19-08 FINAL REPORT:

2019 TAX PREFERENCE PERFORMANCE REVIEWS

Financial Institutions' Income from Certain Airplane Loans

LEGISLATIVE AUDITOR'S CONCLUSION:

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

December 2019

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

Estimated Biennial Beneficiary Savings
$2.1 Million - $3.4 Million
Tax Types Business and Occupation Tax RCW 82.04.43391 Applicable Statutes

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

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

The preference does not have an expiration date.

Preference achieves inferred public policy objective

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

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

Recommendations

Legislative Auditor's Recommendation: Clarify the intent and duration

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

More information is available on the Recommendations Tab.

Commissioners' Recommendation

The Commission recommends continue and clarify intent only. Given the Legislature did not add an expiration date in 2010, it can be inferred the tax preference was not intended to be time limited. However, the Legislature should add an explicit performance statement. This would bring it in line with the Legislature's current requirement that similar tax arrangements have an explicit performance statement. Such a statement would aid future reviews by removing any ambiguity about the Legislature's intent.

Committee Action to Distribute Report

On December 4, 2019 this report was approved for distribution by the Joint Legislative Audit and Review Committee.

Action to distribute this report does not imply the Committee agrees or disagrees with the Legislative Auditor recommendations.

REVIEW DETAILS

1. Preference achieves inferred objective

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

JLARC staff infer public policy objective

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

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

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

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

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

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

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

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

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

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

Preference has no expiration date

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

2. Two airlines and 32 lenders benefit

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

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

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

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

Alaska Air Group representatives state that the terms of their loan agreements require them to reimburse the lenders for any additional costs, including state taxes, that may occur during the life of the loan. Because of this preference, the out-of-state lenders do not owe business and occupation (B&O) tax on their loan income, and no additional tax is passed on to the two airlines.

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

Direct beneficiaries: Out-of-state lenders

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

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

3. Estimated biennial savings: $2.1 million - 3.4 million

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

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

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

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

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

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

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

4. Applicable statutes

RCW 82.04.43391, RCW 82.04.080(2)

Business and Occupation Tax

RCW 82.04.43391

Deductions - Commercial aircraft loan interest and fees

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

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

(b) An affiliate of such air carrier; or

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

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

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

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

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

RCW 82.04.080(2)

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

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

RECOMMENDATIONS & RESPONSES

Legislative Auditor's Recommendation

Legislative Auditor's Recommendation: Clarify the intent and duration

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

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

Legislation Required: Yes

Fiscal Impact: Depends on legislative action.

Letter from Commission Chair

State of Washington

Citizen Commission for Performance Measurement of Tax Preferences

106 11th Ave SW, PO Box 40910, Olympia, WA 98504-0910 | Phone: 360-786-5171 | Fax: 360-786-5180
E-mail: JLARC@leg.wa.gov | Website: www.citizentaxpref.wa.gov | Twitter: @WALegAuditor

October 30, 2019

The Honorable Representative Timm Ormsby
The Honorable Representative Drew Stokesbary
The Honorable Representative Cindy Ryu
The Honorable Representative Bill Jenkin
The Honorable Representative Zack Hudgins
The Honorable Representative Norma Smith
The Honorable Representative Gael Tarleton
The Honorable Representative Ed Orcutt
The Honorable Senator Patty Kuderer
The Honorable Senator Hans Zeiger
The Honorable Senator Mark Mullet
The Honorable Senator Lynda Wilson
The Honorable Senator Christine Rolfes
The Honorable Senator John Braun

Re: 2019 Tax Preference Reviews

Dear Senators and Representatives,

I am pleased to forward to you the comments that the Citizen Commission for Performance Measurement of Tax Preferences unanimously adopted for this year's review of tax preferences. The Citizen Commission consists of five voting members, with a member appointed by each of the four caucuses and the Governor's office. Notably, reviews this year included the $569M aerospace preferences that were expanded and extended in 2013, as well as a $262M preference to encourage development of multifamily and affordable housing.

We adopted positions similar to the Legislative Auditor for eight of the nine recommendations issued this year. I would like to call your attention to a recommendation from the Citizen Commission to the Legislature to form a taskforce to improve the information available to the Legislature on the use and consistency of the multifamily tax preference.

The full text of our Commissioner recommendations, summaries of the JLARC staff's analysis and recommendations, and brief video summaries of each preference are available on the 2019 Tax Preference Reviews overview page linked here.

Tax preference reviews provide valuable information as the Legislature considers whether specific preferences are meeting the Legislature's policy objectives. With this year's report, there are now 13 years of tax preference evaluations available to the Legislature, comprising over 296 individual reviews.

I urge you to consider this year's and previous years' recommendations and comments on tax preference statutes in the upcoming legislative session. An interactive summary of legislative action on prior reviews is available here.

As Chair of the Citizen Commission, I would be pleased to discuss the Commission's position and comments with you and any interested legislators. Please feel free to contact me (grant.forsyth@leg.wa.gov) or the Legislative Auditor, Keenan Konopaski (keenan.konopaski@leg.wa.gov or 360-786-5187).

Sincerely,

Grant D. Forsyth

Grant D. Forsyth, Chair
Citizen Commission for Performance Measurement of Tax Preferences

Commissioners' Recommendation

The Commission recommends continue and clarify intent only. Given the Legislature did not add an expiration date in 2010, it can be inferred the tax preference was not intended to be time limited. However, the Legislature should add an explicit performance statement. This would bring it in line with the Legislature's current requirement that similar tax arrangements have an explicit performance statement. Such a statement would aid future reviews by removing any ambiguity about the Legislature's intent.

Agency Response

STATE OF WASHINGTON

October 1, 2019

TO: Keenan Konopaski, Legislative Auditor
Joint Legislative Audit and Review Committee

FROM: David Schumacher, Director
Office of Financial Management

Vikki Smith, Director
Department of Revenue

SUBJECT: JLARC PRELIMINARY REPORT ON 2019 TAX PREFERENCE PERFORMANCE REVIEWS

The Office of Financial Management and Department of Revenue have reviewed the Joint Legislative Audit and Review Committee's (JLARC) preliminary report on the 2019 tax preference performance reviews.

We appreciate JLARC's thorough analysis and the detailed assessment provided by the Citizen Commission for Performance Measurement of Tax Preferences. A system that provides for a continuous review of state tax preferences is critical to ensure that the state of Washington maintains a fair and equitable tax system.

The Department of Revenue has provided a formal response on the property tax exemption for multifamily housing in urban areas. While we have no specific comments on the other eight preferences in the 2019 preliminary report, we continue to support JLARC's recommendations for the inclusion of performance statements and specific public policy objectives for all tax preferences where they do not exist in statute today.

Thank you for the opportunity to provide comments on this material and the recommendations made by JLARC.

More about 2019 reviews

Audit authority

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

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

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

Timeframe for the study

A preliminary audit report will be presented at the July 2019 JLARC meeting and at the August 2019 meeting of the Commission. A final report will be presented to JLARC in December 2019.

Committee Action to Distribute Report

On December 4, 2019 this report was approved for distribution by the Joint Legislative Audit and Review Committee.

Action to distribute this report does not imply the Committee agrees or disagrees with the Legislative Auditor recommendations.

More about 2019 reviews

Study process

What is a tax preference?

Tax preferences are defined in statute (RCW 43.136.021) 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. Washington has approximately 600 tax preferences.

Why a review of tax preferences?

Legislature creates a process to review tax preferences

In 2006, the Legislature 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 (RCW 43.136).

Statute assigns specific roles to two different entities:

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

Citizen Commission sets the schedule

The Legislature directed the Commission 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 may also exclude preferences from review that the Commission determines are a critical part of the tax structure.

The Commission conducts its reviews based on analysis prepared by JLARC staff. In addition, the Commission may elect to rely on information supplied by the Department of Revenue.

In 2019, JLARC staff reviewed 17 preferences compiled into nine reports (similar preferences may be combined into one report). The Commission's website includes analysis of preferences completed in previous years: See http://www.citizentaxpref.wa.gov/.

JLARC staff's approach to the tax preference reviews

Statute guides the main topics typically covered in the reviews.

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)

JLARC staff's analysis process

JLARC staff carefully analyze a variety of evidence in conducting these reviews:

- Legal and public policy history of the tax preferences.
- Beneficiaries of the tax preferences.
- Government and other relevant data pertaining to the utilization of these tax preferences.
- Economic and revenue impact of the tax preferences.
- Other states' laws to identify similar tax preferences.

Key: understanding the purpose of the preference

The Legislature now requires that any legislation creating a new preference, or expanding or extending an existing preference, must include a tax preference performance statement. The performance statement must contain a statement of legislative purpose as well as metrics to evaluate the effectiveness of the preference (RCW 82.32.808).

Some of the preferences included in this report were passed before the 2013 legislation that requires performance statements. When a preference's purpose or objective is identified in statute, staff are able to affirmatively state the public policy objective. Sometimes the objective may be found in intent statements or in other parts of statute if there is no tax preference performance statement.

When the Legislature did not state the public policy objective of a preference, JLARC staff may be able to infer what the implied public policy objective might be. To arrive at this inferred policy objective, staff review the following:

- Legislative history, including
  - Final bill reports for any statements on the intent or public policy objectives.
  - Bills prior to the final version and legislative action on bills related to the same topic.
  - Bill reports and testimony from various versions of the bill.
  - Records of floor debate.
- Relevant court cases that provide information on the objective.
- Department of Revenue information on the history of tax preferences, including rules, determinations, appeals, audits, and taxpayer communication.
- Press reports during the time of the passage of the bill which may indicate the intention of the preference.
- Other historic documents, such as stakeholder statements, that may address the issue addressed by the tax preference.

JLARC staff also interview the agencies that administer the tax preferences or are knowledgeable of the industries affected by the tax. Agencies may 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.

If there is sufficient information in this evidence to infer a policy objective, JLARC staff state that in the reviews. In these instances, the purpose may be a more generalized statement than when there is explicit statutory language.

More about 2019 reviews

Contact information

JLARC staff members

Dana Lynn, **Research Analyst** - 360-786-5177

Rachel Murata, **Research Analyst** - 360-786-5293

Pete van Moorsel, **Research Analyst** - 360-786-5185

Eric Whitaker, **Research Analyst** - 360-786-5618

Zack Freeman, **Research Analyst** - 360-786-5179

Josh Karas, **Research Analyst** - 360-786-5298

Aaron Cavin, **Research Analyst** - 360-786-5194

Eric Thomas, Audit Coordinator

Keenan Konopaski, Legislative Auditor

JLARC members on publication date

Senators
Bob Hasegawa
Mark Mullet, *Chair*
Rebecca Saldaña
Shelly Short
Dean Takko
Lynda Wilson, *Secretary*
Keith Wagoner

Representatives
Jake Fey
Noel Frame
Larry Hoff
Christine Kilduff
Vicki Kraft
Ed Orcutt, *Vice Chair*
Gerry Pollet, *Assistant Secretary*
Drew Stokesbary

Citizen Commission for Performance Measurement of Tax Preferences

Voting members
Dr. Grant D. Forsyth
Ronald L. Bueing
Diane Lourdes Dick
Dr. Justin Marlowe
Andi Nofziger-Meadows

Non-voting members
Mark Mullet, JLARC Chair
Pat McCarthy, State Auditor

Washington Joint Legislative Audit and Review Committee

106 11th Avenue SW, Suite 2500
PO Box 40910
Olympia, WA 98504-0910

Phone: 360-786-5171
Fax: 360-786-5180
Email: JLARC@leg.wa.gov