.S. government motor vehicles, and (6) urban passenger transportation systems (publicly or privately owned) with a seating capacity over 15 persons, not exceeding a certain number of miles beyond city limits.

1979 The Legislature extended the special fuel tax exemptions to heating fuel and fuel incidentally used in a vehicle moving between two pieces of private property on a public road. The Legislature also extended the urban passenger transportation exemption to auto transportation companies and passenger charter carriers, as defined in Chapters 81.68 and 81.70 RCW.

1983 The Legislature added an exemption for transit services for persons with special transportation needs by a private, nonprofit transportation provider.

1990 The Legislature added fuel used to pick up milk from a farm or dairy farm storage tank to the exemption for powering auxiliary equipment.

1998 The Legislature enacted several measures to curb motor vehicle and special fuel tax evasion. A 1994 Federal Highway Administration report estimated fuel tax was being evaded on 3 to 7 percent of gasoline gallons and 15 to 25 percent of diesel gallons nationally. A 1996 legislative task force concluded there was likely "significant" fuel tax evasion occurring in Washington, causing large revenue losses. The task force made recommendations to address the problem.

The major change was moving the point of taxation from where the distributor sold the fuel (at the pump) to where the fuel was removed from a refinery or terminal rack (at the wholesale distribution point).

The Legislature also exempted from the special fuel tax fuel used in refrigeration units, special fuel used in logging operations, and exported or dyed special fuel sold under certain conditions.

2008 The Legislature added an exemption for waste vegetable oil used to manufacture biodiesel.

Other Relevant Background

How Is Fuel Taxed in Washington?

In general, fuel purchasers owe either a fuel tax or a sales/use tax on fuel they buy, depending on whether the fuel will be used on public roads or for off-highway purposes. Fuel taxes are intended to apply to all fuel used by motor vehicles on public highways, under either the motor vehicle fuel tax (if gasoline) or the special fuel tax (for diesel fuel and other fuels). Both fuel taxes are administered by the Department of Licensing (DOL) and tax collections are deposited into the Motor Vehicle fund.

Fuel not used on public roads is subject to sales or use tax (for example, boat fuel or construction equipment fuel), unless specifically exempted.

The fuel or sales taxes are paid:

(1) At the terminal rack by licensed fuel distributors who purchase untaxed fuel from refineries, terminals, or other licensed distributors and then sell the fuel, with taxes included, to unlicensed buyers; or

(2) By licensed dyed special fuel users, who purchase special fuel without fuel tax applied and pay tax directly to DOL for any fuel subsequently used on-road.

Public Policy Objectives

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

The Legislature did not provide a public policy purpose for any of the tax exemptions under review, either in enacting legislation or subsequently.

However, the Legislature's stated public policy purpose when it enacted the special fuel tax in 1971was to "supplement the Motor Vehicle Fuel Tax Act . . . by imposing a tax upon the use, within this state, of all fuels not taxed under said Motor Vehicle Fuel Tax Act."

JLARC infers the Legislature had two public policy objectives for the exemptions:

1. **To establish the tax base for special fuel tax.** As discussed previously, the general rule in Washington is that fuel used for non-highway purposes is not to be subject to fuel taxes. According to the Department of Licensing, unlike motor vehicle fuel which is mostly used to propel motor vehicles on public roads, approximately 50 percent of special fuel is used for non-highway purposes. The preferences exempt many non-highway uses from the special fuel tax.
2. **To exempt fuel used for public purposes.** JLARC infers that the remaining exemptions were meant to exempt fuel used in vehicles serving public purposes.

   In addition to exempting them from special fuel tax, the Legislature provides sales/use tax exemptions for fuel used in three of these public purposes: urban passenger transportation, nonprofit special needs transportation, and U.S. government vehicles. This supports the inference that the Legislature supports fuel tax exemptions for vehicles serving public purposes.

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

The exemptions appear to be achieving the inferred public policy objectives:

1. They establish the tax base for special fuel tax by detailing specific non-highway uses exempted from special fuel tax because the fuel is not used to propel a motor vehicle on public roads (e.g., special mobile equipment, powering auxiliary equipment, vehicle refrigeration units, heating, use of logging equipment on federally-owned land, or incidental use, such as driving on highways just to move between private properties).
2. They exempt special fuel used for public purposes, such as public road building and maintenance, firefighting, U.S. government purposes, urban passenger transportation, and transporting persons with special needs.

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

The tax preferences will continue to define the tax base for the special fuel tax and to exempt fuel used for public purposes.

Beneficiaries

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

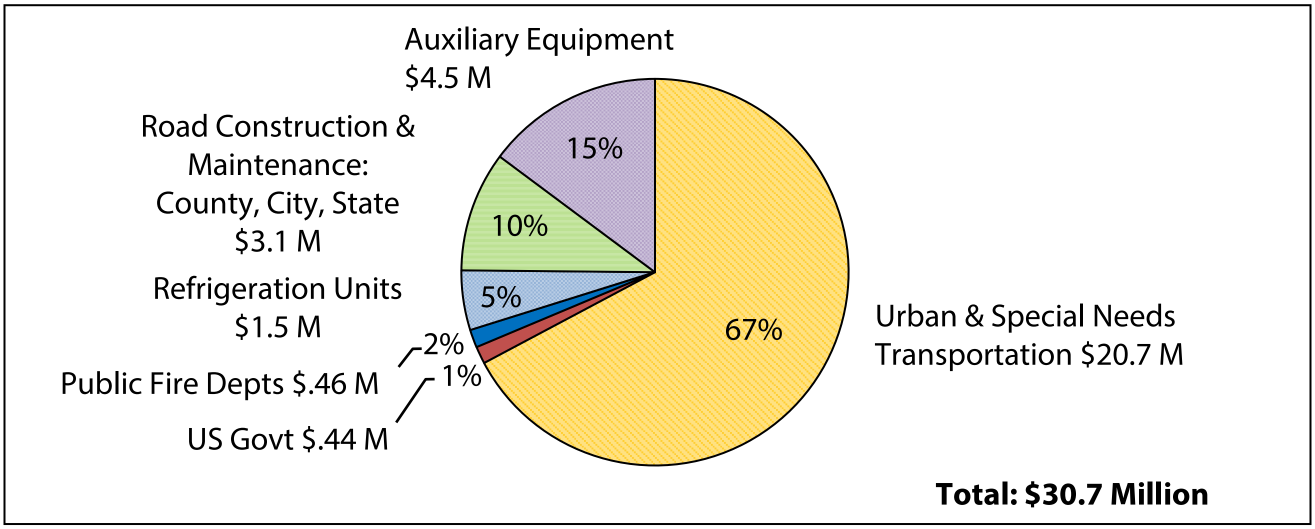
The beneficiaries of the preference are public and private entities that purchase fuel for any of the 12 exempted uses identified in RCW 82.38.080(1) and (3).

For the 2009-11 Biennium, the Department of Licensing reports six categories of beneficiaries of these preferences:

1. Public and private passenger transportation providers and private, nonprofit special needs transporters;
2. Auxiliary equipment operators using fuel from their fuel tanks;
3. State and local governments performing road construction/maintenance;
4. Refrigeration unit operators;
5. Publicly owned fire departments; and
6. The U.S. government.

Exhibit 50, below, shows DOL's estimate of the value of these special fuel tax exemptions for each category.

Exhibit 50 – FY 2009-11 Special Fuel Tax Exemptions
($ in Millions)



Source: DOL FY 2009-11 detail on RCW 82.38.080 exemptions.

Revenue and Economic Impacts

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

JLARC estimates the net beneficiary savings to be $36.4 million for the 2013-15 Biennium. The net beneficiary savings are calculated by reducing the savings realized by beneficiaries from not paying special fuel tax by the amount of sales/use tax collected on such fuel. Although this preference exempts a number of uses from special fuel tax, the user still pays sales or use tax on their use, unless a specific sales/use tax exemption is provided in law. See Exhibit 51, below.

Exhibit 51 – Estimated 2013-15 Net Beneficiary Savings for Special Fuel Tax Exemptions

FY	Beneficiary Savings from Preference	Sales Tax Paid on Fuel	Net Beneficiary Savings
2010	$18,372,000	$1,705,000	$16,667,000
2011	$18,296,000	$1,752,000	$16,544,000
2012	$18,255,000	$1,716,000	$16,539,000
2013	$18,957,000	$1,782,000	$17,175,000
2014	$19,703,000	$1,852,000	$17,851,000
2015	$20,426,000	$1,920,000	$18,506,000
2013-15 Biennium	**$40,129,000**	**$3,772,000**	**$36,357,000**

Source: FY09-11 DOL tax exemption data; FY12-15, estimated by JLARC using growth rates determined by Transp. Revenue Forecast Council Table, 3.1, Feb. 2012, and average rate of sales tax paid on special fuel in 2010 and 2011.

Fuel uses exempt from both special fuel tax and sales/use tax are:

- U.S. government operated motor vehicles;
- Transporting persons with special needs by private, nonprofit transportation providers;
- Publicly/privately owned urban passenger transportation systems; and
- Waste vegetable oil used to manufacture biodiesel.

The special fuel tax is levied on volume rather than price. Thus, receipts are influenced by consumption patterns more than changes in the retail selling price. As the average fuel efficiency of vehicles rises, the volume of gas used tends to stabilize or decrease, causing gas tax revenues to fall.

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

If the exemption were terminated, purchasers and users of special fuels now exempted would be subject to special fuel tax at a rate of 37.5 cents per gallon. Since many of the exemptions are provided for state and local governmental activities (fire departments, urban transportation systems, special needs transportation, state and local government road construction/maintenance), the costs to the government entities would increase. Proceeds from the special fuel tax are distributed according to complex formulas. Various transportation programs receive dedicated portions of the tax pursuant to statute.

Repealing the preference could raise constitutional questions regarding use by the federal government. If challenged for constitutional reasons, it is questionable whether repealing the preference would result in revenue collections from federal government use.

Likewise, if the preference were removed from non-government users, they would have greater fuel costs. They could choose to decrease the amount of fuel they consume, increase prices charged to their customers to recover the additional costs, or absorb the costs.

Other States

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

All states impose fuel taxes on diesel, ranging from 7.5 cents a gallon (Georgia) to 46.2 cents per gallon (Connecticut). Most states also provide a variety of exemptions, credits, and refunds for this fuel tax.

Twenty-eight other states exempt fuel sold to state or local governments, including to school districts or for student transportation. JLARC found 15 other states that provide exemptions for auxiliary equipment, and 23 other states that exempt fuel sold for heating purposes. JLARC also found seven other states that exempt fuel used for urban mass transit. JLARC found two states (Maryland and Tennessee) that specifically exempt fuel used by nonprofits to transport people with special needs.

Auditor Recommendation:

The Legislature should continue the exemptions from special fuel tax because they are achieving the inferred public policy objectives of: 1) establishing the tax base for special fuel tax; and 2) exempting fuel used for public purposes from special fuel tax.

Legislation Required:	No.
Fiscal Impact:	None.

STEVEDORING AND INTERNATIONAL CHARTER AND FREIGHT BROKERS (B&O TAX)

<table>
<tr><th colspan="4">Report Summary</th></tr>
<tr><th>What the Preference Does</th><th>Public Policy Objectives</th><th>Estimated Beneficiary Savings</th><th>Auditor Recommendation</th></tr>
<tr>
<td>These two preferences provide a preferential B&O tax rate of 0.275 percent to stevedoring and associated activities and to international charter and freight brokers.</td>
<td>The Legislature did not state the initial public policy objective of the tax preferences.

JLARC infers the public policy objective for the preferential tax rate for stevedoring activities is to keep Washington’s ports and the businesses there competitive.

JLARC could not determine the public policy objective for the preferential tax rate for international charter and freight brokers.

The stated public policy objective in 1998 for reducing the tax rates for both stevedoring and international charter and freight brokers was to simplify the tax code by consolidating B&O tax rates.</td>
<td>Stevedoring:
$17.9 million in 2013-15 Biennium

International Charter and Freight Brokers:
$8.5 million in 2013-15 Biennium</td>
<td>Review and clarify: Because:
1) The public policy objective for why the Legislature chose the particular current preferential tax rate for stevedoring activities is unclear;
2) The objective for providing the preferential tax rate for international charter and freight brokers is unclear; and
3) The objective to consolidate B&O tax rates and classifications may no longer apply.</td>
</tr>
</table>

STEVEDORING AND INTERNATIONAL CHARTER AND FREIGHT BROKERS (B&O TAX)

Current Law

These preferences provide a preferential business and occupation (B&O) tax rate of 0.275 percent to: 1) stevedoring and associated activities related to waterborne interstate and foreign commerce (RCW 82.04.260(7)); and 2) international charter brokers and freight brokers (RCW 82.04.260(6)). Without this preference, such businesses would be subject to B&O tax under the service and other activities classification, currently at a rate of 1.8 percent.

In addition, certain activities included within stevedoring and associated activities that are taxed under B&O tax are not taxed under the public utility tax (PUT). Because the preferences both involve international commerce-related business activities and are closely related, JLARC is covering both preferences in one report.

Stevedoring and associated activities currently include labor, service, or transportation activities where cargo is loaded or unloaded to or from vessels or barges involved in waterborne interstate and foreign commerce. Stevedoring services may be provided by independent businesses contracting with ports or shippers, or the shipper/port may use their own employees to perform these services.

International charter and freight brokers is the collective term currently used to refer to businesses that arrange international transportation of goods. This does not include actual transportation or freight providers. Persons that conduct charter and freight brokering activities domestically do not qualify for the preferential B&O tax rate and instead pay service and other activities B&O tax on their income.

See Appendix 3 for the current statutes, RCW 82.04.260(7) and RCW 82.04.260(6).

Legal History

1935 The Legislature passed the Revenue Act of 1935, establishing the B&O tax on gross income/receipts. Stevedoring activities and international charter and freight brokers were subject to the service activities classification.

1937 The U.S. Supreme Court ruled in *Puget Sound Stevedoring v. Tax Commission*[11] that loading and unloading cargo is part of interstate and foreign commerce. The Court determined Washington's attempt to tax stevedoring activities violated the federal Constitution's Commerce Clause as an unlawful burden on interstate and foreign commerce and that Washington was "not at liberty to" impose B&O tax on these services.

In response to *Puget Sound Stevedoring*, Washington's Tax Commission issued a rule allowing a deduction from B&O tax for income from stevedoring activities. International charter and freight brokers, however, continued to be taxed under the service activities B&O classification.

[11] *Puget Sound Stevedoring Co. v. Tax Commission*, 302 U.S. 90 (1937).

1974 Due to several subsequent U.S. Supreme Court decisions that permitted more taxation of activities related to interstate commerce, the Department of Revenue (DOR) changed its position on taxing stevedoring services. It issued a new rule, removing the B&O deduction provided since 1937 for stevedoring activities. The Association of Washington Stevedoring Companies filed suit in 1974 against the Department to retain the tax exempt status for stevedoring activities. DOR continued to allow a B&O tax deduction for stevedoring activities while the lawsuit progressed through the courts.

1978 In April, the U.S. Supreme Court overruled the 1937 *Puget Sound Stevedoring* case and other similar cases in *Department of Revenue v. Stevedoring Association.*[12] The Court noted the 1977 *Complete Auto*[13] decision had eroded the prior rulings. The Court ruled that Washington's B&O tax was on the local activity of stevedoring only and did not infringe on import or export activities. Thus, the B&O tax did not violate the federal Commerce Clause. The Court emphasized that interstate commerce must bear its fair share of the state tax burden.

The result of the *Stevedoring Association* decision was that stevedoring activities that had previously been untaxed were now subject to B&O tax under the service and other activities classification, the same classification and rate under which international charter and freight brokers were taxed. Including the temporary surcharge in place at the time, stevedoring activities and international charter/freight brokers paid a B&O tax rate of 1.06 percent.

1979 The year after the *Stevedoring Association* decision, the Legislature provided a preferential B&O tax rate of 0.33 percent to stevedoring activities. The Legislature also extended the same preferential tax rate of 0.33 percent to international charter and freight brokering activities. With the expiration of the temporary surcharge, this compared to a B&O service classification rate of 1 percent.

1998 In a bill that consolidated several B&O tax rates, the Legislature reduced the B&O tax rate for stevedoring and international charter/freight brokers to 0.275 percent.

2010 The Legislature adopted a new economic nexus standard and apportionment method. This changed how income earned by businesses that conduct certain service-related activities for customers in other states are taxed. The law established guidelines for determining whether a business has a "substantial nexus" in this state for B&O tax purposes and also established a specific apportionment method for determining the taxable income in Washington for most services, including stevedoring and international charter/freight broker activities. The law does not affect the preferential B&O tax rate provided for these activities.

Historical comparison of tax rates

Exhibit 52, on the following page, compares the applicable B&O tax rate for stevedoring and associated activities and for international charter and freight brokers in relation to the general service and other activities B&O tax rate.

[12] *Department of Revenue v. Stevedoring Assn.*, 435 U.S. 734 (1978).
[13] *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

Exhibit 52 – Comparing Historical B&O Tax Rates for Stevedoring, Intn'l Charter/Freight Brokers, and Service & Other Activities

Year	Stevedoring Activities Tax		Intn'l Charter/ Freight Broker Tax	Service & Other Activities Tax
	Rate	Note	Rate	Rate
1935	0.50%		0.50%	0.50%
1937	0.00%	Not taxed per U.S. Supreme Court decision	0.50%	0.50%
1974	1.06%	DOR rule issued; lawsuit filed so tax not imposed	1.06%	1.06%
1978	1.06%	Ability to tax upheld per U.S. Supreme Court decision	1.06%	1.06%
1979	0.33%	**Legislature provided preferential rate**	0.33%	1.00%
1998	0.275%	Rate reduced by Legislature in B&O tax consolidation	0.275% Rate reduced in B&O tax consolidation	1.50%
2010	0.275%		0.275%	1.80%

Source: JLARC analysis of historical B&O tax rates.

Other Relevant Background

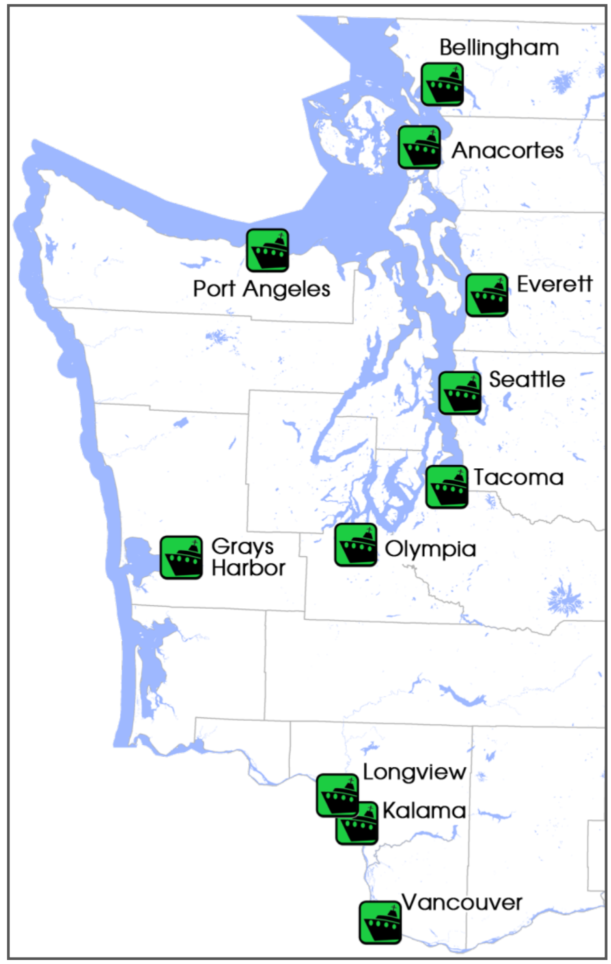
Historical taxation of stevedoring and related activities

The statutory definition of "stevedoring and associated activities" income includes a variety of activities and income sources. Some of these activities and income sources, such as boom, dock, and water transportation and wharfage were in the past taxed under public utility tax (PUT). However, that changed in 1979 when the Legislature defined "stevedoring and associated activities" to include many more activities than the Tax Commission had initially defined and taxed as stevedoring activities. The statute specifies in RCW 82.04.260(7) that any activities taxed under the stevedoring and associated activities B&O tax classification are exempt from PUT.

Washington's Deep Water Ports

Washington has 11 deep-draft facilities capable of accommodating large ocean-going vessels: seven of the deep draft ports are on Puget Sound; one on the coast; and three on the Columbia River. See Exhibit 53, at right.

Exhibit 53 – Most of Washington's Trade Comes Through its 11 Deep Water Ports



Source: WSDOT.

Public Policy Objectives

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

The Legislature did not state a public policy objective when the two preferences providing preferential rates were initially enacted.

Stevedoring & Related Activities

The preferential rate for stevedoring and related activities appears to be an effort to keep Washington's ports and related businesses competitive. Stevedoring activities were initially not subject to B&O tax. The 1978 Supreme Court decision affirmed Washington's authority to tax these activities. The Legislature may have believed the imposition of a tax on this industry would have an impact on the competitiveness of its ports and businesses.

Senate floor testimony regarding the preference for stevedoring activity reflects concern for the competitiveness of Washington's ports in international trade. The sponsor of the amendment adding the stevedoring preference noted it was related to international trade and said Washington was losing a lot of business to Portland. Additional testimony noted:

> *This legislation arose out of a Supreme Court decision making certain activities subject to tax that were not before. For that reason it is necessary to prevent them from being taxed at the higher services rate and put them in a category where they are competitive… if Washington's tax situation is more unfavorable than in other states, the state could lose the business.*

It is unclear why the particular rate of 0.33 percent set in 1979 was assumed to be sufficient to mitigate the competitive issue.

A 1982 Department of Revenue report provides additional comments regarding the stevedoring rate:

> *In granting the differential tax rate for shipping activities, the legislature apparently sought to partially support the U.S. Supreme Court ruling by continuing the taxation of shipping activities. However, the legislature additionally sought to mitigate the complaints of the shipping industry by reducing the tax rate…*
>
> *In granting the exemption, the legislature acted on comments by the shipping industry that stevedoring firms' profits were only 2 percent of gross revenue and that prices could not easily be raised to cover paying the tax as competing firms' rates along the West Coast were all the same. Industry representatives also testified that it would be easy to transfer stevedoring and related activities out-of-state.*

International Charter/Freight Brokers

JLARC was unable to find evidence suggesting a public policy objective for extending the preferential B&O tax rate to international charter and freight brokers. These businesses had been paying B&O tax under the service and other activities classification since 1935. Their situation did not match the condition of the newly imposed B&O tax faced by the stevedoring industry.

1998 Tax Rate Consolidation

The stated public policy purpose for reducing the B&O tax rates for both stevedoring activities and international charter/freight brokers in 1998 was to simplify the tax code. The Legislature lowered the applicable tax rate for the two classifications from 0.33 percent to 0.275 percent as part of an effort to consolidate ten B&O tax rates down to six rates in order to simplify the tax code.

What evidence exists to show that the tax preferences have contributed to the achievement of any of these public policy objectives?

Stevedoring & Related Activities

The Legislature's inferred intent in providing the preferential B&O tax rate to stevedoring activities was to keep Washington's ports and the businesses competitive. Evidence suggests that Washington's ports handle significant amounts of import and export trade. However, it is unclear if the reduced B&O tax rate has had any role in making the ports more competitive.

The Ports of Seattle and Tacoma together comprise the nation's second largest load center behind the Los Angeles/Long Beach complex. Per capita, Washington is the most trade dependent state in the U.S. In 2010, Washington's marine terminals moved approximately 7 percent of all U.S. exports and handled 6 percent of all imports. A 2010 ranking of U.S. ports based on the amount of foreign trade realized at each location as measured by cargo volume shows Washington ports are competitive nationally, as well as with other West Coast ports. See Exhibit 54, on the following pages.

Exhibit 54 – U.S. Foreign Trade Port Ranking by Cargo Volume – 2010 – Short Tons

Washington State ports highlighted yellow; West Coast ports highlighted orange.

Rank	Imports		Rank	Exports		Rank	Total Foreign Trade	
	Port/State	Tons		Port/State	Tons		Port/State	Tons
1	Houston, TX	88,507,605	1	South Louisiana, LA, Port of	73,983,660	1	Houston, TX	159,560,593
2	New York, NY and NJ	63,884,008	2	Houston, TX	71,052,988	2	South Louisiana, LA, Port of	115,151,087
3	Beaumont, TX	44,309,994	3	Hampton Roads, VA	42,832,656	3	New York, NY and NJ	83,714,367
4	Corpus Christi, TX	41,654,989	4	Long Beach, CA	23,748,366	4	Long Beach, CA	62,564,823
5	South Louisiana, LA	41,167,427	5	Los Angeles, CA	21,294,727	5	Los Angeles, CA	55,943,535
6	Long Beach, CA	38,816,457	6	New York, NY and NJ	19,830,359	6	Corpus Christi, TX	54,822,817
7	Los Angeles, CA	34,648,808	7	New Orleans, LA	18,358,147	7	Hampton Roads, VA	51,947,644
8	Texas City, TX	32,553,419	8	Plaquemines, LA	17,551,711	8	Beaumont, TX	51,781,986
9	Lake Charles, LA	26,986,570	9	Baltimore, MD	16,650,882	9	Texas City, TX	40,075,782
10	Philadelphia, PA	20,986,570	10	Savannah, GA	15,387,882	10	New Orleans, LA	34,079,280
11	Freeport, TX	20,083,819	11	Portland, OR	14,297,767	11	Lake Charles, LA	33,000,559
12	Pascagoula, MS	20,026,182	12	Mobile, AL	14,295,696	12	Savannah, GA	32,892,652
13	Savannah, GA	17,504,770	13	Seattle, WA	13,490,753	13	Baltimore, MD	30,166,961
14	Portland, ME	16,509,276	14	Corpus Christi, TX	13,167,828	14	Mobile, AL	29,356,583
15	New Orleans, LA	15,721,133	15	Tacoma, WA	12,183,484	15	Pascagoula, MS	26,598,231
16	Mobile, AL	15,060,887	16	Kalama, WA	11,285,727	16	Freeport, TX	22,328,447
17	Baton Rouge, LA	14,126.05	17	Oakland, CA	9,609,773	17	Seattle, WA	22,097,410
18	Baltimore, MD	13,516.08	18	Duluth-Superior, MN and WI	9,330,806	18	Philadelphia, PA	21,471,002
19	Marcus Hook, PA	12,155,728	19	Port Arthur, TX	8,682,215	19	Baton Rouge, LA	20,768,165
20	Boston, MA	11,721,627	20	Texas City, TX	7,522,363	20	Port Arthur, TX	19,464,914
21	Port Arthur, TX	10,782,699	21	Beaumont, TX	7,471,992	21	Plaquemines, LA	18,908,754
22	Richmond, CA	10,557,556	22	Baton Rouge, LA	6,642,115	22	Portland, OR	17,770,571
23	Jacksonville, FL	9,618,481	23	Pascagoula, MS	6,572,049	23	Tacoma, WA	17,044,956
24	Paulsboro, NJ	9,535,925	24	Charleston, SC	6,183,872	24	Portland, ME	16,529,730
25	Hampton Roads, VA	9,114,988	25	Galveston, TX	6,136,966	25	Oakland, CA	16,344,665
26	Charleston, SC	8,916,147	26	Lake Charles, LA	6,072,478	26	Charleston, SC	14,100,019
27	Seattle, WA	8,606,657	27	Vancouver, WA	5,454,883	27	Boston, MA	12,952,800
28	Barbers Point, Oahu, HI	7,336,838	28	Tampa, FL	5,438,757	28	Richmond, CA	12,765,737
29	Port Everglades, FL	6,822,724	29	Longview, WA	4,662,822	29	Marcus Hook, PA	12,409,654
30	Oakland, CA	6,734,892	30	Miami, FL	3,489,497	30	Kalama, WA	11,765,737

Other West Coast Ports Noted

Rank	Imports		Rank	Exports		Rank	Total Foreign Trade	
	Port/State	Tons		Port/State	Tons		Port/State	Tons
32	Tacoma, WA	4,861,472	36	Richmond, CA	2,097,596	41	Vancouver, WA	6,371,213
38	Portland, OR	3,472,804	40	Coos Bay, OR	1,409,295	42	Longview, WA	5,542,907
58	Stockton, CA	1,258,305	42	Grays Harbor, WA	1,392,850	62	Anacortes, WA	1,787,289
59	Port Hueneme, CA	1,224,401	43	Anacortes, WA	1,350,755	63	Stockton, CA	1,780,881
61	San Diego, CA	977,165	59	Olympia, WA	582,229	70	Coos Bay, OR	1,436,345
62	Vancouver, WA	916,330	61	Redwood City, CA	573,809	71	Grays Harbor, WA	1,409,387
64	Longview, WA	880,085	66	Stockton, CA	522,576	72	Port Hueneme, CA	1,362,561
73	Kalama, WA	480,010	80	Everett, WA	268,151	79	San Diego, CA	1,002,275
74	San Francisco, CA	475,855	89	San Francisco, CA	144,103	80	Redwood City, CA	993,955
76	Anacortes, WA	436,534	90	Port Hueneme, CA	138,160	83	Olympia, WA	652,480
77	Redwood City, CA	420,146	95	Port Angeles, WA	84,180	85	San Francisco, CA	619,958
83	Everett, WA	201,368	105	San Diego, CA	25,110	93	Everett, WA	469,519
87	Port Angeles, WA	154,717				102	Port Angeles, WA	238,897
96	Olympia, WA	70,251						
104	Coos Bay, OR	27,050						
110	Grays Harbor, WA	16,537						

Source: U.S. Army Corps of Engineers, Waterborne Commerce Statistics Center.

International Charter/Freight Brokers

Because there is no clear public policy objective for providing international charter and freight brokers with a preferential B&O tax rate, JLARC cannot determine if it is meeting a public policy objective.

Consolidating B&O Taxes

The B&O tax rate consolidation in 1998 reduced the number of rates from ten to six in an effort to "simplify" tax reporting. However, today taxpayers may pay B&O tax at any of 12 different B&O tax rates and under 51 separate tax classifications. This evidence suggests that the objective of consolidating and simplifying B&O tax rates and classifications is no longer relevant, as the Legislature has continued to add more B&O tax classifications and rates through the years.

To what extent will continuation of the tax preferences contribute to these public policy objectives?

JLARC cannot isolate what, if any, impact this particular preferential B&O rate for stevedores and associated businesses has on port competitiveness. The public policy objective for the preferential B&O tax rate for international charter/freight brokers is unclear. The public policy objective of consolidating B&O taxes may no longer be relevant.

Beneficiaries

Who are the entities whose state tax liabilities are directly affected by the tax preferences?

The beneficiaries of these preferences are businesses conducting stevedoring and related activities and international charter/freight brokering businesses serving customers in Washington. These businesses receive a preferential rate of 0.275 percent, compared to the current service and other activities B&O tax rate of 1.8 percent (including a temporary surtax).

JLARC identified 25 businesses reporting stevedoring and related activities in the state in Fiscal Year 2011. Taxpayers reporting under the preferential international charter/freight broker classification were more difficult to identify. JLARC was able to identify about 180 probable beneficiaries in Fiscal Year 2011.

Revenue and Economic Impacts

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

JLARC estimates the beneficiary savings realized by stevedoring and associated activities to be $17.9 million in the 2013-15 Biennium. See Exhibit 55, below.

Exhibit 55 – Estimated 2013-15 Beneficiary Savings for Preferential B&O Tax Rate for Stevedoring and Associated Activities

Fiscal Year	Taxable Gross Income	Preferential B&O Tax Rate	Service & Other B&O Tax Rate	Beneficiary Savings
2010	$567,704,000	0.275%	1.5%	$6,954,000
2011	$633,131,000	0.275%	1.8%*	$9,655,000
2012	$650,226,000	0.275%	1.8%*	$9,916,000
2013	$704,845,000	0.275%	1.8%*	$10,749,000
2014	$714,713,000	0.275%	1.5%	$8,755,000
2015	$748,304,000	0.275%	1.5%	$9,167,000
2013-15 Biennium	**$1,463,017,000**			**$17,922,000**

*Temporary B&O tax surcharge in effect 7/01/10 through 6/30/13.

Source: JLARC calculation using DOR tax reporting data for NAICS 488320, FY10-11; JLARC estimate for FY2012-2015 using Feb 2012 ERFC B&O growth rate estimates.

JLARC estimates the beneficiary savings realized by international charter and freight brokers to be $8.5 million in the 2013-15 Biennium. See Exhibit 56, on the following page.

Exhibit 56 – Estimated 2013-15 Beneficiary Savings for Preferential B&O Tax Rate for International Charter and Freight Brokering

Fiscal Year	Taxable Gross Income	Preferential B&O Tax Rate	Service & Other B&O Tax Rate	Beneficiary Savings
2010	$251,217,000	0.275%	1.5%	$3,077,000
2011	$300,495,000	0.275%	1.8%*	$4,583,000
2012	$308,609,000	0.275%	1.8%*	$4,706,000
2013	$334,532,000	0.275%	1.8%*	$5,102,000
2014	$339,215,000	0.275%	1.5%	$4,155,000
2015	$355,159,000	0.275%	1.5%	$4,351,000
2013-15 Biennium	**$694,374,000**			**$8,506,000**

*Temporary B&O tax surcharge in effect 7/01/10 through 6/30/13.

Source: JLARC calculation using DOR tax reporting data for NAICS 488510, 541614, FY10-11; JLARC estimate for FY2012-2015 using Feb 2012 ERFC B&O growth rate estimates.

The combined beneficiary savings for both preferences in the 2013-15 Biennium is estimated at $26.4 million, as shown in Exhibit 57, below.

Exhibit 57 – Combined Estimated 2013-15 Beneficiary Savings for Preferential B&O Tax Rates for Stevedoring and Associated Activities and International Charter/Freight Brokers

Fiscal Year	Combined Taxable Gross Income	Preferential B&O Tax Rate	Service & Other Activities Rate	Beneficiary Savings
2010	$818,920,000	0.275%	1.5%	$10,032,000
2011	$933,627,000	0.275%	1.8%*	$14,238,000
2012	$958,835,000	0.275%	1.8%*	$14,622,000
2013	$1,039,377,000	0.275%	1.8%*	$15,850,000
2014	$1,053,928,000	0.275%	1.5%	$12,911,000
2015	$1,103,463,000	0.275%	1.5%	$13,517,000
2013-15 Biennium	**$2,157,391,000**			**$26,428,000**

*Temporary B&O tax surcharge in effect 7/01/10 through 6/30/13.

Source: JLARC calculation using DOR tax reporting data for NAICS 488320, 541514, 488510, FY10-11; JLARC estimation for FY2012-2015 using Feb 2012 ERFC B&O growth rate estimates.

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

If the preferential B&O tax rate provided under RCW 82.04.260(7) to stevedoring and associated activities were terminated, businesses conducting such activities would be subject to B&O tax under the service and other activities classification (currently at a rate of 1.8 percent) on the majority of their activities. Assuming the public utility tax (PUT) exemption would also be terminated, some activities currently taxed under the stevedoring classification might fall within the definition of public service activities and be subject to PUT (currently at a rate of 1.926 percent).

If the preferential B&O tax rate for international charter/freight brokers were terminated, these businesses would be subject to the service and other activities B&O tax rate (currently 1.8 percent) on the income taxable in Washington.

The effect of these terminations on employment and the economy would depend on the extent to which these industries could absorb the increased costs or pass them along to their customers.

Other States

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

JLARC could find no other state that provides a preferential tax rate under a corporate income tax or similar gross receipts tax for stevedoring and related activities or for international charter/freight broker-type activities. Until recently, Hawaii exempted stevedoring from its general excise tax, but this exemption was suspended in 2011. Texas and Mississippi provide some sales and use tax deductions for materials used in stevedoring activities.

Auditor Recommendation:

The Legislature should review and clarify these two preferences because: 1) the public policy objective for why the Legislature chose the particular current preferential B&O tax rate for stevedoring and associated activities is unclear; 2) the public policy objective for providing the preferential B&O tax rate for international freight/charter brokers is unclear; and 3) the objective to consolidate B&O tax rates and classifications may no longer apply.

Legislation Required:	Yes.
Fiscal Impact:	Depends on legislative action.

TRAVEL AGENTS AND TOUR OPERATORS (B&O TAX)

Report Summary			
What the Preference Does	**Public Policy Objectives**	**Estimated Beneficiary Savings**	**Auditor Recommendation**
Provides a preferential B&O tax rate of 0.275 percent to travel agents and tour operators.	The Legislature did not state the initial public policy objective of the tax preferences. JLARC infers the public policy objectives are to: 1) Reduce the financial impact of DOR's 1975 rule change on travel agents by reducing their tax rate in proportion to the commissions earned from arranging interstate air travel; 2) Provide equitable tax treatment between travel agents and air carriers; and 3) Achieve administrative simplicity by taxing tour operators at the same rate as travel agents.	$10.2 million in 2013-15 Biennium	**Review and clarify**: Because it is unclear whether the inferred public policy objectives of reducing the financial impact of DOR's 1975 rule change, providing equitable tax treatment with air carriers, and achieving administrative simplicity still apply in light of the changes to the industry since the time of enactment.

TRAVEL AGENTS & TOUR OPERATORS (B&O TAX)

Current Law

This preference provides a preferential business and occupation (B&O) tax rate of 0.275 percent to travel agents and tour operators. Without this preference, these businesses would be classified under general services and taxed at 1.8 percent on their gross receipts.

Travel agents arrange transportation and accommodations on behalf of their customers. Travel agents may receive commissions from service providers (for example, cruise lines or hotels) and may charge fees to their customers. The B&O tax applies to these commissions and fees rather than to the price of the underlying ticket or room.

Tour operators, in contrast, sell transportation and accommodations to customers that the tour operators provide themselves or purchase from third-party providers. Unlike travel agents, tour operators are personally liable for the services purchased from third-party providers when a customer cancels. Also unlike travel agents, the B&O tax applies to the price the customer pays for the ticket or room.

The same business may operate as both a travel agent and tour operator in the same transaction. For example, the business may sell a vacation package deal that includes air transportation, ground transportation, local guides, and meals. The business might act as a travel agent for the airplane ticket but provide the other services itself as a tour operator. In this case, the taxable receipts would be the commission or fee for the airplane ticket and the full purchase price of the remaining services.

See Appendix 3 for the current statute, RCW 82.04.260(5).

Legal History

Prior to the 1970s, travel agents paid B&O taxes on commissions earned from arranging *intrastate* transportation or accommodations but did not pay B&O taxes for making *interstate* travel arrangements. This was because courts interpreted the Commerce Clause of the U.S. Constitution to prohibit such taxation of interstate commerce. As these interpretations evolved, however, courts began to allow states to tax more and more activities involving interstate commerce.

1970 The Washington State Supreme Court upheld the constitutionality of taxing travel agents on commissions derived from arranging hotel accommodations in other states or countries.[14]

1972 The Supreme Court of Hawaii ruled that it was constitutional to apply a gross receipts tax to travel agents' commissions from arranging interstate transportation. The United States Supreme Court declined to review the case in 1973.[15]

[14] *McKinnis Travel Service, Inc. v. Washington*, 78 Wn.2d 229 (1970).

[15] *Ramsay Travel, Inc. v. Kondo*, 495 P.2d 1172 (1972), *cert. denied*, 410 U.S. 949 (1973).

1975 The Department of Revenue (DOR) updated its rules to reflect these recent court cases. The revised rule expanded the B&O tax base for travel agents by including commissions and fees earned from arranging both intrastate *and interstate* transportation. The new rule went into effect January 1, 1975.

The Legislature adopted a preferential B&O tax rate of 0.25 percent on the gross income of travel agents. Prior to this, travel agents paid the general services rate of 1 percent. The Legislature did not modify the expanded tax base under the new DOR rule, and travel agents continued to pay taxes on commissions derived from both intrastate and interstate travel.

1993 The Legislature changed the preferential tax rate from 0.25 percent to the current 0.275 percent. This change was not specific to travel agents but rather incorporated an existing surtax into several permanent B&O tax rates.

1996 The Legislature expanded the preference by allowing tour operators to also claim the preferential rate. Prior to this, tour operators had paid the general services rate. The Washington Administrative Code has not yet been updated to reflect this statutory change.

2010 The Legislature revised the rules businesses use to apportion their taxes when they have business activity in multiple states. Prior to the change, travel agent services were considered to take place where the travel agent made the arrangement (i.e., in the travel agent's office). Under the new rules, services are considered to be located where the travel takes place (e.g., commissions for booking an Alaskan cruise are attributable to Alaska). This means travel agents and tour operators in Washington may or may not owe B&O tax on income earned from arranging travel in other states, depending on whether the business has "substantial nexus" with those other states.

Public Policy Objectives

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

The Legislature did not state a public policy objective for this preference. JLARC infers that the public policy objectives for this preference may have been to:

1) Reduce the financial impact of DOR's 1975 rule change on travel agents by reducing their tax rate in proportion to the commissions earned from arranging interstate air travel;
2) Provide equitable tax treatment between travel agents and air carriers; and
3) Achieve administrative simplicity by taxing tour operators at the same rate as travel agents.

1) Reduce Financial Impact of DOR Rule Change

The preference was originally introduced as a deduction for commissions and fees derived from arranging travel in interstate or foreign commerce. In this form, the preference would have effectively reversed DOR's 1975 rule change.

In a striking amendment, the House Ways & Means Committee replaced the originally proposed deduction for interstate travel with a reduced B&O tax rate. This amendment allowed DOR to continue to tax commissions and fees generated from both intrastate and interstate transportation under its new rule, but the legislation created a preferential rate that was 25 percent of the rate travel agents had been paying. The Legislature enacted the version of the preference reflected in the striking amendment.

During public testimony leading up to the striking amendment, representatives from the travel agent industry had stated that interstate air transportation made up approximately 75 percent of typical sales by a travel agent. This meant that prior to the rule change, travel agents paid 25 percent of what they paid in taxes after the rule change. By reducing the tax rate from 1.0 percent to 0.25 percent (i.e., a 75 percent reduction), the Legislature restored the approximate tax burden prior to the rule change, while still allowing DOR's new rule to stand.

2) Provide Equitable Tax Treatment with Air Carriers

The bill report and floor debate on the 1975 enacting legislation indicated that the preferential rate was established to mirror the tax treatment received by airlines for interstate travel.

During the Senate floor debate, one proponent described the public policy objective as follows:

> *Originally travel agents were taxed on intrastate commissions only, and just recently the Revenue Department extended this to interstate commissions also. And direct travel agents, agencies such as* ***if you go to the airport directly and purchase your tickets, they pay [tax] on only <u>intra</u>state.*** *And so to make it somewhat* ***equitable****, they thought the travel agent's B&O tax rate should be reduced from 1 percent to 0.25 percent. And that's the reason for that. So it's no rip-off for anyone.*

The bill report also reflected this policy objective in its analysis:

> *Reduces the B&O tax on travel agencies from 1% to .25%* ***as direct sales of interstate tickets by the carriers are exempt from the state B&O tax under Federal law****.*

3) Achieve Administrative Simplicity

In 1996, the Legislature extended this preferential rate to also apply to tour operators. This extension was requested by the Department of Revenue, which testified that:

> *[This legislation] is applying the same low rate to travel agents and tour operators. The reason being, in this day and age it's really hard to distinguish which is which: a lot of these companies are doing both of these things. So it's an administrative nightmare for the industry as well as the Department [of Revenue] trying to say which is which.*

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

While the preference may have fulfilled these implied public policy objectives at one time, it is unclear whether it continues to do so, as circumstances have changed since its enactment.

1) Reduce Financial Impact of DOR Rule Change

The Department of Revenue's rule change in 1975 expanded travel agents' tax base by including commission and fees earned from arranging interstate travel, particularly interstate airline tickets.

At the time, the industry reported that arranging interstate airline tickets accounted for 75 percent of its business. However, circumstances have changed since enactment.

- Interstate air travel no longer makes up 75 percent of travel agent income. In 2011, airline tickets made up only 25 percent of business, while the majority of sales came from cruises and tour packages.
- The preferential rate for travel agents has not increased in proportion to increases in the general service rate. The preferential rate is currently 15 percent of the general service rate, while it was 25 percent of the general service rate when the preference was enacted.
- At the time of enactment, industry representatives stated that the increase in taxes due to the 1975 rule change could not be passed to either the customer or the carrier, due to federal regulations. However, Congress deregulated the airline industry in 1978, and federal law no longer prohibits travel agents from passing on costs to customers. Additionally, most major airlines have discontinued their commissions for travel agents in light of the Internet and changing business models. Instead, travel agents now rely more heavily on fees charged to their customers.
- The 2010 changes to tax apportionment rules impact how this industry is taxed for interstate travel. Travel agents and tour operators may deduct income from arranging travel outside of Washington, assuming business has a substantial nexus with that other state.

2) Provide Equitable Tax Treatment with Air Carriers

The objective of providing equitable tax treatment between travel agents and air carriers is unclear. Unlike travel agents, who paid B&O tax on commissions, at the time of enactment air carriers paid public utility tax on the gross receipts from the sale of airline tickets. Compared to travel agents, the airline carriers paid a different tax, at a different rate, on a different tax base.

The two industries continue to be taxed differently, and other factors have changed as well. For example, there is now a federal prohibition on state taxation of intrastate air transportation of passengers, and prices for airline tickets are no longer set by federal regulations as they were at the time the preference was enacted.

3) Achieve Administrative Simplicity

Under the preference, DOR does not need to differentiate between tour operators and travel agents to determine the correct B&O tax rate. However, according to DOR, these two industries use different coding, and it would not be administratively burdensome for DOR to distinguish between the two. Therefore, it is unclear to what extent taxing tour operators and travel agents at the same preferential rate achieves administrative simplicity.

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

Since circumstances have changed since the enactment of this preference, it is unclear whether continuation of the tax preference would contribute to the inferred public policy objectives.

Beneficiaries

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

The beneficiaries of this tax preference are travel agencies and tour operators that are located in Washington. Since 2010, this preference also provides a preferential rate to out-of-state travel agencies and tour operators that sell enough travel in Washington to have "substantial nexus." Substantial nexus is defined in statute as having a certain amount of sales ($250,000) or a certain percentage of sales (25 percent) in Washington.

In Fiscal Year 2011, 502 firms reported to the Department of Revenue under the travel agent and tour operator classification.

Revenue and Economic Impacts

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

Beneficiaries saved an estimated $8.8 million in B&O taxes in Fiscal Year 2010 due to the preferential rate. Savings are calculated based on the difference between the general service rate and the preferential rate for travel agents and tour operators. The B&O service rate is 1.8 percent effective May 1, 2010, but it will revert to 1.5 percent on July 1, 2013. Beneficiaries are estimated to save $10.2 million in the 2013-15 Biennium. See Exhibit 58, below.

Exhibit 58 – Estimated 2013-15 Beneficiary Savings for Travel Agent and Tour Operator Preferential B&O Rate

Fiscal Year	Taxable Gross Receipts	Preferential Rate	General Service Rate	Total Beneficiary Savings
2008	$877,300,000	0.275%	1.50%	$10,700,000
2009	$771,600,000	0.275%	1.50%	$9,500,000
2010	$689,300,000	0.275%	1.55%	$8,800,000
2011	$362,500,000	0.275%	1.80%	$5,500,000
2012	$374,000,000	0.275%	1.80%	$5,700,000
2013	$389,000,000	0.275%	1.80%	$5,900,000
2014	$406,000,000	0.275%	1.50%	$5,000,000
2015	$427,000,000	0.275%	1.50%	$5,200,000
2013-15 Biennium	**$833,000,000**	**0.275%**	**1.50%**	**$10,200,000**

Source: FYs 2008-11 are actual amounts reported to DOR. The decrease between FY 2010 and FY 2011 is primarily due to the changes in apportionment and economic nexus rules. FYs 2012-15 are estimates based on projections by the Economic Revenue and Forecast Council for transportation services.

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

If the tax preference were terminated, travel agents would pay higher taxes on their commissions and fees, and tour operators would pay higher taxes on their services. The effect on employment and the economy would depend on the ability of these firms to either absorb these higher costs or pass them on to customers and carriers in the form of higher fees, commissions, and prices for tour services.

Other States

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

Unlike in Washington, the primary business tax in most states is a net income tax rather than a gross receipts tax like the B&O tax. In general, net income taxes provide specific credits and deductions instead of preferential rates for specific industries. JLARC found no comparable credits or deductions from business taxes specifically for travel agents in other states.

Auditor Recommendation:

The Legislature should review and clarify the preferential tax rate for travel agents and tour operators because it is unclear whether the inferred public policy objectives of reducing the financial impact of DOR's 1975 rule change, providing equitable tax treatment with air carriers, and achieving administrative simplicity still apply in light of the changes to the industry since the time of enactment.

Legislation Required:	Yes.
Fiscal Impact:	Depends on legislative action.

URBAN PASSENGER TRANSIT FUEL (SALES AND USE TAX)

Report Summary

What the Preference Does	Public Policy Objective	Estimated Beneficiary Savings	Auditor Recommendation
Provides a sales/use tax exemption for fuel purchased for: • Urban passenger public transportation by an urban passenger transportation system; or • Use in passenger-only ferries by public transportation benefit areas, counties, or county ferry districts.	The Legislature did not state the public policy objective of the tax preference. JLARC infers that the public policy objective is to reduce operating costs for public transportation providers and thus improve public transportation and reduce transportation costs for urban transit users.	$22 million in 2013-15 Biennium	**Continue**: Because it is meeting the inferred public policy objective of reducing the costs for providers of urban passenger transportation services.

URBAN PASSENGER TRANSIT FUEL (SALES AND USE TAX)

Current Law

Fuel purchased for use on Washington public roads is subject to motor vehicle fuel tax or special fuel tax. Generally, when a fuel is exempt from fuel tax, it is by default subject to sales/use tax. These preferences provide retail sales and use tax exemptions for sales of fuel when the fuel would have been subject to sales/use tax and is purchased for:

- The purpose of urban passenger public transportation, and the purchaser is entitled to a refund or exemption under the motor vehicle fuel or the special fuel taxes as an urban passenger transportation system; or
- Use in passenger-only ferries (POF) by a public transportation benefit area (PTBA), a county-owned ferry, or county ferry district.

"Urban passenger transportation system" means every transportation system (publicly or privately owned) that:

- Is funded primarily by income from transporting people via vehicles or trackless trolleys;
- With a seating capacity for over 15 people; and
- Operates over prescribed routes that do not exceed 15 miles beyond a corporate city's limit or 25 miles beyond a county's corporate limits.

In 2011, the Legislature extended the exemptions to include fuel purchased and used by the state ferry system and by county-owned auto ferries. This expansion of the exemption does not take effect until July 1, 2013; it will be scheduled for JLARC review at a later date. After July 1, 2013, all fuel purchased for use in state and county-owned ferries (both passenger and automobile ferries) will be exempt from sales and use taxes.

The preferences exempting motor vehicle and special fuels used in urban transportation from fuel taxes (RCWs 82.36.275 and 82.38.080) were reviewed by the Citizen Commission for Performance Measurement of Tax Preferences in 2010.

See Appendix 3 for the current statutes, RCWs 82.08.0255(1)(a), (c) and 82.12.0256(2)(a), (c).

Legal History

1921 The Legislature adopted a 1 cent per gallon tax on sales of liquid fuel gasoline or other fuel used in internal combustion engines.

1923 The Legislature increased the liquid fuel tax to 2 cents per gallon and narrowed the tax base to liquid fuel used to operate motor vehicles on public highways. Liquid fuel used in non-highway use was eligible for a refund of the tax paid.

1933 The Legislature enacted a petroleum products excise tax of 5 cents per gallon on motor vehicle fuel sold, distributed, or used in Washington, replacing the liquid fuel tax. The legislation defined "motor vehicle fuel" as gasoline or any other flammable liquid used chiefly as fuel to propel motor vehicles, motor boats, or airplanes. The Legislature also authorized refunds of the tax for off-highway use of motor vehicle (MV) fuel.

1935 The Legislature enacted the retail sales tax and companion use tax which applied to sales or use of tangible personal property in Washington. Because fuel falls within the definition of tangible personal property, it was subject to sales/use tax. This had the effect of making fuel used in urban passenger transportation on public highways subject to both MV fuel tax and sales/use tax.

1939 The Legislature provided a sales tax exemption for fuel taxed under the MV fuel tax. This eliminated the double taxation of fuel used in urban passenger transportation on public highways. Fuel used to operate motor vehicles on public roads was subject to MV fuel tax and exempt from sales tax. Likewise, fuel used for off-highway purposes was eligible for a refund of any MV fuel tax paid at purchase, but it was subject to sales/use tax.

1941 The Legislature added a use tax exemption for fuel taxable under motor vehicle fuel tax.

1957-1965 The Legislature enacted a refund of MV fuel tax paid on fuel for publicly or privately owned urban passenger transportation systems. The refund was scheduled to expire two years later in 1959. Because MV fuel tax was not paid on these fuels, they instead were subject to sales/use tax. The expiration date was extended another two years in 1959, 1961, 1963, and in 1965 was again extended two years to June 30, 1967.

1967 The Legislature eliminated the June 30, 1967, expiration date for refunds of MV fuel tax on fuel for urban passenger transportation systems, making the refund permanent. The fuel remained subject to sales/use tax.

1971 The Legislature imposed a special fuel tax on fuels other than gasoline (e.g., diesel) used to propel motor vehicles on public highways. The stated purpose of the special fuel tax was to supplement the MV fuel tax by taxing all fuels not subject to MV fuel tax that are used to propel motor vehicles on state highways. The Legislature provided an exemption from special fuel tax for urban passenger transportation systems. This made fuel used in urban passenger transportation systems exempt from special fuel tax, eligible for a refund of MV fuel tax, and subject to sales/use tax.

1980 The Legislature added this preference for urban transit fuel. This provided a sales/use tax exemption for MV fuel and special fuels if the fuel is purchased for the purpose of urban passenger public transportation and the purchase is entitled to a MV or special fuel tax refund or exemption. This meant that fuels for urban passenger public transportation were not subject to either sales/use tax or MV/special fuel tax.

2007 The Legislature expanded the sales/use tax exemptions to include fuel purchased and used in passenger-only ferry vessels by:

- A public transportation benefit area (PTBA) created under Chapter 36.57A RCW; or
- A county-owned ferry or county ferry district created under Chapter 36.54 RCW.

2011 The Legislature extended the urban passenger transportation fuel sales/use tax exemptions to include fuel purchased by either the Washington State ferry system or county-owned ferries for use in ferry vessels they own. The exemptions take effect July 1, 2013. This 2011 extension of the preference has not yet been scheduled for review by JLARC.

Public Policy Objectives

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

The Legislature did not state a public policy objective for the preference.

JLARC infers from historical bill reports, bill analysis compiled by legislative staff at the time of enactment, and Department of Revenue reports that the public policy objective may have been to reduce operating costs for public transportation providers, and in the process improve public transportation and reduce transportation costs for urban transit users.

Prior to this preference, urban passenger transportation providers (publicly and privately operated) already received refunds of motor vehicle fuel taxes they paid and exemptions from special fuel taxes. This preference provides a sales/use tax exemption as well, resulting in no taxes being collected on fuel used for urban passenger transportation systems.

Testimony by the prime sponsor of the 2007 bill to extend the preference to counties, county ferry districts, and PTBAs operating passenger-only ferries (POFs) stated that the extension was about improving transportation, supporting ferries and ferry users, and about economic development. The sponsor noted that no transit agency at that time paid sales tax on fuel and that this treatment should be extended to POFs.

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

The preference does reduce costs for public and private urban passenger transportation providers and local government POF providers, as it reduces their expenditures for fuel by the combined state and local tax rates (currently between 7.0 and 9.5 percent). JLARC is not able to measure whether the preference has improved public transportation or reduced transportation costs for passengers using urban transit or POFs.

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

Continuing the preference will provide continued savings on fuel expenditures for urban passenger transportation services and county or PTBA-operated passenger-only ferries.

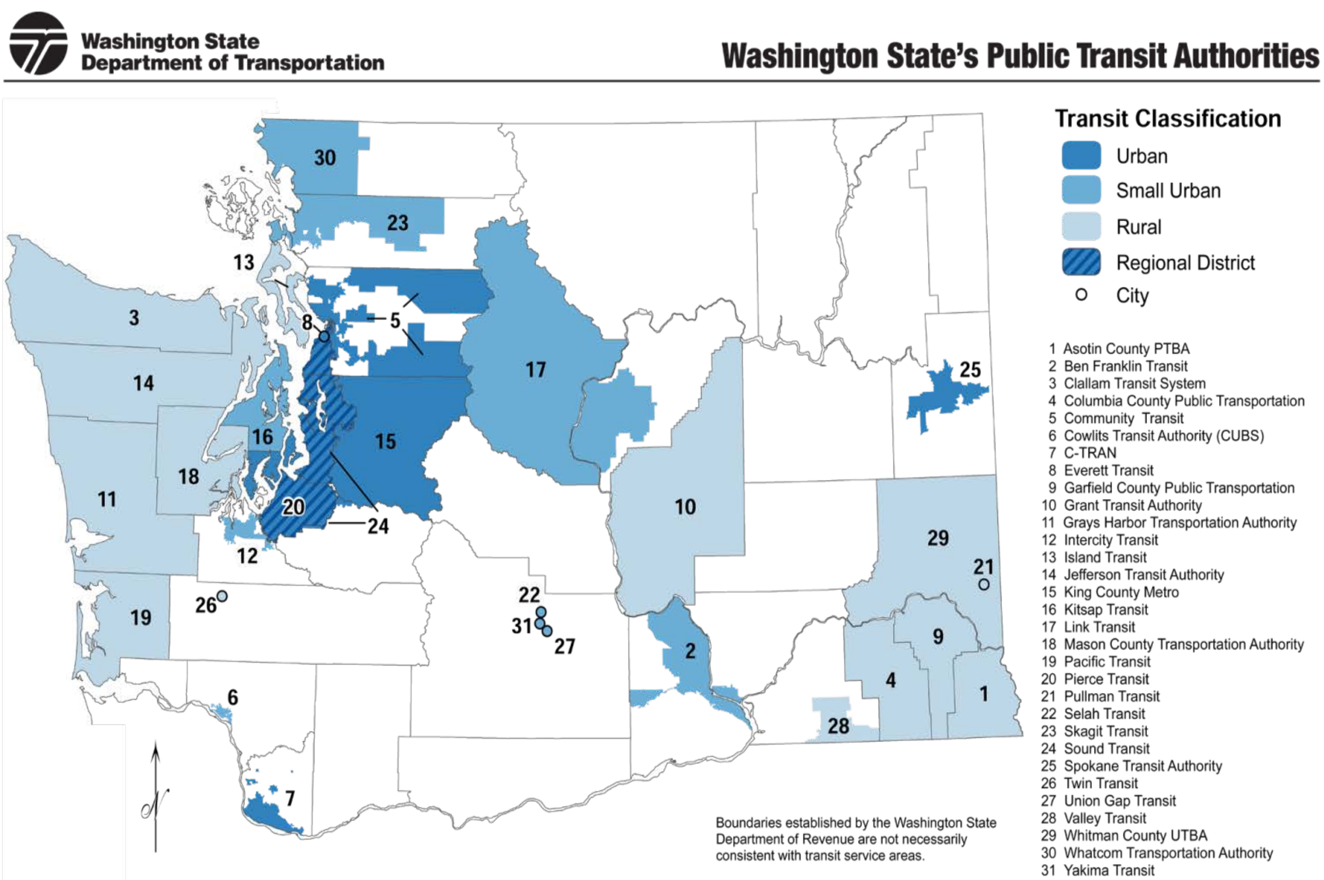
Beneficiaries

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

The beneficiaries of the preference are privately and publicly operated urban passenger transportation providers. These include bus services, commuter rail, and light rail services, as the service must provide transportation for 15 or more passengers.

According to WSDOT, as of January 2011, there are 31 publicly operated transit authorities. Exhibit 59, below, displays the publicly operated transit authorities, but does not include privately operated systems. In addition there are two county-operated passenger-only ferry systems: Kitsap Transit and King County Ferry District. JLARC does not have an estimate for the number of privately operated urban passenger transportation providers.

Exhibit 59 – Beneficiaries Provide Public Transportation Throughout the State



Source: Washington State 2009 Transit Data Update, January 2011.

Revenue and Economic Impacts

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

JLARC estimates the beneficiary savings for this preference in the 2013-15 Biennium at $22 million. See Exhibit 60, below.

Exhibit 60 – Estimated 2013-15 Beneficiary Savings for Urban Passenger Transportation Sales/Use Tax Exemption

Year	Estimated Fuel Costs	State Sales/ Use Tax	Local Sales/ Use Tax	Combined Sales/ Use Tax
2010	$70,292,000	$4,569,000	$1,699,000	$6,268,000
2011	$92,186,000	$5,992,000	$2,228,000	$8,220,000
2012	$106,346,000	$6,912,000	$2,570,000	$9,482,000
2013	$113,379,000	$7,370,000	$2,740,000	$10,110,000
2014	$120,205,000	$7,813,000	$2,905,000	$10,718,000
2015	$127,053,000	$8,258,000	$3,070,000	$11,328,000
			2013-15 Biennium	**$22,046,000**

Note: This estimate does not include amounts attributable to privately owned providers or the future exemption to Washington State Ferries and county ferry systems other than passenger-only providers beginning in FY 2014. The preference for ferry systems will be separately studied at a later time.

Source: JLARC analysis of DOR data, U.S. Dept. of Energy AFDC data, and Global Insights (ERFC) data with growth calculated using average growth rate from 2007-2009.

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

If the preference were terminated, it would result in increased fuel costs for public and private urban passenger transportation service providers. The effect on employment and the economy would depend on whether these transportation providers can either absorb the higher costs or pass them on to their passengers.

Other States

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

Of the 45 states and the District of Columbia that impose a sales/use tax, five states (Arkansas, Indiana, Massachusetts, South Dakota, and Washington) exempt fuel sold for some sort of public transit or transportation services from sales and use tax. Additionally, West Virginia provides a full sales/use tax refund and Texas a partial one on fuel used for public transportation systems. New

York provides a sales/use tax exemption for all ferry boats. JLARC was unable to determine how many states completely exempt fuel used in publicly and privately operated urban public transportation from all taxes.

Auditor Recommendation:

The Legislature should continue the sales and use tax exemption for fuel used in urban passenger transportation systems because it is meeting the inferred public policy objective of reducing the costs for providers of urban passenger transportation services.

Legislation Required: No.

Fiscal Impact: None.

APPENDIX 1 – SCOPE AND OBJECTIVES

2012
TAX PREFERENCE PERFORMANCE REVIEWS

SCOPE AND OBJECTIVES

OCTOBER 2011

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Why a JLARC Study of Tax Preferences?

Engrossed House Bill 1069 (2006) established the Citizen Commission for Performance Measurement of Tax Preferences and directed it to develop a schedule for periodic review of the state's tax preferences. The bill also directed the Joint Legislative Audit and Review Committee (JLARC) to conduct the periodic reviews.

Background

Tax preferences are exemptions, exclusions, or deductions from the base of a state tax; a credit against a state tax; a deferral of a state tax; or a preferential state tax rate. JLARC estimates the state currently has 603 tax preferences.

Recognizing the need to assess the effectiveness of these tax preferences through an orderly process, the Legislature established the Citizen Commission for Performance Measurement of Tax Preferences. One of the Commission's roles is to develop a schedule for the orderly 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 the Commission determines is critical to the structure of the tax system may also be omitted. Additionally, the Commission may recommend an expedited process for any tax preference.

JLARC is to review tax preferences according to the schedule developed by the Commission, consistent with guidelines set forth in statute. For each tax preference the Commission selects for a performance review, JLARC is to provide a recommendation to either: (1) continue, (2) modify, (3) add an expiration date and conduct another review prior to the expiration date, or (4) terminate the preference.

Study Scope

The Citizen Commission selected the following tax preferences for a performance review by JLARC in 2012:

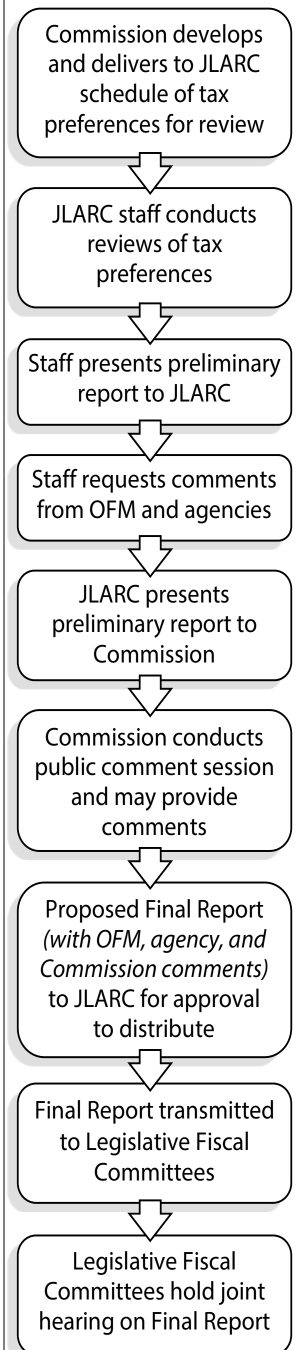
	Brief Description and Tax Type	RCW Citation	Year Enacted
1.	Annuities (Insurance Premium)	48.14.020(1)	1979
2.	Biotechnology Deferral (Sales & Use)	82.75.010; 82.75.030	2006
3.	Business Inventories (Property)	84.36.477; 84.36.510	1974
4.	Charter and Freight Brokers (B&O)	82.04.260(6)	1979
5.	Commuting Programs (B&O, PUT)	82.70.020	2003
6.	Condominium Maintenance Fees (B&O)	82.04.4298	1979
7.	Ferry Boats (Sales & Use)	82.08.0285; 82.12.0279	1977
8.	Fish Tax Rates (Fish)	82.27.020(4)	1980
9.	Fuel Use Exemptions (Fuel)	82.38.080	1971
10.	Health Insurance by State Pool (Insurance Premium)	48.14.022	1987
11.	High Technology Deferral (Sales & Use)	82.63.010; 82.63.030	1994
12.	High Technology Research and Development (B&O)	82.04.4452	1994
13.	Insurance Agents (B&O)	82.04.260(9)	1983

	Brief Description and Tax Type	RCW Citation	Year Enacted
14.	Insurance Guarantee Funds (Insurance Premium)	48.32.145; 48.32A.125	1976
15.	Leases Under $250 Per Year or Short Term (Leasehold Excise)	82.29A.130 (8)-(9)	1976
16.	Manufacturing Completed In-State (B&O)	82.04.4295	1977
17.	Natural and Manufactured Gas (Sales & Use)	48.14.020(1)	1979
18.	Precious Metals and Bullion (Sales & Use)	82.04.062	1985
19.	Solar Energy and Silicon Manufacturing (B&O)	82.04.294	2005
20.	Stevedoring (B&O)	82.04.260(7)	1979
21.	Travel Agents (B&O)	82.04.260(5)	1975
22.	Urban Transit Fuel (Sales & Use)	82.08.0255(1)(a),(c); 82.12.0256(2)(a)	1980

In addition, using the expedited process, the Commission will consider the following tax preferences. The expedited process is based on information published by the Department of Revenue in its most recent statutorily required tax exemption study.

	Brief Description and Tax Type	RCW Citation	Year Enacted
1.	Adult Family Homes (B&O)	82.04.327	1987
2.	Cargo Containers (Property)	84.36.105	1975
3.	Computers Donated to Schools (Use)	82.12.0284	1988
4.	Conservation Futures (Property)	84.36.500	1984
5.	Credit for Excess Tax (Leasehold Excise)	82.29A.120(1)	1991
6.	Crude Oil (Petroleum Products)	82.23A.010(1)	1989
7.	Delinquent Penalty Waivers (Property)	84.56.025	1984
8.	Domestic Use (Petroleum Products)	82.23A.030(2)	1989
9.	Exported Petroleum Products (Petroleum Products)	82.23A.030(6)	1989
10.	Federal Government Structure Labor (Sales & Use)	82.04.050(12)	1975
11.	Ferrosilicon (Sales & Use)	82.04.050(1)(a)(iv); 82.04.190(1)(d)	1986
12.	Fuel Exported in Fuel Tanks (Petroleum Products)	82.23A.040(1)	1989
13.	Fuel Used Before Tax Imposed (Petroleum Products)	82.23A.030(4)	1989
14.	Fuel Used to Process Petroleum Products (Petroleum Products)	82.23A.030(5)	1989
15.	Hazardous Substance Exemptions (Hazardous Substance)	82.21.040(1)-(4),(6)	1989
16.	Health Insurance Claims (B&O)	82.04.4331	1988
17.	Historic Vessels (Property)	84.36.080(2)	1986
18.	Life Insurance Sales Employees (B&O)	82.04.360(1)	1991
19.	Lodging for the Homeless (Sales & Use)	82.08.0299	1988
20.	Manufacturing for Government (Leasehold Excise)	82.29A.020(1)	1976
21.	Packaged Petroleum Products (Petroleum Products)	82.23A.030(7)	1989
22.	Precious Metals & Bullion (B&O)	82.04.062	1985

Tax Preference Review Process



	Brief Description and Tax Type	RCW Citation	Year Enacted
23.	Public Timber Credit (Timber)	84.33.077	1983
24.	Returned Motor Vehicles (Sales & Use)	82.32.065	1987
25.	Student Loan Organizations (B&O)	82.04.367	1987
26.	Student Loan Organizations (Property)	84.36.030(6)	1987
27.	Subsidized Housing (Leasehold Excise)	82.29A.130(3)	1976
28.	Successive Use (Petroleum Products)	82.23A.030(1)	1989
29.	Syrup Exported (Syrup)	82.64.030(2)	1989
30.	Syrup Previously Taxed (Syrup)	82.64.030(1)	1989
31.	Syrup Purchased before Tax Imposed (Syrup)	82.64.030(4)	1989
32.	Timber Tax Minimum (Timber)	84.33.086	1984
33.	Trademarked Syrup (Syrup)	84.64.030(3)	1991
34.	Used Floating Homes (Sales & Use)	82.08.034; 82.12.034	1984

Study Objectives

In response to the legislative directive, each performance review may answer questions relevant to the tax preference from the following list of questions.

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))
10. For those preferences enacted for economic development purposes, what are the economic impacts of the tax preference compared to the economic impact of government activities funded by the tax? (This analysis involves conducting an economic impact study using OFM's input-output model.) (RCW 43.136.055(j))

Other States:

11. 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(k))

Timeframe for the Study

A preliminary audit report will be presented at the July 2012 JLARC meeting and at the August 2012 meeting of the Commission. A final report will be presented to JLARC in January 2013.

JLARC Staff Contact for the Study

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APPENDIX 2 – AGENCY RESPONSES

- Department of Revenue
- Office of Financial Management/Department of Revenue

STATE OF WASHINGTON
DEPARTMENT OF REVENUE
OFFICE OF THE DIRECTOR
P.O. Box 47454 • Olympia, Washington 98504-7454 • (360) 534-1600 • FAX (360) 534-1606

August 28, 2012

TO: Keenan Konopaski, Legislative Auditor
Joint Legislative Audit and Review Committee

FROM: Brad Flaherty, Director
Department of Revenue

SUBJECT: **JLARC 2012 TAX PREFERENCE PERFORMANCE REVIEWS – PRELIMINARY REPORT – DOR RESPONSE TO ANNUAL SURVEY**

This is a follow-up to the joint response provided by the Office of Financial Management and the Department of Revenue on August 7, 2012. In that response, the Department of Revenue indicated no formal position on JLARC's recommendation to convene a work group to address how to improve the reliability and accuracy of information collected in the annual survey. Subsequently, JLARC staff has requested clarification of this response.

The official Department of Revenue response regarding the recommendation to convene a work group to improve the survey is that the Department does concur with the recommendation. Although the current information captured in the survey meets the statutory requirements, we agree that it could be improved and would welcome an opportunity to work with interested stakeholders in such a process. In particular, we would look to JLARC and legislative staff to provide insight into the types of information and formats that would be most useful for the Legislature.

The Department will convene an internal work group to review the information captured in the survey and our administrative processes to see if we can provide information to meet the identified needs without placing an additional reporting burden on taxpayers. The work group will develop a recommendation by January 15, 2013.

If the result of the work group is a modified annual survey, we believe these changes can be implemented in time for the Calendar Year 2013 surveys that will be due to the Department on April 30, 2014. However, any changes to the survey or the process may require legislation and funding to implement system changes to continue to allow us to capture the survey information electronically.

cc: Kathy Oline, Assistant Director for Research and Fiscal Analysis

STATE OF WASHINGTON

August 7, 2012

TO: Keenan Konopaski, Legislative Auditor
Joint Legislative Audit and Review Committee

FROM: Marty Brown, Director
Office of Financial Management

Marty Brown

Brad Flaherty, Director
Department of Revenue

Brad Flaherty

SUBJECT: JLARC 2012 TAX PREFERENCE PERFORMANCE REVIEWS – PRELIMINARY REPORT

Thank you for the opportunity to review and comment on the Joint Legislative Audit and Review Committee's (JLARC) preliminary report titled, "2012 Tax Preference Performance Reviews."

We appreciate the efforts of JLARC and the Citizen Commission for Performance Measurement of Tax Preferences to continuously review and analyze the state's numerous tax preferences. It is important to systematically 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. It also may be beneficial to consider the administrative burdens for both taxpayers and state agencies that result from a particular tax preference.

We appreciate your team's thorough analysis of the tax preferences selected for review, and offer the following comments on items in the report that impact the Office of Financial Management and/or the Department of Revenue.

Our comments are specifically regarding the following two sections of the preliminary report:

- BIOTECHNOLOGY MANUFACTURING DEFERRAL/WAIVER (SALES AND USE TAX) SUPPLEMENT, Pages 29 – 31
- HIGH TECHNOLOGY R&D DEFERRAL/WAIVER SUPPLEMENT, Pages 97 – 100

The preliminary report states that:

- Annual surveys do not provide the information needed by the Legislature to evaluate the tax preferences, (Pages 30 and 98); and
- Improvements are needed in the Office of Financial Management's (OFM's) Input-Output Model, (Page 100)

Annual Surveys Do Not Provide the Information Needed by the Legislature to Evaluate the Tax Preferences

The Department of Revenue believes that annual surveys do provide the information required by the Legislature. The uniformity desired to allow comparison between tax preference programs provides challenges with respect to collecting and reporting data specific to deferrals. The data provided is the result of a combination of data required by statute, and includes the amount of tax deferred and the number of total employment positions, information stakeholders want to provide. As an example, when stakeholder work was conducted to create the current survey form, the business community specifically asked to report "new positions created" as a way to better reflect benefits directly tied to the tax preference.

We recognize that requiring taxpayers to include the full amount of the deferred tax on the annual survey can create confusion for those who request public information about the deferral, or for those who look up the information on our website. We are currently examining ways to more accurately convey the value of tax deferrals within the confines of the statute. We have also provided a notice about this issue on our public disclosure website and a telephone number to call for additional information.

While the Department of Revenue does not have a formal position on JLARC's recommendation to convene a work group to address how to improve the reliability and accuracy of information collected in the annual survey, we want to comment on JLARC's assumptions that this work can be completed within existing resources, has no fiscal impact, and will require no legislation. We believe that participating in the work group can be done within existing resources. However, we want to point out that if the result is a significantly modified annual survey, this may require legislation and funding to implement system changes to allow us to capture the new information.

Improvements are Needed in OFM's Input-Output Model

The Office of Financial Management will convene a work group to develop and recommend a methodology to evaluate the impact of Washington's state and local government sectors on the state's economy using our Input-Output Model for the state. The work group, comprised of technical experts from state agencies, will complete its recommendation by January 15, 2013.

Again, thank you for the opportunity to provide input on this preliminary report.

APPENDIX 3 – CURRENT LAW

Table of Contents

Annuities (Insurance Premium Tax)

RCW 48.14.020(1)

(1) Subject to other provisions of this chapter, each authorized insurer except title insurers shall on or before the first day of March of each year pay to the state treasurer through the commissioner's office a tax on premiums. Except as provided in subsection (2) of this section, such tax shall be in the amount of two percent of all premiums, excluding amounts returned to or the amount of reductions in premiums allowed to holders of industrial life policies for payment of premiums directly to an office of the insurer, collected or received by the insurer under RCW 48.14.090 during the preceding calendar year other than ocean marine and foreign trade insurances, after deducting premiums paid to policyholders as returned premiums, upon risks or property resident, situated, or to be performed in this state. For tax purposes, the reporting of premiums shall be on a written basis or on a paid-for basis consistent with the basis required by the annual statement. For the purposes of this section the consideration received by an insurer for the granting of an annuity shall not be deemed to be a premium.

[2009 c 161 § 3; 2008 c 217 § 6; 1986 c 296 § 1; 1983 2nd ex.s. c 3 § 7; 1982 2nd ex.s. c 10 § 1; 1982 1st ex.s. c 35 § 15; 1979 ex.s. c 233 § 2; 1969 ex.s. c 241 § 9; 1947 c 79 § .14.02; Rem. Supp. 1947 § 45.14.02.]

RCW 48.14.021

Reduction of tax — Policies connected with pension, etc., plans exempt or qualified under internal revenue code.

As to premiums received from policies or contracts issued in connection with a pension, annuity or profit-sharing plan exempt or qualified under sections 401, 403(b), 404, 408(b), or 501(a) of the United States internal revenue code, the rate of tax specified in RCW 48.14.020 shall be reduced twelve and one-half percent with respect to the tax payable in 1964, twenty-five percent with respect to the tax payable in 1965, thirty-seven and one-half percent with respect to the tax payable in 1966, fifty percent with respect to the tax payable in 1967, sixty-two and one-half percent with respect to the tax payable in 1968, seventy-five percent with respect to the tax payable in 1969, eighty-seven and one-half percent with respect to the tax payable in 1970, and one hundred percent with respect to the tax payable in 1971 and annually thereafter.

[1975-'76 2nd ex.s. c 119 § 1; 1974 ex.s. c 132 § 1; 1963 c 166 § 1.]

Biotechnology Manufacturing Deferral/Waiver (Sales and Use Tax)

RCW 82.75.010

Definitions.

Unless the context clearly requires otherwise, the definitions in this section apply throughout this chapter.

(1) "Applicant" means a person applying for a tax deferral under this chapter.

(2) "Biotechnology" means a technology based on the science of biology, microbiology, molecular biology, cellular biology, biochemistry, or biophysics, or any combination of these, and includes, but is not limited to, recombinant DNA techniques, genetics and genetic engineering, cell fusion techniques, and new bioprocesses, using living organisms, or parts of organisms.

(3) "Biotechnology product" means any virus, therapeutic serum, antibody, protein, toxin, antitoxin, vaccine, blood, blood component or derivative, allergenic product, or analogous product produced through the application of biotechnology that is used in the prevention, treatment, or cure of diseases or injuries to humans.

(4) "Department" means the department of revenue.

(5)(a) "Eligible investment project" means an investment in qualified buildings or qualified machinery and equipment, including labor and services rendered in the planning, installation, and construction of the project.

(b) The lessor or owner of a qualified building is not eligible for a deferral unless:

(i) The underlying ownership of the buildings, machinery, and equipment vests exclusively in the same person; or

(ii)(A) The lessor by written contract agrees to pass the economic benefit of the deferral to the lessee;

(B) The lessee that receives the economic benefit of the deferral agrees in writing with the department to complete the annual survey required under RCW 82.75.070; and

(C) The economic benefit of the deferral passed to the lessee is no less than the amount of tax deferred by the lessor and is evidenced by written documentation of any type of payment, credit, or other financial arrangement between the lessor or owner of the qualified building and the lessee.

(6)(a) "Initiation of construction" means the date that a building permit is issued under the building code adopted under RCW 19.27.031 for:

(i) Construction of the qualified building, if the underlying ownership of the building vests exclusively with the person receiving the economic benefit of the deferral;

(ii) Construction of the qualified building, if the economic benefits of the deferral are passed to a lessee as provided in subsection (5)(b)(ii)(A) of this section; or

(iii) Tenant improvements for a qualified building, if the economic benefits of the deferral are passed to a lessee as provided in subsection (5)(b)(ii)(A) of this section.

(b) "Initiation of construction" does not include soil testing, site clearing and grading, site preparation, or any other related activities that are initiated before the issuance of a building permit for the construction of the foundation of the building.

(c) If the investment project is a phased project, "initiation of construction" applies separately to each phase.

(7) "Manufacturing" has the meaning provided in RCW 82.04.120.

(8) "Medical device" means an instrument, apparatus, implement, machine, contrivance, implant, in vitro reagent, or other similar or related article, including any component, part, or accessory, that is designed or developed and:

(a) Recognized in the national formulary, or the United States pharmacopeia, or any supplement to them;

(b) Intended for use in the diagnosis of disease, or in the cure, mitigation, treatment, or prevention of disease or other conditions in human beings or other animals; or

(c) Intended to affect the structure or any function of the body of human beings or other animals, and which does not achieve any of its primary intended purposes through chemical action within or on the body of human beings or other animals and which is not dependent upon being metabolized for the achievement of any of its principal intended purposes.

(9) "Person" has the meaning provided in RCW 82.04.030.

(10) "Qualified buildings" means construction of new structures, and expansion or renovation of existing structures for the purpose of increasing floor space or production capacity used for biotechnology product manufacturing or medical device manufacturing activities, including plant offices, commercial laboratories for process development, quality assurance and quality control, and warehouses or other facilities for the storage of raw material or finished goods if the facilities are an essential or an integral part of a factory, plant, or laboratory used for biotechnology product manufacturing or medical device manufacturing. If a building is used partly for biotechnology product manufacturing or medical device manufacturing and partly for other purposes, the applicable tax deferral must be determined by apportionment of the costs of construction under rules adopted by the department.

(11) "Qualified machinery and equipment" means all new industrial and research fixtures, equipment, and support facilities that are an integral and necessary part of a biotechnology product manufacturing or medical device manufacturing operation. "Qualified machinery and equipment" includes: Computers; software; data processing equipment; laboratory equipment; manufacturing components such as belts, pulleys, shafts, and moving parts; molds, tools, and dies; operating structures; and all equipment used to control or operate the machinery.

(12) "Recipient" means a person receiving a tax deferral under this chapter.

[2010 c 114 § 145; 2009 c 549 § 1033; 2006 c 178 § 2.]

RCW 82.75.030

Issuance of certificate. (Expires January 1, 2017.)

(1) The department shall issue a sales and use tax deferral certificate for state and local sales and use taxes due under chapters 82.08, 82.12, and 82.14 RCW for each eligible investment project.

(2) No certificate may be issued for an investment project that has already received a deferral under chapter 82.60 or 82.63 RCW or this chapter.

(3) The department shall keep a running total of all deferrals granted under this chapter during each fiscal biennium.

(4) This section expires January 1, 2017.

[2006 c 178 § 4.]

Business Inventories (Property Tax)

RCW 84.36.477

(1) Business inventories are exempt from property taxation.

(2) As used in this section:

(a)(i) "Business inventories" means all livestock, inventories of finished goods and work in process, and personal property not under lease or rental, acquired, or produced solely for the purpose of sale or lease or for the purpose of consuming the property in producing for sale or lease a new article of tangible personal property of which the property becomes an ingredient or component.

(ii) "Business inventories" also includes:

(A) All grains and flour, fruit and fruit products, unprocessed timber, vegetables and vegetable products, and fish and fish products, while being transported to or held in storage in a public or private warehouse or storage area if actually shipped to points outside the state on or before April 30th of the first year for which they would otherwise be taxable;

(B) All finished plywood, hardboard, and particleboard panels shipped from outside this state to any processing plant within this state, if the panels are moving under a through freight rate to final destination outside this state and the carrier grants the shipper the privilege of stopping the shipment in transit for the purpose of storing, milling, manufacturing, or other processing, while the panels are in the process of being treated or shaped into flat component parts to be incorporated into finished products outside this state and for thirty days after completion of the processing or treatment;

(C) All ore or metal shipped from outside this state to any smelter or refining works within this state, while in process of reduction or refinement and for thirty days after completion of the reduction or refinement; and

(D) All metals refined by electrolytic process into cathode or bar form while in this form and held under negotiable warehouse receipt in a public or private warehouse recognized by an established incorporated commodity exchange and for sale through the exchange.

(iii) "Business inventories" does not include personal property acquired or produced for the purpose of lease or rental if the property was leased or rented at any time during the calendar year immediately preceding the year of assessment and was not thereafter remanufactured, nor does it include property held within the normal course of business for lease or rental for periods of less than thirty days.

(iv) "Business inventories" does not include agricultural or horticultural property fully or partially exempt under RCW 84.36.470.

(v) "Business inventories" does not include timber that is standing on public land and that is sold under a contract entered into after August 1, 1982;

(b) "Fish and fish products" means all fish and fish products suitable and designed for human consumption, excluding all others;

(c) "Fruit and fruit products" means all raw edible fruits, berries, and hops and all processed products of fruits, berries, or hops, suitable and designed for human consumption, while in the hands of the first processor;

(d) "Processed" means canning, barreling, bottling, preserving, refining, freezing, packing, milling, or any other method employed to keep any grain, fruit, vegetable, or fish in an edible condition or to put it into more suitable or convenient form for consuming, storing, shipping, or marketing;

(e) "Remanufactured" means the restoration of property to essentially its original condition, but does not mean normal maintenance or repairs; and

(f) "Vegetables and vegetable products" means all raw edible vegetables such as peas, beans, beets, sugar beets, and other vegetables, and all processed products of vegetables, suitable and designed for human consumption, while in the hands of the first processor.

[2001 c 187 § 15; 1983 1st ex.s. c 62 § 6.]

RCW 84.36.510

Mobile homes in dealer's inventory.

Any mobile home which is a part of a dealer's inventory and held solely for sale in the ordinary course of the dealer's business and is not used for any other purpose shall be exempt from property taxation: PROVIDED, That this exemption shall not apply to property taxes already levied or delinquent on such mobile home at the time it becomes part of a dealer's inventory.

[1985 c 395 § 7.]

Commuting Programs (B&O Tax, PUT)

RCW 82.70.020

Tax credit authorized. (Expires July 1, 2013.)

(1) Employers in this state who are taxable under chapter 82.04 or 82.16 RCW and provide financial incentives to their own or other employees for ride sharing, for using public transportation, for using car sharing, or for using nonmotorized commuting before July 1, 2013, are allowed a credit against taxes payable under chapters 82.04 and 82.16 RCW for amounts paid to or on behalf of employees for ride sharing in vehicles carrying two or more persons, for using public transportation, for using car sharing, or for using nonmotorized commuting, not to exceed sixty dollars per employee per fiscal year.

(2) Property managers who are taxable under chapter 82.04 or 82.16 RCW and provide financial incentives to persons employed at a worksite in this state managed by the property manager for ride sharing, for using public transportation, for using car sharing, or for using nonmotorized commuting before July 1, 2013, are allowed a credit against taxes payable under chapters 82.04 and 82.16 RCW for amounts paid to or on behalf of these persons for ride sharing in vehicles carrying two or more persons, for using public transportation, for using car sharing, or for using nonmotorized commuting, not to exceed sixty dollars per person per fiscal year.

(3) The credit under this section is equal to the amount paid to or on behalf of each employee multiplied by fifty percent, but may not exceed sixty dollars per employee per fiscal year. No refunds may be granted for credits under this section.

(4) A person may not receive credit under this section for amounts paid to or on behalf of the same employee under both chapters 82.04 and 82.16 RCW.

(5) A person may not take a credit under this section for amounts claimed for credit by other persons.

[2005 c 297 § 3; 2003 c 364 § 2.]

Condominium and Homeowner Maintenance Fees (B&O Tax)

RCW 82.04.4298

Deductions — Repair, maintenance, replacement, etc., of residential structures and commonly held property — Eligible organizations.

(1) In computing tax there may be deducted from the measure of tax amounts used solely for repair, maintenance, replacement, management, or improvement of the residential structures and commonly held property, but excluding property where fees or charges are made for use by the public who are not guests accompanied by a member, which are derived by:

(a) A cooperative housing association, corporation, or partnership from a person who resides in a structure owned by the cooperative housing association, corporation, or partnership;

(b) An association of owners of property as defined in RCW 64.32.010, as now or hereafter amended, from a person who is an apartment owner as defined in RCW 64.32.010; or

(c) An association of owners of residential property from a person who is a member of the association. "Association of owners of residential property" means any organization of all the owners of residential property in a defined area who all hold the same property in common within the area.

(2) For the purposes of this section "commonly held property" includes areas required for common access such as reception areas, halls, stairways, parking, etc., and may include recreation rooms, swimming pools and small parks or recreation areas; but is not intended to include more grounds than are normally required in a residential area, or to include such extensive areas as required for golf courses, campgrounds, hiking and riding areas, boating areas, etc.

(3) To qualify for the deductions under this section:

(a) The salary or compensation paid to officers, managers, or employees must be only for actual services rendered and at levels comparable to the salary or compensation of like positions within the county wherein the property is located;

(b) Dues, fees, or assessments in excess of amounts needed for the purposes for which the deduction is allowed must be rebated to the members of the association;

(c) Assets of the association or organization must be distributable to all members and must not inure to the benefit of any single member or group of members.

[1980 c 37 § 18. Formerly RCW 82.04.430(17).]

Ferry Boats (Sales and Use Tax)

RCW 82.08.0285

Exemptions — Sales of ferry vessels to the state or local governmental units — Components thereof — Labor and service charges.

The tax levied by RCW 82.08.020 shall not apply to sales of ferry vessels to the state of Washington or to a local governmental unit in the state of Washington for use in transporting pedestrians, vehicles, and goods within or outside the territorial waters of the state; also sales of tangible personal property which becomes a component part of such ferry vessels; also sales of or charges made for labor and services rendered in respect to constructing or improving such ferry vessels.

[1980 c 37 § 50. Formerly RCW 82.08.030(32).]

RCW 82.12.0279

Exemptions — Use of ferry vessels by the state or local governmental units — Components thereof.

The provisions of this chapter shall not apply in respect to the use of ferry vessels of the state of Washington or of local governmental units in the state of Washington in transporting pedestrian or vehicular traffic within and outside the territorial waters of the state, in respect to the use of tangible personal property which becomes a component part of any such ferry vessel, and in respect to the use of labor and services rendered in respect to improving such ferry vessels.

[2003 c 5 § 9; 1980 c 37 § 77. Formerly RCW 82.12.030(27).]

Fish Tax Differential Rates (Enhanced Food Fish Tax)

RCW 82.27.020(4)

Excise tax imposed — Deduction — Measure of tax — Rates — Additional tax imposed.

(1) In addition to all other taxes, licenses, or fees provided by law there is established an excise tax on the commercial possession of enhanced food fish as provided in this chapter. The tax is levied upon and shall be collected from the owner of the enhanced food fish whose possession constitutes the taxable event. The taxable event is the first possession in Washington by an owner after the enhanced food fish has been landed. Processing and handling of enhanced food fish by a person who is not the owner is not a taxable event to the processor or handler…

(4) The tax shall be equal to the measure of the tax multiplied by the rates for enhanced food fish as follows:

(a) Chinook, coho, and chum salmon and anadromous game fish: Five and twenty-five one-hundredths percent;

(b) Pink and sockeye salmon: Three and fifteen one-hundredths percent;

(c) Other food fish and shellfish, except oysters, sea urchins, and sea cucumbers: Two and one-tenth percent;

(d) Oysters: Eight one-hundredths of one percent;

(e) Sea urchins: Four and six-tenths percent through December 31, 2013, or until the department of fish and wildlife notifies the department that the number of sea urchin licenses has been reduced to twenty licenses, whichever occurs first, and two and one-tenth percent thereafter; and

(f) Sea cucumbers: Four and six-tenths percent through December 31, 2013, or until the department of fish and wildlife notifies the department that the number of sea cucumber licenses has been reduced to twenty licenses, whichever occurs first, and two and one-tenth percent thereafter.

(5) An additional tax is imposed equal to the rate specified in RCW 82.02.030 multiplied by the tax payable under subsection (4) of this section.

[2010 c 193 § 16; 2005 c 110 § 3; 2001 c 320 § 9; 1999 c 126 § 3; 1993 sp.s. c 17 § 12; 1985 c 413 § 2; 1983 2nd ex.s. c 3 § 17; 1983 c 284 § 6; 1982 1st ex.s. c 35 § 10; 1980 c 98 § 2.]

Health Insurance by State Pool (Insurance Premiums Tax)

RCW 48.14.022

Taxes — Exemptions and deductions.

(1) The taxes imposed in RCW 48.14.020 and 48.14.0201 do not apply to premiums and prepayments collected or received for policies of insurance issued under RCW 48.41.010 through 48.41.210.

(2) In computing tax due under RCW 48.14.020 and 48.14.0201, there may be deducted from taxable premiums and prepayments the amount of any assessment against the taxpayer under RCW 48.41.010 through 48.41.210. Any portion of the deduction allowed in this section which cannot be deducted in a tax year without reducing taxable premiums below zero may be carried forward and deducted in successive years until the deduction is exhausted.

[1995 c 304 § 1; 1987 c 431 § 23.]

High Technology R&D Deferral/Waiver (Sales and Use Tax) and Credit (B&O Tax)

RCW 82.63.010

Definitions.

Unless the context clearly requires otherwise, the definitions in this section apply throughout this chapter.

(1) "Advanced computing" means technologies used in the designing and developing of computing hardware and software, including innovations in designing the full spectrum of hardware from hand-held calculators to super computers, and peripheral equipment.

(2) "Advanced materials" means materials with engineered properties created through the development of specialized processing and synthesis technology, including ceramics, high value-added metals, electronic materials, composites, polymers, and biomaterials.

(3) "Applicant" means a person applying for a tax deferral under this chapter.

(4) "Biotechnology" means the application of technologies, such as recombinant DNA techniques, biochemistry, molecular and cellular biology, genetics and genetic engineering, cell fusion techniques, and new bioprocesses, using living organisms, or parts of organisms, to produce or modify products, to improve plants or animals, to develop microorganisms for specific uses, to identify targets for small molecule pharmaceutical development, or to transform biological systems into useful processes and products or to develop microorganisms for specific uses.

(5) "Department" means the department of revenue.

(6) "Electronic device technology" means technologies involving microelectronics; semiconductors; electronic equipment and instrumentation; radio frequency, microwave, and millimeter electronics; optical and optic-electrical devices; and data and digital communications and imaging devices.

(7) "Eligible investment project" means an investment project which either initiates a new operation, or expands or diversifies a current operation by expanding, renovating, or equipping an existing facility. The lessor or owner of the qualified building is not eligible for a deferral unless:

(a) The underlying ownership of the buildings, machinery, and equipment vests exclusively in the same person; or

(b)(i) The lessor by written contract agrees to pass the economic benefit of the deferral to the lessee;

(ii) The lessee that receives the economic benefit of the deferral agrees in writing with the department to complete the annual survey required under RCW 82.63.020(2); and

(iii) The economic benefit of the deferral passed to the lessee is no less than the amount of tax deferred by the lessor and is evidenced by written documentation of any type of payment, credit, or other financial arrangement between the lessor or owner of the qualified building and the lessee.

(8) "Environmental technology" means assessment and prevention of threats or damage to human health or the environment, environmental cleanup, and the development of alternative energy sources.

(9)(a) "Initiation of construction" means the date that a building permit is issued under the building code adopted under RCW 19.27.031 for:

(i) Construction of the qualified building, if the underlying ownership of the building vests exclusively with the person receiving the economic benefit of the deferral;

(ii) Construction of the qualified building, if the economic benefits of the deferral are passed to a lessee as provided in subsection (7) of this section; or

(iii) Tenant improvements for a qualified building, if the economic benefits of the deferral are passed to a lessee as provided in subsection (7) of this section.

(b) "Initiation of construction" does not include soil testing, site clearing and grading, site preparation, or any other related activities that are initiated before the issuance of a building permit for the construction of the foundation of the building.

(c) If the investment project is a phased project, "initiation of construction" shall apply separately to each phase.

(10) "Investment project" means an investment in qualified buildings or qualified machinery and equipment, including labor and services rendered in the planning, installation, and construction or improvement of the project.

(11) "Multiple qualified buildings" means qualified buildings leased to the same person when such structures: (a) Are located within a five-mile radius; and (b) the initiation of construction of each building begins within a sixty-month period.

(12) "Person" has the meaning given in RCW 82.04.030 and includes state universities as defined in RCW 28B.10.016.

(13) "Pilot scale manufacturing" means design, construction, and testing of preproduction prototypes and models in the fields of biotechnology, advanced computing, electronic device technology, advanced materials, and environmental technology other than for commercial sale. As used in this subsection, "commercial sale" excludes sales of prototypes or sales for market testing if the total gross receipts from such sales of the product, service, or process do not exceed one million dollars.

(14) "Qualified buildings" means construction of new structures, and expansion or renovation of existing structures for the purpose of increasing floor space or production capacity used for pilot scale manufacturing or qualified research and development, including plant offices and other facilities that are an essential or an integral part of a structure used for pilot scale manufacturing or qualified research and development. If a building or buildings are used partly for pilot scale manufacturing or qualified research and development, and partly for other purposes, the applicable tax deferral shall be determined by apportionment of the costs of construction under rules adopted by the department. Such rules may include provisions for determining the amount of the deferral based on apportionment of costs of construction of an investment project consisting of a building or multiple buildings, where qualified research and development or pilot scale manufacturing activities are shifted within a building or from one building to another building.

(15) "Qualified machinery and equipment" means fixtures, equipment, and support facilities that are an integral and necessary part of a pilot scale manufacturing or qualified research and development operation. "Qualified machinery and equipment" includes: Computers; software; data processing equipment; laboratory equipment, instrumentation, and other devices used in a process of experimentation to develop a new or improved pilot model, plant process, product, formula, invention, or similar property; manufacturing components such as belts, pulleys, shafts, and moving parts; molds, tools, and dies; vats, tanks, and fermenters; operating structures; and all other equipment used to control, monitor, or operate the machinery. For purposes of this chapter, qualified machinery and equipment must be either new to the taxing jurisdiction of the state or new to the certificate holder, except that used machinery and equipment may be treated as qualified machinery and equipment if the certificate holder either brings the machinery and equipment into Washington or makes a retail purchase of the machinery and equipment in Washington or elsewhere.

(16) "Qualified research and development" means research and development performed within this state in the fields of advanced computing, advanced materials, biotechnology, electronic device technology, and environmental technology.

(17) "Recipient" means a person receiving a tax deferral under this chapter.

(18) "Research and development" means activities performed to discover technological information, and technical and nonroutine activities concerned with translating technological information into new or improved products, processes, techniques, formulas, inventions, or software. The term includes exploration of a new use for an existing drug, device, or biological product if the new use requires separate licensing by the federal food and drug administration under chapter 21, C.F.R., as amended. The term does not include adaptation or duplication of existing products where the products are not substantially improved by application of the technology, nor does the term include surveys and studies, social science and humanities research, market research

or testing, quality control, sale promotion and service, computer software developed for internal use, and research in areas such as improved style, taste, and seasonal design.

[2009 c 268 § 2; 2004 c 2 § 3; 1995 1st sp.s. c 3 § 12; 1994 sp.s. c 5 § 3.]

RCW 82.63.030

Sales and use tax deferral certificate — Eligible investment projects and pilot scale manufacturing. (Expires January 1, 2015.)

(1) Except as provided in subsection (2) of this section, the department shall issue a sales and use tax deferral certificate for state and local sales and use taxes due under chapters 82.08, 82.12, and 82.14 RCW on each eligible investment project.

(2) No certificate may be issued for an investment project that has already received a deferral under chapter 82.60 RCW or this chapter, except that an investment project for qualified research and development that has already received a deferral may also receive an additional deferral certificate for adapting the investment project for use in pilot scale manufacturing.

(3) This section shall expire January 1, 2015.

[2008 c 15 § 4; 2004 c 2 § 5; 1994 sp.s. c 5 § 5.]

RCW 82.04.4452

Credit – Research and development spending. (Expires January 1, 2015.)

(1) In computing the tax imposed under this chapter, a credit is allowed for each person whose research and development spending during the year in which the credit is claimed exceeds 0.92 percent of the person's taxable amount during the same calendar year.

(2) The credit is calculated as follows:

(a) Determine the greater of the amount of qualified research and development expenditures of a person or eighty percent of amounts received by a person other than a public educational or research institution in compensation for the conduct of qualified research and development;

(b) Subtract 0.92 percent of the person's taxable amount from the amount determined under (a) of this subsection;

(c) Multiply the amount determined under (b) of this subsection by the following:

(i) For the period June 10, 2004, through December 31, 2006, the person's average tax rate for the calendar year for which the credit is claimed;

(ii) For the calendar year ending December 31, 2007, the greater of the person's average tax rate for that calendar year or 0.75 percent;

(iii) For the calendar year ending December 31, 2008, the greater of the person's average tax rate for that calendar year or 1.0 percent;

(iv) For the calendar year ending December 31, 2009, the greater of the person's average tax rate for that calendar year or 1.25 percent;

(v) For the calendar year ending December 31, 2010, and thereafter, 1.50 percent.

For purposes of calculating the credit, if a person's reporting period is less than annual, the person may use an estimated average tax rate for the calendar year for which the credit is claimed by using the person's average tax rate for each reporting period. A person who uses an estimated average tax rate must make an adjustment to the total credit claimed for the calendar year using the person's actual average tax rate for the calendar year when the person files its last return for the calendar year for which the credit is claimed.

(3) Any person entitled to the credit provided in subsection (2) of this section as a result of qualified research and development conducted under contract may assign all or any portion of the credit to the person contracting for the performance of the qualified research and development.

(4) The credit, including any credit assigned to a person under subsection (3) of this section, must be claimed against taxes due for the same calendar year in which the qualified research and development expenditures are incurred. The credit, including any credit assigned to a person under subsection (3) of this section, for each calendar year may not exceed the lesser of two million dollars or the amount of tax otherwise due under this chapter for the calendar year.

(5) For any person claiming the credit, including any credit assigned to a person under subsection (3) of this section, whose research and development spending during the calendar year in which the credit is claimed fails to exceed 0.92 percent of the person's taxable amount during the same calendar year or who is otherwise ineligible, the department must declare the taxes against which the credit was claimed to be immediately due and payable. The department must assess interest, but not penalties, on the taxes against which the credit was claimed. Interest must be assessed at the rate provided for delinquent excise taxes under chapter 82.32 RCW, retroactively to the date the credit was claimed, and accrues until the taxes against which the credit was claimed are repaid. Any credit assigned to a person under subsection (3) of this section that is disallowed as a result of this section may be claimed by the person who performed the qualified research and development subject to the limitations set forth in subsection (4) of this section.

(6) A person claiming the credit provided in this section must file a complete annual survey with the department under RCW 82.32.585.

(7) For the purpose of this section:

(a) "Average tax rate" means a person's total tax liability under this chapter for the calendar year for which the credit is claimed divided by the taxpayer's total taxable amount under this chapter for the calendar year for which the credit is claimed.

(b) "Qualified research and development expenditures" means operating expenses, including wages, compensation of a proprietor or a partner in a partnership as determined under rules adopted by the department, benefits, supplies, and computer expenses, directly incurred in qualified research and development by a person claiming the credit provided in this section. The term does not include amounts paid to a person other than a public educational or research institution to conduct qualified research and development. Nor does the term include capital costs and overhead, such as expenses for land, structures, or depreciable property.

(c) "Qualified research and development" shall have the same meaning as in RCW 82.63.010.

(d) "Research and development spending" means qualified research and development expenditures plus eighty percent of amounts paid to a person other than a public educational or research institution to conduct qualified research and development.

(e) "Taxable amount" means the taxable amount subject to the tax imposed in this chapter required to be reported on the person's combined excise tax returns for the calendar year for which the credit is claimed, less any taxable amount for which a credit is allowed under RCW 82.04.440.

(8) This section expires January 1, 2015.

[2010 c 114 § 114; 2005 c 514 § 1003; 2004 c 2 § 2; 2000 c 103 § 7; 1997 c 7 § 4; 1994 sp.s. c 5 § 2.]

Insurance Guaranty Funds (Insurance Premium Tax)

RCW 48.32.145

Credit against premium tax for assessments paid pursuant to RCW 48.32.060(1)(c).

Every member insurer that prior to April 1, 1993, or after July 27, 1997, shall have paid one or more assessments levied pursuant to RCW 48.32.060(1)(c) shall be entitled to take a credit against any premium tax falling due under RCW 48.14.020. The amount of the credit shall be one-fifth of the aggregate amount of such aggregate assessments paid during such calendar year for each of the five consecutive calendar years beginning with the calendar year following the calendar year in which such assessments are paid. Whenever the allowable credit is or becomes less than one thousand dollars, the entire amount of the credit may be offset against the premium tax at the next time the premium tax is paid.

[1997 c 300 § 1; 1993 sp.s. c 25 § 901; 1977 ex.s. c 183 § 1; 1975-'76 2nd ex.s. c 109 § 11.]

RCW 48.32A.125

Credits for assessments paid — Tax offsets.

(1) A member insurer may offset against its premium tax liability to this state an assessment described in RCW 48.32A.085(8) to the extent of twenty percent of the amount of the assessment for each of the five calendar years following the year in which the assessment was paid. In the event a member insurer ceases doing business, all uncredited assessments may be credited against its premium tax liability for the year it ceases doing business.

(2) Any sums that are acquired by refund, under RCW 48.32A.085(6), from the association by member insurers, and that have been offset against premium taxes as provided in subsection (1) of this section, must be paid by the insurers to the commissioner and then deposited with the state treasurer for credit to the general fund of the state of Washington. The association shall notify the commissioner that refunds have been made.

[2001 c 50 § 13.]

Insurance Producers (B&O Tax)

RCW 82.04.260

(9) Upon every person engaging within this state as an insurance producer or title insurance agent licensed under chapter 48.17 RCW or a surplus line broker licensed under chapter 48.15 RCW; as to such persons, the amount of the tax with respect to such licensed activities is equal to the gross income of such business multiplied by the rate of 0.484 percent.

[2011 c 2 § 203 (Initiative Measure No. 1107, approved November 2, 2010); 2010 1st sp.s. c 23 § 506; (2010 1st sp.s. c 23 § 505 expired June 10, 2010); 2010 c 114 § 107. Prior: 2009 c 479 § 64; 2009 c 461 § 1; 2009 c 162 § 34; prior: 2008 c 296 § 1; 2008 c 217 § 100; 2008 c 81 § 4; prior: 2007 c 54 § 6; 2007 c 48 § 2; prior: 2006 c 354 § 4; 2006 c 300 § 1; prior: 2005 c 513 § 2; 2005 c 443 § 4; prior: 2003 2nd sp.s. c 1 § 4; 2003 2nd sp.s. c 1 § 3; 2003 c 339 § 11; 2003 c 261 § 11; 2001 2nd sp.s. c 25 § 2; prior: 1998 c 312 § 5; 1998 c 311 § 2; prior: 1998 c 170 § 4; 1996 c 148 § 2; 1996 c 115 § 1; prior: 1995 2nd sp.s. c 12 § 1; 1995 2nd sp.s. c 6 § 1; 1993 sp.s. c 25 § 104; 1993 c 492 § 304; 1991 c 272 § 15; 1990 c 21 § 2; 1987 c 139 § 1; prior: 1985 c 471 § 1; 1985 c 135 § 2; 1983 2nd ex.s. c 3 § 5; prior: 1983 1st ex.s. c 66 § 4; 1983 1st ex.s. c 55 § 4; 1982 2nd ex.s. c 13 § 1; 1982 c 10 § 16; prior: 1981 c 178 § 1; 1981 c 172 § 3; 1979 ex.s. c 196 § 2; 1975 1st ex.s. c 291 § 7; 1971 ex.s. c 281 § 5; 1971 ex.s. c 186 § 3; 1969 ex.s. c 262 § 36; 1967 ex.s. c 149 § 10; 1965 ex.s. c 173 § 6; 1961 c 15 § 82.04.260; prior: 1959 c 211 § 2; 1955 c 389 § 46; prior: 1953 c 91 § 4; 1951 2nd ex.s. c 28 § 4; 1950 ex.s. c 5 § 1, part; 1949 c 228 § 1, part; 1943 c 156 § 1, part; 1941 c 178 § 1, part; 1939 c 225 § 1, part; 1937 c 227 § 1, part; 1935 c 180 § 4, part; Rem. Supp. 1949 § 8370-4, part.]

Leases Under $250 per Year and Short Term Leases (Leasehold Excise Tax)

RCW 82.29A.130

Exemptions — Certain property.

The following leasehold interests shall be exempt from taxes imposed pursuant to RCW 82.29A.030 and 82.29A.040:

(1) All leasehold interests constituting a part of the operating properties of any public utility which is assessed and taxed as a public utility pursuant to chapter 84.12 RCW.

(2) All leasehold interests in facilities owned or used by a school, college or university which leasehold provides housing for students and which is otherwise exempt from taxation under provisions of RCW 84.36.010 and 84.36.050.

(3) All leasehold interests of subsidized housing where the fee ownership of such property is vested in the government of the United States, or the state of Washington or any political subdivision thereof but only if income qualification exists for such housing.

(4) All leasehold interests used for fair purposes of a nonprofit fair association that sponsors or conducts a fair or fairs which receive support from revenues collected pursuant to RCW 67.16.100 and allocated by the director of the department of agriculture where the fee ownership of such property is vested in the government of the United States, the state of Washington or any of its political subdivisions: PROVIDED, That this exemption shall not apply to the leasehold interest of any sublessee of such nonprofit fair association if such leasehold interest would be taxable if it were the primary lease.

(5) All leasehold interests in any property of any public entity used as a residence by an employee of that public entity who is required as a condition of employment to live in the publicly owned property.

(6) All leasehold interests held by enrolled Indians of lands owned or held by any Indian or Indian tribe where the fee ownership of such property is vested in or held in trust by the United States and which are not subleased to other than to a lessee which would qualify pursuant to this chapter, RCW 84.36.451 and 84.40.175.

(7) All leasehold interests in any real property of any Indian or Indian tribe, band, or community that is held in trust by the United States or is subject to a restriction against alienation imposed by the United States: PROVIDED, That this exemption shall apply only where it is determined that contract rent paid is greater than or equal to ninety percent of fair market rental, to be determined by the department of revenue using the same criteria used to establish taxable rent in RCW 82.29A.020(2)(b).

(8) All leasehold interests for which annual taxable rent is less than two hundred fifty dollars per year. For purposes of this subsection leasehold interests held by the same lessee in contiguous properties owned by the same lessor shall be deemed a single leasehold interest.

(9) All leasehold interests which give use or possession of the leased property for a continuous period of less than thirty days: PROVIDED, That for purposes of this subsection, successive leases or lease renewals giving substantially continuous use of possession of the same property to the same lessee shall be deemed a single leasehold interest: PROVIDED FURTHER, That no leasehold interest shall be deemed to give use or possession for a period of less than thirty days solely by virtue of the reservation by the public lessor of the right to use the property or to allow third parties to use the property on an occasional, temporary basis.

(10) All leasehold interests under month-to-month leases in residential units rented for residential purposes of the lessee pending destruction or removal for the purpose of constructing a public highway or building.

(11) All leasehold interests in any publicly owned real or personal property to the extent such leasehold interests arises solely by virtue of a contract for public improvements or work executed under the public works statutes of this state or of the United States between the public owner of the property and a contractor.

(12) All leasehold interests that give use or possession of state adult correctional facilities for the purposes of operating correctional industries under RCW 72.09.100.

(13) All leasehold interests used to provide organized and supervised recreational activities for persons with disabilities of all ages in a camp facility and for public recreational purposes by a nonprofit organization, association, or corporation that would be exempt from property tax under RCW 84.36.030(1) if it owned the property. If the publicly owned property is used for any taxable purpose, the leasehold excise taxes set forth in RCW 82.29A.030 and 82.29A.040 shall be imposed and shall be apportioned accordingly.

(14) All leasehold interests in the public or entertainment areas of a baseball stadium with natural turf and a retractable roof or canopy that is in a county with a population of over one million, that has a seating capacity of over forty thousand, and that is constructed on or after January 1, 1995.

"Public or entertainment areas" include ticket sales areas, ramps and stairs, lobbies and concourses, parking areas, concession areas, restaurants, hospitality and stadium club areas, kitchens or other work areas primarily servicing other public or entertainment areas, public rest room areas, press and media areas, control booths, broadcast and production areas, retail sales areas, museum and exhibit areas, scoreboards or other public displays, storage areas, loading, staging, and servicing areas, seating areas and suites, the playing field, and any other areas to which the public has access or which are used for the production of the entertainment event or other public usage, and any other personal property used for these purposes. "Public or entertainment areas" does not include locker rooms or private offices exclusively used by the lessee.

(15) All leasehold interests in the public or entertainment areas of a stadium and exhibition center, as defined in RCW 36.102.010, that is constructed on or after January 1, 1998. For the purposes of this subsection, "public or entertainment areas" has the same meaning as in subsection (14) of this section, and includes exhibition areas.

(16) All leasehold interests in public facilities districts, as provided in chapter 36.100 or 35.57 RCW.

(17) All leasehold interests in property that is: (a) Owned by the United States government or a municipal corporation; (b) listed on any federal or state register of historical sites; and (c) wholly contained within a designated national historic reserve under 16 U.S.C. Sec. 461.

(18) All leasehold interests in the public or entertainment areas of an amphitheater if a private entity is responsible for one hundred percent of the cost of constructing the amphitheater which is not reimbursed by the public owner, both the public owner and the private lessee sponsor events at the facility on a regular basis, the lessee is responsible under the lease or agreement to operate and maintain the facility, and the amphitheater has a seating capacity of over seventeen thousand reserved and general admission seats and is in a county that had a population of over three hundred fifty thousand, but less than four hundred twenty-five thousand when the amphitheater first opened to the public.

For the purposes of this subsection, "public or entertainment areas" include box offices or other ticket sales areas, entrance gates, ramps and stairs, lobbies and concourses, parking areas, concession areas, restaurants, hospitality areas, kitchens or other work areas primarily servicing other public or entertainment areas, public rest room areas, press and media areas, control booths, broadcast and production areas, retail sales areas, museum and exhibit areas, scoreboards or other public displays, storage areas, loading, staging, and servicing areas, seating areas including lawn seating areas and suites, stages, and any other areas to which the public has access or which are used for the production of the entertainment event or other public usage, and any other personal property used for these purposes. "Public or entertainment areas" does not include office areas used predominately by the lessee.

(19) All leasehold interests in real property used for the placement of military housing meeting the requirements of RCW 84.36.665.

[2008 c 194 § 1; 2008 c 84 § 2; 2007 c 90 § 1. Prior: 2005 c 514 § 601; 2005 c 170 § 1; 1999 c 165 § 21; 1997 c 220 § 202 (Referendum Bill No. 48, approved June 17, 1997); 1995 3rd sp.s. c 1 § 307; 1995 c 138 § 1; 1992 c 123 § 2; 1975-'76 2nd ex.s. c 61 § 13.]

Minor Final Assembly Completed in Washington (B&O Tax)

RCW 82.04.4295

Deductions — Manufacturing activities completed outside the United States.

In computing tax there may be deducted from the measure of tax by persons subject to payment of the tax on manufacturers pursuant to RCW 82.04.240, the value of articles to the extent of manufacturing activities completed outside the United States, if:

(1) Any additional processing of such articles in this state consists of minor final assembly only; and

(2) In the case of domestic manufacture of such articles, can be and normally is done at the place of initial manufacture; and

(3) The total cost of the minor final assembly does not exceed two percent of the value of the articles; and

(4) The articles are sold and shipped outside the state.

[1980 c 37 § 15. Formerly RCW 82.04.430(14).]

RCW 82.04.120

"To manufacture."

(1) "To manufacture" embraces all activities of a commercial or industrial nature wherein labor or skill is applied, by hand or machinery, to materials so that as a result thereof a new, different or useful substance or article of tangible personal property is produced for sale or commercial or industrial use, and includes:

(a) The production or fabrication of special made or custom made articles;

(b) The production or fabrication of dental appliances, devices, restorations, substitutes, or other dental laboratory products by a dental laboratory or dental technician;

(c) Cutting, delimbing, and measuring of felled, cut, or taken trees; and

(d) Crushing and/or blending of rock, sand, stone, gravel, or ore.

(2) "To manufacture" does not include:

(a) Conditioning of seed for use in planting; cubing hay or alfalfa;

(b) Activities which consist of cutting, grading, or ice glazing seafood which has been cooked, frozen, or canned outside this state;

(c) The growing, harvesting, or producing of agricultural products;

(d) Packing of agricultural products, including sorting, washing, rinsing, grading, waxing, treating with fungicide, packaging, chilling, or placing in controlled atmospheric storage;

(e) The production of digital goods;

(f) The production of computer software if the computer software is delivered from the seller to the purchaser by means other than tangible storage media, including the delivery by use of a tangible storage media where the tangible storage media is not physically transferred to the purchaser; and

(g) Any activity that is integral to any public service business as defined in RCW 82.16.010 and with respect to which the gross income associated with such activity: (i) Is subject to tax under chapter 82.16 RCW; or (ii) would be subject to tax under chapter 82.16 RCW if such activity were conducted in this state or if not for an exemption or deduction.

(3) With respect to wastewater treatment facilities:

(a) "To manufacture" does not include the treatment of wastewater, the production of reclaimed water, and the production of class B biosolids; and

(b) "To manufacture" does include the production of class A or exceptional quality biosolids, but only with respect to the processing activities that occur after the biosolids have reached class B standards.

[2011 c 23 § 3; 2009 c 535 § 406; 2003 c 168 § 604; 1999 sp.s. c 9 § 1; 1999 c 211 § 2; 1998 c 168 § 1; 1997 c 384 § 1; 1989 c 302 § 201. Prior: 1989 c 302 § 101; 1987 c 493 § 1; 1982 2nd ex.s. c 9 § 2; 1975 1st ex.s. c 291 § 6; 1965 ex.s. c 173 § 3; 1961 c 15 § 82.04.120; prior: 1959 ex.s. c 3 § 2; 1955 c 389 § 13; prior: 1949 c 228 § 2, part; 1945 c 249 § 1, part; 1943 c 156 § 2, part; 1941 c 178 § 2, part; 1939 c 225 § 2, part; 1937 c 227 § 2, part; 1935 c 180 § 5, part; Rem. Supp. 1949 § 8370-5, part.]

RCW 82.04.110

"Manufacturer."

(1) Except as otherwise provided in this section, "manufacturer" means every person who, either directly or by contracting with others for the necessary labor or mechanical services, manufactures for sale or for commercial or industrial use from his or her own materials or ingredients any articles, substances, or commodities.

(2)(a) When the owner of equipment or facilities furnishes, or sells to the customer prior to manufacture, all or a portion of the materials that become a part or whole of the manufactured article, the department shall prescribe equitable rules for determining tax liability.

(b) A person who produces aluminum master alloys is a processor for hire rather than a manufacturer, regardless of the portion of the aluminum provided by that person's customer. For the purposes of this subsection (2)(b), "aluminum master alloy" means an alloy registered with the aluminum association as a grain refiner or a hardener alloy using the American national standards institute designating system H35.3.

(3) A nonresident of this state who is the owner of materials processed for it in this state by a processor for hire shall not be deemed to be engaged in business in this state as a manufacturer because of the performance of such processing work for it in this state. [enacted in 1971 ex.s. c 186 § 1]

(4) The owner of materials from which a nuclear fuel assembly is made for it by a processor for hire shall not be subject to tax under this chapter as a manufacturer of the fuel assembly.

(5) For purposes of this section, the terms "articles," "substances," "materials," "ingredients," and "commodities" do not include digital goods.

[2009 c 535 § 405; 1997 c 453 § 1; 1971 ex.s. c 186 § 1; 1961 c 15 § 82.04.110. Prior: 1955 c 389 § 12; prior: 1949 c 228 § 2, part; 1945 c 249 § 1, part; 1943 c 156 § 2, part; 1941 c 178 § 2, part; 1939 c 225 § 2, part; 1937 c 227 § 2, part; 1935 c 180 § 5, part; Rem. Supp. 1949 § 8370-5, part.]

WAC 458-20-136

Manufacturing, processing for hire, fabricating.

(1) **Introduction.** This section explains the application of the business and occupation (B&O), retail sales, and use taxes to manufacturers. It identifies the special tax classifications and rates that apply to specific manufacturing activities. The law provides a retail sales and use tax exemption for certain machinery and equipment used by manufacturers. Refer to RCW 82.08.02565, 82.12.02565, and WAC 458-20-13601 (Manufacturers and processors for hire--Sales and use tax exemption for machinery and equipment) for more information regarding this exemption. Persons engaging in both extracting and manufacturing activities should also refer to WAC 458-20-135 (Extracting natural products) and 458-20-13501 (Timber harvest operations).

(2) **Manufacturing activities.** RCW 82.04.120 explains that the phrase "to manufacture" embraces all activities of a commercial or industrial nature wherein labor or skill is applied, by hand or machinery, to materials so that as a result thereof a new, different, or useful substance or articles of tangible personal property is produced for sale or commercial or industrial use. The phrase includes the production or fabrication of special-made or custom-made articles.

(a) "To manufacture" includes, but is not limited to:

(i) The production or fabrication of dental appliances, devices, restorations, substitutes, or other dental laboratory products by a dental laboratory or dental technician;

(ii) The cutting, delimbing, and measuring of felled, cut, or taken trees;

(iii) The crushing and/or blending of rock, sand, stone, gravel, or ore; and

(iv) The cleaning (removal of the head, fins, or viscera) of fish.

(b) "To manufacture" does not include:

(i) The conditioning of seed for use in planting;

(ii) The cubing of hay or alfalfa;

(iii) The growing, harvesting, or producing of agricultural products;

(iv) The cutting, grading, or ice glazing of seafood which has been cooked, frozen, or canned outside this state;

(v) The packing of agricultural products, including sorting, washing, rinsing, grading, waxing, treating with fungicide, packaging, chilling, or placing in controlled atmospheric storage; and

(vi) The repairing and reconditioning of tangible personal property for others.

(3) **Manufacturers and processors for hire.** RCW 82.04.110 defines "manufacturer" to mean every person who, either directly or by contracting with others for the necessary labor or mechanical services, manufactures for sale or for commercial or industrial use from his or her own materials or ingredients any articles, substances, or commodities. However, a nonresident of the state of Washington who is the owner of materials processed for it in this state by a processor for hire is not deemed to be a manufacturer in this state because of that processing. Additionally, any owner of materials from which a nuclear fuel assembly is fabricated in this state by a processor for hire is also not deemed to be a manufacturer because of such processing.

(a) The term "processor for hire" means a person who performs labor and mechanical services upon property belonging to others so that as a result a new, different, or useful article of tangible personal property is produced for sale or commercial or industrial use. Thus, a processor for hire is any person who would be a manufacturer if that person were performing the labor and mechanical services upon his or her own materials.

(b) If a particular activity is excluded from the definition of "to manufacture," a person performing the labor and mechanical services upon materials owned by another is not a processor for hire. For example, the cutting, grading, or ice glazing of seafood that has been cooked, frozen, or canned outside this state is excluded from the definition of "to manufacture." Because of this exclusion, a person who performs these activities on seafood belonging to others is not a "processor for hire."

(c) A person who produces aluminum master alloys, regardless of the portion of the aluminum provided by that person's customer, is considered a "processor for hire." RCW 82.04.110. For the purpose of this specific provision, the term "aluminum master alloy" means an alloy registered with the Aluminum Association as a grain refiner or a hardener alloy using the American National Standards Institute designating system H35.3.

(d) In some instances, a person furnishing the labor and mechanical services undertakes to produce an article, substance, or commodity from materials or ingredients furnished in part by the person and in part by the customer. Depending on the circumstances, this person will either be considered a manufacturer or a processor for hire.

(i) If the person furnishing the labor and mechanical services furnishes materials constituting less than twenty percent of the value of all of the materials or ingredients which become a part of the produced product, that person will be presumed to be processing for hire.

(ii) The person furnishing the labor and mechanical services will be presumed to be a manufacturer if the value of the materials or ingredients furnished by the person is equal to or greater than twenty percent of the total value of all materials or ingredients which become a part of the produced product.

(iii) If the person furnishing the labor and mechanical services supplies, sells, or furnishes to the customer, before processing, twenty percent or more in value of the materials or ingredients from which the product is produced, the person furnishing the labor and mechanical services will be deemed to be the owner of the materials and considered a manufacturer.

(e) There are occasions where a manufacturing facility and ingredients used in the manufacturing process are owned by one person, while another person performs the actual manufacturing activity. The person operating the facility and performing the manufacturing activity is a processor for hire. The owner of the facility and ingredients is the manufacturer.

(4) **Tax-reporting responsibilities for income received by manufacturers and processors for hire.** Persons who manufacture products in this state are subject to the manufacturing B&O tax upon the value of the products, including by-products (see also WAC 458-20-112 regarding "value of products"), unless the activity qualifies for one of the special tax rates discussed in subsection (5) of this section. See also WAC 458-20-193 (Inbound and outbound interstate sales of tangible personal property).

For example, Corporation A stains door panels that it purchases. Corporation A also affixes hinges, guide wheels, and pivots to unstained door panels. Corporation B shears steel sheets to dimension, and slits steel coils to customer's requirements. The resulting products are sold and delivered to out-of-state customers. Corporation A and Corporation B are subject to the manufacturing B&O tax upon the value of these manufactured products. These manufacturing activities take place in Washington, even though the manufactured product is delivered out-of-state. A credit may be available if a gross receipts tax is paid on the selling activity to another state. (See also WAC 458-20-19301 on multiple activities tax credits.)

(a) Manufacturers who sell their products at retail or wholesale in this state are also subject to either the retailing or wholesaling B&O tax, as the case may be. In such cases, the manufacturer must report under both the "production" (manufacturing) and "selling" (wholesaling or retailing) classifications of the B&O tax, and claim a multiple activities tax credit (MATC). See also WAC 458-20-19301 for a more detailed explanation of the MATC reporting requirements.

For example, Incorporated purchases raw fish that it fillets and/or steaks. The resulting product is then sold at wholesale in its raw form to customers located in Washington. Incorporated is subject to both the manufacturing raw seafood B&O tax upon the value of the manufactured product, and the wholesaling B&O tax upon the gross proceeds of sale. Incorporated is entitled to claim a MATC.

(b) Processors for hire are subject to the processing for hire B&O tax upon the total charge made to those services, including any charge for materials furnished by the processor. The B&O tax applies whether the resulting product is delivered to the customer within or outside this state.

(c) The measure of tax for manufacturers and processors for hire with respect to "cost-plus" or "time and material" contracts includes the amount of profit or fee above cost received, plus the reimbursements or prepayments received on account of materials and supplies, labor costs, taxes paid, payments made to subcontractors, and all other costs and expenses incurred by the manufacturer or processor for hire.

(d) A manufacturing B&O tax exemption is available for the cleaning of fish, if the cleaning activities are limited to the removal of the head, fins, or viscera from fresh fish without further processing other than freezing. RCW 82.04.2403. Processors for hire performing these cleaning activities remain subject to the processing for hire B&O tax.

(e) Amounts received by hop growers or dealers for hops shipped outside the state of Washington for first use, even though the hops have been processed into extract, pellets, or powder in this state are exempt from the B&O tax. RCW 82.04.337. However, a processor for hire with respect to hops is not exempt on amounts charged for processing these products.

(f) Manufacturers and processors for hire making retail sales must collect and remit retail sales tax on all sales to consumers, unless the sale is exempt by law (e.g., see WAC 458-20-244 regarding sales of certain food products). A manufacturer or processor for hire making wholesale sales must obtain resale certificates for sales made before January 1, 2010, or reseller permits for sales made on or after January 1, 2010, from the customers to document the wholesale nature of any sale as provided in WAC 458-20-102A (Resale certificates) and WAC 458-20-102 (Reseller permits). Even though resale certificates are no longer used after December 31, 2009, they must be kept on file by the seller for five years from the date of last use or December 31, 2014.

(5) **Manufacturing--Special tax rates/classifications.** RCW 82.04.260 provides several special B&O tax rates/classifications for manufacturers engaging in certain manufacturing activities. In all such cases the principles set forth in subsection (4) of this section concerning multiple activities and the resulting credit provisions are also applicable.

Special tax classifications/rates are provided for the activities of:

(a) Manufacturing wheat into flour, barley into pearl barley, soybeans into soybean oil, canola into canola oil, meal, or canola by-products, or sunflower seeds into sunflower oil;

(b) Splitting or processing dried peas;

(c) Manufacturing seafood products, which remain in a raw, raw frozen, or raw salted state;

(d) Manufacturing by canning, preserving, freezing, processing, or dehydrating fresh fruits and vegetables;

(e) Slaughtering, breaking, and/or processing perishable meat products and/or selling the same at wholesale and not at retail; and

(f) Manufacturing nuclear fuel assemblies.

(6) **Repairing and/or refurbishing distinguished from manufacturing.** The term "to manufacture" does not include the repair or refurbishing of tangible personal property. To be considered "manufacturing," the application of labor or skill to materials must result in a "new, different, or useful article." If the activity merely restores an existing article of tangible personal property to its original utility, the activity is considered a repair or refurbishing of that property. (See WAC 458-20-173 for tax-reporting information on repairs.)

(a) In making a determination whether an activity is manufacturing as opposed to a repair or reconditioning activity, consideration is given to a variety of factors including, but not limited to:

(i) Whether the activity merely restores or prolongs the useful life of the article;

(ii) Whether the activity significantly enhances the article's basic qualities, properties, or functional nature; and

(iii) Whether the activity is so extensive that a new, different, or useful article results.

(b) The following example illustrates the distinction between a manufacturing activity resulting in a new, different, or useful article, and the mere repair or refurbishment of an existing article. This example should only be used as a general guide. The tax results of other situations must be determined after a review of all the facts and circumstances. In cases of uncertainty, persons should contact the department for a ruling.

(i) Corporation rebuilds engine cores. When received, each core is assigned an individual identification number and disassembled. The cylinder head, connecting rods, crankshaft, valves, springs, nuts, and bolts are all removed and retained for reassembly into the same engine core. Unusable components are discarded. The block is then baked to burn off dirt and impurities, then blasted to remove any residue. The cylinder walls are rebored because of wear and tear. The retained components are cleaned, and if needed straightened and/or reground. Corporation then reassembles the cores, replacing the pistons, gaskets, timing gears, crankshaft bearings, and oil pumps with new parts. The components retained from the original engine core are incorporated only into that same core.

(ii) Corporation is under these circumstances not engaging in a manufacturing activity. The engine cores are restored to their original condition, albeit with a slightly larger displacement because of wear and tear. The cores have retained their original functional nature as they run with approximately the same efficiency and horsepower. The rebuilding of these cores is not so extensive as to result in a new, different, or useful article. Each engine core has retained its identity because all reusable components of the original core are reassembled in the same core. Corporation has taken an existing article and extended its useful life.

(7) **Combining and/or assembly of products to achieve a special purpose as manufacturing.** The physical assembly of products from various components is manufacturing because it results in a "new, different, or useful" product, even if the cost of the assembly activity is minimal when compared with the cost of the components. For example, the bolting of a motor to a pump, whether bolted directly or by using a coupling, is a manufacturing activity. Once physically joined, the resulting product is capable of performing a pumping function that the separate components cannot.

(a) In some cases the assembly may consist solely of combining parts from various suppliers to create an entirely different product that is sold as a kit for assembly by the purchaser. In these situations, the manufacturing B&O tax applies even if the person combining the parts does not completely assemble the components, but sells them as a package. For example, a person who purchases component parts from various suppliers to create a wheelbarrow, which will be sold in a "kit" or "knock-down" condition with some assembly required by purchaser, is a manufacturer. The purchaser of the wheelbarrow kit is not a manufacturer, however, even though the purchaser must attach the handles and wheel.

(b) The department considers various factors in determining if a person combining various items into a single package is engaged in a manufacturing activity. Any single one of the following factors is not considered conclusive evidence of a manufacturing activity, though the presence of one or more of these factors raises a presumption that a manufacturing activity is being performed:

(i) The ingredients are purchased from various suppliers;

(ii) The person combining the ingredients attaches his or her own label to the resulting product;

(iii) The ingredients are purchased in bulk and broken down to smaller sizes;

(iv) The combined product is marketed at a substantially different value from the selling price of the individual components; and

(v) The person combining the items does not sell the individual items except within the package.

(c) The following examples should be used only as a general guide. The specific facts and circumstances of each situation must be carefully examined to determine if the combining of ingredients is a manufacturing activity or merely a packaging or marketing activity. In cases of uncertainty, persons combining items into special purpose packages should contact the department for a ruling.

(i) Combining prepackaged food products and gift items into a wicker basket for sale as a gift basket is not a manufacturing activity when:

(A) The products combined in the basket retain their original packaging;

(B) The person does not attach his or her own labels to the components or the combined basket;

(C) The person maintains an inventory for sale of the individual components and does sell these items in this manner as well as the combined baskets.

(ii) Combining bulk food products and gift items into a wicker basket for sale as a gift basket is a manufacturing activity when:

(A) The bulk food products purchased by the taxpayer are broken into smaller quantities; and

(B) The taxpayer attaches its own labels to the combined basket.

(iii) Combining components into a kit for sale is not a manufacturing activity when:

(A) All components are conceived, designed, and specifically manufactured by and at the person's direction to be used with each other;

(B) The person's label is attached to or imprinted upon the components by supplier;

(C) The person packages the components with no further assembly, connection, reconfiguration, change, or processing.

(8) **Tax liability with respect to purchases of equipment or supplies and property manufactured for commercial or industrial use.** The retail sales tax applies to purchases of tangible personal property by manufacturers and processors for hire unless the property becomes an ingredient or component part of a new article produced for sale, or is a chemical used in the processing of an article for sale. If the seller fails to collect the appropriate retail sales tax, the buyer is required to remit the retail sales tax (commonly referred to as "deferred retail sales tax") or use tax directly to the department. Refer to WAC 458-20-113 for additional information about what qualifies as an ingredient or component or a chemical used in processing.

(a) RCW 82.08.02565 and 82.12.02565 provide a retail sales and use tax exemption for certain machinery and equipment used by manufacturers and/or processors for hire. Refer to WAC 458-20-13601 for additional information regarding how these exemptions apply.

(b) Persons manufacturing tangible personal property for commercial or industrial use are subject to both the manufacturing B&O and use taxes upon the value of the property manufactured, unless a specific exemption applies. (See also WAC 458-20-134 on commercial or industrial use.) Persons who also extract the product used as an ingredient in a manufacturing process should refer to WAC 458-20-135 for additional information regarding their tax-reporting responsibilities.

[Statutory Authority: RCW 82.32.300, 82.01.060(2), chapters 82.04, 82.08, 82.12 and 82.32 RCW. 10-06-069, § 458-20-136, filed 2/25/10, effective 3/28/10. Statutory Authority: RCW 82.32.300. 00-11-096, § 458-20-136, filed 5/17/00, effective 6/17/00; 88-21-014 (Order 88-7), § 458-20-136, filed 10/7/88; 86-20-027 (Order 86-17), § 458-20-136, filed 9/23/86; 83-07-032 (Order ET 83-15), § 458-20-136, filed 3/15/83. Statutory Authority: RCW 82.01.060(2) and 82.32.300. 78-07-045 (Order ET 78-4), § 458-20-136, filed 6/27/78; Order ET 71-1, § 458-20-136, filed 7/22/71; Order ET 70-3, § 458-20-136 (Rule 136), filed 5/29/70, effective 7/1/70.]

Natural and Manufactured Gas (Sales and Use Tax)

RCW 82.08.026

Exemptions — Sales of natural or manufactured gas.

The tax levied by RCW 82.08.020 shall not apply to sales of natural or manufactured gas that is taxable under RCW 82.12.022.

[1994 c 124 § 8; 1989 c 384 § 4.]

RCW 82.12.023

Natural or manufactured gas, exempt from use tax imposed by RCW 82.12.020.

The tax levied by RCW 82.12.020 shall not apply in respect to the use of natural or manufactured gas that is taxable under RCW 82.12.022.

[1994 c 124 § 10; 1989 c 384 § 5.]

RCW 82.14.030

Sales and use taxes authorized — Additional taxes authorized — Maximum rates.

(1) The governing body of any county or city, while not required by legislative mandate to do so, may, by resolution or ordinance for the purposes authorized by this chapter, impose a sales and use tax in accordance with the terms of this chapter. Such tax shall be collected from those persons who are taxable by the state under chapters 82.08 and 82.12 RCW, upon the occurrence of any taxable event within the county or city as the case may be. Except as provided in RCW 82.14.230, this sales and use tax shall not apply to natural or manufactured gas. The rate of such tax imposed by a county shall be five-tenths of one percent of the selling price (in the case of a sales tax) or value of the article used (in the case of a use tax). The rate of such tax imposed by a city shall not exceed five-tenths of one percent of the selling price (in the case of a sales tax) or value of the article used (in the case of a use tax). However, in the event a county imposes a sales and use tax under this subsection, the rate of such tax imposed under this subsection by any city therein shall not exceed four hundred and twenty-five one-thousandths of one percent.

(2) In addition to the tax authorized in subsection (1) of this section, the governing body of any county or city may by resolution or ordinance impose an additional sales and use tax in accordance with the terms of this chapter. Such additional tax shall be collected upon the same taxable events upon which the tax imposed under subsection (1) of this section is imposed. The rate of such additional tax imposed by a county shall be up to five-tenths of one percent of the selling price (in the case of a sales tax) or value of the article used (in the case of a use tax). The rate of such additional tax imposed by a city shall be up to five-tenths of one percent of the selling price (in the case of a sales tax) or value of the article used (in the case of a use tax). However, in the event a county imposes a sales and use tax under the authority of this subsection at a rate equal to or greater than the rate imposed under the authority of this subsection by a city within the county, the county shall receive fifteen percent of the city tax. In the event that the county imposes a sales and use tax under the authority of this subsection at a rate which is less than the rate imposed under this

subsection by a city within the county, the county shall receive that amount of revenues from the city tax equal to fifteen percent of the rate of tax imposed by the county under the authority of this subsection. The authority to impose a tax under this subsection is intended in part to compensate local government for any losses from the phase-out of the property tax on business inventories.

[2008 c 86 § 101; 1989 c 384 § 6; 1982 1st ex.s. c 49 § 17; 1970 ex.s. c 94 § 4.]

Precious Metals and Bullion (Sales and Use Tax, B&O Tax)

RCW 82.04.062

"Sale at wholesale," "sale at retail" excludes sale of precious metal bullion and monetized bullion — Computation of tax.

(1) For purposes of this chapter, "wholesale sale," "sale at wholesale," "retail sale," and "sale at retail" do not include the sale of precious metal bullion or monetized bullion.

(2) In computing tax under this chapter on the business of making sales of precious metal bullion or monetized bullion, the tax shall be imposed on the amounts received as commissions upon transactions for the accounts of customers over and above the amount paid to other dealers associated in such transactions, but no deduction or offset is allowed on account of salaries or commissions paid to salesmen or other employees.

(3) For purposes of this section, "precious metal bullion" means any precious metal which has been put through a process of smelting or refining, including, but not limited to, gold, silver, platinum, rhodium, and palladium, and which is in such state or condition that its value depends upon its contents and not upon its form. For purposes of this section, "monetized bullion" means coins or other forms of money manufactured from gold, silver, or other metals and heretofore, now, or hereafter used as a medium of exchange under the laws of this state, the United States, or any foreign nation, but does not include coins or money sold to be manufactured into jewelry or works of art.

[1985 c 471 § 5.]

Solar Energy and Silicon Product Manufacturers (B&O Tax)

RCW 82.04.294

Tax on manufacturers or wholesalers of solar energy systems. (Expires June 30, 2014.)

(1) Upon every person engaging within this state in the business of manufacturing solar energy systems using photovoltaic modules or stirling converters, or of manufacturing solar grade silicon, silicon solar wafers, silicon solar cells, thin film solar devices, or compound semiconductor solar wafers to be used exclusively in components of such systems; as to such persons the amount of tax with respect to such business is, in the case of manufacturers, equal to the value of the product manufactured, or in the case of processors for hire, equal to the gross income of the business, multiplied by the rate of 0.275 percent.

(2) Upon every person engaging within this state in the business of making sales at wholesale of solar energy systems using photovoltaic modules or stirling converters, or of solar grade silicon,

silicon solar wafers, silicon solar cells, thin film solar devices, or compound semiconductor solar wafers to be used exclusively in components of such systems, manufactured by that person; as to such persons the amount of tax with respect to such business is equal to the gross proceeds of sales of the solar energy systems using photovoltaic modules or stirling converters, or of the solar grade silicon to be used exclusively in components of such systems, multiplied by the rate of 0.275 percent.

(3) Silicon solar wafers, silicon solar cells, thin film solar devices, or compound semiconductor solar wafers are "semiconductor materials" for the purposes of RCW 82.08.9651 and 82.12.9651.

(4) The definitions in this subsection apply throughout this section.

(a) "Compound semiconductor solar wafers" means a semiconductor solar wafer composed of elements from two or more different groups of the periodic table.

(b) "Module" means the smallest nondivisible self-contained physical structure housing interconnected photovoltaic cells and providing a single direct current electrical output.

(c) "Photovoltaic cell" means a device that converts light directly into electricity without moving parts.

(d) "Silicon solar cells" means a photovoltaic cell manufactured from a silicon solar wafer.

(e) "Silicon solar wafers" means a silicon wafer manufactured for solar conversion purposes.

(f) "Solar energy system" means any device or combination of devices or elements that rely upon direct sunlight as an energy source for use in the generation of electricity.

(g) "Solar grade silicon" means high-purity silicon used exclusively in components of solar energy systems using photovoltaic modules to capture direct sunlight. "Solar grade silicon" does not include silicon used in semiconductors.

(h) "Stirling converter" means a device that produces electricity by converting heat from a solar source utilizing a stirling engine.

(i) "Thin film solar devices" means a nonparticipating substrate on which various semiconducting materials are deposited to produce a photovoltaic cell that is used to generate electricity.

(5) A person reporting under the tax rate provided in this section must file a complete annual report with the department under RCW 82.32.534.

(6) This section expires June 30, 2014.

[2011 c 179 § 1; 2010 c 114 § 109; 2009 c 469 § 501; 2007 c 54 § 8; 2005 c 301 § 2.]

Special Fuel Use Exemptions (Fuel Tax)

RCW 82.38.080

Exemptions.

(1) There is exempted from the tax imposed by this chapter, the use of fuel for:

(a) Street and highway construction and maintenance purposes in motor vehicles owned and operated by the state of Washington, or any county or municipality;

(b) Publicly owned firefighting equipment;

(c) Special mobile equipment as defined in RCW 46.04.552;

(d) Power pumping units or other power take-off equipment of any motor vehicle which is accurately measured by metering devices that have been specifically approved by the department or which is established by any of the following formulae:

(i) Pumping propane, or fuel or heating oils or milk picked up from a farm or dairy farm storage tank by a power take-off unit on a delivery truck, at a rate determined by the department: PROVIDED, That claimant when presenting his or her claim to the department in accordance with this chapter, shall provide to the claim, invoices of propane, or fuel or heating oil delivered, or such other appropriate information as may be required by the department to substantiate his or her claim;

(ii) Operating a power take-off unit on a cement mixer truck or a load compactor on a garbage truck at the rate of twenty-five percent of the total gallons of fuel used in such a truck; or

(iii) The department is authorized to establish by rule additional formulae for determining fuel usage when operating other types of equipment by means of power take-off units when direct measurement of the fuel used is not feasible. The department is also authorized to adopt rules regarding the usage of on board computers for the production of records required by this chapter;

(e) Motor vehicles owned and operated by the United States government;

(f) Heating purposes;

(g) Moving a motor vehicle on a public highway between two pieces of private property when said moving is incidental to the primary use of the motor vehicle;

(h) Transportation services for persons with special transportation needs by a private, nonprofit transportation provider regulated under chapter 81.66 RCW;

(i) Vehicle refrigeration units, mixing units, or other equipment powered by separate motors from separate fuel tanks;

(j) The operation of a motor vehicle as a part of or incidental to logging operations upon a highway under federal jurisdiction within the boundaries of a federal area if the federal government requires a fee for the privilege of operating the motor vehicle upon the highway, the proceeds of which are reserved for constructing or maintaining roads in the federal area, or requires maintenance or construction work to be performed on the highway for the privilege of operating the motor vehicle on the highway; and

(k) Waste vegetable oil as defined under RCW 82.08.0205 if the oil is used to manufacture biodiesel.

(2) There is exempted from the tax imposed by this chapter the removal or entry of special fuel under the following circumstances and conditions:

(a) If it is the removal from a terminal or refinery of, or the entry or sale of, a special fuel if all of the following apply:

(i) The person otherwise liable for the tax is a licensee other than a dyed special fuel user or international fuel tax agreement licensee;

(ii) For a removal from a terminal, the terminal is a licensed terminal; and

(iii) The special fuel satisfies the dyeing and marking requirements of this chapter;

(b) If it is an entry or removal from a terminal or refinery of taxable special fuel transferred to a refinery or terminal and the persons involved, including the terminal operator, are licensed; and

(c)(i) If it is a special fuel that, under contract of sale, is shipped to a point outside this state by a supplier by means of any of the following:

(A) Facilities operated by the supplier;

(B) Delivery by the supplier to a carrier, customs broker, or forwarding agent, whether hired by the purchaser or not, for shipment to the out-of-state point;

(C) Delivery by the supplier to a vessel clearing from port of this state for a port outside this state and actually exported from this state in the vessel.

(ii) For purposes of this subsection (2)(c):

(A) "Carrier" means a person or firm engaged in the business of transporting for compensation property owned by other persons, and includes both common and contract carriers; and

(B) "Forwarding agent" means a person or firm engaged in the business of preparing property for shipment or arranging for its shipment.

(3)(a) Notwithstanding any provision of law to the contrary, every privately owned urban passenger transportation system and carriers as defined by chapters 81.68 and 81.70 RCW shall be exempt from the provisions of this chapter requiring the payment of special fuel taxes. For the purposes of this section "privately owned urban passenger transportation system" means every privately owned transportation system having as its principal source of revenue the income from transporting persons for compensation by means of motor vehicles or trackless trolleys, each having a seating capacity for over fifteen persons over prescribed routes in such a manner that the routes of such motor vehicles or trackless trolleys, either alone or in conjunction with routes of other such motor vehicles or trackless trolleys subject to routing by the same transportation system, shall not extend for a distance exceeding twenty-five road miles beyond the corporate limits of the county in which the original starting points of such motor vehicles are located: PROVIDED, That no refunds or credits shall be granted on special fuel used by any privately owned urban transportation vehicle, or vehicle operated pursuant to chapters 81.68 and 81.70 RCW, on any trip where any portion of the trip is more than twenty-five road miles beyond the corporate limits of the county in which the trip originated.

(b) Every publicly owned and operated urban passenger transportation system is exempt from the provisions of this chapter that require the payment of special fuel taxes. For the purposes of this subsection, "publicly owned and operated urban passenger transportation systems" include public transportation benefit areas under chapter 36.57A RCW, metropolitan municipal corporations under chapter 36.56 RCW, city-owned transit systems under chapter 35.58 RCW, county public transportation authorities under chapter 36.57 RCW, unincorporated transportation benefit areas under chapter 36.57 RCW, and regional transit authorities under chapter 81.112 RCW.

[2009 c 352 § 1; 2008 c 237 § 1; 1998 c 176 § 60; 1996 c 244 § 6; 1993 c 141 § 2; 1990 c 185 § 1; 1983 c 108 § 4; 1979 c 40 § 4; 1973 c 42 § 1. Prior: 1972 ex.s. c 138 § 2; 1972 ex.s. c 49 § 1; 1971 ex.s. c 175 § 9.]

Stevedoring and International Charter and Freight Brokers (B&O Tax)

RCW 82.04.260

Tax on manufacturers and processors of various foods and by-products — Research and development organizations — Travel agents — Certain international activities — Stevedoring and associated activities — Low-level waste disposers — Insurance producers, surplus line brokers, and title insurance agents--Hospitals — Commercial airplane activities — Timber product activities — Canned salmon processors.

(6) Upon every person engaging within this state in business as an international steamship agent, international customs house broker, international freight forwarder, vessel and/or cargo charter broker in foreign commerce, and/or international air cargo agent; as to such persons the amount of the tax with respect to only international activities is equal to the gross income derived from such activities multiplied by the rate of 0.275 percent.

(7) Upon every person engaging within this state in the business of stevedoring and associated activities pertinent to the movement of goods and commodities in waterborne interstate or foreign commerce; as to such persons the amount of tax with respect to such business is equal to the gross proceeds derived from such activities multiplied by the rate of 0.275 percent. Persons subject to taxation under this subsection are exempt from payment of taxes imposed by chapter 82.16 RCW for that portion of their business subject to taxation under this subsection. Stevedoring and associated activities pertinent to the conduct of goods and commodities in waterborne interstate or foreign commerce are defined as all activities of a labor, service or transportation nature whereby cargo may be loaded or unloaded to or from vessels or barges, passing over, onto or under a wharf, pier, or similar structure; cargo may be moved to a warehouse or similar holding or storage yard or area to await further movement in import or export or may move to a consolidation freight station and be stuffed, unstuffed, containerized, separated or otherwise segregated or aggregated for delivery or loaded on any mode of transportation for delivery to its consignee. Specific activities included in this definition are: Wharfage, handling, loading, unloading, moving of cargo to a convenient place of delivery to the consignee or a convenient place for further movement to export mode; documentation services in connection with the receipt, delivery, checking, care, custody and control of cargo required in the transfer of cargo; imported automobile handling prior to delivery to consignee; terminal stevedoring and incidental vessel services, including but not limited to plugging and unplugging refrigerator service to containers, trailers, and other refrigerated cargo receptacles, and securing ship hatch covers.

Travel Agents & Tour Operators (B&O Tax)

RCW 82.04.260(5)

Upon every person engaging within this state in the business of acting as a travel agent or tour operator; as to such persons the amount of the tax with respect to such activities is equal to the gross income derived from such activities multiplied by the rate of 0.275 percent.

[2011 c 2 § 203 (Initiative Measure No. 1107, approved November 2, 2010); 2010 1st sp.s. c 23 § 506; (2010 1st sp.s. c 23 § 505 expired June 10, 2010); 2010 c 114 § 107. Prior: 2009 c 479 § 64; 2009 c 461 § 1; 2009 c 162 § 34; prior: 2008 c 296 § 1; 2008 c 217 § 100; 2008 c 81 § 4; prior: 2007 c 54 § 6; 2007 c 48 § 2; prior: 2006 c 354 § 4; 2006 c 300 § 1; prior: 2005 c 513 § 2; 2005 c 443 § 4; prior: 1998 c 312 § 5; 1996 c 148 § 2; 1993 sp.s. c 25 § 104; 1981 c 172 § 3; 1975 1st ex.s. c 291 § 7]

Urban Passenger Transit Fuel (Sales and Use Tax)

RCW 82.08.0255

Exemptions — Sales of motor vehicle and special fuel — Conditions — Credit or refund of special fuel used outside this state in interstate commerce.

(1) The tax levied by RCW 82.08.020 shall not apply to sales of motor vehicle and special fuel if:

(a) The fuel is purchased for the purpose of public transportation and the purchaser is entitled to a refund or an exemption under RCW 82.36.275 or 82.38.080(3); or

(b) The fuel is purchased by a private, nonprofit transportation provider certified under chapter 81.66 RCW and the purchaser is entitled to a refund or an exemption under RCW 82.36.285 or 82.38.080(1)(h); or

(c) The fuel is purchased by a public transportation benefit area created under chapter 36.57A RCW or a county-owned ferry or county ferry district created under chapter 36.54 RCW for use in passenger-only ferry vessels; or

(d) The fuel is purchased by the Washington state ferry system for use in a state-owned ferry after June 30, 2013; or

(e) The fuel is purchased by a county-owned ferry for use in ferry vessels after June 30, 2013; or

(f) The fuel is taxable under chapter 82.36 or 82.38 RCW.

(2) Any person who has paid the tax imposed by RCW 82.08.020 on the sale of special fuel delivered in this state shall be entitled to a credit or refund of such tax with respect to fuel subsequently established to have been actually transported and used outside this state by persons engaged in interstate commerce. The tax shall be claimed as a credit or refunded through the tax reports required under RCW 82.38.150.

[2011 1st sp.s. c 16 § 4; 2007 c 223 § 9; 2005 c 443 § 5; 1998 c 176 § 4. Prior: 1983 1st ex.s. c 35 § 2; 1983 c 108 § 1; 1980 c 147 § 1; 1980 c 37 § 23. Formerly RCW 82.08.030(5).]

RCW 82.12.0256

Exemptions — Use of motor vehicle and special fuel — Conditions.

The provisions of this chapter shall not apply in respect to the use of:

(1) Special fuel purchased in this state upon which a refund is obtained as provided in RCW 82.38.180(2); and

(2) Motor vehicle and special fuel if:

(a) The fuel is used for the purpose of public transportation and the purchaser is entitled to a refund or an exemption under RCW 82.36.275 or 82.38.080(3); or

(b) The fuel is purchased by a private, nonprofit transportation provider certified under chapter 81.66 RCW and the purchaser is entitled to a refund or an exemption under RCW 82.36.285 or 82.38.080(1)(h); or

(c) The fuel is purchased by a public transportation benefit area created under chapter 36.57A RCW or a county-owned ferry or county ferry district created under chapter 36.54 RCW for use in passenger-only ferry vessels; or

(d) The fuel is taxable under chapter 82.36 or 82.38 RCW: PROVIDED, That the use of motor vehicle and special fuel upon which a refund of the applicable fuel tax is obtained shall not be exempt under this subsection(2)(d), and the director of licensing shall deduct from the amount of such tax to be refunded the amount of tax due under this chapter and remit the same each month to the department of revenue; or

(e) The fuel is purchased by a county-owned ferry for use in ferry vessels after June 30, 2013; or

(f) The fuel is purchased by the Washington state ferry system for use in a state-owned ferry after June 30, 2013.

[2011 1st sp.s. c 16 § 5; 2007 c 223 § 10; 2005 c 443 § 6; 1998 c 176 § 5. Prior: 1983 1st ex.s. c 35 § 3; 1983 c 108 § 2; 1980 c 147 § 2; 1980 c 37 § 56. Formerly RCW 82.12.030(6).]

RCW 82.36.275 (Motor Vehicle Fuel Tax)

Refunds for urban transportation systems.

Notwithstanding RCW 82.36.240, every urban passenger transportation system shall receive a refund of the amount of the motor vehicle fuel tax paid on each gallon of motor vehicle fuel used, whether such vehicle fuel tax has been paid either directly to the vendor from whom the motor vehicle fuel was purchased or indirectly by adding the amount of such tax to the price of such fuel.

For the purposes of this section "urban passenger transportation system" means every transportation system, publicly or privately owned, having as its principal source of revenue the income from transporting persons for compensation by means of motor vehicles and/or trackless trolleys, each having a seating capacity for over fifteen persons, over prescribed routes in such a manner that the routes of such motor vehicles and/or trackless trolleys (either alone or in conjunction with routes of other such motor vehicles and/or trackless trolleys subject to routing by the same transportation system) do not extend for a distance exceeding fifteen road miles beyond the corporate limits of the city in which the original starting points of such motor vehicles are located: PROVIDED, That no refunds authorized by this section shall be granted on fuel used by any urban transportation vehicle on any trip where any portion of said trip is more than fifteen road miles beyond the corporate limits of the city in which said trip originated.

RCW 82.38.080 (Special Fuel Tax)

Exemptions.

(1) There is exempted from the tax imposed by this chapter, the use of fuel for:

(a) Street and highway construction and maintenance purposes in motor vehicles owned and operated by the state of Washington, or any county or municipality;

(b) Publicly owned firefighting equipment;

(c) Special mobile equipment as defined in RCW 46.04.552;

(d) Power pumping units or other power take-off equipment of any motor vehicle which is accurately measured by metering devices that have been specifically approved by the department or which is established by any of the following formulae:

(i) Pumping propane, or fuel or heating oils or milk picked up from a farm or dairy farm storage tank by a power take-off unit on a delivery truck, at a rate determined by the department: PROVIDED, That claimant when presenting his or her claim to the department in accordance with this chapter, shall provide to the claim, invoices of propane, or fuel or heating oil delivered, or such other appropriate information as may be required by the department to substantiate his or her claim;

(ii) Operating a power take-off unit on a cement mixer truck or a load compactor on a garbage truck at the rate of twenty-five percent of the total gallons of fuel used in such a truck; or

(iii) The department is authorized to establish by rule additional formulae for determining fuel usage when operating other types of equipment by means of power take-off units when direct measurement of the fuel used is not feasible. The department is also authorized to adopt rules regarding the usage of on board computers for the production of records required by this chapter;

(e) Motor vehicles owned and operated by the United States government;

(f) Heating purposes;

(g) Moving a motor vehicle on a public highway between two pieces of private property when said moving is incidental to the primary use of the motor vehicle;

(h) Transportation services for persons with special transportation needs by a private, nonprofit transportation provider regulated under chapter 81.66 RCW;

(i) Vehicle refrigeration units, mixing units, or other equipment powered by separate motors from separate fuel tanks;

(j) The operation of a motor vehicle as a part of or incidental to logging operations upon a highway under federal jurisdiction within the boundaries of a federal area if the federal government requires a fee for the privilege of operating the motor vehicle upon the highway, the proceeds of which are reserved for constructing or maintaining roads in the federal area, or requires maintenance or construction work to be performed on the highway for the privilege of operating the motor vehicle on the highway; and

(k) Waste vegetable oil as defined under RCW 82.08.0205 if the oil is used to manufacture biodiesel.

(2) There is exempted from the tax imposed by this chapter the removal or entry of special fuel under the following circumstances and conditions:

(a) If it is the removal from a terminal or refinery of, or the entry or sale of, a special fuel if all of the following apply:

(i) The person otherwise liable for the tax is a licensee other than a dyed special fuel user or international fuel tax agreement licensee;

(ii) For a removal from a terminal, the terminal is a licensed terminal; and

(iii) The special fuel satisfies the dyeing and marking requirements of this chapter;

(b) If it is an entry or removal from a terminal or refinery of taxable special fuel transferred to a refinery or terminal and the persons involved, including the terminal operator, are licensed; and

(c)(i) If it is a special fuel that, under contract of sale, is shipped to a point outside this state by a supplier by means of any of the following:

(A) Facilities operated by the supplier;

(B) Delivery by the supplier to a carrier, customs broker, or forwarding agent, whether hired by the purchaser or not, for shipment to the out-of-state point;

(C) Delivery by the supplier to a vessel clearing from port of this state for a port outside this state and actually exported from this state in the vessel.

(ii) For purposes of this subsection (2)(c):

(A) "Carrier" means a person or firm engaged in the business of transporting for compensation property owned by other persons, and includes both common and contract carriers; and

(B) "Forwarding agent" means a person or firm engaged in the business of preparing property for shipment or arranging for its shipment.

(3)(a) Notwithstanding any provision of law to the contrary, every privately owned urban passenger transportation system and carriers as defined by chapters 81.68 and 81.70 RCW shall be exempt from the provisions of this chapter requiring the payment of special fuel taxes. For the purposes of this section "privately owned urban passenger transportation system" means every privately owned transportation system having as its principal source of revenue the income from transporting persons for compensation by means of motor vehicles or trackless trolleys, each having a seating capacity for over fifteen persons over prescribed routes in such a manner that the routes of such motor vehicles or trackless trolleys, either alone or in conjunction with routes of other such motor vehicles or trackless trolleys subject to routing by the same transportation system, shall not extend for a distance exceeding twenty-five road miles beyond the corporate limits of the county in which the original starting points of such motor vehicles are located: PROVIDED, That no refunds or credits shall be granted on special fuel used by any privately owned urban transportation vehicle, or vehicle operated pursuant to chapters 81.68 and 81.70 RCW, on any trip where any portion of the trip is more than twenty-five road miles beyond the corporate limits of the county in which the trip originated.

(b) Every publicly owned and operated urban passenger transportation system is exempt from the provisions of this chapter that require the payment of special fuel taxes. For the purposes of this subsection, "publicly owned and operated urban passenger transportation systems" include public transportation benefit areas under chapter 36.57A RCW, metropolitan municipal corporations under chapter 36.56 RCW, city-owned transit systems under chapter 35.58 RCW, county public transportation authorities under chapter 36.57 RCW, unincorporated transportation benefit areas under chapter 36.57 RCW, and regional transit authorities under chapter 81.112 RCW

APPENDIX 4 – CONSULTANT ANALYSIS

An Analysis of the Employment Effects of the Washington High Technology Business and Occupation (B&O) Tax Credit

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Introduction

This paper analyzes the employment impact of the state of Washington's tax credit for research and development expenditures. The data used for the analyses are administrative tax records and supporting documents and administrative wage record data for all firms that received this credit from 2004 to 2009. These data sources were used to construct a six-year panel data set for individual firms that contains information on, among other things, employment and R&D credit received. Using estimates that properly control for the endogeneity of business receipt of this tax credit, we find that this tax credit creates some jobs, but at a high cost per job created. Our estimates are consistent with the overall research literature on effects on state and local business activity of business taxes.

The R&D tax credit was begun by the state of Washington in 1994. The purpose of the tax credit is to "encourage the formation of high-wage, high-skilled jobs," according to the Washington legislature. Such jobs are believed by the Washington legislature to be "vital to the economic health of the state's citizens."

The tax credit is explicitly designed to reward businesses that are particularly research-intensive. To qualify for the tax credit, businesses must spend more than the average business on R&D. This threshold is calculated by comparing the business's R&D spending with its taxable base for the main Washington state business tax, which is a tax on gross receipts from state of Washington sources. Firms are potentially eligible for the R&D tax credit if their R&D spending exceeds 0.92 percent of their taxable gross receipts, which was believed by the legislature to be an average R&D spending rate for business.

Over the time period considered by this study (2004–2009), a firm's R&D tax credit depended on R&D spending, the firm's industry, the year, and some caps on the credit. From 2004–2006, the R&D credit rate for uncapped firms was equal to the firm's gross receipts tax rate times the excess of the firm's qualified R&D spending over 0.92 percent of the firm's taxable gross receipts. The firm's gross receipts tax rate varied by industry. For example, the gross receipts tax rate was 0.471 percent for retail firms, 1.8 percent for service industry firms, and 0.484 percent for manufacturing, wholesaling, and extraction industry firms. From 2007–2009, a floor was added to the credit rate. The R&D credit rate for uncapped firms was the maximum of the firm's gross receipt tax rate or an alternative rate (0.75 percent for 2007, 1.0 percent for 2008, and 1.25 percent for 2009). For all years from 2004 to 2009, the R&D credit received by an individual firm was capped in two ways. One cap was that no firm could receive more than $2 million in credits annually. A second cap was that the credit was nonrefundable, so the R&D credit could not exceed the firm's tax liability under the gross receipts tax.

The R&D credit applied only to "qualified" R&D spending. However, "qualified" was defined broadly. "Qualified" R&D activity was "research and development performed within this state in the fields of advanced computing, advanced materials, biotechnology, electronic device technology, and environmental technology." Spending eligible for the credit included operating expenses of the R&D, including wages and benefits, supplies, and computer expenses, but not including capital costs. The R&D activity had to be either directly conducted by the firm, or subcontracted to a public educational or research institution.

The design of this R&D credit has several consequences for how we conducted our research. First, the caps mean that there is often a big difference between average R&D credit rates and marginal R&D credit rates. By average credit rates, we mean the R&D credit for the firm as a percentage of the firm's R&D spending. By marginal credit rate, we mean the percentage the credit is of additional R&D spending by the firm, for a small increment in R&D spending. Because of the caps, there are firms with a zero percent marginal credit rate who still have a significant average R&D credit rate.

For most existing firms, the marginal credit rate is likely to be a more important determinant of job creation decisions. The modest credit provides some incentive for a research-intensive firm to expand a little more, by lowering its R&D costs. The magnitude of this incentive is given by the marginal credit rate, not the average credit rate. The average credit rate is a relevant incentive for firms that might be considering total shutdown as an option.

For the goal of obtaining precise estimation, it is fortuitous that the marginal credit rate is likely to be a more important determinant of firm behavior than the average credit rate. For the average credit rate, one consequence of the R&D credit design is the difficulty of precise estimation because of limited variation. The average credit rate varies only modestly across industries, or over time. But plausible estimation might control for industry effects or even firm effects, as well as for time effects, so the modest variation of the average credit rate across industry or time likely means that any estimation that controls for industry or firm effects, and for time effects, will probably yield imprecise estimates.

On the other hand, there is much more statistically relevant variation in marginal credit rates. Marginal credit rates vary greatly over time across the different firms due in large part to the caps. As will be seen later in this paper, this allows for much more precise estimation, even after controlling for firm and time effects.

As we will review in more detail later, one of the key problems in estimating the effects of any economic development tax incentive is that such incentives are "endogenous." By "endogenous," we simply mean that the magnitude of these incentives depends upon the firm's growth, which makes it difficult to infer the causal effects of incentives on job creation from observed correlations between incentives and job creation. The magnitude of effects of any economic development incentive is likely to depend on the percentage reduction it induces in the firm's overall costs of job creation. (See the methodology section later for more discussion of this point.) These percentage effects on the firm's costs depend on the dollar magnitude of the incentives received by the firm. Yet the dollars of incentives received by the firm are likely to depend on the firm's job creation. For example, the dollars in Washington R&D tax credits received by an individual firm will go up for firms that are expanding and therefore spending more on R&D. A positive correlation between a firm's tax credit dollars received, and the firm's job creation, may reflect causation in either direction.

As we will describe, we make careful efforts to correct for the endogeneity of the R&D tax credit variable through the use of instrumental variables. This estimation approach makes a great deal of difference to our results. The results correcting for endogeneity bias yield more sensible estimates than do results from uncorrected models.

The plan of the paper is as follows. The next section reviews the previous literature on effects of business tax incentives on state and local business activity. The following section develops our methodology and estimation equations in more detail. We then describe our data, and present our estimates, followed by our conclusion.

Review of the Incentives-Related Research Literature

Incentives' effects have been estimated in many publications. A much more extensive research literature has examined how state and local business activity is affected by overall state and local business taxes. The overall business tax research is relevant to incentives' research because it seems plausible that the effects of both incentives and business taxes would depend upon their effects on business costs.

Most incentives' research does not find much effect on state or local business activity. Buss (2001) provides a review. More recent papers that do not find much effect include Byrne (2010); Calcagno and Thompson (2004); Chirinko and Wilson (2010a, 2010b); Dye and Merriman (1999); Elvery (2009); Gabe and Kraybill (2002); Greenbaum and Landers (2009); Hansen and Kalambokidis (2010); Hicks and LaFaive (2011); Lee (2008); Lynch and Zax (2010); Mason and Thomas (2010); Merriman, Skidmore, and Kashian (2007, 2011); Neumark and Kolko (2010); Peters and Fisher (2002); and Weber, Bhatta, and Merriman (2003). However, some recent papers do find some substantively large and statistically significant effects of incentives. Customized job training incentives have some supportive research (Holzer et al. 1993; Hollenbeck 2008; Hoyt et al. 2008). Manufacturing extension services have some research support (Jarmin 1998, 1999; MEP 2010). The federal Empowerment Zone program is found to have significant effects in one study (Busso et al. forthcoming). Job creation tax credits have one study in support by Faulk (2008).

However, incentives are typically quite small when measured as a share of business costs. This small share implies small effects of incentives on state or local business activity, which makes it more difficult to detect statistically significant effects. These small true effects of incentives may also be easily masked by any estimation biases. In particular, as we discuss in the methodology section, incentive effects may be biased by the endogeneity of incentives, with the dollar magnitude of incentives increasing with increased state or local business activity.

The extensive research literature on the effects on state or local business activity of overall state and local taxes has been reviewed by Bartik (1991), Phillips and Goss (1995), and Wasylenko (1997). Overall business tax effects may be easier to accurately detect than incentive effects, because state and local business taxes are a larger share of business costs than business incentives. State and local business tax effects on business activity should be larger, and therefore easier to detect. Biases due to endogeneity effects may not loom as large.

Based on these reviews of the literature, the range of estimates for the long-run elasticity of state or local business activity with respect to overall state and local business taxes is from −0.1 to −0.6. State and local business taxes average around 5 percent of overall business costs. Therefore, assuming that business tax effects are due to their effects on costs, the implied elasticity of state or local business activity with respect to overall business costs would be in the range from −2 to −12.

The research literature on how local wages affect local business activity implies a somewhat lower effect of business costs on business activity. The average elasticity of local business activity with respect to local wages is −0.7. Labor is about 70 percent of business costs. This implies an elasticity of state and local business activity with respect to overall costs of −1. However, it seems plausible that many studies of wages may underestimate the effects of wages on business activity. Wages will tend to go up when business activity goes up. This endogeneity bias will tend to bias estimated wage effects towards zero. Therefore, minus one may be viewed as a lower bound to estimated effects on local business activity of variations in overall business costs.

These cost elasticities have implications for plausible ranges of effects of incentives on local business activity. Suppose, as we will argue in the methodology section below, that the effect of incentives, business taxes, or other cost factors on local business activity is roughly proportional to effects on overall business costs. Then if the effect of an incentive on overall business costs is calculated, this allows a rough gauge of a plausible long-run effect of that incentive on state and local business activity.

Methodology

Relative to overall business costs—even in research-intensive firms—the Washington R&D credit is quite small. To detect its effects, we have to be careful in specifying the estimating equation so that we accurately capture how its effects would vary across different firm's circumstances.

The underlying assumption in our specification is that the magnitude of output of a particular firm in the state of Washington depends on profits. Specifically, we assume that the natural logarithm of output will depend on the natural logarithm of expected profits of the firm. That is, a shock to profits will engender a percentage change in employment that varies directly with the percentage change to profits.

We assume factor substitution effects are of secondary importance. This assumption can be justified by calculations by Bartik (1991, pp. 214–215). These calculations show that for factor demand dependent variables, such as employment, the effects of overall local costs on local employment is likely to be considerably greater in magnitude than the factor substitution effects of changes in the relative price of labor versus other factors of production. As a result of our assumptions, a firm's employment, or other variables, will also be assumed to have the same type of relationship to local costs as the firm's output. That is, the natural logarithm of the firm's employment, or earnings, will vary directly with the natural logarithm of the firm's expected profits.

Therefore, we assume that ln(employment) can be written as a linear function of the natural logarithm of profits.

(1) $$\ln\left(E_{ft}\right) = B_{10} + B_{11}\ln\left(\pi_{ft}\right) + e_{ft1}$$

E_{ft} is employment of firm *f* in year *t*, π_{ft} is profits of firm *f* in year *t*, and e_{ft1} is an error term. Profits are defined as revenue minus costs, or

(2) $$\pi_{ft} = P_{yft} * Y_{ft} - \sum_i P_{ift} * X_{ift}$$

P_{yft} is the price of output for the firm, Y_{ft} is output for the firm, P_{ift} is the price of input *i* for the firm, and X_{ift} is the quantity of input *i* for the firm. Then the derivative of the natural logarithm of profits with respect to the natural logarithm of any input price will be equal to

(3) $$\frac{\partial \ln\left(\pi_{ft}\right)}{\partial \ln\left(P_{ift}\right)} = \left(\frac{P_{ift} * X_{ift}}{C_{ft}}\right)\left(\frac{C_{ft}}{\pi_{ft}}\right)$$

C_{ft} is total costs for the firm, that is, the sum of the expenditures on all inputs. This equation is derived by applying the envelope theorem to the definition of profits.

The ratio of costs to profits is constant for all input prices for all homogeneous production functions (Lau 1978). Therefore, the effects of a percentage shock to any input price is to cause a percentage shock to profits whose magnitude is proportional to the factor share of that input in total costs.

We can use a Taylor series expansion of the logarithm of profit term in equation (1) to re-express the log of employment as a linear function of the vector of log factor prices. Therefore, for plausible production function parameters, the logarithm of employment in a state will have a linear estimation equation in the logarithm of factor prices, when the logarithm of each factor price is weighted by that input's factor share for that particular firm.

However, in our cases, we are focusing on one factor price, the price of R&D. Therefore, we assume that the natural logarithm of the firm's employment depends on the natural log of the price of R&D, other features of Washington such as the log of other factor prices, and year effects. Other factors are summarized by a dummy variable for the firm, as we have multiple observations for each firm. Year effects are summarized by a dummy variable for the year over all firms. This leads to the following equation:

$$\ln\left(E_{ft}\right) = B_{40} + B_{41}\left\{\left[\left(P_{r\&dft} * X_{r\&dft}\right)/C_{ft}\right] * \left[\ln\left(P_{r\&dft}\right)\right]\right\} + F_f + F_t + e_{4ft} \tag{4}$$

$P_{r\&dft}$ is the price of R&D to the firm, $X_{r\&df}$ is the quantity of R&D used by the firm, and therefore ($P_{r\&dft}$*$X_{r\&d}ft/C_{ft}$) is the R&D factor share for the firm, F_f and F_t are fixed effects for the firm and year, and e_{4ft} is the error term for this equation, expressing other employment determinants such as local wages, other taxes, etc. Thus, we are saying that the coefficient on ln(R&D factor price) will be a constant across some sample of firms if we weight that variable by the R&D factor share for that particular firm.

We do not observe the price of R&D. However, we do observe the R&D tax credit, which affects the price of R&D. Specifically, the natural logarithm of the net after-tax credit price of R&D will depend on the before tax price of R&D, and the tax credit, as described by the following equation:

$$\ln(P_{r\&dft}) = \ln\left(P_{gr\&dft}\right) + \ln\left(1 - CREDIT_{ft}\right) \tag{5}$$

ln($P_{gr\&dft}$) is the ln of the gross R&D price before the Washington credit, and $CREDIT_{ft}$ is the credit rate facing the firm. We assume that the gross R&D price varies across firms, over time, and across firms and over time, but that its variation across firms and over time is uncorrelated with the credit rate. Therefore, we can substitute equation (5) into equation (4), and the gross R&D price term will be absorbed by the fixed effects for firm effects or year effects, and by the error term, without biasing the estimation.

After substitution, we get something closer to an estimating equation:

$$\ln\left(E_{ft}\right) = B_{60} + B_{61}\left\{\left[\left(P_{r\&dft} * X_{r\&dft}\right)/C_{ft}\right] * \ln\left(1 - CREDIT_{FT}\right)\right\} + F_f + F_t + e_{6ft} \tag{6}$$

The point of this specification discussion is that the R&D tax credit variable should be specified as weighted by the factor share of R&D in overall costs. This specification results in a coefficient B_{61} that we would expect to be roughly constant across different firms, but only after the $\ln(1-CREDIT_{ft})$ variable for each firm is weighted by each firm's factor share for R&D spending. The specification implies that for small changes in the credit rate, we would expect effects on firm employment to be proportional to effects as a percentage of total business costs. This is a restriction that aids in estimation, as it means our right hand side variable is varied across firms due to their R&D intensity.

To proceed with the estimation, we need to address the possibility of lagged adjustment to factor prices. The simplest alternative is to assume no lagged adjustment. Equation (6) can then be first differenced to obtain a possible estimating equation:

(7)
$$\ln\left(E_{ft}\right)-\ln\left(E_{ft7}\right)=B_{70}+B_{71}\{\left[\left(P_{r\&dft}*X_{r\&dft}\right)/C_{ft}\right]*\ln\left(1-CREDIT_{ft}\right)$$
$$-\left[P_{r\&dft-1}*X_{r\&dft-1}/C_{ft}\right]*\ln\left(1-CREDIT\right)\}+F_t+e_{7ft}$$

Alternatively, we can allow for lagged adjustment. We assume equation (6) expressed desired employment E^*_{ft}, and actual employment adjusts towards desired employment by only a portion of the gap between the two.

(8) $$\ln E_{ft}=\ln E_{ft-1}+\lambda(\ln E^*_{ft}-\ln E_{ft-1})$$

Which implies

(9) $$\ln E_{ft}=\lambda\ln E^*_{ft}+(1-\lambda)\ln E_{ft-1}$$

Substitution of (6) (with equation 6 modified to be true only for desired employment) into (9) then yields another possible estimating equation:

(10)
$$\ln E_{ft}=\lambda B_{60}+\lambda B_{61}\left\{[(P_{r\&dft}*X_{r\&dft})/C_{ft}]*\ln\left(1-CREDIT_{ft}\right)\right\}$$
$$+F_f+F_t+(1-\lambda)\ln E_{ft-1}+e_{10ft}$$

In this estimating equation, the coefficient on the tax credit variable is the short-run effect of the tax credit on employment. The long-run effect is equal to that short-run effect times one over (1 minus the coefficient on lagged employment).

As is well-known, with a lagged dependent variable, a fixed cross-sectional effect, and a short panel (6 years in our case), ordinary least squares estimation of the parameters will be biased. This bias occurs because the estimation cannot distinguish between the effects of the lagged dependent variables and the fixed effect in a short panel, even as the number of cross-sectional observations approaches infinity. This bias is discussed in Nickell (1981).

Solutions to this bias have been developed by Arellano and Bond (1991). The solution is essentially to first difference equation (10), to get the following equation:

$$\ln E_{ft} - \ln E_{ft-1} = B_{110} + \lambda B_{61}$$
$$(11) \quad * \left\{ \left[\frac{\left(P_{r\&dft} * X_{r\&dft}\right)}{C_{ft}} \right] * \ln\left(1 - CREDIT_{ft}\right) - \left[\frac{\left(P_{r\&dft-1} * X_{r\&dft-1}\right)}{C_{ft-1}} \right] * \ln\left(1 - CREDIT_{ft-1}\right) \right\}$$
$$+ F_t + (1-\lambda)\left[\ln E_{ft-1} - \ln E_{ft-2}\right] + e_{11ft}$$

This eliminates the firm fixed effect without having to directly estimate it. However, the first difference in the lagged dependent variable will now be correlated with the disturbance term. The proposed solution is to use further lags in levels of the dependent variable as instruments. As compared to the simple first differencing that derives equation (7), first differencing this model is more complex and requires further assumptions about how the disturbance terms behaves over time for a given firm. Furthermore, because it allows for changes in employment to be due both to current changes in the R&D variable, as well as lagged changes in R&D from the lagged dependent variable, this approach is likely to yield less precise estimates. However, the lagged dependent variable approach is more appropriate if we are convinced that lags in adjustment are of sizable importance.

One issue is whether the credit rate included in estimating equations (11) or equation (7) should be the average R&D credit rate or the marginal credit rate. As argued above, it seems likely that for most firms, the marginal price of R&D for small expansions should be of greater importance.

The key endogeneity problem in estimating equations (7) or (11) is that the R&D credit variable as specified is clearly endogenous. We are specifying the variable as the natural logarithm of the effect on the R&D price due to the credit weighted by the current R&D factor share, or alternatively, we can view this as specifying the R&D credits paid as a percent of total costs. The reason for this specification is that it assumes that the coefficient on this combination variable will be the same across firms. But actual R&D spending is clearly endogenous. As the firm expands output and employment, it will also expand R&D. Without correcting for this endogeneity, we would expect the estimated coefficient on the combination R&D variable to be biased towards finding larger effects of R&D credits on employment. (That is, the estimated coefficient on the R&D variable in these equations will be biased in a negative direction.)

To deal with this, we instrument for the R&D variable by predicting the R&D factor share with variables that do not depend upon the firm's decisions, after controlling for firm fixed effects. That is, the instrumental variables do not depend upon changes in the firm's decisions over time. The actual R&D credit rate that is part of the R&D variable is assumed to simply be equal to the calculated average or marginal R&D credit rate for that firm in creating this instrumental variable.

We used three different approaches in creating the instrument. Approach (1) recalculates the R&D credit variable by multiplying ln(1−firm's credit rate) × the factor share for R&D observed in that year for all Washington firms in that industry other than the firm itself. Approach (2) recalculates the R&D Credit variable by multiplying ln(1−firm's credit rate) × the factor share for R&D observed in that year for the entire nation for that industry. Approach (3) takes the firm's actual R&D factor share for the first year it is observed in our sample. It then updates that factor share based on changes over time in the nation for R&D factor shares in that firm's industry. For all of these approaches, since the estimating equation is ultimately first differenced, the instrumental variables we create are also first differenced after substituting predicted factor shares for actual firm factor shares to create a predicted R&D credit variable.

Approach (1) controls for firm-specific effects on employment and output that might bias results. However, this approach might be biased if there are Washington state employment trends by industry that are correlated with changes in industry R&D spending, which is certainly possible. Approach (2) avoids the problem of Washington state trends by industry by using national factor shares. However, both approach (1) and approach (2) suffer from only having variation in the predicted firm factor share across industry. This limited variation limits the predictive quality of an instrument. Approach (3) uses firm-specific information for the first year it is observed for R&D factor share. This information does not bias the instrument because our estimating equations implicitly control for firm fixed effects by first differencing. Using this firm-specific information helps the instrument's predictive ability.

We explore a variety of estimating approaches in our resulting estimation. Even though we have a large panel of firms, we are straining the ability of estimators to detect employment effects because the R&D credit is such a modest cost shifter. Therefore, we must be pragmatic in seeing what restrictions we need to impose to get reasonably precise estimates.

Data

Firms that claim the credit are required to file a response to a survey questionnaire as back-up documentation. JLARC constructed a data set with these responses covering the years 2004 to 2009 and supplied it to us. In addition to the survey data, JLARC had requested and included in the data set employment and earnings data from the Washington Employment Security Department (ESD) for each of the firms. Table 1 provides descriptive information about the firms in this data set.

In each year of the data, there are about 700 observations. Just under half of the firms are in the Professional, Scientific, and Technical Services sector. The next most populous sector is Manufacturing, which accounts for about 20 percent of the firms. About five-sixths of the firms are headquartered in Washington State. Most of the firms are relatively modest in size. The median level of gross revenues is about $3.0 million, and the median level of (self-reported) employment is about 20. Note that there is a share of much larger firms that causes the averages of these statistics to be much larger. Not surprisingly, these firms undertake a substantial amount of R&D. The median self-reported annual expenditures on R&D ranged between $0.5 and $0.8 million—a sizeable proportion of gross revenues. The average share of the Washington work force reported to be in R&D is around half.

Table 1 Descriptive Statistics about Firm, by Year

Characteristics	2004	2005	2006	2007	2008	2009
Industry (NAICS Code)						
Manufacturing (33)	18.2%	18.9%	18.7%	18.5%	18.9%	18.6%
Wholesale trade (42)	7.1	6.7	6.6	6.4	6.4	6.0
Information (51)	11.8	10.5	9.8	9.6	9.6	9.3
Prof., Tech., and Scientific (56)	45.2	46.7	48.1	48.4	48.1	49.4
All other	17.7	17.2	16.8	16.1	17.0	16.7
Location of Headquarters						
Washington	83.2%	83.7%	83.4%	84.4%	84.8%	85.3%
All other	16.8	16.3	16.6	15.6	15.2	14.7
Gross Revenue, Median/Average ($ million)	2.1 / 27.7	2.7 / 27.5	2.9 / 30.7	3.1 / 37.5	3.3 / 45.6	3.2 / 43.2
R&D Spending, Median/Average ($ million)	0.5 / 11.4	0.8 / 10.2	0.7 / 11.7	0.8 / 12.6	0.8 / 14.2	0.6 / 13.4
High-tech Credit, Median/Average ($ thousand)	5.3 / 39.6	4.4 / 31.0	4.3 / 34.2	5.3 / 37.5	5.5 / 43.6	6.0 / 46.7
Employment						
In Washington, Median/Average	16 / 186	20 / 225	20 / 252	20 / 270	21 / 295	19 / 286
Percent full time, Average	83.3	88.3	87.4	86.6	86.8	85.6
Percent in R&D, Average	40.2	53.5	51.1	51.4	50.3	51.3
Worldwide, Median/Average	17 / 714	21 / 826	24 / 879	25 / 1,231	25 / 1,035	22 / 1,119
Sample Size	736	715	722	738	718	699

SOURCE: Tabulation of Washington Tax Incentive Survey.

Questions on the survey ask firms to report, “the amount of credit claimed for the calendar year,” and, “How many new employment positions did your firm create in Washington State during the calendar year?” Table 2 summarizes these survey data by year. Note that these data are again somewhat skewed by the larger firms in the population of firms.

Table 2 Self-Reported Employment Creation and Tax Credit, by Year

Year	Average Employment Created (Question 10)	Total Employment Created	Average Credit (Question 1a)	Total Credits Taken ($million)
2004	5.39	3,223	$39,611	$23.687
2005	31.07	16,622	31,003	16.587
2006	27.49	13,937	34,229	17.354
2007	27.05	14,309	37,499	19.837
2008	33.17	16,885	43,599	22.192
2009	18.25	9,305	46,696	23.815
All Years	23.30	74,282	38,730	$123.472

SOURCE: Washington Tax Incentive Survey.

Data Exclusions

Table 3 presents the number of firms in the survey data and used in the estimation of the models. A total of just under 1,000 unique firms claimed the credit during at least one of the analysis years (2004–2009). As noted in the table, the annual number of firms claiming the credit ranged between 507 and 574 during those years. The entries in the second and third columns in that table come from Department of Revenue (DOR) tax return data that were appended to the data base. They show the average credit taken and the total credit taken, by year. The average credit taken by firms during this period is just under $40,000. The total credit taken, by year, is quite similar to the data presented in table 2, indicating that the self-reported credit data on the survey were reasonably accurate.

Table 3 Number of Firms and Credits Taken, by Year

Year	Number of Firms with Credit	Average Credit ($)	Total Credit ($ million)	Number of Firms after Data Editing
2004	574	41,521	23.833	413
2005	548	33,834	18.541	447
2006	516	33,674	17.376	430
2007	528	36,908	19.487	445
2008	511	44,367	22.672	439
2009	507	48,010	24.341	412
TOTAL UNDUPLICATED	991	39,651	126.250	672

SOURCE: Tabulations of Department of Revenue (DOR) data.

To estimate the models, several data editing steps were taken that resulted in observations being deleted from the data. The final column of table 3 shows the number of firms that were left after data editing. This column provides the sample sizes used in estimating the models. The deletions that were made include omitting NAICS codes 112 (Animal Production) and 921 (Public

Administration - Executive, Legislative, and Other Government Support) because we had no national R&D data for these industries to use in the construction of the IVs. This deleted two firms. We also deleted firms in which there was a single year of data because the models described above included lagged dependent variables. This deleted 167 firms. We deleted observations in which the credit and the value of R&D spending were 0 or missing. This further reduced the number of firms by 19. Finally, we deleted observations that were missing the administrative-sourced employment or earnings data from the ESD. This deleted 131 additional firms. The total number of firms in the remaining analysis sample was 672, ranging between 412 and 447 each year.

Results

We estimated the levels model, equation (10), and the growth model, equation (7), for three dependent variables (employment, earnings, earnings/worker) with all three IVs. Table 4 shows the estimation results for the levels and for the growth models for employment and earnings for the three sets of IVs using the marginal credit ratio. The entries in the table are the B_{61} and B_{71} parameter estimates and their standard errors. Our preferred specification is using the growth model and the IV that is presented in the 3rd column, i.e., using a baseline R&D factor share and inflating it annually at the rate of growth of R&D in the industry. Not only are the results in agreement with our hypothesized sign and level, but also, the IV is estimated with precision in the first stage regression.[16]

Table 4 Parameter Estimates

	Instrumental Variable		
Dependent variable/model	Industry average (w/o firm)	National R&D factor share growth rate	Baseline factor share growing at national rate
Employment/ levels	−2.89	−0.26	−6.98
	(6.21)	(5.36)	(4.27)
Employment/growth	−10.44	−2.02	−4.94***
	(8.06)	(6.32)	(1.92)
Earnings/ levels	15.20***	13.97***	4.77
	(6.56)	(5.90)	(3.89)
Earnings/growth	−13.14	−2.64	−2.90
	(10.68)	(8.21)	(2.42)

NOTE: Entries are the estimates of the parameters B_{61} from equation (10) for the levels model and B_{71} from equation (7) for the growth model. Robust standard errors are presented in parentheses.
*** denotes significance level of 0.01.

[16] Equation (10), the levels models, were estimated by the Generalized Method of Moments (GMM) with the Stata routine xtdpd. The Sargan test of overidentifying restrictions had $\chi^2(9)$ levels of 9.2, 7.7, and 8.2 for the three employment equations. These levels were not sufficient to reject the null hypothesis of valid restrictions. On the other hand, the $\chi^2(9)$ levels for the earnings equations were 22.2, 20.5, and 25.6 for the earnings equations. All of these levels were sufficient to reject the null hypothesis of valid overidentifying restrictions. Equation (7), the growth models, were estimated by two-stage generalized least squares using the Stata routine xtivreg, which is suitable for panel data. The first-stage coefficient estimates and robust standard errors for the employment equations were 0.169 (0.047), 2.791 (0.718), and 0.402 (0.029), all significant at the 0.01 level, The first-stage coefficient estimates and robust standard errors for the earnings equations were 0.166 (0.051), 2.817 (0.764), and 0.401 (0.031), all significant at the 0.01 level.

The parameter estimates do not easily translate into employment growth. To estimate the job growth that resulted from the tax credit, we have used the firms' data and used the parameters from our (preferred) estimated model with the actual marginal credit ratio and with a marginal credit rate of 0 (assuming that the credit did not exist) to predict employment growth with and without the credit.[17] We did a similar calculation for total wages at the firm. Table 5 presents these results.

Table 5 Estimated Employment and Earnings Creation, by Year

Year	Employment	Earnings ($ million)	Total Credit Taken ($ million)
2005	378	14.244	18.541
	(84, 672)	(-9.528, 38.016)	
2006	430	18.988	17.376
	(96, 764)	(-12.702, 50.678)	
2007	469	21.114	19.487
	(117, 833)	(-14.125, 56.353)	
2008	511	23.019	22.672
	(114, 907)	(-15.399, 61.437)	
2009	484	20.728	24.341
	(108, 860)	(-13.866, 55.322)	

NOTE: Table entries in the 2nd and 3rd column are estimated employment and earnings created as a result of the R&D tax credit. The entries in parentheses are the lower and upper bounds of a 95% confidence interval. All entries have been adjusted upward by a factor to take into account that the simulations of the growth model could only be done when data existed for consecutive years. The adjustment factors for employment, by year, were 1.1310, 1.1583, 1.1162, 1.0771, and 1.0705. The adjustment factors for earnings were 1.1307, 1.1554, 1.1154, 1.0755, and 1.0702. In other words, these factors ranged from about 7 to about 16 percent. The total credit taken data are from Department of Revenue (DOR) data.

As seen in the table, the number of jobs created by the tax credit annually ranged between about 380 and about 510. These represented a growth in jobs at these firms of between 0.53 and 0.62 percent. The amount of earnings generated in the state from these jobs ranges from about $14.2 million to $23.0 million. These levels of earnings represented a growth in earnings of 0.62 percent.[18] The amount of earnings generated in the state from these jobs ranges from about between 0.20 and 0.25 percent.[19] The average cost per job created calculated by dividing the entries in the last column of table 5 by the jobs created in the second column range from $40,409 (2006) to $50,291 (2009).

The employment creation numbers reported in Table 5 are "job-years" created. They should not be interpreted as existing permanent jobs created each year. Our model estimates that a change in the tax credit causes a once-and-for-all permanent change in the number of jobs in the state. Therefore, the job-years listed in the second column should not be summed to get a cumulative total

[17] Note that many firms' marginal credit ratio is 0, so that no simulated job creation occurs at these firms.

[18] Calculations based on average firm size: 202, 211, 199, 219, and 226 in 2004 through 2008, respectively.

[19] The fact that wages increased less than employment suggests that the credit had a negative impact on wages per employee. That is precisely what our estimates show when the ratio of wages to employment is used as the dependent variable. This finding is not surprising because one would assume that new hires make, on average, less than incumbent workers. In addition, lower wage firms may have higher percentage effects of the tax credit on costs.

of jobs created. A negative interpretation of the results may be easier to understand: If policymakers had eliminated the tax credit in 2009, the state would have had had a level of jobs in these firms that would have been permanently lower by 484 jobs.

Sensitivity Analyses

We conducted three types of sensitivity analyses to get a sense of the robustness of our estimates. First, in the above table, we considered the confidence intervals for our results, based on the statistical confidence intervals around our point estimates. For example, for 2009, the confidence interval for jobs created spans from 108 jobs to 860 jobs. With a tax credit cost of $24.34 million, this implies a cost per job created that spans from $225 thousand ($24.34 million divided by 108) to $28 thousand ($24.34 million divided by 860).

Second, we used the coefficient from the first column in table 4 that used industry average R&D factor shares as instrumental variables. Note that this coefficient is more than twice as large as our preferred specification (−10.44 compared to −4.94) implying that firms are much more responsive in their hiring decisions to the "cost" of R&D than the responsiveness implied by the preferred specification. The permanent employment gain was correspondingly about twice as large—in 2009, the simulated number of jobs created was 1,023 as compared to 484. This represents an employment growth at the firms taking the credits of approximately 1.2 percent. With more jobs created, the cost per job decreases. Specifically, the cost per job created was $23,800. Similarly, we used the coefficient from the first column of table 3 to calculate the additional wages. The coefficient was about 4 times larger, and concomitantly, the increase in total wages was about 4 times larger—in 2009, the simulated increase in wages paid was $93.89 million compared to $20.73 million.

As noted above, the marginal tax credit ratio is 0 for firms whose credits have been capped at $2 million and for firms whose credit is equal to or exceeds their tax liability (the credit is nonrefundable), so the simulated job gains are 0 for those firms.[20] Consequently, we did a third sensitivity analysis in which we used the average credit ratio to calculate job gains rather than the marginal credit ratio. This assumption was combined with the −4.94 coefficient estimated in the table using the marginal tax credit variable. The number of jobs created in 2009 because of the tax credit was 623 in this analysis, and the average cost per job created was $39,069.[21]

Discussion

Export-based Industries

Arguably, output and employment growth in an export-based industry[22] has more positive implications for the economic growth of a state than does growth in a non-export-based industry.

[20] The $2,000,000 cap affected only 2 firms in our data—a total 7 observations in our 6 year panel of data. On the other hand, almost 30 percent of the firms in our analysis file (198 out of 672) had marginal tax rates of 0 because the credit equaled their entire tax liability.

[21] For the majority of observations in our data, the marginal credit ratio and the average credit ratio are the same. The exceptions to this are the firms for which the credit was capped. For those firms, this sensitivity analysis suggests that the firms respond to their average credit ratio. So the difference in results is solely due to those firms.

[22] For this discussion, an export is defined as a sale that crosses state lines. It could be to an international buyer or to a domestic buyer in another state. Thus, Washington state's "export-base" includes goods and services sold to residents

For export-based industries, we might expect multiplier effects of employment expansions on other industries, due to supplier links or respending of the export-based industry workers' wages at local retailers. Such multipliers could quite plausibly be in the 1.5 to 2.0 range, that is from 0.5 to 1.0 additional spinoff jobs for every 1 additional export-based industry job. More precise multipliers require a regional econometric model for the State of Washington that would incorporate state-specific supplier links and wage rate data.

In contrast, it is unclear whether encouraging employment growth in non-export-based firms will have any net positive effects on state employment. Non-export-based firms provide output based on local demand. If such firms expand in response to some tax policy, this reduces potential sales for other firms in that same industry. As a result, net industry employment may not increase. The subsidy may merely redistribute sales in the industry. (The non-export-based firms may also have supplier links within the state economy, but if the magnitude of sales within a state to these non-export-based firms as a group is determined by the size of the state's economy, any redistribution of employment and sales among non-export-based firms will merely redistribute activity among their suppliers as well.)

Using earlier analysis by one of the authors (Bartik, Erickcek, and Huang 2007) that identified export-based and non-export-based sectors using location quotients, we calculated the employment gain for these two types of firms. Whereas about 75 percent of the employment in the sample of firms claiming a credit was in export-based industries (58,600 out of 80,600), only about 40 percent of the employment creation occurred in those industries. If there were a multiplier of 2.0 for the export-based firms, and 0.0 for the non-export-based firms, the net employment creation would be approximately 80 percent as large as the figures presented in table 5.

Opportunity Cost of Public Funds

With a balanced state budget, the funds used to pay for the R&D tax credit have to come from somewhere. Plausible sources are some reduction in public spending or some increase in other taxes. This reduction in public spending or increase in other taxes would have a negative impact on demand on goods and services in the state economy. These negative impacts would be offset to some degree by the demand-side impact of the use of the R&D tax credit by business owners. Depending upon what public services were altered, or what taxes were altered, there might also be some negative impacts from affecting the supply of labor or capital or other factors of production. The economic impact of such changes in public spending or taxes would be best measured with a Washington state-specific econometric model of the state economy.

However, we can estimate plausible magnitudes of these changes in other public spending and taxes by using results from previous studies of regional economies. For example, Bartik and Erickcek (2003) estimate that a state public spending cut that finances an equal-sized state tax cut will have balanced budget effects on job creation in which each $138,045 in state public spending cuts will result in the net loss of one job. In the case of the high-tech tax credit incentive, the $24.341 million of resources devoted to the R&D tax credit in 2009, if financed by a cut in public spending, would result in a loss of 176 jobs. This would offset a portion, but by no means all, of the positive effects of our 2009 estimate in table 5 that the tax credit creates 484 jobs.

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and businesses in such "foreign" places as Oregon. It is these export-based sales that bring new dollars into a state's economy.

Fiscal Benefits

The net jobs created by the R&D tax credit would result in fiscal benefits and costs. The job creation generates income and wealth that will result in a larger tax base for state and local governments. On the other hand, the job creation will also result in additional population that will require additional public spending to avoid service deterioration. On net, we expect the fiscal benefits to exceed costs.

Estimating fiscal benefits and costs requires a fiscal impact model specific to the state and local tax system in Washington, along with an econometric model of how population will adjust to the job creation. Rough magnitudes of possible fiscal benefit offsets can be gauged from previous studies of state economies. Bartik and Erickcek (2010) conclude that each new job created by a state tax credit program in Michigan produced about $3,100 (in 2009 dollars) in fiscal benefits to partially offset the costs of the program. If a similar number applied in the state of Washington, the 484 jobs that are estimated to be created in 2009 due to the tax credit would provide about $1.5 million in fiscal benefits. This would offset less than 10 percent of the $24.34 million cost of the credit.

Conclusion

Our analyses of tax credit data suggest that the high tech R&D tax credit does increase employment to a very modest extent. The analyses suggest that employment grew by between 0.5 and 0.6 percent at the firms that claimed credits because of the tax credit; however, our sensitivity analysis suggests that the rate may be as high as twice that if firms are as responsive to their R&D costs as our largest estimated response suggests. The specification that seemed to work best empirically suggests that firms respond to the marginal credit rate, which it should be noted, is zero for slightly less than one-quarter of the sample.

The cost per job created implied by these estimates is relatively high. The range in the above estimates is from just over $40,000 to just over $50,000 per job created. Although the jobs created may pay more than those figures, not all earnings generated are a pure benefit. We know from previous studies that only a portion of newly created jobs actually result in increased local employment rates and earnings per capita. In general, up to four-fifths of all new jobs in a state will end up being reflected in higher population rather than higher state employment rates. That is, a 1 percent increase in a state's employment is estimated to lead after 5 or more years to a 0.8 percent increase in state population, with a resulting increase of 0.2 percent in the state's employment to population ratio (Bartik 1991, 1993). Some of the new jobs will also lead to the state's residents being able to move up to better-paying jobs than would have occurred otherwise, as the new jobs make it easier for state residents to be hired in better-paying occupations. Estimates suggest that a 1 percent increase in a state's employment leads to a 0.2 percent increase in earnings per capita due to state residents moving up to better-paying occupations (Bartik 1991).

Combining these two effects, a 1 percent increase in jobs, which would directly increase state earnings by 1 percent if the jobs pay similarly to the average state job, will actually lead to a somewhat lower 0.4 percent increase in state earnings per capita: 0.2 percent due to higher state employment rates, and 0.2 percent due to state residents moving up to better-paying occupations. The boost in state earnings of 0.4 percent is 40 percent of the 1 percent extra earnings directly associated the new jobs. Therefore, in evaluating the benefits for state residents from new jobs, we should not assume that 100 percent of the earnings from the new jobs lead to higher earnings for the original state residents. Only about 40 percent of the earnings from the new jobs are likely to do so.

Why is this study's cost per job created so high? Four reasons seem most important. First, this study finds, consistent with the research literature on business tax effects and wage effects on local business activity, that state and local business activity is only modestly responsive to subsidies that lower costs. Second, for the firms receiving this particular tax credit, the ratio of earnings and output to employment is relatively high, which implies that a given dollar tax credit has more modest percentage effects in lowering overall business costs. Third, a significant proportion of the tax credits are capped, which means that on the margin these tax credits do not lower the costs of expanding Washington employment. Fourth, a significant proportion of the tax credits are awarded to non-export-based firms, which will have lower effects on overall Washington employment.

These explanations point to ways to lower the cost per job created from this policy. In particular, targeting export-based firms with high multiplier effects, and making sure that incentives affect marginal costs to firms of expanding, will help reduce the cost per job created. Higher multiplier effects will be more likely if firms have stronger local supplier links. Finally, if the goal is job creation, directly tying the magnitude of the incentive to job creation provides a greater reason for firms to respond to the incentive with job creation.

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APPENDIX 5 – QUESTIONS ON PEW CENTER REPORT

State of Washington

Joint Legislative Audit and Review Committee (JLARC)

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September 26, 2012

To: Citizen Commission for Performance Measurement of Tax Preferences

From: Keenan Konopaski, Legislative Auditor

Re: Questions on Pew Center's Report on State Efforts to Evaluate Tax Preferences

At the August 24, 2012, Tax Preference Commission meeting, Jeff Chapman from the Pew Center for the States made a presentation about his organization's recent report titled "Evidence Counts: Evaluating State Tax Incentives for Jobs and Growth."

Subsequent to the meeting, Chairman Longbrake has asked me two questions about the report. I am providing a copy of the questions and my responses for all the Commissioners in this memorandum.

Question: Do JLARC staff feel the Pew Center's characterization of Washington State's effort to evaluate tax preferences is accurate?

<u>Legislative Auditor's Response</u>: Yes - at the time their report was released (April 2012), I think the Pew Center correctly characterized our state when it concluded we were one of thirteen states "leading the way" in efforts to evaluate tax incentives for jobs and growth.

Specifically, the Pew Center identified that we were "leading the way" in three out of four criteria: *informing policy choices; including all tax incentives; and drawing clear conclusions*. I agree our state's processes in these areas have been informative and comprehensive. Only one state in the nation (Oregon) was identified as having met all four criteria.

The fourth criteria the Pew Center used was *measuring economic impact*. The Pew Center report indicated we had mixed results in this area. I agree this was an accurate characterization at the time their report was prepared.

Like two-thirds of the states, prior to the release of our 2012 reviews this July we had not completed a rigorous analysis of the economic impact of a specific preference. This is because many preferences reviewed previously had either not been intended for economic development, or they were too small or had insufficient data to attempt a rigorous economic analysis.

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Commissioners will recall we conducted such an analysis this year on the high technology research and development tax credit, with the assistance of expert economic consultants.

Measuring economic impacts like this in the future will require additional resources for similar consulting assistance. I anticipate that some of the aerospace-related reviews that begin in 2014 will be preferences where complex economic analysis can be performed if JLARC receives funding to assist with this.

Question: What are my office's views on the six key questions the Pew Center posed for measuring economic impact?

<u>Legislative Auditor's Response</u>: I agree that the six key questions identified by the Pew Center for measuring economic impact are appropriate to pursue. The ability for JLARC to answer them will depend upon whether we can identify reliable data for analyzing them, and whether JLARC has resources available when additional technical assistance is needed.

These questions below, though appropriate for evaluation, can be extremely challenging to accurately answer. I agree with the statement in the Pew Center report that, "There is no simple way to isolate the impact of tax incentives…."

The questions posed by the Pew Center are:

1. Cause and effect: To what extent did tax incentives change businesses' decisions, and how much did they reward what would happen anyway?

2. Winners and losers: To what extent did the incentive benefit some businesses or individuals at the expense of others?

3. Unintended beneficiaries: How much of the benefit of the incentive flowed across state borders?

4. Timing: When will the costs and benefits of the incentive occur, and how long will they last?

5. Indirect impacts: To what extent do the investment of companies receiving incentives filter into the broader economy, causing further economic gains?

6. Economics of budget trade-offs: What were the adverse economic impacts of the tax increases or spending cuts made to fund the incentive? Do the benefits of the incentive outweigh those impacts?

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Our 2012 analysis of the high technology credit incorporated the impact of the first five of the Pew Center's questions.

The sixth question on budget trade-offs is an especially complex issue. The State Legislature also expressed interest in the topic and posed a similar question for JLARC staff in 2011 legislation amending the tax preference review process.

As directed by the Legislature, JLARC staff attempted to estimate this trade-off for the high technology credit using budget information and the Office of Financial Management's (OFM) Input-Output Model. The Input-Output Model can be used to simulate the possible economic effect of a tax preference.

However, upon careful review JLARC staff determined the Input-Output Model was not designed to reflect the economic effect of public sector spending in the same way that it reflects private sector spending. Since both sectors must be treated consistently for an accurate trade-off analysis, we determined it was not possible to do this analysis with the current Input-Output Model.

Our 2012 Tax Preference report includes a recommendation for OFM to estimate the cost of modifying their Input-Output Model to allow such an analysis. OFM has concurred with this recommendation, and we will update the Commission when they have completed their estimate.