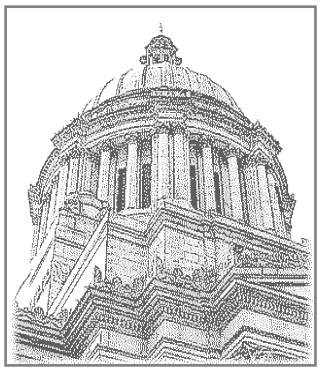
STATE OF WASHINGTON

CITIZEN COMMISSION FOR PERFORMANCE MEASUREMENT OF TAX PREFERENCES



COMMISSION MEMBERS

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

Lily Kahng, *Vice Chair*
Seattle University Law School

James Bobst
Pacific Fibre Products, Inc.

Paul Guppy
Washington Policy Center

Stephen B. Miller
Washington Education Association

NON-VOTING MEMBERS

Craig Pridemore, State Senator
Chair, Joint Legislative Audit and Review Committee

Brian Sonntag
State Auditor

Citizen Commission for
Performance Measurement of Tax Preferences

1300 Quince St. SE
Olympia, WA 98504-0910
(360) 786-5171
(360) 786-5180 Fax

www.citizentaxpref.wa.gov

AGENDA

Monday, August 15, 2011
2:00 p.m.
John A. Cherberg Bldg.
Senate Hearing Rm. 3
Olympia, WA

1a. Other Commission Business

- Introduction of New Commission Member

*1b. Approval of May Meeting Minutes

1c. JLARC Staff Reports

- Introduction of New JLARC Staff Member
- Recap of Legislative Actions on Prior Reviews

2011 Reviews

2. 2011 Tax Preference Reviews – Preliminary Report

2012 Reviews

3. Preliminary 2012 Tax Preference Review Schedule

General public comment period immediately following regular Commission business.

Please note that the Commission will focus at the August 15 meeting on the JLARC staff presentation of the 2011 Tax Preference Performance Reviews. The Commission is scheduled to hear public testimony on the 2011 reviews at its September 23 meeting.

* *Action Item*

The Commission reserves the right to move agenda items as needed.

State of Washington

Citizen Commission for Performance Measurement of Tax Preferences

E-mail: lisa.hennessy@leg.wa.gov
www.citizentaxpref.wa.gov

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Rep. Troy Kelley
Chair, Joint Legislative Audit and Review Committee

Brian Sonntag
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Citizen Commission for Performance Measurement of Tax Preferences
Meeting Minutes

May 20, 2011
John A. Cherberg Bldg.,
Senate Hearing Rm. 3
Olympia, WA

Members Present:

William A. Longbrake	Lily Kahng
James Bobst	Paul Guppy
Stephen Miller	

Members Absent:

Rep. Troy Kelley	Brian Sonntag

Staff:

Keenan Konopaski	John Woolley
Mary Welsh	Curt Rogers
Dana Lynn	Peter Heineccius
Cindy Evans	Suzanne Kelly
Lisa Hennessy	John Bowden

WELCOME / INTRODUCTIONS

Commission Chair Bill Longbrake welcomed those in attendance and called the meeting to order at 2:05 p.m.

APPROVAL OF MEETING MINUTES

MOTION: A motion was made to approve the October 15, 2010, meeting minutes.

The motion was seconded and carried.

OTHER BUSINESS

Chair Longbrake recognized Legislative Auditor, Keenan Konopaski, who is new to the position since the Commission's last meeting in October.

Chair Longbrake recognized outgoing JLARC Chair, Rep. Troy Kelley.

MOTION: A motion was made recognizing Rep. Kelley and thanking him for his service to the Commission.

The motion was seconded and carried.

DRAFT

The Commission discussed changing the dates of the August and October, 2011, meetings, as some Members are not available for those currently scheduled.

MOTION: A motion was made to reschedule the August, 2011, meeting from August 19 to August 15, and to reschedule the October, 2011, meeting from October 14 to October 11.

The motion was seconded and carried.

Chair Longbrake reported that he had recently met with the Editorial Board of the Kitsap Sun (Bremerton) regarding the Commission's work. He also made available an article from The Seattle Times regarding the "chicken-bedding" tax exemption that mentioned the Commission.

STAFF REPORTS

Keenan Konopaski introduced Deputy Legislative Auditor, John Woolley, also new to the position since the Commission's last meeting.

John Woolley briefed the Commission on bills that had passed to date in the 2011 Legislative Session with impacts for tax preference reviews. There is one bill implementing Task Force on Tax Preference Reform recommendations; four bills adding tax preferences; and two bills impacting 2011 tax preference reviews. In addition there was a bill introduced to change the two-thirds vote threshold required for terminating a tax preference, but this bill had not passed the Legislature.

ADJUSTMENTS TO THE 2011 REVIEW SCHEDULE

Keenan Konopaski presented adjustments to the 2011 Tax Preference Review Schedule. The Commission discussed the adjustments.

MOTION: A motion was made to adopt changes to the 2011 Tax Preference Review Schedule:

- move the International Banking Facilities preference to an Expedited Light review,
- move the Motion Picture preference to an Expedited Light review, and
- move the Limited Income Property Tax Deferral to a Full review.

The motion was seconded and carried.

2011 EXPEDITED LIGHT REPORT AND ADDITIONAL INFORMATION ON SELECTED TAX PREFERENCES

Keenan Konopaski gave the Commission an overview of the 2011 Expedited Light Tax Preference Report and the additional information requested by the Commission and provided by the Department of Revenue (DOR). The Commission discussed 2011 Expedited Light Tax Preferences and the information provided by DOR. DOR representative, Gary Grossmann, was present to answer questions.

Keenan Konopaski mentioned that the Commission has the option to adopt comments on the Expedited Light Report along with the Expedited and Full Tax Preference Reports.

2012 LIST OF REVIEWS

Keenan Konopaski, John Woolley, and Mary Welsh discussed possible revisions to the 10-Year Review Schedule in light of new legislation (SB 5044), and provided information about the preferences scheduled for review in 2012. Mary Welsh explained that SB 5044 provides for changes to the tax preference review process. The new law gives the Commission greater flexibility in selecting preferences to be reviewed, such as grouping preferences by industry type, economic sector, or policy area. It also gives JLARC staff greater flexibility in selecting questions to answer in tax preference reviews.

The Commission discussed various aspects of SB 5044, including using an economic model developed by the Office of Financial Management (OFM) for addressing a new question regarding economic development incentives. Lorrie Brown and Ta-Win Lin, from OFM, were present to answer questions pertaining to their model.

Mary Welsh presented a list of 59 tax preferences proposed by JLARC for review in 2012. She also presented a preview of these preferences using DOR Exemption Study information. Ms. Welsh indicated that JLARC has the capacity to evaluate 22 of the 59 tax preferences; reviews by the Commission of the remaining preferences would be based solely on DOR information. Any additions made by the Commission to the list of 22 suggested by the JLARC staff would require removing another preference from the list, so that the total number of preferences evaluated by JLARC does not exceed 22.

Ms. Welsh offered next steps for the Commission in developing the 2012 Review Schedule: 1) consider the 2012 schedule as proposed; 2) submit any requests for more information from DOR by May 31 (JLARC will forward requests to DOR), as well as proposed revisions to the schedule; 3) an opportunity to ask questions of DOR at the August 15 meeting; and 4) approve the 2012 10-Year Review Schedule at the September 23 meeting.

The Commission discussed the list of tax preferences for review in 2012. The Commission agreed to consider the list as proposed by JLARC staff, and submit any requests for additional information and/or proposed revisions to JLARC by May 31.

PUBLIC COMMENT

Dick Nelson provided public comment pertaining to the review of tax preferences.

With no further public comment or Commission discussion, the meeting was adjourned at 3:45 p.m.

Recap of Legislative Actions on Prior Reviews - As of July 2011

2007, 2008, 2009 and 2010 Studies

Implementation of JLARC's recommendations

JLARC Recommendation	Implemented	Bill introduced, but not enacted	Allowed to expire	No action required	No action taken	Total
Allow to expire			5	4**		9
Continue			2	56		58
Continue and modify expiration date	2					2
Re-examine or Clarify		16	1		4	21
Terminate		3			2	5
Total	**2**	**19**	**8**	**60**	**6**	**95**

*Preferences with expiration date in the future

For 7 of the 95 reviews, the Commission adopted a different recommendation than JLARC:

Implementation of Commission's recommendations

Study Title	Commission Recommendation	Implemented	Bill Introduced, but Not Enacted	Allowed to Expire	No Action Taken
Instate portion of interstate transportation	Re-examine or clarify				1
Intangibles	Re-examine or clarify		1		
Janitorial Services	Terminate				1
Kidney Dialysis, Nursing Homes, and Hospice	Terminate		1		
Through freight in interstate transportation	Re-examine or clarify				1
Tuition and Fees	Re-examine or clarify				1
Wood Biomass Fuel: Production Facilities/ Sales / Distribution	Re-examine or clarify			1	

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

2011 Tax Preference Performance Reviews

Preliminary Report

Revised August 1, 2011

Upon request, this document is available in alternative formats for persons with disabilities.

Joint Legislative Audit and Review Committee

1300 Quince St SE

PO Box 40910

Olympia, WA 98504

(360) 786-5171

(360) 786-5180 Fax

www.jlarc.leg.wa.gov

Committee Members

Senators

Nick Harper

Jeanne Kohl-Welles

Sharon Nelson

Janéa Holmquist Newbry

Linda Evans Parlette, *Secretary*

Cheryl Pflug

Craig Pridemore, *Chair*

Joseph Zarelli

Representatives

Gary Alexander, *Vice Chair*

Cathy Dahlquist

Kathy Haigh, *Assistant Secretary*

Troy Kelley

Mark Miloscia

Ed Orcutt

Derek Stanford

Hans Zeiger

Legislative Auditor

Keenan Konopaski

Audit Authority

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

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

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

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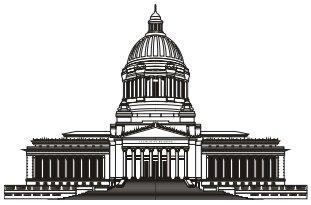
2011 Tax Preference Performance Reviews

Preliminary Report

July 20, 2011



STATE OF WASHINGTON
JOINT LEGISLATIVE AUDIT AND REVIEW COMMITTEE

STUDY TEAM
Mary Welsh
Dana Lynn
Peter Heineccius
John Bowden

PROJECT SUPERVISOR
John Woolley

LEGISLATIVE AUDITOR
Keenan Konopaski

Copies of Final Reports and Digests are available on the JLARC website at:

www.jlarc.leg.wa.gov

or contact

Joint Legislative Audit & Review Committee
1300 Quince St SE
Olympia, WA 98504-0910
(360) 786-5171
(360) 786-5180 FAX

REPORT SUMMARY

What Is a Tax Preference?

Tax preferences are exemptions, exclusions, or deductions from the base of a state tax; a credit against a state tax; a deferral of a state tax; or a preferential state tax rate. Washington has nearly 590 tax preferences.

Why a JLARC Review of Tax Preferences?

Legislature Creates a Process to Review Tax Preferences

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

Citizen Commission Sets the Schedule

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

In October 2010, the Commission adopted its fifth ten-year schedule for the tax preference reviews. This volume includes reviews of a total of 25 tax preferences under the business and occupation tax, sales tax, use tax, property tax, aircraft fuel tax, and the real estate excise tax.

JLARC's Approach to the Tax Preference Reviews

JLARC's assignment from EHB 1069 is to conduct the reviews of tax preference according to the schedule developed by the Commission and consistent with the guidelines set forth in statute. The reviews are conducted independently by JLARC staff.

Preferences with a Fiscal Impact Greater than $10 Million

For tax preferences with an estimated biennial fiscal impact of greater than $10 million, JLARC staff evaluated the tax preferences using a set of ten 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))

Other States:

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

Preferences with a Fiscal Impact Between $2 and $10 Million

For the tax preferences with estimated fiscal impacts between $2 and $10 million, JLARC evaluated the tax preferences using a set of four questions.

Public Policy Objectives:

1. What are the public policy objectives that provide a justification for the tax preference? Is the purpose or intent of the tax preference clear?
2. Is there any readily available evidence related to the achievement of any of these public policy objectives?

Beneficiaries:

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

Revenue and Economic Impacts:

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

Forty-three preferences with an estimated impact of less than $2 million are presented in a separate document, based on information compiled by the Department of Revenue

Methodology

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

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

Staff interviewed the agencies that administer the tax preferences or are knowledgeable of the industries affected by the tax (the Department of Revenue, the Department of Licensing, the Department of Transportation, and the Department of Financial Institutions). These parties provided data on the value and usage of the tax preference and the beneficiaries. JLARC staff also obtained data from other state and federal agencies to which the beneficiaries are required to report.

Summary of the Results from JLARC's Reviews

The table beginning on page 5 provides a summary of the recommendations from JLARC's analysis of the tax preferences scheduled for review in 2011. Of the 25 tax preferences included in this volume, this report recommends the Legislature:

- Terminate one tax preference;
- Allow two tax preferences to expire;
- Review and/or clarify the intent of eight tax preferences; and
- Continue 14 tax preferences.

Organization of This Report

The report begins with a summary of all 25 preferences, presented in alphabetical order. More detailed information is then presented for each preference. For those accessing the information electronically, a link is provided with each summary to "jump" to the detailed analysis. The current appendices provide the Scope and Objectives and the text of current law for each preference.

Summary of 2011 Tax Preference Performance Reviews

What the Preference Does	Public Policy Objective	Estimated Beneficiary Savings	JLARC Recommendation
Aircraft Fuel Tax, Export and Commercial Use (Aircraft Fuel Tax) / 82.42.030; 82.42.070			Detail on page 19
Exempts certain purchases of aircraft fuel from aircraft fuel tax.	The Legislature did not specifically state the public policy objectives of the preferences. JLARC infers two possible objectives: 1) To structure the preferences so the parties that benefited from the expenditure of aircraft fuel tax receipts were the ones that paid the tax. 2) To comply with U.S. Constitutional prohibitions on taxing goods in interstate or foreign commerce and taxing the federal government.	$299.9 million in 2011-13 Biennium	**Review and clarify**: Because parties that currently are exempt from paying the aircraft fuel tax benefit from the expenditures of fuel tax receipts.
Boat Sales to Nonresidents/Foreign Residents (Sales Tax) / 82.08.0266; 82.08.02665			Detail on page 31
Provides sales tax exemptions to residents from other states and countries when they purchase and take possession of boats in Washington.	The Legislature did not specifically state the public policy objectives of the preferences. The implied intent is to support sales of boats in Washington by removing a disincentive for nonresidents and foreign residents to purchase and take possession of boats in-state.	$13.7 million in 2011-13 Biennium	**Continue**: Because the preferences are meeting the implied public policy objective of removing a disincentive for nonresidents to purchase and take delivery of boats in Washington.

Summary of 2011 Tax Preference Performance Reviews

What the Preference Does	Public Policy Objective	Estimated Beneficiary Savings	JLARC Recommendation
Church Camps (Property Tax) / 84.36.030(2)			Detail on page 45
Exempts from property tax camps owned by nonprofit churches, denominations, or organizations whose membership is comprised of churches.	The Legislature did not specifically state the public policy objective of the preference. JLARC infers two public policy objectives: 1) To ensure that church camps conducted for sectarian purposes are treated consistently for tax purposes with nonprofit camps conducted for nonsectarian purposes. 2) The Legislature may have wanted to support church camps in the same manner it has supported other nonprofit organizations that provide social services to youth.	$6.9 million in 2011-13 Biennium	**Continue**: Because the preference is fulfilling the implied public policy objective of ensuring that church camps are being treated consistently for tax purposes with nonsectarian camps.
Display Items for Trade Shows (Use Tax) / 82.12.0272			Detail on page 53
Provides a use tax exemption for personal property used by businesses (not in excess of 30 days) at a single trade show to promote sales of products or services.	The Legislature did not specifically state the public policy objective of the preference. Historic documents imply the preference was intended to remove a potential disincentive for vendor participation in trade shows held in Washington.	$5 million in 2009-11 Biennium per DOR (JLARC unable to determine)	**Continue**: Because the preference is meeting the implied public policy objective of removing a potential disincentive for vendor participation in trade shows held in Washington.

Summary of 2011 Tax Preference Performance Reviews

What the Preference Does	Public Policy Objective	Estimated Beneficiary Savings	JLARC Recommendation
Extracted Fuel (Use Tax) / 82.12.0263			Detail on page 59
Provides a use tax exemption for fuel produced by an extractor/manufacturer during extracting or manufacturing activities, when the fuel is used by the producer directly in the same extracting or manufacturing activity.	The Legislature did not specifically state the public policy objective of the preference. JLARC infers two possible objectives: 1) The Legislature wanted to generally apply a use tax to byproducts but did not want to contradict a state Supreme Court decision, so it provided a limited use tax exemption. 2) The Legislature wanted to provide a tax preference to certain extractors/manufacturers to support those industries, so it structured the preference narrowly. A court decision made shortly before the Legislature created the preference in 1949 dealt with the taxability of a wood product manufacturer. However, the majority of the beneficiary savings now appear to be realized by oil refineries.	$69.2 million in 2011-13 Biennium	**Review and clarify**: Because the public policy objective and intended beneficiaries are unclear.
Hog Fuel to Produce Energy (Sales & Use Tax) / 82.08.956; 82.12.956			Detail on page 71
Provides sales and use tax exemptions for hog fuel used to produce electricity, steam, heat, or biofuel.	The Legislature did not specifically state a public policy objective for these preferences; however, it did make the preferences temporary. Because of the sharp declines in oil and natural gas prices occurring at the time that the preferences were enacted, JLARC infers that the Legislature may have intended to temporarily make the price of hog fuel more competitive.	$3.2 million in 2011-13 Biennium	**Allow to expire**: Because the Legislature intended the exemptions to be temporary and did not provide performance goals to guide any other assessment of performance.

Summary of 2011 Tax Preference Performance Reviews

What the Preference Does	Public Policy Objective	Estimated Beneficiary Savings	JLARC Recommendation
Interest from State and Municipal Obligations (Business & Occupation Tax) / 82.04.4293			Detail on page 79
Provides a B&O tax deduction to financial businesses for gross income received as interest from state and municipal government obligations.	The Legislature did not specifically state the public policy objective of the preference. JLARC infers that the public policy objective is to provide consistent tax treatment for interest income from all forms of government obligations.	$1.8 million in 2011-13 Biennium	**Continue**: Because the implied public policy objective of ensuring that tax treatment is consistent for interest from state, municipal, and U.S. government obligations is being achieved.
Interest on Real Estate Loans (Business & Occupation Tax) / 82.04.4292			Detail on page 85
Provides a B&O tax deduction to banks and other financial businesses for interest derived from investments or loans primarily secured by first mortgages or trust deeds on non-transient residential properties in Washington.	The Legislature did not specifically state the public policy objective of the preference. Documents from the period of enactment suggest the original purpose was to encourage Washingtonians to buy homes by making loans more available and less expensive.	$172.6 million in 2011-13 Biennium	**Review and clarify**: Because it is unclear whether the original public policy objective applies, given changes in the lending industry and the rise in the secondary mortgage market.
Interstate Bridges (Property and Other Taxes) / 84.36.230			Detail on page 97
Provides an exemption from Washington property taxes and all other state taxes to other states for bridges and bridge approaches over rivers or bodies of water forming interstate boundaries.	The Legislature did not specifically state the public policy objective of the preference. The implied public policy objective is to avoid paying Oregon property taxes on Washington-owned interstate bridges by exempting Oregon-owned bridges.	$29 million in 2011-13 Biennium	**Continue**: Because Oregon is not currently taxing Washington on Washington-owned bridges.

Summary of 2011 Tax Preference Performance Reviews

What the Preference Does	Public Policy Objective	Estimated Beneficiary Savings	JLARC Recommendation
Investment of Businesses in Related Entities (Business & Occupation Tax) / 82.04.4281(1)(b),(c)			Detail on page 105
Provides a B&O tax deduction for two types of investments in related entities: 1) Dividends and distributions paid by subsidiaries to parent entities; and 2) Interest on loans between certain affiliated entities if the total investment and loan income is less than 5 percent of gross receipts of the parent business annually.	The Legislature did not specifically state the public policy objective of the preference. However, by adopting the preference, the Legislature indicated it wanted to exempt income earned by a business from investing in its own subsidiaries and in intercompany loans. These investments are not considered engaging in business for B&O tax purposes.	$14.4 million in 2011-13 Biennium	**Continue**: Because the preference is meeting the implied public policy objective of not treating income from intercompany investments in affiliates as a business activity.
Laundry Services for Nonprofit Health Care Facilities (Sales Tax) / 82.04.050(2)(a)			Detail on page 113
Provides a sales tax exemption to nonprofit health care facilities for purchases of laundry services.	The Legislature did not specifically state the public policy objective of the preference. When enacted, the preference provided a specific, targeted sales tax exemption for cooperative nonprofit associates formed by nonprofit hospitals to operate a central laundry facility for hospital members. Documents from this time note the purpose was to reduce member hospitals' laundry costs and assure a standard of laundry quality and cleanliness. JLARC infers the public policy purpose for the 1998 expansion of the preference was to reduce the cost of outsourced laundry services for all nonprofit health care facilities.	$8.8 million in 2011-13 Biennium	**Continue**: Because the implied public policy objective of reducing costs for outsourced laundry services for nonprofit health care facilities is being achieved.

Summary of 2011 Tax Preference Performance Reviews

What the Preference Does	Public Policy Objective	Estimated Beneficiary Savings	JLARC Recommendation
Limited Income Property Tax Deferral (Property Tax) / 84.37.030			Detail on page 119
Allows taxpayers with less than $57,000 of disposable income to defer one half of the property taxes or special assessments due on their primary place of residence.	The Legislature stated in the enacting legislation that the intent of the preference is to: "(a) provide a property tax safe harbor for families in economic crisis; and (b) prevent existing homeowners from being driven from their homes because of overly burdensome property taxes."	$270,891 in 2009-11 Biennium (to be repaid with interest)	**Review and clarify**: Because the intended beneficiaries of this preference are not clear in light of the recent economic recession, the Legislature should clarify the preference to define "families in economic crisis" and identify measurable evaluation criteria.
Meat Processors (Business & Occupation Tax) / 82.04.260(4)			Detail on page 133
Provides a preferential B&O tax rate to businesses that slaughter, break, or process perishable meat products, and wholesalers of perishable meat products.	The Legislature did not specifically state the public policy objective of the preference. Historic documents and legislative action suggest two implied policy objectives: 1) To lower costs for meat packing businesses for the purpose of allowing Washington to compete favorably with competitor states and to retain these industries in the state. 2) To treat Washington food processors consistently under the tax law. Initiative 1107 stated a public policy objective similar to the Legislature's purpose to allow meat processors to compete. The Initiative repealed legislation that would have provided more consistent tax treatment of Washington food processors.	$30.5 million in 2011-13 Biennium	**Review and clarify**: Because it is unclear what the public purpose is for providing differential tax treatment of meat processors compared to other food processors.

Summary of 2011 Tax Preference Performance Reviews

What the Preference Does	Public Policy Objective	Estimated Beneficiary Savings	JLARC Recommendation
Municipal Sewer Charges (Business & Occupation Tax) / 82.04.432			Detail on page 145
Provides municipalities/cities a B&O tax deduction for amounts paid to other cities or governmental entities for sewage transfer, treatment, or disposal services they provide.	The Legislature did not specifically state the public policy objective of the preference. A Department of Revenue report states the preference's purpose was to eliminate taxing both the collection and the transfer/treatment/disposal of sewage when multiple utilities are involved in providing sewer services.	$3 million in 2011-13 Biennium	**Review and clarify**: Because it is unclear whether the purpose of the preference is to only avoid the pyramiding effect of the B&O tax or to completely eliminate taxation of sewage transfer, treatment, and disposal activities.
Nonprofit Blood and Tissue Banks (Property Tax) / 84.36.035			Detail on page 151
Exempts blood and tissue banks and their administrative offices from property tax.	The Legislature did not specifically state the public policy objective of the preference. Based on the legal history of how the taxation of hospital-like services has evolved, the implied public policy objective is to provide support for organizations that: are nonprofit benevolent and charitable entities, and provide services traditionally performed in hospitals, but that are now performed outside the hospital setting.	$6.1 million in 2011-13 Biennium	**Continue**: Because the exemption for blood and tissue banks is consistent with the public policy objective to reduce costs for nonprofit organizations performing hospital-like services.
Nonprofit Day Care Centers (Property Tax) / 84.36.040(1)(a)			Detail on page 159
Exempts licensed nonprofit child day care centers from property tax.	The Legislature did not specifically state the public policy objective of the preference. JLARC infers the public policy objective is to support nonprofit organizations that provide social services to children and youth, consistent with long-standing legislative policy.	$15.8 million in 2011-13 Biennium	**Continue**: Because the preference is meeting the implied public policy objective of supporting nonprofit organizations that provide social services for youth.

Summary of 2011 Tax Preference Performance Reviews

What the Preference Does	Public Policy Objective	Estimated Beneficiary Savings	JLARC Recommendation
Nonprofit Sheltered Workshops (Property Tax) / 84.36.350			Detail on page 167
Provides a property tax exemption for property owned and leased by nonprofit sheltered workshops for people with disabilities.	The Legislature did not specifically state the public policy objective of the preference. JLARC infers that the original public policy objective was to encourage employment of persons with disabilities in sheltered workshops. However, government social services laws are now intended to encourage employment of persons with disabilities in supported work environments, particularly in work settings along with persons without disabilities.	$ 4.4 million in 2011-13 Biennium	**Review and clarify**: Because public policy related to employment of people with disabilities has changed from the time the tax preference was enacted.
Open Space Additional Tax (Property Tax) / 84.34.108(6)			Detail on page 175
Provides certain exemptions to the additional tax owed when an owner removes private property from an "open space" designation (referred to as the Current Use Program).	The Legislature did not specifically state the public policy objective of the preference. JLARC infers that the Legislature intended to avoid penalizing owners in certain circumstances: 1) For circumstances beyond the control of the owner; 2) Where the change in use is compatible with the purpose of the Current Use Program; and 3) Where the property becomes fully exempt from property taxation upon transfer to a church or upon qualifying under a new property exemption.	$3.9 million in 2011-13 Biennium	**Continue**: Because the preference is achieving the implied public policy objective of avoiding penalizing property owners that remove property from current use under certain circumstances.

Summary of 2011 Tax Preference Performance Reviews

What the Preference Does	Public Policy Objective	Estimated Beneficiary Savings	JLARC Recommendation
Real Estate Excise Tax Exemptions (Real Estate Excise Tax) / 82.45.010(3)(a)-(m)			Detail on page 183
The preferences specifically exclude 13 types of property transfers or sales from the definition of a taxable "sale" for real estate excise tax purposes.	The Legislature did not specifically state the public policy objective of the preference. JLARC assumes these exclusions from the definition of what is a taxable "sale" for real estate excise tax purposes may function to define the tax and its base.	$1.4 billion in 2011-13 Biennium	**Continue**: Because the preferences are meeting the implied public policy objective of defining the tax base for application of the real estate excise tax.
Renewable Energy Machinery (Sales & Use Tax) / 82.08.962; 82.12.962			Detail on page 197
Provides sales and use tax exemptions for renewable energy machinery and equipment used directly in generating electricity from wind, sun, fuel cells, biomass energy, tidal or wave energy, geothermal resources, anaerobic digestion, and technology that converts otherwise lost energy from exhaust, or landfill gas into electricity.	The Legislature did not specifically state the public policy objective of these preferences; however, it did make the preferences temporary. JLARC infers that the Legislature's public policy objective was to encourage and support generation of electricity using renewable energy sources on a temporary basis.	$40.8 million in 2011-13 Biennium	**Allow to expire**: Because the Legislature intended the exemptions to be temporary and did not provide performance goals to guide any other assessment of performance.

Summary of 2011 Tax Preference Performance Reviews

What the Preference Does	Public Policy Objective	Estimated Beneficiary Savings	JLARC Recommendation
Repaired Goods Delivered Out-of-State (Sales Tax) / 82.08.0265			Detail on page 211
Provides a sales tax exemption to nonresidents for: materials that become a component part of items repaired, installed, cleaned, altered, or improved; and labor charges for items repaired, installed, cleaned, or altered	The Legislature did not specifically state the public policy objective of the preference. The implied public policy objective was to remove the disincentive created by the sales tax in order to make Washington merchants who repair, clean, install, etc., items for nonresidents more competitive with business in neighboring states.	$0 in 2011-13 Biennium	**Terminate**: Because Washington's adoption of destination-sourcing for sales tax has made this preference unnecessary.
Sales of Goods to Certain Nonresidents for Use Outside the State (Sales Tax) / 82.08.0273			Detail on page 219
Provides a sales tax exemption on purchases of certain goods for use outside the state to nonresidents from states, possessions, or territories of the U.S. or Canadian provinces or territories that do not impose a sales, use, value-added or similar tax at a rate of 3 percent or more.	The Legislature did not specifically state the public policy objective of the preference. JLARC infers that the preference was intended to support Washington retailers by removing a disincentive for residents of states with a sales tax of less than 3 percent to purchase goods in Washington.	$58 million in 2011-13 Biennium	**Continue**: Because the preference is meeting its implied public policy objective of removing a disincentive for residents from states with a sales tax of less than 3 percent to purchase goods in Washington.

Summary of 2011 Tax Preference Performance Reviews

What the Preference Does	Public Policy Objective	Estimated Beneficiary Savings	JLARC Recommendation
Sales or Use Tax Paid in Another State (Use Tax) / 82.12.035			Detail on page 233
Provides a use tax credit against sales and use tax owed in Washington on tangible personal property or certain services for the amount of "legally imposed" sales or use tax paid to another state, possession, territory, or commonwealth of the U.S. or any political subdivision of such, or any foreign country.	The Legislature did not specifically state the public policy objective of the preference. However, the preference is linked to Washington's membership in the Multistate Tax Commission and the Legislature's passage of the Multistate Tax Compact in 1967. Both of these actions were undertaken to provide a structure for states to work cooperatively on multistate tax issues and to avoid duplicative taxation of multistate taxpayers.	$1million in 2009-11 Biennium	**Continue**: Because the tax preference is meeting its implied objective of avoiding duplicative taxation to multistate taxpayers.
Shared Real Estate Commissions (Business & Occupation Tax) / 82.04.255			Detail on page 241
Removes B&O pyramiding by providing real estate brokers participating in the closing of a real estate sale to pay B&O tax on their share of commissions. Also exempts sales agents if the broker has paid tax.	The Legislature did not specifically state a public policy objective for this preference. The Legislature, through its actions, demonstrated that it did not want to impose the "pyramiding" effect of the B&O tax on the commission shared with real estate agents and with other real estate firms. It is not clear why the Legislature provided a tax preference to the real estate industry and not to other businesses with similar broker-agent and cooperating broker relationships.	$36 million in 2011-13 Biennium	**Review and clarify**: Because it is not clear why the Legislature granted a tax preference to real estate brokers and agents and not to other businesses with similar broker-agent and cooperating broker relationships.

Summary of 2011 Tax Preference Performance Reviews

What the Preference Does	Public Policy Objective	Estimated Beneficiary Savings	JLARC Recommendation
State-Chartered Credit Unions (Business & Occupation Tax) / 82.04.405			Detail on page 251
Provides a B&O tax exemption for state-chartered credit unions.	The Legislature did not explicitly state the public policy objective for this preference. JLARC infers the Legislature may have originally had two objectives: 1) To remove an incentive for state-chartered credit unions to become federal credit unions, so that they would remain under state regulation; and 2) To support credit unions because they were originally formed to serve low-income groups underserved by commercial banks.	$60.9 million in 2011-13 Biennium	**Continue**: Because the B&O exemption removes an incentive for state credit unions to become federal credit unions and thus leave the state system of regulation.

AIRCRAFT FUEL TAX, EXPORT AND COMMERCIAL USE (AIRCRAFT FUEL TAX)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**JLARC Recommendation**
Exempts certain purchases of aircraft fuel from aircraft fuel tax.	The Legislature did not specifically state the public policy objectives of the preferences. JLARC infers two possible objectives: 1) To structure the preferences so the parties that benefited from the expenditure of aircraft fuel tax receipts were the ones that paid the tax. 2) To comply with U.S. Constitutional prohibitions on taxing goods in interstate or foreign commerce and taxing the federal government.	$299.9 million in 2011-13 Biennium	**Review and clarify**: Because parties that currently are exempt from paying the aircraft fuel tax benefit from the expenditures of fuel tax receipts.

AIRCRAFT FUEL TAX, EXPORT AND COMMERCIAL USE (AIRCRAFT FUEL TAX)

Report Detail

Current Law

Aircraft fuel tax applies to each gallon of aircraft fuel sold, delivered, or used in aircraft in Washington. These preferences exempt certain purchases in Washington of aircraft fuel from the aircraft fuel tax when the fuel is:

RCW 82.42.030	RCW 82.42.070
• Sold for export • Used by commercial air carriers • Used for aircraft experimental or testing activities • Used by certified air carriers that purchased aircraft in Washington to train crews in-state • Used by local commuter air service provider	• Exported from the state • Imported into state in interstate/foreign commerce and intended to be sold while in interstate/foreign commerce • Purchased by U.S. government or its agencies

See page A3-1 in Appendix 3 for the current statutes, RCW 82.42.030 and RCW 82.42.070.

Legal History

1921 The Legislature adopted a 1 cent per gallon tax on sales of liquid fuel – gas or other fuel for use in internal combustion engines. The tax, as defined in 1921, applied to purchases of fuel for aircraft, as most airplanes used exclusively internal combustion engines to fly until the 1940s.

1923 The Legislature increased the liquid fuel tax rate to 2 cents per gallon and narrowed the tax base to apply to sales of liquid fuel for use in operating motor vehicles on public highways. This exempted fuel used in aircraft from the motor vehicle fuel tax.

1935 The Legislature created the retail sales tax and companion use tax which applied to the sale or use of tangible personal property in Washington. Because fuel falls under the definition of tangible personal property, fuel used in aircraft in Washington became subject to sales or use tax.

1967 The Legislature enacted the Aircraft Fuel Tax Act, imposing a new tax on sales of aircraft fuel at a rate of 2 cents per gallon. The tax was to be collected by every dealer or retail seller of aircraft fuel sold, delivered, or used in Washington. The tax was only to be collected and paid once and was in addition to sales/use tax due on aircraft fuel sold or used in-state.

The Legislature established the Aeronautics Account within the State Treasury and directed that the tax proceeds be deposited into the account. The funds are then appropriated in the budget to the Department of Transportation's Aviation Division. The Aviation Division was to use these funds to support and maintain local airports, maintain state-owned airports, and assist in planning and technical advice.

The Legislature also provided exemptions from the tax for various uses or sales under two statutes:

- RCW 82.42.030:
  - Commercial air carrier use
  - Operating aircraft for testing or experimental purposes
  - Operating aircraft to train crews for an aircraft purchaser
- RCW 82.42.070:
  - Imported into the state in interstate/foreign commerce and intended to be sold while in interstate/foreign commerce
  - Exported from the state
  - Sold to the armed services of the U.S. for export.

Also in 1967, the Legislature enacted a requirement for Washington pilots and other air industry personnel to register with the Department of Transportation and pay a registration fee. Fees were to be deposited into a new Aircraft Search and Rescue, Safety, and Education Account and used for air search and rescue, and safety and education.

1969 The Legislature specified the aircraft fuel tax was to be collected by every distributor of aircraft fuel rather than by the retail seller. "Distributor" was defined as "any person engaged in the sale of aircraft fuel to any dealer."

1971 The Legislature removed the restriction under RCW 82.42.070 that fuel sold to the armed services must be for export. The revised statute provided the exemption to aircraft fuel sold to the U.S. government or any of its agencies.

1982 The Legislature changed the tax rate from 2 cents per gallon to a variable rate to be determined by the Department of Licensing each fiscal half year using a formula detailed in statute. Rates were to remain the same until subsequent calculations required a change. Additionally, the Legislature:

- Clarified the exemption for fuel used to train crews was for aircraft purchasers who were certified air carriers; and
- Added an exemption for fuel used in operating a local service commuter. "Local service commuter" was specifically defined, and charter use did not qualify for the exemption.

1983 The Legislature set a minimum variable aircraft fuel tax rate of 5 cents per gallon.

1989 The Legislature added a new exemption under RCW 82.42.030 for fuel sold for export. This duplicated the exemption for fuel sold for export that was included in the enacting 1967

legislation under RCW 82.42.070. The Legislature also added specific data recording and reporting requirements for export sale exemptions.

2003 The Legislature removed the variable tax rate and established a 10 cents per gallon tax rate.

2005 The Legislature made the following changes:

- Increased the aircraft fuel tax rate to 11 cents per gallon,
- Repealed the requirement for pilots and other air industry personnel to pay a registration fee,
- Repealed the separate aircraft search and rescue, safety, and education account in the general fund, and
- Defined "air carrier" for purposes of the exemption for training crews.

Other Relevant Background

History

During World War II, a number of airfields were built in Washington as part of the national defense effort. After the war, the U.S. military handed most of these back to the local communities to maintain. In Washington, the state created a State Aeronautics Commission to manage general aviation concerns in the state.

In the 1960s, the aviation industry grew beyond just military and commercial users. Nationally, the Federal Aviation Administration (FAA) developed a "National Plan of Integrated Airports" (NPIA) that included several larger Washington airports. These "federal airports" receive FAA funds and resources. For smaller airports, the aircraft fuel tax enacted in 1967 provided a source of funding to help maintain them, as they did not receive FAA funding. Also in 1967, the Aeronautics Commission was integrated into the Washington State Department of Transportation (WSDOT), and renamed the Aviation Division. The Aviation Division's work and responsibilities now include working with the FAA to plan the state's aviation system as part of the national system.

Aircraft Fuel Types

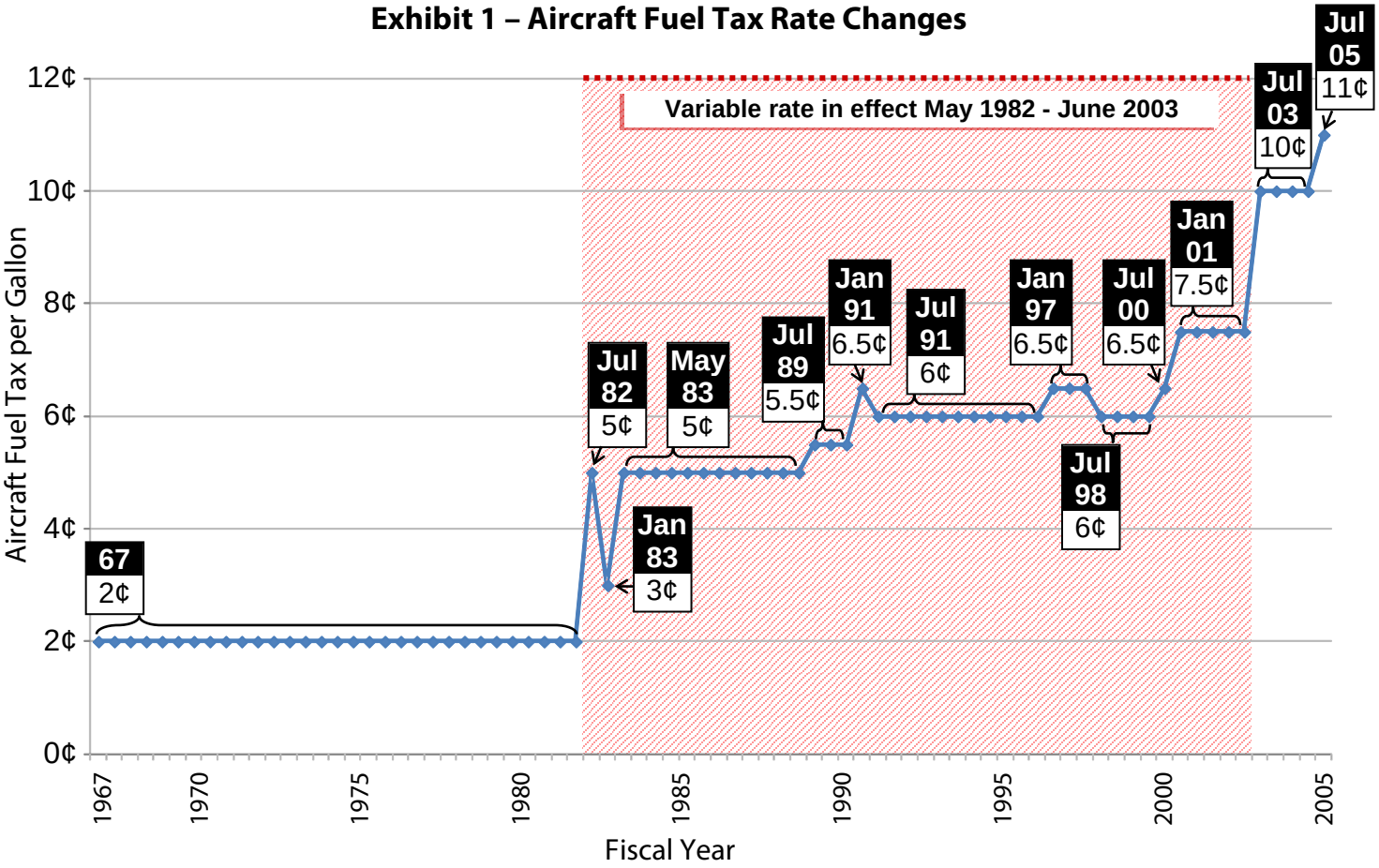
There are two types of aviation fuel: aviation gas and jet fuel. Both fuels are subject to aviation fuel tax. Aviation gas, a derivative of gasoline, has a higher octane and is used by planes with smaller engines. Jet fuel is composed of various diesel fuel mixes and is used by jets with larger engines, as it burns faster and hotter. The type of jet fuel used depends on the performance required or desired from the aircraft, engine size, and other factors. Department of Licensing fuel sale records over a multi-year period reflect that 111 gallons of jet fuel are sold in Washington for every one gallon of aviation gas.

Aviation Fuel Tax General Information

Aircraft fuel tax is generally due and collected by the fuel distributor at the point of sale/distribution to a non-licensed buyer. Aircraft fuel tax is in addition to any sales or use tax owed on the fuel. However, a sales tax exemption is provided under RCW 82.08.0261 for items used in interstate commerce (including aircraft fuel); this preference was previously reviewed by JLARC in 2009. Distributors report their aircraft and jet fuel sales and pay the collected tax to the Department of

Licensing on a monthly basis. The tax proceeds are deposited into the dedicated Aeronautics Fund within the State Treasurer's Office and appropriated in the budget to WSDOT's Aviation Division.

Exhibit 1 – Aircraft Fuel Tax Rate Changes



Source: Department of Revenue 2010 Tax Reference Manual, page 85.

The tax rate started at 2 cents per gallon in 1967 and has remained at 11 cents per gallon since 2005. Exhibit 1 illustrates the applicable tax rate over time.

According to WSDOT, 80 percent of aircraft fuel tax paid in Washington is generated by fuel sales to businesses for use in their aircraft.

Federal and State Funding for Airports

Of Washington's 138 public use airports, 65 are designated as critical to the nation's transportation system and included as part of the National Plan of Integrated Airport System (NPIAS), making them eligible for federal funding. The remaining 73 non-NPIAS airports are primarily small- to medium-sized airports that rely solely on state and local funding.

WSDOT's Aviation Division

WSDOT's Aviation Division is responsible for "protecting and preserving Washington State's 138 public use general aviation airports."[1] "General aviation" means all aviation that is not commercial (regularly scheduled transport of passengers) or military in nature.

Ninety-six percent of the Aviation Division's state funding is from aircraft fuel tax receipts. The Legislature appropriates the funds to the Aviation Division for programs the Division administers, including:

- Airport Aid Grant Program (for all 138 airports)
- Statewide aviation management and support
- State-owned and managed airports (17 airports)
- Statewide aviation system and land use planning (funded through Aviation Division beginning in 1995)
- Statewide air emergency search and rescue services (funded by Aeronautics Fund beginning in 2005)

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 preferences were enacted.

It appears from interviews with Licensing and Legislative staff that the preferences were structured so that the parties that benefited from the expenditure of aircraft fuel tax receipts were the ones that paid the tax. At the time the tax and most of the preferences were enacted, the fund into which the aircraft fuel tax was deposited was mostly used to maintain local public use airports, which are most commonly used by privately owned personal and business aircraft.

An implied second public policy objective associated with the export, import, and federal government exemptions is an effort to comply with U.S. Constitutional prohibitions on taxing goods in interstate or foreign commerce and prohibitions on taxing the federal government.

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

It does not appear that the aircraft excise tax is fulfilling its implied original public policy purpose. The Legislature has expanded the use of the funds generated by the aviation fuel tax, and now additional parties benefit from these expenditures, but do not pay the tax.

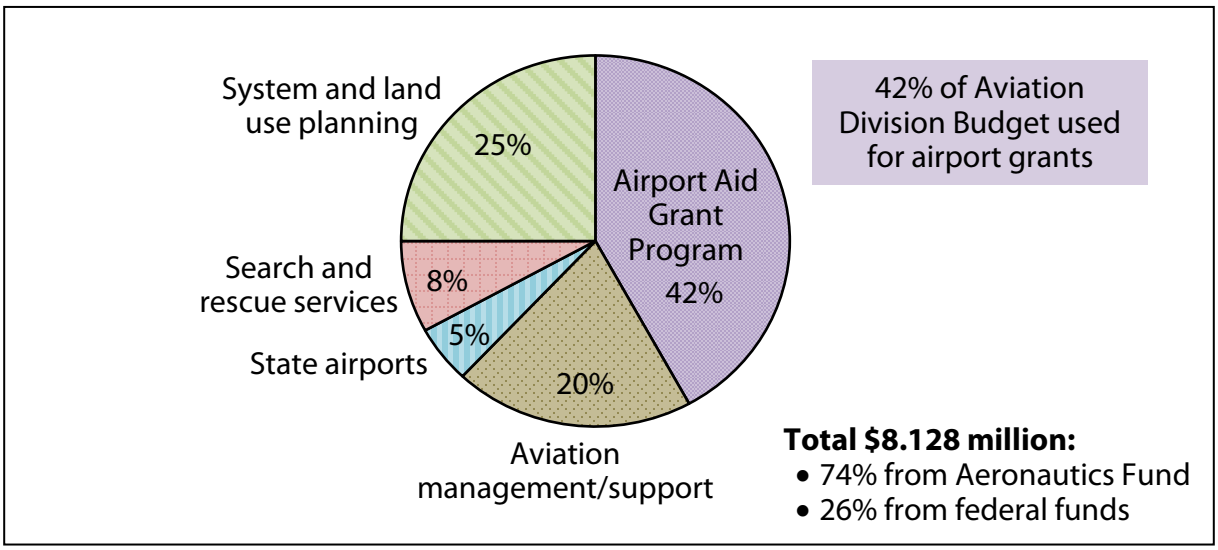
According to WSDOT Aviation budget detail, 42 percent of the Aviation Division's 2009-11 budget expenditures were used for grants to maintain both NPIAS and non-NPIAS airports. (See Exhibit 2, on the following page.) The remaining funding was used to pay for statewide programs that benefit

[1] WSDOT Aviation home page: http://www.wsdot.wa.gov/aviation.

all aviation, as well. These programs include aviation management, state-owned or managed airports, air search and rescue, and land use planning.

Additionally, the dedicated fund is used to pay for programs and WSDOT Aviation responsibilities that it did not fund when it was formed in 1967. These programs, including air search and rescue and air system and land use planning, are funded by the aircraft excise tax. Due to the preferences, the tax is paid by a limited number of fuel users, but the tax proceeds benefit a much larger population. In the case of air search and rescue, the account originally dedicated to fund this program was repealed in 2005. Since then, the services are funded through the Aeronautics Fund.

Exhibit 2 – WSDOT Aviation 2009-2011 Budget Breakdown (Including Federal Funds)



Source: WSDOT Air Transportation Revenue and Expenditure Report to Legislature, 1/25/2011, pg. 13.

The Constitution prohibits states from taxing the federal government or its agencies. In addition, the Commerce and the Import/Export Clauses of the U.S. Constitution limit how states may tax exports and imports from other states and countries. However, it is possible that Washington could tax aircraft fuel if it provided a credit for taxes paid in another state. Thus, the exemptions for exported aircraft fuel in RCW 82.42.030 and RCW 82.42.070 may be written more broadly than necessary to comply with the Commerce Clause of the U.S. Constitution.

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

If one public policy objective was to ensure that those that benefited from the aircraft fuel tax were the ones that paid it, then the preferences no longer appear to meet that public policy objective. Although the programs funded by the aircraft fuel tax have increased since the tax and preferences were enacted, the Legislature has not altered the preferences so that more of the parties that benefit from these various programs actually pay the tax. Currently, the tax is paid only by individual and business aircraft fuel users.

The preferences do meet the second public policy objective of ensuring compliance with the U.S. Constitution. However, the preferences may be broader than necessary for this purpose.

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

Because the aircraft fuel tax is now used to pay for many other programs in addition to maintaining non-NPIAS airports, the Legislature may want to determine if it wants to change the preferences so more of the parties that benefit from aircraft fuel tax proceeds pay the tax that funds these services and programs.

Additionally, the exemptions addressing Constitutional concerns for exported aircraft fuel in RCW 82.42.030 and RCW 82.42.070 may be written more broadly than necessary. The Legislature may be able to narrow these exemptions and still meet Commerce Clause restrictions if it provided a credit for aircraft fuel taxes paid in other states.

Beneficiaries

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

Beneficiaries of the preferences are persons (businesses, individuals, or governments) that do not pay aircraft fuel tax due to the preferences. JLARC found the top beneficiaries for these preferences to be consistent for the periods we examined exemption reporting data (2005 – 2010). These three categories of beneficiaries accounted for an average of 89 percent of all the exempt fuel purchased over a 5-year period. The top three beneficiaries and their cumulative exempt purchases (January through September 2010) are noted in Exhibit 3, below.

Exhibit 3 – Top Beneficiaries of Aircraft Fuel Tax Exemptions in 82.42.030 and 82.42.070

Beneficiaries	Purchases exempt from aircraft fuel tax due to preferences - Jan- Sept 2010 (in millions)	Percentage
Customers purchasing for export from refineries and fuel distributors	$417.7 M	43%
Commercial airlines	$229.0 M	24%
United States government	$202.0 M	21%
All other beneficiaries	$122.8 M	12%
Total	**$971.5 M**	**100%**

Source: JLARC analysis of DOL aircraft fuel tax exemption data, Jan.-Sept. 2010. Data for Oct –Dec 2010 was not available.

The Department of Licensing maintains data on aircraft fuel sales and exempt sales. This information reflects that the yearly average of aircraft fuel gallons sold in Washington over the six-

year period from 2005 through 2010 is 1.5 billion gallons. The average annual percentage of these fuel sales exempted from aircraft fuel tax due to the preferences under review is 96 percent.

To what extent are the tax preferences providing unintended benefits to entities other than those the Legislature intended?

Originally, the aircraft fuel tax and preferences appear to have been structured so that the parties most likely to benefit from the expenditures of the tax receipts were the ones to pay the tax. However, aircraft fuel tax receipts are now used to fund many programs within WSDOT Aviation that provide benefits to parties that do not pay the tax. It is not clear if the Legislature intended these additional programs to benefit those that do not pay the tax.

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 these preferences saved $148.4 million in Fiscal Year 2010 due to the preferences. The estimated savings in the 2011-13 Biennium is $299.9 million. Exhibit 4, below, illustrates these amounts. It should be noted that some of the exemptions included in the total exempt amount are constitutionally prohibited from state taxation, such as some export sales and sales made to the U.S. government or its agencies.

Exhibit 4 – Aircraft Fuel Tax Exemptions – Estimated Beneficiary Savings

FY	Total Exempt Gallons	Aircraft Fuel Tax Exemption
2009	1.3 billion	$137.9 million
2010	1.4 billion	$148.4 million
2011	1.3 billion	$138.5 million
2012	1.3 billion	$146.5 million
2013	1.4 billion	$153.4 million
2011-13 Biennial Total	**2.7 billion**	**$299.9 million**

Source: Actual Exempt Sales for FY09, FY10 from DOL tax exemption data. JLARC estimation for 2011-13 calculated using growth rates in aviation fuel tax from WA Transportation Revenue Forecast council, Table D.3., November 2010.

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?

JLARC cannot determine the overall impact on the economy if the preferences were terminated.

It is unlikely that the preferences for the U.S. government or for imported or exported fuels provided under RCWs 82.42.030 and 82.42.070 could be fully terminated due to constitutional

concerns. For instance, states are constitutionally prohibited from imposing taxes on the U.S. Government or its agencies. However, the exemptions on all imported or exported fuels could likely be narrowed and still be permissible under the Commerce Clause if a credit were provided for fuel taxes paid in other states.

If the other preferences provided under RCW 82.42.030 were terminated, the state would be unlikely to collect all the estimated beneficiary savings. To avoid constitutional concerns, the tax may need to be applied to fuel used in-state, in a manner similar to that used when calculating use tax on aircraft fuel. In 2008, the Department of Revenue estimated that terminating the exemption for aircraft fuel sold to and used by commercial aircraft in Washington would result in revenue of $8.5 million in FY 2011. Additionally, local commuter air businesses would be subject to the tax on their fuel purchases.

Both commercial airlines and local air commuter businesses would need to choose whether to absorb the increase or pass it on to their customers in the form of increased prices.

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

There would be no change in the distribution of liability for payment of the aircraft fuel tax for beneficiaries of the tax preferences. If the preferences were terminated, most of the current beneficiaries, except for the U.S. Government and its agencies, and potentially some exporters, would pay the tax.

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?

There are 38 states that impose a fuel excise tax specifically on aviation gas and/or jet fuel. The tax rate among these states ranges from 1 cent to 23 cents per gallon, with 13 states providing a lower tax rate for jet fuel than for aviation gasoline.

Six of the 38 states entirely exempt fuel used in aircraft from a fuel excise tax. Of the remaining 32 states, several provide preferences for fuel used on international flights or for fuel sold to common carriers and/or the U.S. government.

JLARC found only two states other than Washington (Nebraska and Nevada) that exempt fuel sold for use in interstate commerce. JLARC did not find any other state that exempted fuel sold for testing, experimental, or crew training purposes. However, California exempts fuel sold to persons who manufacture, assemble, maintain, or repair aircraft.

Recommendation

When the Legislature originally enacted the aircraft fuel tax and the related tax preferences, it appears the Legislature structured the preferences so that the parties that benefited from the expenditures of the tax receipts were the ones that paid the tax. Now, additional parties benefit

from the expenditures, but do not pay the tax. Also, while the preferences meet the public policy objective of ensuring compliance with the U.S. Constitution, they may be broader than is necessary for this purpose.

Because parties that are exempt from paying the aircraft fuel tax now benefit from the expenditures of fuel tax receipts, the Legislature should review and clarify the preferences to determine whether more of the parties that benefit from the expenditures should pay the tax.

Legislation Required:	Yes
Fiscal Impact:	Possibly

BOAT SALES TO NONRESIDENTS/FOREIGN RESIDENTS (SALES TAX)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**JLARC Recommendation**
Provides sales tax exemptions to residents from other states and countries when they purchase and take possession of boats in Washington.	The Legislature did not specifically state the public policy objectives of the preferences. The implied intent is to support sales of boats in Washington by removing a disincentive for nonresidents and foreign residents to purchase and take possession of boats in-state.	$13.7 million in 2011-13 Biennium	**Continue**: Because the preferences are meeting the implied public policy objective of removing a disincentive for nonresidents to purchase and take delivery of boats in Washington.

BOAT SALES TO NONRESIDENTS/FOREIGN RESIDENTS (SALES TAX)

Report Detail

Current Law

These preferences provide sales tax exemptions to residents from other states (nonresidents) (RCW 82.08.0266) and to foreign residents (RCW 82.08.02665) when they take possession of boats in Washington, so long as the watercraft:

- Requires Coast Guard registration or registration in the state of principal use per the Federal Boating Act of 1958 (for U.S. residents only);
- Is removed from Washington within 45 days after delivery is taken;
- Is purchased by a nonresident with identification proving residence and providing an exemption certificate; and
- Is for use outside the state.

Retail sales tax applies to sales of tangible personal property, including watercraft, to consumers when delivery is made in Washington. Without these preferences, watercraft purchased by nonresidents in Washington would be subject to sales tax.

Additionally, related sales and use tax exemptions for nonresident individuals' purchases or use of boats in Washington were enacted in 2007 (RCWs 82.08.700 and 82.12.700). These preferences are scheduled for JLARC review in 2017.

See page A3-2 in Appendix 3 for the current statutes, RCW 82.08.0266 and RCW 82.08.02665.

Legal History

1935 The Legislature enacted the retail sales tax and companion use tax. At this time, sales tax applied to retail sales of tangible personal property in Washington. No exemptions were provided for tangible personal property, including boats sold and delivered in Washington to nonresidents or foreign residents for use outside the state.

1948 In *Alaska Steamship Co., v. State*[2], the Washington State Supreme Court recognized that the U.S. Constitution prohibits a state from levying a sales tax on goods sold as exports to foreign businesses or residents. Tax Commission historical documents illustrate many instances where foreign boat buyers were denied sales tax exemptions after this case, indicating that the Commission narrowly construed those boat sales that qualified as exports for purposes of the constitutional prohibition.

[2] *Alaska S.S. Co. v. State*, 31 Wn.2d 328 (1948).

1959 The Legislature enacted a sales tax exemption for sales of boats to nonresidents when the boats are delivered in Washington for use outside the state (RCW 82.08.0266). The exemption was for watercraft "of a length requiring Coast Guard registration" and was available only when the watercraft would not be used in the state for more than 45 days after delivery and when the buyer provided an exemption certificate and identification proving out-of-state residence. The exemption applied to the boat and component parts included on the boat sold by the dealer.

1961 The Legislature clarified the exemption applied to "watercraft requiring Coast Guard registration or registration by the state of principal use according to the Federal Boating Act of 1958."

1960s-1980 Over the next 20 years, the Tax Commission repeatedly dealt with two issues regarding this preference: 1) did the statutory language allow sales tax exemption for watercraft that was Coast Guard "documented," as opposed to registered; and 2) did the exemption apply to boats sold to foreign residents (usually Canadians).

1) ***Documented v. registered watercraft:*** Coast Guard documented and Coast Guard registered watercraft are two different designations. Coast Guard documentation of watercraft requires numerous documents and forms; until recently, it was generally done for large, commercial vessels. The Tax Commission's policy and reasoning in rulings and appeals was: the law specifically exempted Coast Guard registered watercraft; if the Legislature had intended the exemption to apply to documented watercraft as well, it would have said so. Thus, the Commission concluded because Coast Guard documented watercraft were not specifically exempted in the statute, they did not qualify for the exemption. Until the Legislature amended the law, the Commission was without authority to allow the exemption.
2) ***Foreign residents:*** The Tax Commission's policy was that the exemption did not apply to purchasers from foreign countries because the statutory language requiring either Coast Guard or state registration applied only to boats owned by U.S. residents. A boat purchased by a person from another country would have neither a Coast Guard registration nor a registration from another state.

1981 At the urging of the Marine Trade Association and after reviewing federal and state law changes, the Department of Revenue (formerly the Tax Commission) changed its position and determined it would allow the sales tax exemption for Coast Guard documented watercraft and would revise its administrative rule. It did not, however, alter its position on allowing the exemption for foreign residents.

1993 The Legislature enacted a new sales tax exemption for boats sold to residents of foreign countries delivered in Washington for use outside the state (RCW 82.08.02665). The exemption applied only if the boat was not used in Washington for more than 45 days after the buyer took delivery.

2007 The Legislature enacted a separate but related sales and use tax exemptions for boats sold to or brought into Washington by nonresident individuals (RCW 82.08.700 and RCW

82.12.700). The exemptions apply to purchases or use in Washington by U.S. or foreign nonresident individuals of watercraft 30 feet or longer, when the nonresident buys a permit from the dealer when the watercraft is purchased.

Other Relevant Background

The Federal Boating Act of 1958

The Federal Boating Act of 1958 shifted the responsibility of registering watercraft that are not documented with the Coast Guard from the federal government to the states. Pursuant to this and other federal legislation, states are required to assign numbers to all boats powered by engines that are used in waters under federal jurisdiction. Exceptions to this requirement include Coast Guard documented boats and foreign boats temporarily in the U.S.

Comparing Exemptions

The two preferences under review provide sales tax exemptions for boats purchased by nonresidents or foreign residents and limit the time the boats may be used in Washington waters to 45 days after delivery is taken. If the boat returns to Washington waters after it has been taken outside the state after purchase, its in-state use is subject to time limits detailed under use tax statutes. A similar preference passed in 2007 allows nonresidents or foreign individuals to purchase an exemption permit allowing them to purchase a boat without paying sales tax and to use the boat in Washington waters for up to one year without owing use tax.

At the time of purchase, nonresident boat buyers must make an "irrevocable election" regarding which sales tax exemption they want to use: 82.08.0266, 82.08.02665, or 82.08.700. The sales and use tax exemptions provided when a permit is purchased (RCWs 82.08.700, 82.12.700) differ in many ways from the other two sales tax exemptions (RCWs 82.08.0266, 82.08.02665). See Exhibit 5, on the following page, for a comparison of the exemptions.

Exhibit 5 – Sales Tax Exemptions for Boats Sold and Delivered In-state to Nonresidents

RCW	82.08.0266	82.08.02665	82.08.700/82.12.700
Enacted	1959	1993	2007
Who gets the exemption?	Nonresidents from U.S.	Foreign nonresidents	Nonresident individuals from U.S. or foreign countries
What is exempted?	Boats requiring registration by Coast Guard or in home state for use outside the state	Boats for use outside the state	Boats of 30 feet or longer
Cost of permits	N/A	N/A	• $500 for boats 50 feet and under • $800 for boats over 50 feet
Use allowed in WA after delivery is taken	45 days	45 days	1 year
Documentation required	Exemption certificate and I.D. proving nonresidence	Exemption certificate and I.D. proving nonresidence	Signed affidavit and I.D. proving nonresidence
Future limits on use in Washington waters	• After initial 45 days, can return to WA for 60 days • Can extend two more times for total of 180 days in a one-year period	• After initial 45 days, can return to WA for 60 days • Can extend two more times for total of 180 days in a one-year period	• Must display permit while in WA waters • Cannot bring boat back into WA waters for at least 24 months after permit expires

Source: JLARC analysis of RCWs 82.08.0266, 82.08.02665, and 82.08.700/82.12.700.

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?

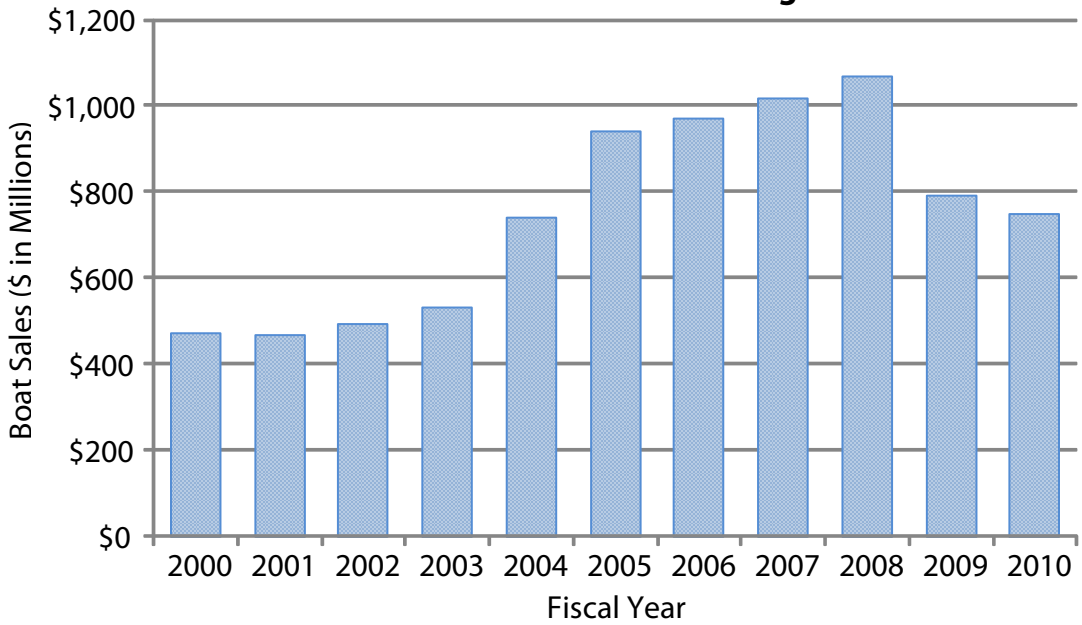
The Legislature did not provide a public policy objective when it enacted these preferences.

However, the implied intent is to support sales of boats in Washington by removing the disincentive for nonresidents and foreign residents to purchase and take possession of boats in the state. Similar preferences are provided to nonresidents for purchases of automobiles and farm machinery and equipment (both reviewed by JLARC in 2010).

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

The preferences eliminate the disincentive for nonresidents and foreign residents to purchase and take delivery of boats in Washington by making their purchase tax-free. Overall sales by boat retailers in Washington peaked in Fiscal Year 2008. See Exhibit 6 on the following page.

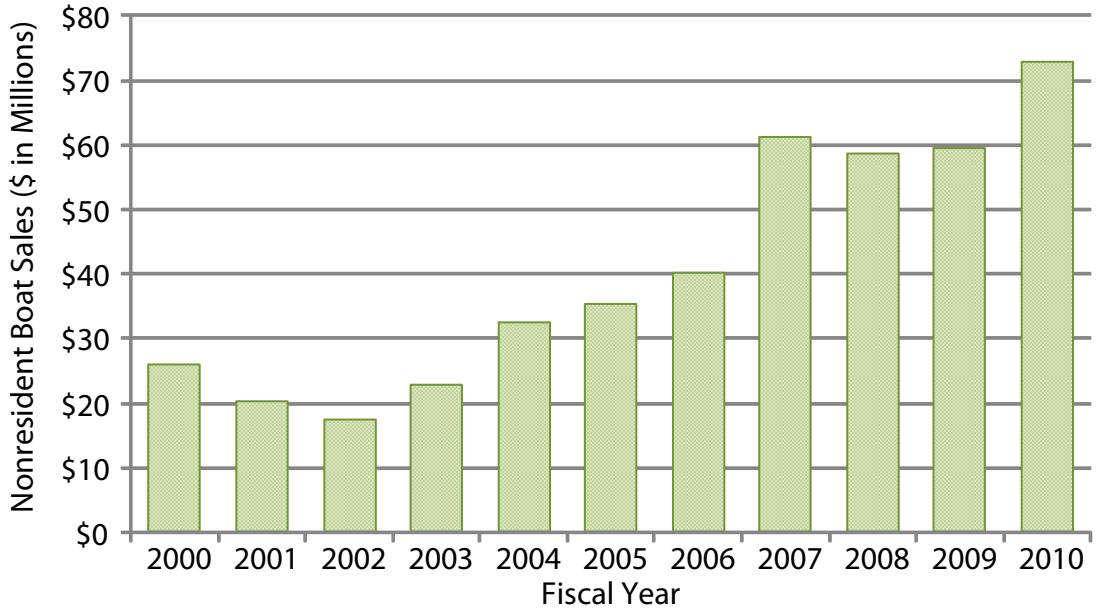
Exhibit 6 – Total Boat Sales in Washington Decline



Source: JLARC analysis of DOR tax return data, retail sales for NAIC codes 441222, 336612, FY00-10.

Though overall boat sales in Washington have recently decreased, data shows the percentage of Washington boat sales to nonresidents/foreign residents has increased steadily starting in Fiscal Year 2003. See Exhibits 7 and 8 on this and the following page. JLARC cannot isolate what, if any, impact these preference had on sales. JLARC is also unable to determine whether the addition of RCW 82.08.700 in 2007 factored into the increase in nonresident/foreign boat sales.

Exhibit 7 – Sales of Boats to Nonresidents Increase



Source: JLARC analysis of DOR tax returns NAICs 441222, 336612 with 0123 ded.

Exhibit 8 – Percent of Washington Boats Sold to Nonresidents or Foreign Residents, FY 2000 - 2010

FY	% of Total WA Boat Sales Made to Nonresidents
2000	6%
2001	4%
2002	4%
2003	4%
2004	4%
2005	4%
2006	4%
2007	6%
2008	5%
2009	8%
2010	10%

Source: JLARC analysis of DOR tax return data, boat sales and 0123 deductions for NAICS 441222 & 336612, FY00-10.

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

Continuing the exemptions will continue to remove a disincentive for nonresidents and foreign residents to purchase and take possession of boats in Washington.

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

The preferences appear to be fulfilling the public policy objective.

Beneficiaries

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

Beneficiaries of the preferences are residents of other states and foreign residents who purchase and take delivery of watercraft in Washington. The preferences allow them to buy and take possession of watercraft in Washington without paying sales tax. The preferences also allow buyers tax-free use of the vessel in Washington waters for up to 45 days after they take delivery in-state. Other sales tax exemptions are provided for commercial watercraft that transport persons or property for hire in interstate or foreign commerce or watercraft used in commercial deep sea fishing (RCW 82.08.0262).

To what extent are the tax preferences providing unintended benefits to entities other than those the Legislature intended?

JLARC could find no evidence of unintended beneficiaries.

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 saved $6.5 million in sales tax in Fiscal Year 2010 due to these preferences. The estimated beneficiary savings for the 2011-13 Biennium is $13.7 million. See Exhibit 9, below.

It should be noted, the beneficiary savings include sales to nonresidents that were exempted from sales tax via purchase of a permit, as there is no differentiation in tax reporting between the different sales tax exemptions. According to the Department of Revenue, there have been 78 permits sold to nonresidents over the lifetime of this preference.

Exhibit 9 – Estimated Beneficiary Savings for Nonresident and Foreign Boat Sales in Washington (in Millions)

Fiscal Year	Nonresident and Foreign Resident Sale Deductions	State Sales Tax	Local Sales Tax	Total Sales Tax
2009	$59.6 M	$3.9 M	$1.4 M	$5.3 M
2010	$72.9 M	$4.7 M	$1.7 M	$6.5 M
2011	$74.2 M	$4.8 M	$1.8 M	$6.6 M
2012	$75.9 M	$4.9 M	$1.9 M	$6.8 M
2013	$78.1 M	$5.1 M	$1.9 M	$7.0 M
2011-13 Biennial Total	**$154 M**	**$10 M**	**$3.8 M**	**$13.8 M**

Source: JLARC analysis of FY09, FY10 DOR tax return data, NAICS 441222 & 336612 0123 deductions. FY11- FY13 JLARC calculation. Growth from 2011 – 2013 based on Table 1, U.S. Economic Forecast Summary, U.S. Real Personal Income estimated growth.

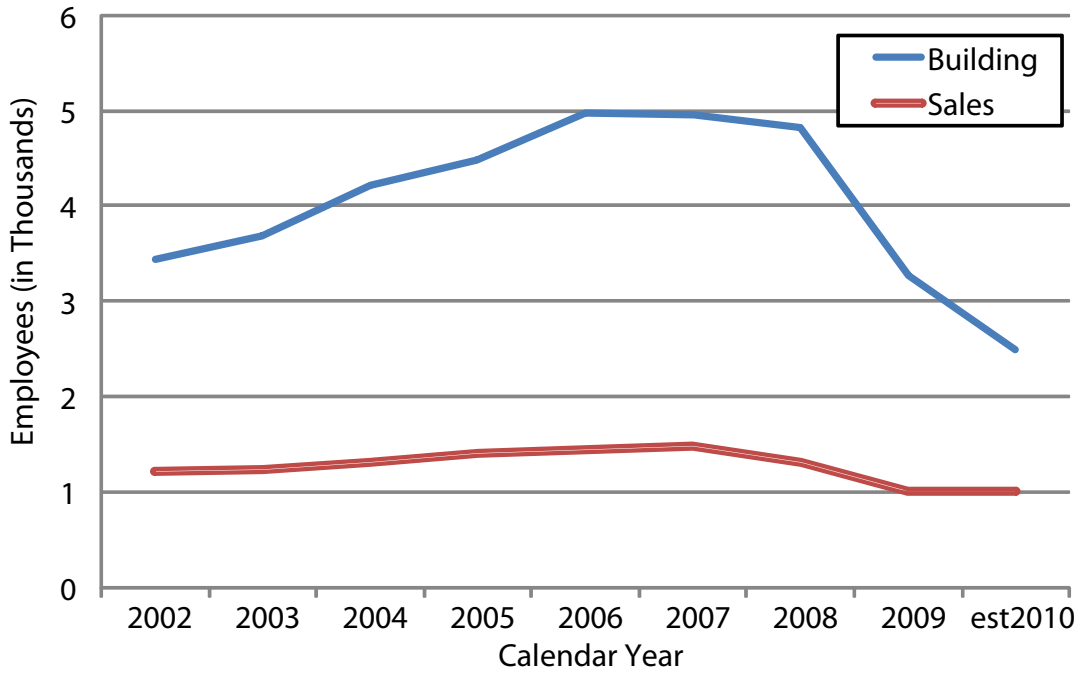
JLARC is unable to determine the aggregate economic impact of these preferences if they are continued.

Information is available, however, to provide a snapshot of Washington's boat sales industry. Many boat retailers are located in the state, as well as several custom boat/yacht building businesses that may also make retail boat sales. The most recent available data (through June 2010) identifies approximately 135 retail boat outlets and 85 businesses engaged in boat building.

According to industry employment data, the number of employees working in the boat building and boat sale industries has decreased during the last few years. Data reviewed shows the number of employees in the boat building sector has dropped from a high in 2007 to below 2002 employment levels. See Exhibit 10, on the following page. However, wages for employees in the boat building sector steadily grew through 2009, then dropped slightly. See Exhibit 11 on page 39. For the boat

sale industry, there was less job growth from 2002 through 2007 than in boat building (Exhibit 10, below), while annual wages for boat sale employees have dropped from a high in 2007 (Exhibit 11, on the following page).

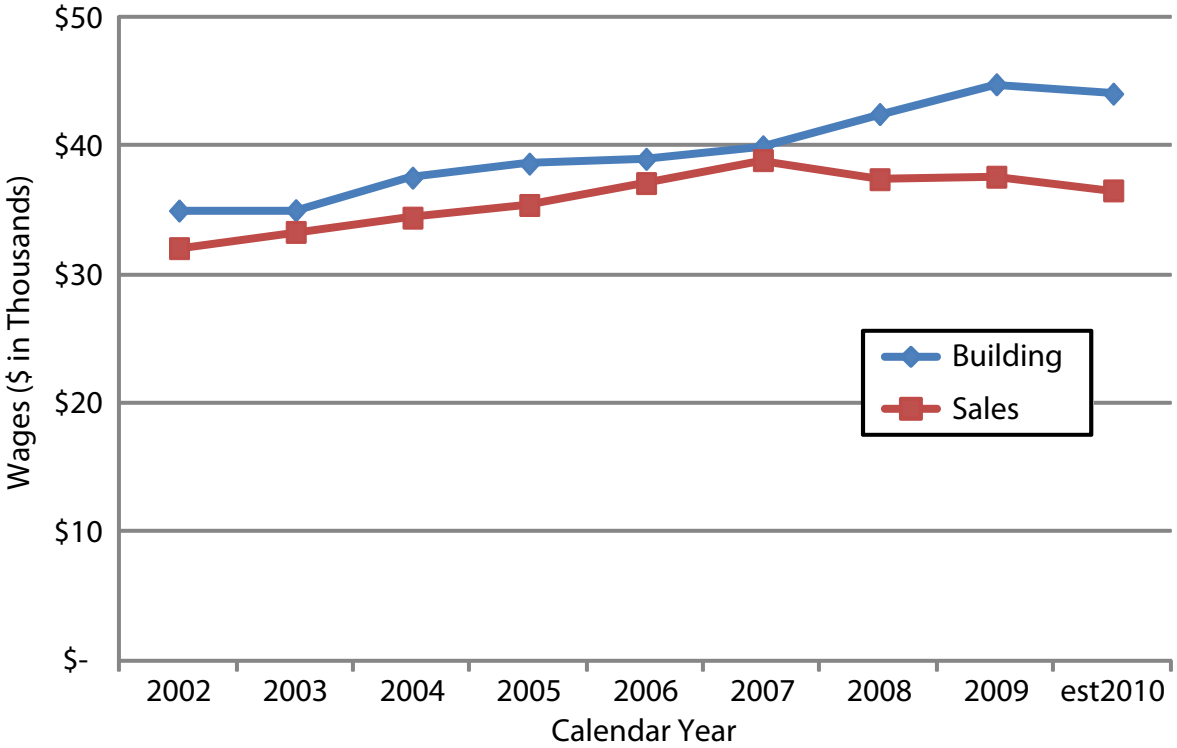
Exhibit 10 – Comparing Boat Industry Employee Figures 2002-2010



Source: JLARC analysis of ES Quarterly Employment Annual Reports CY02 – 09; Q1 & Q210 quarterly reports.

Compared to other transportation equipment manufacturing wages, annual wages earned by workers in the boat building industry are lower. See Exhibit 12 on the following page. However, this industry is dominated by more highly paid aircraft industry manufacturing jobs. Excluding airplane manufacturing jobs and their pay from the calculation, boat building wages fall above truck trailer manufacturers and below ship and motor vehicle body building wages. Compared with similar industries, both the number of boat sale employees and their average annual wages were lower than average. See Exhibit 13 on page 40.

Exhibit 11 – Annual Boat Industry Wages in WA



Source: JLARC analysis of ES Quarterly Employment Annual Reports CY 02 – 09; Q1 & Q210 quarterly reports.

Exhibit 12 – Wages for Transportation Equipment Manufacturing in Washington (CY09)

Industry	Number of WA Employees	Average Annual Wages
Boat Building	3,270	$44,751
Wages for similar industries		
Aircraft	72,604	$92,311
Ship Building & Repair	2,869	$57,129
Truck Trailer	119	$46,743
Motor Vehicle Body	146	$39,673
All Transportation Equipment	92,412	$84,120

Note: Average is mean wages.

Source: JLARC analysis of CY09 Employment Security quarterly employment records.

Exhibit 13 – Wages for Vehicle and Boat Retail Sales in Washington (CY09)

Industry	Number of WA Employees	Average Annual Wages
Boat	1,002	$37,558
Wages for similar industries		
New Car	18,745	$46,444
Used Car	2,221	$35,217
Recreational Vehicle	1,066	$41,581
All Vehicle & Parts Sales	35,383	$41,348

Source: JLARC analysis of CY09 Employment Security quarterly employment records.

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, a sales tax exemption would still remain for nonresidents or foreign residents for boats 30 feet or over where a permit is purchased (RCW 82.08.700). Additionally, boats could still be sold to nonresidents tax free by delivering the boat to the buyer outside the state. However, the cost of delivery would be an additional cost that would either be paid by the consumer or absorbed by the retailer.

Terminating the preferences may result in increased collected sales tax but may also reduce the number of nonresident and foreign resident boat sales in Washington. Economic theory uses the concept of elasticity to determine how much the quantity demanded of a good responds to changes in its price. If the change in demand for goods is proportionately greater than the change in price, the good is considered to be price elastic. Luxury goods, such as boats or goods with many substitutes, are often characterized as price elastic goods. According to established economic theory, if the price for boats to nonresidents increased by about 9 percent (the average Washington sales tax rate), a drop in demand for boats by nonresidents would be expected.

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

There would be no change in tax liability distribution.

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 found several states with a similar exemption, including Connecticut, Florida, Maine, New Jersey, New York, and Rhode Island. Ohio will only grant the exemption if the state where the boat will be registered does not provide a credit for Ohio sales tax.

Recommendation

Because the preferences are meeting the public policy objective of removing a disincentive for nonresidents and foreign residents by allowing them to purchase and take delivery of boats in Washington exempt from sales tax, the Legislature should continue them.

Legislation Required:	No
Fiscal Impact:	No

CHURCH CAMPS (PROPERTY TAX)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**JLARC Recommendation**
Exempts from property tax camps owned by nonprofit churches, denominations, or organizations whose membership is comprised of churches.	The Legislature did not specifically state the public policy objective of the preference. JLARC infers two public policy objectives: 1) To ensure that church camps conducted for sectarian purposes are treated consistently for tax purposes with nonprofit camps conducted for nonsectarian purposes. 2) The Legislature may have wanted to support church camps in the same manner it has supported other nonprofit organizations that provide social services to youth.	$6.9 million in 2011-13 Biennium	**Continue**: Because the preference is fulfilling the implied public policy objective of ensuring that church camps are being treated consistently for tax purposes with nonsectarian camps.

CHURCH CAMPS (PROPERTY TAX)

Report Detail

Current Law

This tax preference exempts from the property tax camps owned by nonprofit churches, denominations, or organizations whose membership is comprised of churches. The church may select up to a maximum of 200 acres to be exempt, and the camp must be used for regularly-scheduled, organized, and supervised recreational and religious activities.

In addition, church camps are exempt from the business and occupation (B&O) tax on receipts from lodging, conference and meeting rooms, food and meals, books, and other products that are available exclusively to participants at the camp. JLARC will report on this B&O tax preference in 2014.

Camps may be exempt from property taxes under two separate statutes depending on whether they are conducted for **sectarian** or **nonsectarian** purposes. Sectarian is not defined in statute. According to Webster's dictionary, sectarian means affiliated with a religious denomination. Nonsectarian means the opposite—not related to a particular religious denomination. The property tax preference for camps owned by sectarian organizations is reviewed in this chapter. JLARC reviewed the tax preference for nonprofit nonsectarian organizations in 2007.

See page A3-2 in Appendix 3 for the current statute for church camps, RCW 84.36.030(2).

Legal History

Church property has been exempt from property tax since Territorial days. However, early Legislatures limited the amount of church land and the type of buildings to be exempted.

1854 The Territorial Legislature created an exemption for all property belonging to a religious organization.

1887 The amount of church land qualifying for exemption could not exceed half an acre.

1915 The Legislature enacted a property tax exemption for properties owned by nonprofit nonsectarian organizations used for religious purposes to include religious, educational, benevolent, protective, or social purposes.

1933 The Legislature expanded the amount of land a church may claim for exemption to a maximum of five acres. There was no limit to the amount of land a nonsectarian organization could claim.

1934 The Washington Supreme Court held that property owned by a church qualified for the nonsectarian exemption if it was used for nonsectarian purposes.3

[3] *Norwegian Lutheran Church v. Worster*, 176 Wash. 581 (1934).

1969 The Legislature limited the nonsectarian exemption by requiring property to be owned by the organization and not leased or loaned. This action raised concern among property owners that rented their camps to groups, such as the Campfire Girls and Girl Scouts.

In the same year, the Washington Supreme Court denied the nonsectarian exemption to a church camp **used for sectarian purposes**, that of *"teaching a particular set of religious beliefs."* The court stated that it is the use made of the property and not the identity of the owner that determines whether the exemption is granted.[4]

According to a Department of Revenue report at the time, several county assessors put sectarian church camps on the property tax rolls as a result of the court ruling, and left the decision to county boards of equalization to determine whether the organization was run for sectarian or nonsectarian purposes.

1971 The Legislature added this tax preference for church camps. The church could select up to a maximum of 200 acres to be exempt. The law also allowed owners to rent the camp property to other exempt organizations without losing the exemption. The Legislature set an expiration date of July 1, 1977.

1973 The Legislature removed the 1977 expiration date for the church camp exemption.

1984 The Legislature narrowed the exemption by restricting the use of the property to the owner and not to the rental or loan of the camp facility.

There have been unsuccessful proposals to expand the property tax exemption to include camps up to 400 acres.

Public Policy Objective

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

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

JLARC infers that the public policy objective is to ensure that church camps conducted for **sectarian** purposes are treated consistently with nonprofit camps conducted for **nonsectarian** purposes. Both types of camps received a property tax exemption under the same statute from 1915 until a court ruling in 1969. The Legislature may have enacted a separate exemption for sectarian church camps in response to that court ruling that stated a church camp conducted for sectarian purposes no longer qualified for the nonsectarian exemption.

[4] *Pacific Northwest Conference v. Barlow*, 77 Wn.2d 487 (1969).

A second implied public policy objective is that the Legislature may have intended to support church camps because it has provided property tax exemptions to other nonprofit organizations that provide social services for youth. See Exhibit 14.

Exhibit 14 – Property Tax Exemptions for Certain Nonprofits Related to Providing Social Services to Children and Youth

Exemption	Year Enacted	Social Service
Orphanages	1891	Care of orphans
Nonsectarian organizations	1915	Character-building, benevolent, protective or rehabilitative services—all ages
Private schools and colleges	1925	Educational
Youth organizations	1933	Character-building organizations serving boys and girls under 18 years of age
Church camps	1971	Camps provided by nonprofit church, denomination, group of churches, or association of churches
Child day care centers	1973	Care of children during the day

Source: JLARC analysis of property tax law.

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

The public policy objective of providing consistent tax treatment to sectarian and nonsectarian camps is being achieved. With the exception of the brief period following the court decision in 1969, the Legislature has continued to exempt both types of camps from the property tax since 1915.

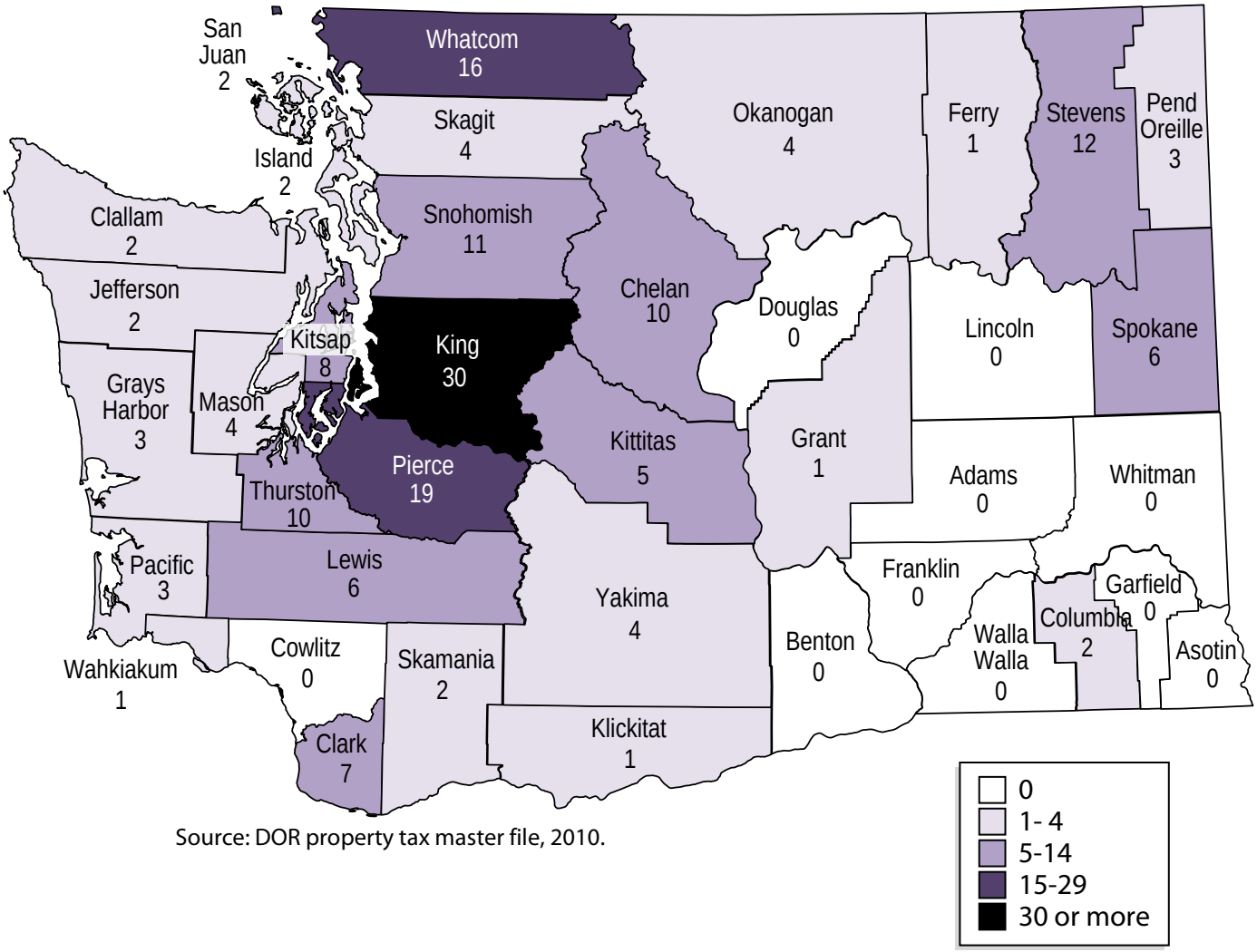
Both preferences are also fulfilling the public policy objective of supporting nonprofit organizations that provide social services to youth. Camps owned by the YMCA, Boy Scouts, Girl Scouts and Camp Fire, and other nonprofit organizations are exempt under the nonsectarian exemption. Church-affiliated camps are exempt under this tax preference.

Beneficiaries

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

There are 181 church camps in Washington with an estimated property value of $320 million that qualify for the exemption. The largest in terms of recorded assessed value is Morningside Farms Camp on Vashon Island. The largest in terms of acreage is Quaker Cove in Snohomish County. Counties with the highest concentration of exempt church camps are King, Pierce, and Whatcom counties.

Exhibit 15 – Church Camps



Source: DOR property tax master file, 2010.

Revenue Impacts

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

Beneficiaries of the tax preference saved an estimated $3.3 million in Fiscal Year 2010 in state and local property taxes. They are expected to save $6.9 million in the two-year period of the 2011-13 Biennium. For property tax exemptions, savings to the beneficiary generally do not equal lost revenues to the state or local governments, because other property owners pay higher taxes when property is taken off the rolls. See Exhibit 16.

Exhibit 16 – Church Camps—Estimated Beneficiary Tax Savings

Fiscal Year	Beneficiary Tax Savings		Total
	State	Local	
2009	$570,000	$2,635,000	$3,205,000
2010	$575,000	$2,733,000	$3,308,000
2011	$578,000	$2,763,000	$3,341,000
2012	$584,000	$2,795,000	$3,379,000
2013	$589,000	$2,910,000	$3,499,000
2011-13 Biennial Total	**$1,173,000**	**$5,705,000**	**$6,878,000**

Source: JLARC estimate based on DOR exempt property file, county assessors' rolls, and growth rates from the Economic and Revenue Forecast Council.

Recommendation

Because the tax preference is fulfilling the public policy objective of ensuring that church camps are being treated consistently with nonsectarian camps, the Legislature should continue the property tax exemption for church camps. Both types of camps are also fulfilling the objective of providing social services for youth.

Legislation Required: No

Fiscal Impact: None

DISPLAY ITEMS FOR TRADE SHOWS (USE TAX)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**JLARC Recommendation**
Provides a use tax exemption for personal property used by businesses (not in excess of 30 days) at a single trade show to promote sales of products or services.	The Legislature did not specifically state the public policy objective of the preference. Historic documents imply the preference was intended to remove a potential disincentive for vendor participation in trade shows held in Washington.	$5 million in 2009-11 Biennium per DOR (JLARC unable to determine)	**Continue**: Because the preference is meeting the implied public policy objective of removing a potential disincentive for vendor participation in trade shows held in Washington.

DISPLAY ITEMS FOR TRADE SHOWS (USE TAX)

Report Detail

Current Law

This preference provides a use tax exemption for personal property used by businesses not in excess of 30 days at a single trade show for the purpose of promoting sales of products or services. The items exempted are not part of the vendor's regular inventory for sale. For example, the preference would apply to vacuum cleaners used as demonstrator models, or display countertops or cabinets used by a vendor at a home show.

Merchandise used in Washington by businesses to promote sales or for demonstration purposes is generally subject to Washington's sales or use tax, for example, vehicles or samples carried by salespersons, or goods given away as promotional items. If Washington sales tax was not paid on such goods when purchased, or if they were pulled from the inventory of goods held for sale, the business owes use tax on the value of the goods, since the business is the consumer of the merchandise. RCW 82.12.010(1) defines "consumer" as "any person who distributes or displays, or causes to be distributed or displayed, any article of tangible personal property, the primary purpose of which is to promote the sale of products or services."

See page A3-3 in Appendix 3 for the current statute, RCW 82.12.0272.

Legal History

1935 Faced with a revenue shortfall, the Legislature passed the Revenue Act of 1935, establishing much of the current state tax structure, including the retail sales tax and the companion use tax. The act provided some use tax exemptions, but none for items displayed in trade shows or used by businesses in displays or demonstrations.

The Tax Commission's policy at the time was that merchandise displayed for sale was not subject to use tax. Such merchandise could be demonstrated to potential customers. However, merchandise used as samples or demonstrators but not for sale was subject to sales or use tax, as these items were being used by businesses in their sales activities.

1962 In response to inquiries from World's Fair exhibitors, the Tax Commission noted in several letters that tangible personal property used in the state only for demonstration or advertising purposes was subject to Washington sales or use tax. If the property was also held out for sale, then it was considered part of the stock of goods for sale and was not subject to tax, even though it might be used in demonstrations.

1965 The Tax Commission issued an audit assessment for use tax on clothing samples used by a travelling manufacturer's representative. The assessment noted that the samples were not part of the inventory for sale, and thus assessed use tax. The clothing manufacturing industry responded in a letter to Governor Evans, noting that this issue had not come up in prior Tax Commission audits of industry businesses and that assessing use tax on clothing

samples might discourage manufacturers from sending representatives into the state or to trade shows in Washington.

1966 The Tax Commission issued an advisory, "Use Tax on Goods Demonstrated in the Process of Sale." Consistent with established practice, the advisory stated that if tangible personal property was part of the regular stock of goods for sale and was used by the vendor for demonstration purchases, then it was not a separate, taxable use of the property by the business.

1967 The Legislature passed a specific use tax exemption for wearing apparel used as samples.

Later that year, the Tax Commission audited several businesses representing over 400 out-of-state furniture manufacturers that operated displays at the Northwest Home Furnishings Mart. The Furnishings Mart displayed furniture at one location to wholesale purchasers for the retail furniture trade. Six businesses were assessed use tax on furniture used in displays that was not part of an inventory of goods for sale.

1968 The Tax Commission issued an advisory, "Use Tax on Display Merchandise," clarifying use tax applied to articles "substantially used for sales promotion purposes," including automobiles, boats, or appliances regularly used as demonstrators, display advertising materials, samples or advertising material given away to customers, and samples carried by salespeople. The advisory further noted use tax did not apply to "brief and superficial use," such as when items are displayed in single trade shows (such as boat, home, or auto shows, agricultural fairs, or conventions) for short periods, or when used in floor or window displays and afterward sold as new merchandise. The advisory stated that goods were generally subject to use tax if they were carried on the business's books as demonstrator or display merchandise, or if the goods were used so extensively that they could no longer be sold as new merchandise.

In that same year, the six businesses assessed use tax as part of the 1967 Furnishings Mart audits were denied a petition for review by the Tax Commission. The Tax Commission determined that use tax was clearly owed on display furnishings by the businesses.

1969 Upon appeal by the six businesses, the Board of Tax Appeals (BTA) upheld the Tax Commission's assessment of use tax, finding the items placed in the Mart were "used primarily for display purposes." However, the BTA decision further stated that the Tax Commission had exceeded its authority by providing specific details on the criteria used to determine use taxability or exemption in the interpretation provided in its 1968 advisory. The BTA stated that "if such distinctions should be made . . . they should be made by the legislature. . . We are of the firm opinion the Respondent has exceeded its interpretative authority in this instance."

During the 1969 Legislative Session, the Legislature considered several bills regarding use tax exemptions for advertising, promotional, and display merchandise, but none of them were enacted.

1971 The Legislature passed a use tax exemption for tangible personal property held for sale and displayed in single trade shows for periods of not more than 30 days for the primary purpose of promoting product sales or services.

Other Relevant Background

JLARC reviewed the sales and use tax law detail for 19 states and the District of Columbia looking for a similar tax preference. We chose states that might be popular trade show locations and that imposed a sales or use tax. JLARC could find no similar exemption provided for property used to display or demonstrate products at trade shows in any of the state tax laws.

Public Policy Objectives

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

The Legislature did not state the public policy objective of this preference when it was enacted.

Historic documents imply the preference was intended to remove a disincentive for vendor participation in trade shows held in Washington. The Tax Commission issued an advisory providing guidance on the use of merchandise by trade and related show vendors in 1968. However, in an appeal on the issue, the Board of Tax Appeals found that clarifications on use tax application should be made by the Legislature. The issue was contested over two legislative sessions with several variations proposed for use tax exemption before this preference was enacted.

Historic documents imply that although this issue started as one involving furniture manufacturer merchandise displays, it raised questions as to whether items displayed in boat, home, or auto shows, agricultural fairs, or conventions would be subjected to use tax.

Proponents of bills to provide this exemption contended that without a use tax exemption, Washington's viability as a potential trade show location was jeopardized, as businesses would choose to attend shows in other states rather than pay Washington use tax on merchandise they used for display or demonstration purposes. This preference clarified that tangible personal property used primarily for demonstration and display purposes at trade shows (also fairs, conventions, etc.) for periods not in excess of 30 days was exempt from use tax.

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

Large convention centers are located in: Seattle, Tacoma, Everett, Bellevue, Spokane, the Tri-cities, and Vancouver. Numerous smaller facilities are also located throughout the state. No entity keeps track of all the trade shows, fairs, conventions, etc., held in the state. However, a representative for the Washington State Convention and Trade Center noted that the Convention and Trade Center typically hosts about 50 national conventions and 20 regional conventions or trade shows annually.

It is not possible for JLARC to isolate what, if any, impact this particular preference has had on trade show participation in the state. The preference removes a potential disincentive for trade show vendors to participate in Washington trade shows by exempting goods used for demonstration and display purposes at such events from use tax.

Beneficiaries

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

Beneficiaries of the tax preference are businesses that attend trade shows in the state and that bring goods into the state to display or demonstrate that are not part of their inventory for sale. Due to this preference, these businesses do not pay use tax on goods used for demonstration or display at trade shows lasting less than 30 days and primarily used to promote sales.

The absence of reporting requirements for this preference means it is not possible to identify the exact number or nature of the businesses using the preference.

Revenue Impacts

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

Since the use tax exemption provided by this preference does not require beneficiaries to report, file, deduct, or otherwise document their use of the preference, it is difficult to determine the taxpayer savings realized.

While the Department of Revenue's 2008 Tax Exemption Study estimated the taxpayer savings for this preference to be $2.4 million in Fiscal Year 2010, JLARC cannot verify the accuracy of this estimate. JLARC could not determine an alternative method for estimating the taxpayer savings.

Recommendation

Because the preference is meeting the public policy objective of removing a potential disincentive for vendor participation in trade shows held in Washington, the use tax exemption for goods used primarily for display or demonstration purposes by vendors at trade shows for not more than 30 days should be continued.

Legislation Required:	No
Fiscal Impact:	None

EXTRACTED FUEL (USE TAX)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**JLARC Recommendation**
Provides a use tax exemption for fuel produced by an extractor/manufacturer during extracting or manufacturing activities, when the fuel is used by the producer directly in the same extracting or manufacturing activity.	The Legislature did not specifically state the public policy objective of the preference. JLARC infers two possible objectives: 1) The Legislature wanted to generally apply a use tax to byproducts but did not want to contradict a state Supreme Court decision, so it provided a limited use tax exemption. 2) The Legislature wanted to provide a tax preference to certain extractors/manufacturers to support those industries, so it structured the preference narrowly. A court decision made shortly before the Legislature created the preference in 1949 dealt with the taxability of a wood product manufacturer. However, the majority of the beneficiary savings now appear to be realized by oil refineries.	$69.2 million in 2011-13 Biennium	**Review and clarify**: Because the public policy objective and intended beneficiaries are unclear.

EXTRACTED FUEL (USE TAX)

Report Detail

Current Law

This preference provides a use tax exemption for fuel produced by an extractor or manufacturer during extracting or manufacturing activities, when the fuel is used by the producer directly in the extracting or manufacturing operation that produced the fuel. Generally, businesses that produce and use tangible personal property, including by-products used to generate heat, steam, or electricity, owe use tax on the value of the fuel produced. This preference provides an exemption for such use by certain producers of extracted fuel.

For example, a timber product manufacturer produces wood scraps in the process of manufacturing plywood. The wood scraps are fed through a machine that converts them to scraps of a certain size, commonly known as "hog fuel." If the hog fuel is used by that manufacturer at the same facility as fuel to make steam to dry the lumber, then the hog fuel is exempt from use tax under this preference.

JLARC is reviewing another tax preference related to hog fuel in 2011 – sales and use tax exemptions for hog fuel sold to produce electricity.

See page A3-3 in Appendix 3 for the current statute, RCW 82.12.0263.

Legal History

1935 The Legislature passed the Revenue Act of 1935, creating the retail sales tax and companion use tax. At the time, sales tax applied to retail sales of tangible personal property, while use tax applied to the use of tangible personal property purchased at retail or produced or manufactured *for commercial use.* The law defined "manufacturer" to mean "every person who, either directly or by contracting with others… manufactures for sale *or commercial use* from his own materials or ingredients any articles, substances or commodities." (Emphasis added.) "Commercial use" was defined as the following uses of products by extractors or manufacturers thereof:

1) Manufacturing articles from extracted products;
2) Leasing or renting extracted or manufactured products;
3) Consigning, shipping, or transferring extracted/manufactured products to another without payment or in performing a contract; and
4) Using extracted/manufactured products when similar products are extracted or manufactured for sale by the taxpayer.

The term "commercial use" becomes a factor in a subsequent court case.

1948 In *Buffelin Lumber & Mfg Co. v. State,*[5] the Washington State Supreme Court affirmed a Thurston County Superior Court ruling that hog fuel produced and used by a lumber and

[5] *Buffelin Lumber & Mfg Co v. State*, 32 Wn2d 40, 201 P.2d 509 (1948).

door manufacturer was not subject to use tax. The case stemmed from a Tax Commission audit that assessed: 1) manufacturing business and occupation (B&O) tax on the activity of converting wood scraps to hog fuel, and 2) use tax on hog fuel produced by the manufacturer and subsequently used to operate its plant and equipment. The Court found that the Tax Commission did not have authority to impose manufacturing B&O tax on the hog fuel produced, noting the taxpayer was in the business of manufacturing plywood and doors, and that converting waste materials was only incidental to the manufacturer's business.

The Court also held that burning hog fuel in a lumber manufacturing furnace was an *industrial use,* not a *commercial* use. The decision noted that, as defined in statute, use tax applied only to personal property purchased at retail or manufactured for *commercial use.* Therefore, the Court reasoned that the Tax Commission had no authority to impose use tax on hog fuel used by the taxpayer for industrial use.

The Tax Commission testified that it had collected use tax on by-products like hog fuel for many years and that the Legislature had never taken action to change the law. The Court recognized that often, when an administrating department interprets a law in a certain way for several years, that interpretation is given "considerable weight" in determining legislative intent if the law is ambiguous. The Court found no such ambiguity in the statute, dismissing the Tax Commission's prior interpretation, stating:

> Because the tax has been paid by respondent or other manufacturers, is not warrant for imposing the tax. A wrong cannot be transferred into a virtue or sanctioned by reason of age and acquiescence. A power may be long exercised in violation of the statute, but this does not authorize the infraction.

1949 The following year, the Legislature made several changes that effectively reversed much of the Court's ruling:

- Amended the definitions of "manufacturer" and "extractor" in B&O tax statutes, replacing the term "commercial use" with "commercial or industrial use." This meant that the B&O tax applied to both commercial and industrial uses.
- Defined "commercial or industrial use" in B&O tax statutes to apply to use of products (including by-products) created by a manufacturer or extractor for: 1) any use as a consumer; and 2) use in manufacturing goods from extracted products and by-products.
- Amended the use tax statute to specify that use tax applies to every use of tangible personal property, including by-products used by the manufacturer thereof, except as otherwise provided in the law.

However, the Legislature adhered to the application of the Court's 1948 case ruling by providing a specific use tax exemption for fuel produced in extracting or manufacturing activities when the fuel is used directly in those operations.

Other Relevant Background

Statute does not define the term "fuel" for purposes of this preference. However, historical Department of Revenue documents, the Department's administrative rule, and legislative and Department staff note the fuels at issue are generally wood by-products ("hog fuel") and various petroleum products produced by extractors or manufacturers who use them to operate their facilities or equipment.

Hog fuel is a material made primarily of tree bark and/or wood scraps that is fed through a mechanical chipping device (a "hog") to produce a material of a size and consistency that can easily be burned as a fuel. Hog fuel can be consumed in a power plant or a manufacturer's furnaces, transported to another facility, sold to third parties, or disposed into a landfill. Transportation costs for this product are high in relation to its value, so producers find it uneconomical to ship it more than a short distance.

Petroleum products produced by refineries are also used internally to operate the plants. According to the Department of Energy's Energy Information Administration (EIA), about 60 percent of the energy used by refineries is self-produced. These fuels include still or refinery gas, petroleum coke, diesel, and other residual fuels.

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 this preference was enacted.

However, the Legislature enacted this preference just months after the *Buffelin Mfg.* case. *Buffelin Mfg.* specifically defined an extractor or manufacturer to be a person that produced goods for sale or for commercial use. By-products produced for another use (such as industrial use) did not fit within those activities and were not taxable under the B&O tax or use tax.

The Legislature effectively reversed the *Buffelin Mfg.* ruling by amending the law to redefine the tax base, ensuring that extracting and manufacturing activities subject to B&O tax included, by definition, activities that produced goods for industrial use. The Legislature also added language to ensure use tax applied to by-products used by the extractor/manufacturer that created them, except where otherwise noted.

However, in the same bill the Legislature provided a specific use tax exemption for fuels produced in extracting/manufacturing activities when the fuel was used by the extractor/manufacturer directly in the operation that produced the fuel. Fuel produced and used by a business in their business activity is generally subject to use tax.

It is not clear why the Legislature carved out a specific preference for fuel produced and used by the extractor/manufacturer that produced it. One possibility is that the Legislature wanted to preserve applying use tax to use of by-products, but did not want to completely contradict the *Buffelin Mfg.* decision only months after it was published. Consequently, the Legislature provided a fuel use tax exemption limited to extracting or manufacturing businesses such as Buffelin. Another possibility is

that the Legislature wanted to provide a tax preference to certain Washington extractors/manufacturers to support those industries, but contained it by constructing the preference narrowly for fuel produced and used by extractors/manufacturers at the facility where the fuel was produced.

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

Because the public policy objective is unclear, it is difficult to determine whether the preference is achieving any intended objective. The Legislature specifically rejected the *Buffelin Mfg*. decision by specifying that use tax applies to every use of tangible personal property and by-products used by the extractor/manufacturer thereof, but then the Legislature provided a specific exemption for fuel produced and used internally in operations by extractors and manufacturers.

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

Because the public policy objectives are unclear, JLARC is unable to determine whether they are being fulfilled or if modification of the preference is needed.

Beneficiaries

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

Since a use tax exemption does not require beneficiaries to report, file, deduct, or otherwise document their use of the exemption, it is difficult to determine the number of beneficiaries or identify all industries that may benefit from the preference. The primary beneficiaries appear to be wood product manufacturers and petroleum refineries, as evidenced by Department of Revenue audits and administrative appeals, and acknowledged industry information and practices. Coal mining operations, natural gas extractors, anaerobic digesters, biofuel manufacturers, and others could potentially benefit, as these activities involve some sort of extracting and/or manufacturing activity and might use fuel produced in their operations internally. However, it is unknown whether any actually do so.

Per Department of Revenue tax data, there are currently about 180 wood product manufacturers that may qualify to use this preference, including about 113 sawmill businesses.

There were no refineries operating in Washington when this preference was enacted in 1949. The five active refineries in WA (and their construction dates) are:

1. Conoco Phillips, Ferndale (1954)
2. Tesoro, Anacortes (1955)
3. US Oil, Tacoma (1957)
4. Shell Oil, Anacortes (1957-58)
5. BP Cherry Point, Ferndale (1971)

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

Since the public policy objective is not clear, it is not possible to determine unintended beneficiaries. Because the preference was enacted so soon after *Buffelin Mfg.,* JLARC assumes that wood product extractors/manufacturers were intended beneficiaries. It is not known whether the Legislature intended other industries to benefit from the preference.

Revenue and Economic Impacts

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

Since there is no requirement for beneficiaries to report, file, deduct, or otherwise document their use of the preference, it is difficult to identify the actual savings realized by beneficiaries.

JLARC estimates that beneficiaries saved $31.8 million in Fiscal Year 2010 and $69.2 million in the 2011-2013 Biennium due to the use tax exemption for extracted fuel. See Exhibit 17, below. The estimate is dominated by savings attributable to fuels generated and used by refineries; 98 percent of the estimate is attributable to refinery fuels, while 2 percent is attributed to hog fuel.

Exhibit 17 – Estimated Beneficiary Savings ($ in Millions)

Fiscal Year	State Use Tax	Local Use Tax	Total Use Tax
2010	$23.5 M	$8.3 M	$31.8 M
2011	$28.3 M	$10.0 M	$38.3 M
2012	$26.2 M	$9.3 M	$34.5 M
2013	$25.6 M	$9.1 M	$34.7 M
2011-13 Biennial Total	**$51.8 M**	**$18.4 M**	**$69.2 M**

Source: JLARC analysis of estimated hog fuel and refinery fuel usage by sawmills and refineries. Hog fuel component using DOR fiscal note estimate and consultation with Washington Forest Protection Association. Growth estimated with Table 1.1 from ERFC Nov 2010 Forecast. Refinery use calculated using DOR methodology. Growth estimated using Global Insights data for petroleum production, June 2011.

JLARC cannot determine or predict the effect on likely benefiting industries due to this preference. We can, however, provide some information on these industries in Washington.

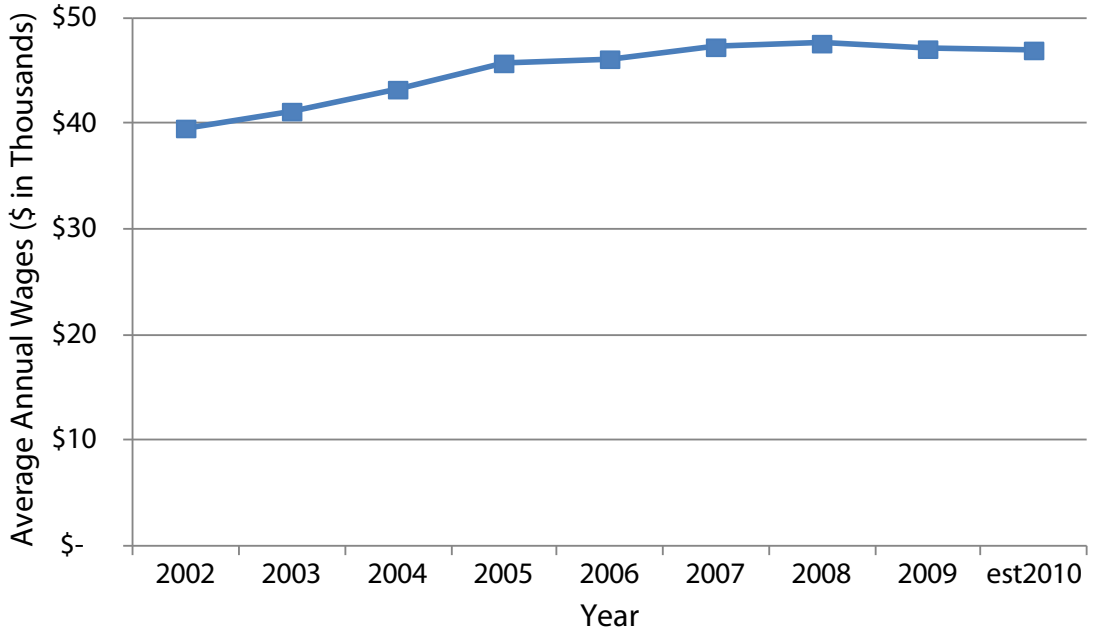
Wood Product Manufacturing

The preference appears to be initially intended for hog fuel produced and used internally by wood product manufacturers. Hog fuel is still produced and used internally by such manufacturers to run facilities and equipment, for instance, to produce steam to dry plywood. Currently the value is about $20 per ton.

There are fewer wood product mills operating in Washington now than in 1949, with an increase in mill efficiency and capacity. Wood product manufacturing operations are now more mechanized and the manufacturing process produces a much higher percentage of usable product from raw materials than when this preference was enacted.

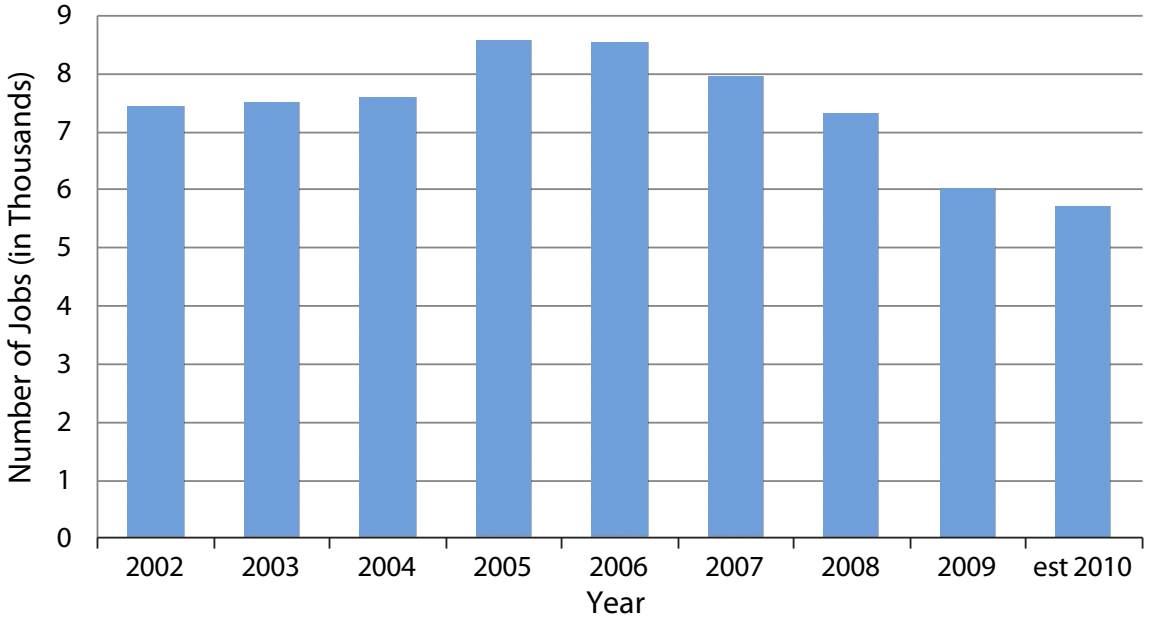
Average annual wages in the wood product manufacturing industry have risen, from $39,500 in 2002 to about $47,000 in 2010 (see Exhibit 18, below), while the number of industry employees in Washington has fallen, as detailed in Exhibit 19, below. Some of the factors influencing this include fewer mills, greater mechanization in the industry, and the recent recession, resulting in a collapse of the construction industry.

Exhibit 18 – Washington Sawmill Employee Wages – 2002 through 2010



Source: JLARC analysis of ES Quarterly Employment data, Q102 through Q310, NAICS 321113.

Exhibit 19 – Employment in Washington Sawmills Declines from 2002 to 2010

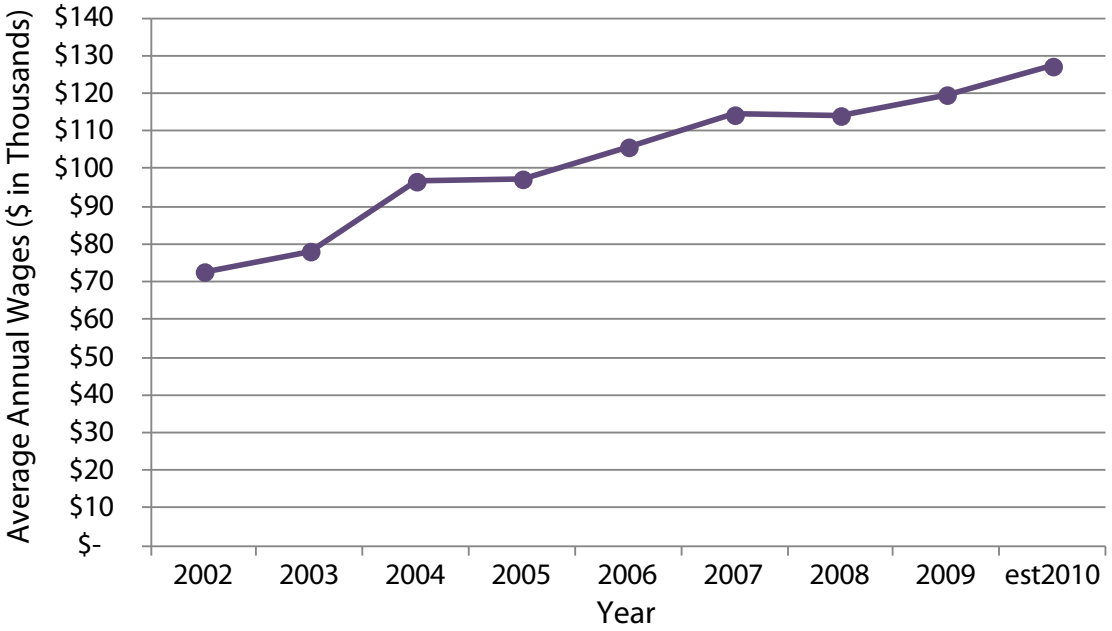


Source: JLARC analysis of ES Quarterly Employment data, Q102 through Q310, NAICS 321113.

Refineries

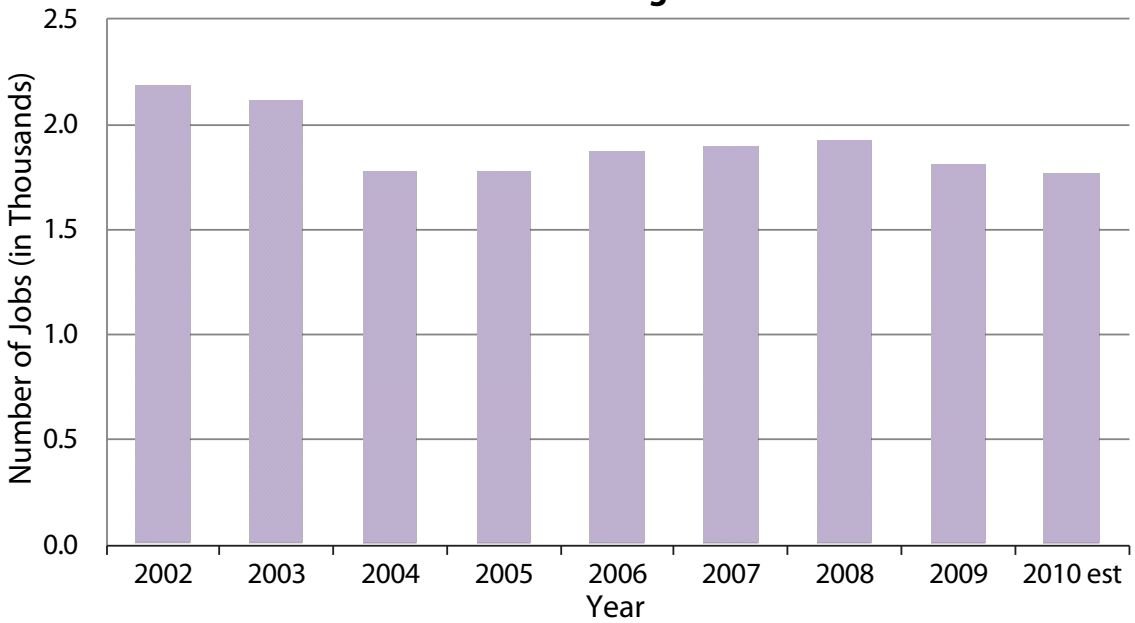
Washington is the principal refining state in the Pacific Northwest. The state's crude oil refining capacity as of January 2010 was 3.6 percent of the U.S.'s capacity. Wages paid to refinery employees exceed both the state's overall average and that of the manufacturing sector, as shown in Exhibit 20, below. Employees at the state's five refineries, all located in the Puget Sound area, have varied from 2,181 in 2002 to about 1,770 in 2010 (see Exhibit 21, below).

Exhibit 20 – Washington Petroleum Refinery Wages – 2002 through 2010



Source: ES Quarterly Employment data, 2002 through Q310, NAICS 324110.

Exhibit 21 – Employment at Washington Petroleum Refineries from 2002 through 2010



Source: ES Quarterly Employment data, 2002 through Q310, NAICS 324110.

Petroleum refining is the most energy-intensive manufacturing industry in Washington. Nationwide, the industry accounts for 7.5 percent of total US energy consumption. However, a large percentage of the energy consumed in refineries is produced onsite. The U.S. Department of Energy's Energy Information Administration notes 60 percent of the power used to run refineries is produced in the refining process and used internally.

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?

JLARC cannot determine the overall impact on the economy if the preference were terminated.

If Washington wood product extractors/manufacturers and refineries were subject to use tax on their use of hog fuel and various refinery-produced fuels, they would either absorb the cost or pass it on to customers in the form of higher prices.

An increase in the price of products could mean lower sales of products produced in Washington, as buyers might choose to not purchase products or purchase them elsewhere. Elasticity of demand refers to the percentage change in demand for a good or service that occurs in response to a percentage change in its price. Demand for timber/wood products is very elastic, meaning demand tends to decrease as prices increase. Demand for fuel tends to be inelastic to a point. Fuel price elasticity studies indicate consumers will not react considerably to substantial price increases due to fuel's inelastic demand. However, fuel prices are inelastic only to a certain point. When fuel prices reach a certain level, they do inhibit consumer and business purchases.

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

There would be no change in tax distribution.

Other States

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

There are 45 states and the District of Columbia that impose a use tax. JLARC found only one other state that provides a specific exemption for fuel used by the plant that manufactured it. Alabama allows a use tax exemption for fuel that is generated by a petroleum-refining process and that is subsequently used to refine petroleum products or generate heat.

Recommendation

Because the public policy objective and intended beneficiaries are unclear, the Legislature should review and clarify the public policy objective of the preference providing a use tax exemption for fuel produced by a manufacturer or extractor and used in the same operation that produced it.

Legislation Required: Possibly

Fiscal Impact: Yes

HOG FUEL TO PRODUCE ENERGY (SALES & USE TAX)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**JLARC Recommendation**
Provides sales and use tax exemptions for hog fuel used to produce electricity, steam, heat, or biofuel.	The Legislature did not specifically state a public policy objective for these preferences; however, it did make the preferences temporary. Because of the sharp declines in oil and natural gas prices occurring at the time that the preferences were enacted, JLARC infers that the Legislature may have intended to temporarily make the price of hog fuel more competitive.	$3.2 million in 2011-13 Biennium	**Allow to expire**: Because the Legislature intended the exemptions to be temporary and did not provide performance goals to guide any other assessment of performance.

HOG FUEL TO PRODUCE ENERGY (SALES & USE TAX)

Report Detail

Current Law

This tax preference provides an exemption from the retail sales and use tax for hog fuel used to produce electricity, steam, heat, or biofuel. The exemptions expire on June 30, 2013.

Statute defines "hog fuel" as wood waste, including forest derived biomass, and specifically states that hog fuel does not include firewood or wood pellets. The sales tax exemption for hog fuel is available only if the purchaser provides the seller with an exemption certificate in a form prescribed by the Department of Revenue. The seller must retain a copy of the certificate for the seller's files. The use tax exemption does not require an exemption certificate.

This review focuses on the sales and use tax exemptions for hog fuel. JLARC is also reviewing three other tax preferences that include consideration of hog fuel. A 2011 review looks at a use tax exemption for extracted fuels, including hog fuel. A second 2011 review discusses a sales and use tax exemption for machinery and equipment used to generate electricity using renewable resources in general. A third preference on harvesting biomass for energy production will be reviewed in 2013.

See page A3-3 in Appendix 3 for the current statutes, RCW 82.08.956 and RCW 82.12.956.

Legal History

1935 The Legislature created the retail sales tax and companion use tax in 1935. The sales tax applied to retail sales of tangible personal property in Washington while use tax applied to the use of tangible personal property purchased at retail in another state or produced or manufactured for commercial use within Washington. No exemptions were provided for hog fuel.

1949 The Legislature provided a specific use tax exemption for fuel produced in extracting or manufacturing activities when the fuel is used directly in the operation of the extracting or manufacturing activity. In the timber industry, hog fuel was considered an extracted fuel. For example, if a timber product manufacturer generated hog fuel and then used it as fuel to dry lumber, the hog fuel was exempt from use tax under the extracted fuel exemption.

2009 The Legislature passed a bill entitled "Environmental Tax Incentives" that included temporary sales and use tax exemptions for hog fuel sold or used to generate electricity, steam, heat, or biofuel.

Other Relevant Background

What Is Hog Fuel?

Hog fuel is composed primarily of tree bark and/or wood scraps that have been fed through a mechanical chipping device (a "hog"). The wood waste is ground into a size and consistency that can be used to fire boilers or furnaces. Because statute defines hog fuel as wood waste and forest derived biomass, the terms hog fuel, wood waste, and wood or forest biomass are intermixed in this review.

Historically, after completing a logging job, many parts of the harvested tree were left uncollected. The branches, tops, bark, and other parts of the tree had no market value. These wood wastes, referred to as slash in the timber industry, were either put into landfills or burned in open piles on the logging site. At wood processing facilities, the wood chips and sawdust were often burned in "teepee" burners just to get rid of them. Urban wood waste from construction and demolition jobs, discarded furniture, pallets and packing crates, etc., was typically disposed into a landfill. Now electricity, steam, heat, and other biofuels can be generated from what was once wood waste.

Where Does Hog Fuel Come From?

Exhibit 22 below shows the types and numbers of tons of wood waste that were produced in Washington in 2010.

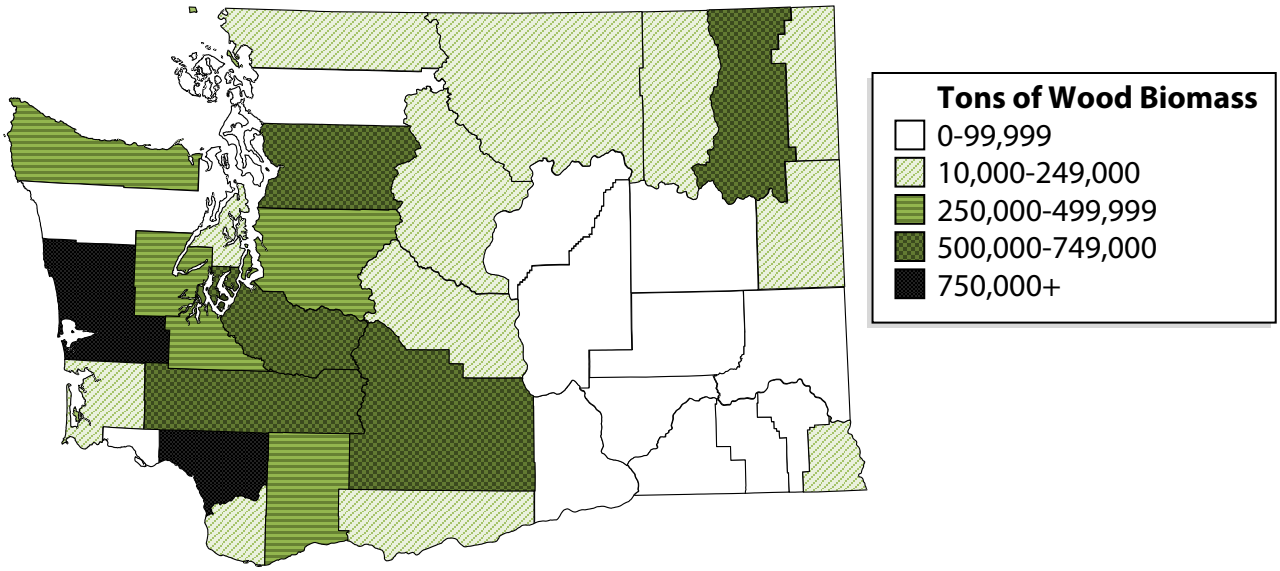
Exhibit 22 – Washington Wood Waste in 2010

Source of Wood Waste	Number of Tons	Percent of Wood Waste
Lumber Mill	5,278,353	59.1%
Logging	1,901,072	21.3%
Forest Thinning	505,666	5.7%
Land Clearing Debris	418,595	4.7%
Urban Wood Waste	834,057	9.3%
TOTAL Wood Waste	**8,937,743**	**100%**

Source: Pacific Region Bioenergy Partnership.

Every county in the state produces some wood waste, ranging in 2010 from less than 2,500 tons in Adams County to nearly 955,500 tons in Grays Harbor County. Exhibit 23 on the following page shows how much wood biomass was produced in each county in 2010.

Exhibit 23 – Tons of Wood Biomass Produced in 2010



Source: Pacific Region Bioenergy Partnership.

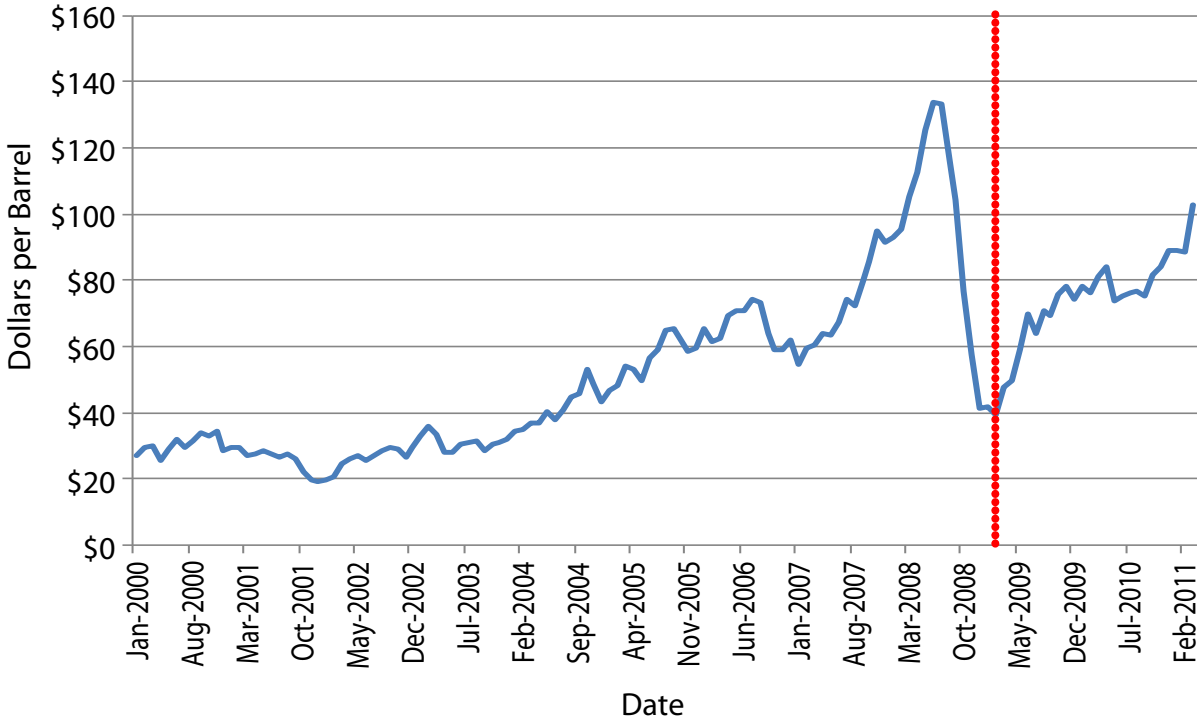
Hog Fuel Used in Energy Generation

Only a portion of the wood waste produced in Washington is used for energy generation. In the 1990s, approximately 3.3 million tons of wood waste were combusted each year for energy production. As the timber industry started a decline in 2005, so did the use of hog fuel for energy. In 2009, less than 1.4 million tons of hog fuel were used to produce energy. Use is projected to remain below this mark for 2011 through 2013. However, in November 2006, Washington voters approved Initiative 937, the Energy Independence Act. The initiative mandates that electric utilities with 25,000 or more customers meet specified electricity generation requirements using renewable energy sources such as wood waste. Because of this, the demand for hog fuel and other wood waste might increase in future years.

Hog Fuel Exemptions Passed at Time of Declining Oil Prices

The Legislature passed the sales and use tax exemptions on hog fuel as oil prices were taking a sharp drop. The price of hog fuel was also declining, though far less dramatically. From an economic standpoint, at the time the tax exemptions were enacted, the new lower price of oil made oil a less expensive source of energy than wood biomass in boilers that could use either fuel. Exhibit 24 on the following page shows changes in oil prices over time and marks the point at which the tax exemptions on hog fuel were being considered.

Exhibit 24 – Oil Prices Dropped Dramatically in 2008



Source: Spot Prices for Crude Oil and Petroleum Products, Thompson Reuters, 4/13/2011.

Public Policy Objective

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

The Legislature did not state a public policy objective for the sales and use tax exemptions on hog fuel.

Because of the sharp declines in oil and natural gas prices occurring at the time the preferences were enacted, JLARC infers that the Legislature may have intended to temporarily make the price of hog fuel more competitive in relation to oil and natural gas prices by providing the tax exemptions.

Additionally, because the sales and use tax exemptions on hog fuel were included in a bill containing several other tax preferences designed to promote renewable energy, the public policy for the hog fuel tax exemptions may have been to promote the use of hog fuel as a source of renewable energy.

Preferences Intended To Be Temporary

As mentioned above, the Legislature included these sales and use tax exemptions for hog fuel in a bill that provided numerous environmental tax incentives. The Legislature made a decision about the end date for each preference. For some preferences, such as the livestock nutrient incentives and an incentive related to radioactive waste cleanup, the Legislature chose to have no expiration dates. Other preferences in the same bill have specific expiration dates, and the dates vary. For example, sales and use tax exemptions related to renewable energy have the same 2013 expiration date as the hog fuel preferences. The Legislature provided a 2015 expiration date for a biomass energy preference and expiration dates of 2018 and 2020 for different solar incentives. Given the

construction of the bill, JLARC assumes the Legislature made a deliberate choice to make the hog fuel exemption temporary.

No Performance Goals Established

When enacting some tax preferences, the Legislature establishes specific performance goals for the preferences. For example, the Legislature established specific employment level targets for a preference for electrolytic processing businesses and for preferences for the aluminum industry (all reviewed by JLARC in 2009). An assessment of the preference's contribution to reaching a desired goal could assist the Legislature in determining whether to extend an expiration date for a temporary preference. However, in this case, the Legislature did not establish any performance goals for the temporary hog fuel preferences.

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

JLARC found no readily available information to determine whether or not the public policy objectives are being achieved. While seven sellers of hog fuel reported using the sales tax exemption, JLARC did not find any evidence to indicate that the tax exemptions have promoted the use of hog fuel for the generation of electricity, steam, heat, or biofuel beyond what might have occurred without the tax preferences.

Very early in 2008 when oil prices exceeded $120 a barrel and were still climbing, the demand for wood fuels throughout the country was expected to grow. U.S. utility companies were planning to build biomass-fueled power facilities to reduce greenhouse gas emissions and avoid the rising costs of oil. These facilities were expected to come online between 2010 and 2012.

In Washington, according to Northwest Power and Conservation Council data, in recent years four biomass power generation sites were proposed and two more sites moved into the planning stage. However, plans for one of the wood waste burning power plants were canceled and the other planned facility is on hold while county commissioners study biomass issues.

The Legislature did not provide any performance goals to assess this preference.

Beneficiaries

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

The direct beneficiaries of the sales and use tax exemptions are Washington facilities using hog fuel to generate energy. According to Northwest Power and Conservation Council data, 18 facilities in Washington are currently using wood waste to produce energy. If one of these facilities purchases hog fuel from a Washington seller, the user benefits from the sales tax exemption. If the hog fuel is purchased from an out-of-state seller, the user benefits from the use tax exemption. A 2003 study by the Department of Ecology identified 13 facilities in Washington that used some purchased hog fuel. Facilities that generate energy from wood waste they have produced can also qualify for this use tax exemption. However, an additional use tax exemption for extracted fuels also applies to this activity. Discussion of the extracted fuel exemption is contained in a separate 2011 review.

Revenue Impacts

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

In 2009, when the Legislature was considering the hog fuel tax preference, the Department of Revenue estimated the tax savings based on a Department of Natural Resources 2006 Mill Survey that found approximately 1.88 million tons of wood and bark residue had been used as fuel. Due to slower economic conditions, DOR assumed that usage would drop to 1.61 million tons and that two-thirds of this amount would be sold at a value of $20 per ton. The fiscal note projected a total taxpayer savings of $1,336,000 in Fiscal Year 2010. Exhibit 25 below shows the estimated beneficiary savings for FY 2010 through FY 2013.

Exhibit 25 – Estimated Beneficiary Savings from Hog Fuel Exemption

Year	State Tax	Local Tax	Total Tax
FY 2010	$1,050,000	$390,000	$1,440,000
FY 2011	$1,004,000	$373,000	$1,377,000
FY 2012	$1,098,000	$408,000	$1,506,000
FY 2013	$1,262,000	$469,000	$1,731,000
2011-13 Biennial Total	**$2,360,000**	**$877,000**	**$3,237,000**

Source: JLARC estimates based on DOR tax return data, Northwest Power and Conservation Council data, and Forecast Council growth rates (Global Insights).

Recommendation

Because the Legislature intended the exemptions to be temporary and did not provide performance goals to guide any other assessment of performance, the Legislature should allow the sales and use tax exemptions for hog fuel to expire.

Legislation Required: No

Fiscal Impact: None

INTEREST FROM STATE AND MUNICIPAL OBLIGATIONS (BUSINESS & OCCUPATION TAX)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**JLARC Recommendation**
Provides a B&O tax deduction to financial businesses for gross income received as interest from state and municipal government obligations.	The Legislature did not specifically state the public policy objective of the preference. JLARC infers that the public policy objective is to provide consistent tax treatment for interest income from all forms of government obligations.	$1.8 million in 2011-13 Biennium	**Continue**: Because the implied public policy objective of ensuring that tax treatment is consistent for interest from state, municipal, and U.S. government obligations is being achieved.

INTEREST FROM STATE AND MUNICIPAL OBLIGATIONS (BUSINESS & OCCUPATION TAX)

Report Detail

Current Law

This tax preference provides financial businesses a deduction from the business and occupation (B&O) tax for gross income amounts received as interest on obligations of the state government, political subdivisions of the state, and municipal corporations. Municipal corporations include entities such as fire districts, public utility districts, public hospital districts, schools, and water districts.

This exemption provided to financial business is similar to other federal and state exemptions for interest income from government debt, as illustrated in Exhibit 26, below. Federal law prohibits states from taxing the income from obligations of the U.S. government, regardless of the type of investor. U.S. government obligations include treasury notes and bills. The preference in federal law is exempted from the JLARC review process. Nonfinancial businesses are exempt from B&O tax on interest from state and municipal obligations under a separate statute. JLARC reviewed that exemption in 2009.

Exhibit 26 – Exemptions for Interest from Government Debt

Investment	Investor	
	Financial Business	Nonfinancial Business
U.S. government obligations	Exempt under federal law and RCW 82.04.4286	Exempt under federal law and RCW 82.04.4286
State and municipal government obligations	Exempt under this tax preference RCW 82.04.4293	Exempt under RCW 82.04.4281(1)(a)

Source: JLARC analysis of tax law.

See page A3-4 in Appendix 3 for the current statute, RCW 82.04.4293.

Legal History

Until 1969, federal law prohibited states from taxing the income of national banks. The Legislature attempted unsuccessfully to tax the income of national banks in 1929, 1933, and 1935, but the courts held these taxes to be in violation of the U.S. Constitution. State law permitted the taxation of state banks only if the courts upheld the validity of the tax on national banks. As a result, Washington did not tax the income of any financial institution until federal law changed to allow taxation of national banks in 1969. However, at that time the state decided it would not tax income earned from interest on Washington State and municipal debt.

1933 Lawmakers adopted a temporary tax imposed on the privilege of engaging in business activities, including financial business activities.

1935 As part of the 1935 Revenue Act, the Legislature enacted the business and occupation (B&O) tax, containing the majority of the business activities included in the 1933 act. The income of banks and other financial institutions was taxed under the B&O service classification.

In the same year, a court held that the state tax on the income of national banks violated the U.S. Constitution. A provision in the 1935 Revenue Act invalidated the B&O tax on **state** financial institutions if the courts ruled the tax on **national** banks to be invalid.

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

1969 Congress reversed long-standing prohibitions and allowed states to tax national banks, but not federally chartered credit unions. Federal law still precluded states from taxing interest on U.S. government obligations.

1970 The Legislature repealed the B&O deduction for state and national banks following the federal law change. The gross income from engaging in financial business became subject to the B&O tax under the service B&O classification. In the same bill, the Legislature enacted this B&O tax deduction for income derived from interest paid on all obligations of Washington State and municipal governments, including "municipal corporations."

1989 The Department of Revenue (DOR) clarified that the deduction applied to a savings and loan association for interest received on bonds issued by schools and water districts. DOR held that the term "municipal corporation" had a broader meaning than cities and counties, and also included fire districts, public utility districts, public hospital districts, schools, water districts, and other "quasi-municipal corporations."

Public Policy Objectives

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

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

However, JLARC infers that the public policy objective is to provide consistent tax treatment for interest income from all forms of government obligations. Interest is exempt no matter if the investment is in U.S. government obligations or Washington State and municipal government obligations. Interest is also exempt no matter if the investor is a financial or a nonfinancial business.

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

State tax law has a long history of exempting interest on state, municipal, and U.S. obligations for both financial and nonfinancial businesses.

- Nonfinancial businesses have been exempt from tax on all interest income since 1935.
- Financial businesses have been exempt from tax on interest on Washington State and municipal obligations since 1937.

- The federal government has prohibited states from taxing interest from U.S. government obligations since 1864 under the National Currency Act.

Beneficiaries

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

The beneficiaries of the tax preference are banks, savings and loans, insurance companies, pension funds, and other financial businesses that receive income from Washington State and municipal government obligations.

Revenue Impacts

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

The beneficiaries of the tax preference saved an estimated $680,000 in Fiscal Year 2010. The beneficiary tax savings are expected to increase to $4.2 million in the two-year period of the 2011-13 Biennium.

Exhibit 27 – Estimated Beneficiary Tax Savings

Fiscal Year	State Taxes
2009	$700,000
2010	$680,000
2011	$820,000
2012	$860,000
2013	$900,000
2011-13 Biennial Total	$1,760,000

Source: JLARC analysis using data from the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Economic and Revenue Forecast Council.

Recommendation

Because the public policy objective of ensuring that tax treatment is consistent for interest from state, municipal, and U.S. government obligations is being achieved, the Legislature should continue the tax preference.

Legislation Required: No

Fiscal Impact: None

INTEREST ON REAL ESTATE LOANS (BUSINESS & OCCUPATION TAX)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**JLARC Recommendation**
Provides a B&O tax deduction to banks and other financial businesses for interest derived from investments or loans primarily secured by first mortgages or trust deeds on non-transient residential properties in Washington.	The Legislature did not specifically state the public policy objective of the preference. Documents from the period of enactment suggest the original purpose was to encourage Washingtonians to buy homes by making loans more available and less expensive.	$172.6 million in 2011-13 Biennium	**Review and clarify**: Because it is unclear whether the original public policy objective applies, given changes in the lending industry and the rise in the secondary mortgage market.

INTEREST ON REAL ESTATE LOANS (BUSINESS & OCCUPATION TAX)

Report Detail

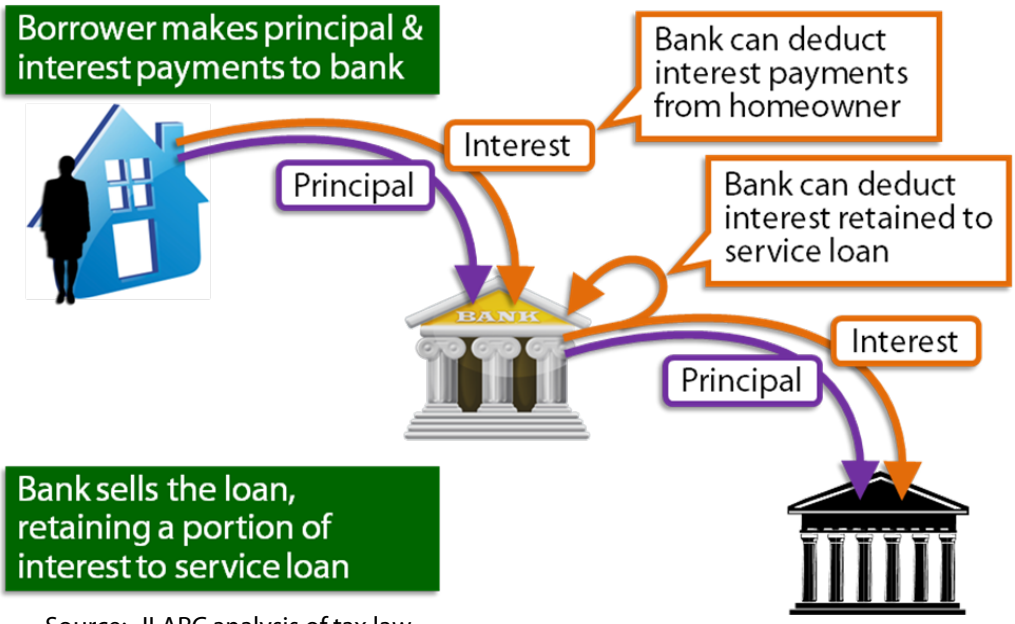
Current Law

This tax preference provides banks and other financial businesses a business and occupation (B&O) tax deduction for interest derived from investments or loans primarily secured by first mortgages or trust deeds on non-transient residential properties in Washington. A deduction is also allowed to the original lender (or successor) for amounts received from servicing loans that have been sold on the secondary market, as long as the servicing fee is based on a percentage of interest paid by the borrower.

Financial businesses include banking, lending, and security businesses. A ***first mortgage*** is the first loan secured by a property, often used to purchase the property. Therefore, home equity loans do not qualify for the exemption if they are second in line to be paid upon sale of a home. ***Non-transient residential property*** is a permanent residence and not a hotel or motel.

The following exhibit provides two examples of the operation of this preference. The first is a simple example of a deduction where a home loan is held by one bank. The second is a more complex example where the bank sells the home loan on the secondary market to investors. Exhibit 28, below, illustrates these transactions.

Exhibit 28 – Mortgage Loan Transactions



Source: JLARC analysis of tax law.

Deductible interest includes amounts received by a financial business to service certain loans after it sells the loan or loan security on the secondary market.

Financial businesses can only deduct amounts paid to service loans if those amounts are:

- Determined by a percent of the interest;
- Received only if the borrower makes payments; and
- Based on a loan originated by the financial businesses claiming the deduction.

A deduction is also allowed for fees charged to borrowers (including points and loan origination fees) that are recognized over the life of the loan as an adjustment to the loan payment.

Financial businesses cannot deduct:

- Fees not recognized over the life of the loan, such as fees for services (such as document preparation fees, finder fees, brokerage fees, title examination fees, fees for credit checks, notary fees, loan application fees);
- Fees received in consideration for an agreement to make funds available for a specific period of time and terms (commonly referred to as commitment fees);
- Gains of the sale of valuable rights; and
- Gains on the sale of loans.

See page A3-4 in Appendix 3 for the current statute, RCW 82.04.4292.

Legal History

National banks are supervised by federal banking law. State banks are supervised by the state banking authority. In Washington, the banking authority is the Department of Financial Institutions (DFI).

Pre-1969 The Legislature attempted unsuccessfully to tax the income of national banks in 1929, 1933, and 1935. In all three instances, the courts found the tax to be in violation of the U.S. Constitution. The Legislature consequently decided it would not tax state banks. As a result, Washington exempted from B&O taxation all income from bank loans of any kind.

1969 Congress reversed long-standing prohibitions and allowed states to tax national banks, but not federally chartered credit unions.

1970 The state Legislature repealed the B&O exemption for national and state banks and certain other financial institutions.

In the same bill, the Legislature provided four specific deductions to maintain the tax status of certain financial income:

1) For **financial businesses**, amounts derived from interest received on investments or loans primarily secured by first mortgages or trust deeds on non-transient residential properties (the subject of this review);

2) For **financial businesses**, amounts derived from interest paid on all obligations of the state, its political subdivisions, and municipal corporations (the subject of a separate 2011 review);

3) For **lending institutions owned exclusively by its borrowers or members engaged solely in making loans for agricultural production**, amounts derived as interest on loans (review scheduled for 2020); and

4) For **state-chartered credit unions**, an exemption for all gross income (the subject of a separate 2011 review).

Following enactment, the Department of Revenue (DOR) and stakeholders engaged in 30-years of administrative appeals and litigation on the first mortgage tax preference. The appeals centered on two issues: 1) what qualifies as non-transient residential property (see Exhibit 29 below), and 2) what qualifies as deductible interest (see Exhibit 30 on the following page). For the most part, subsequent rulings expanded the scope of the deduction.

Exhibit 29 – Rulings on What Qualifies as Non-Transient Residential Property

	Qualifies	Does not Qualify
1974	• Single family residences (1 to 4 units) • Apartments • Construction loans for residential property, including trailer park sites • Mixed residential and business property if the business use is 20% or less of the value • Permanent care nursing & convalescent homes *(reversed in 2000 court ruling)*	• Hotels • Motels • Transient apartments (less than 30 day stay) • Churches
2000		• Nursing homes and convalescent care homes *(court reversed 1974 DOR ruling)*[6]

Source: JLARC Analysis of statute, DOR rulings, and court rulings. All decisions are Department of Revenue rulings, unless noted as a court ruling.

[6] *Lacey Nursing Center v. The Department of Revenue,* 103 Wn. App. 169 (2000).

Exhibit 30 – Rulings on What Qualifies as Deductible Interest

Qualifies	Does not Qualify
1971 Interest on loans by speculative builders and land developers	
1974 Discount points *(codified in 2010)*	
1976 Late charges and pre-payment penalties	
1981 Security interest in mobile homes *(court ruling)*[8]	**1984** Fees for services provided by the lender (setup charges, document preparation fees, title insurance, and recording fees) *(court ruling)*[7] *(codified in 2010)*
1986 Interest on mortgage-backed securities	
1988 Loan origination fees which represent an interest yield adjustment *(codified in 2010)*	**1989** Gain on sale of mortgage-backed securities *(codified in 2010)*
	1999 Interest retained by the lender to service a loan sold on the secondary market (*reversed in 2009 court ruling*)
	2000 Mortgage brokerage fees for serving as a broker between the bank making the loan and the buyer *(codified in 2010)*
2002 Advances to mortgage brokers to fund loans *(court ruling)*[9]	
2009 Interest retained by the lender to service a loan sold on the secondary market *(court reversed 1999 determination) (codified and limited in 2010)*	

Source: JLARC analysis of statute, DOR rulings, and court rulings. All decisions are Department of Revenue rulings, unless noted as a court ruling.

2009 The Washington Supreme Court held in *HomeStreet v. DOR*[10] that interest retained by the lender to service a loan sold on the secondary market qualifies for the deduction.

2010 The Legislature made three major changes in the law related to mortgage interest by:

1) Codifying many of the previous rulings on what qualifies as deductable interest (See Exhibits above);
2) Clarifying the deduction provided in the 2009 *HomeStree*t case applied to the specific circumstances of that case (i.e., to situations where the taxpayer originates the loan and where the retained service fees are based on interest paid by the borrower); and
3) Redefining the nexus required of out-of-state financial businesses in order to be liable for Washington B&O taxes ("nexus" is the connection with a state determined by physical and/or economic presence).

[7] *Aetna Finance v. Darwin*, 38 Wn. App 921 (1984).
[8] *Tacoma Savings & Loan Association v. The Department of Revenue,* No. 277826 (Pierce County Super. Ct. 1981).
[9] *Department of Revenue v. Security Pacific Bank*, 109 Wn. App. 795 (2002).
[10] *HomeStreet v. DOR,* 166 Wn.2d 444 (2009).

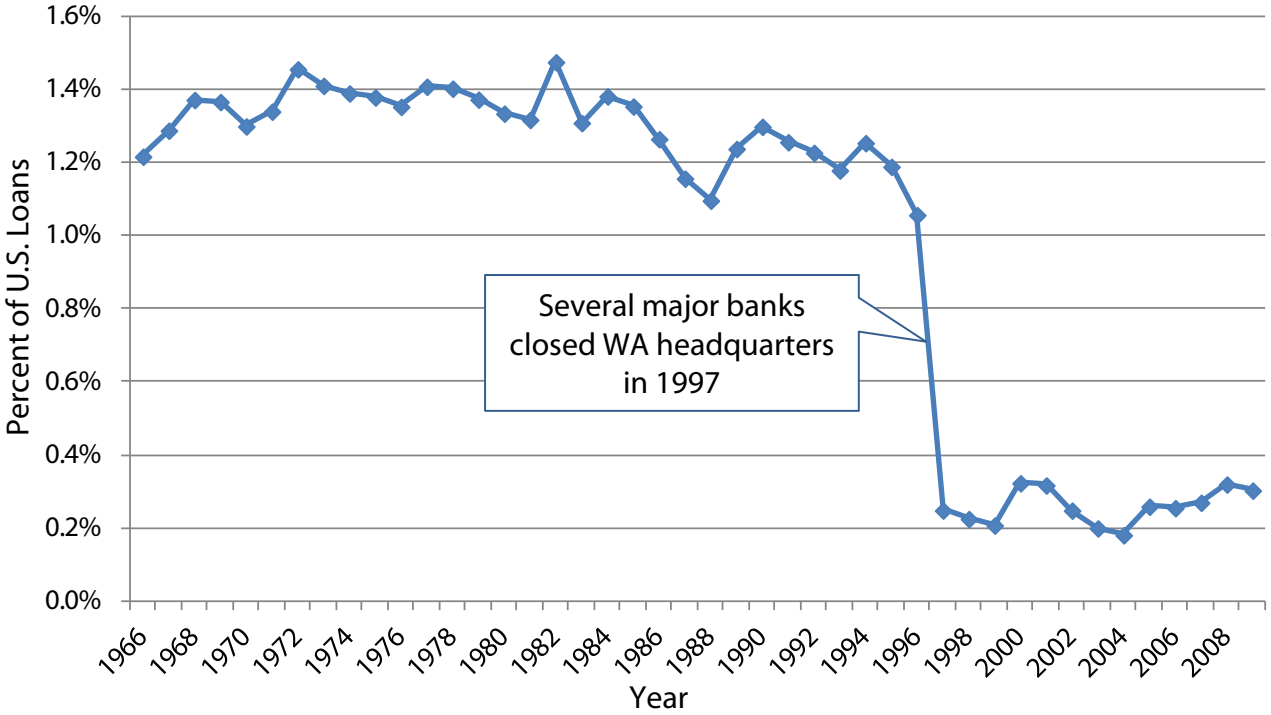
Other Relevant Background

Significant changes in the mortgage lending industry have taken place since enactment of the first mortgage deduction. A number of Washington banks have closed or merged with large multi-state banks. In addition, a secondary market for mortgage-backed securities which began building in the 1980s has developed to the point where the loan originator sells most mortgages on the secondary market.

Bank Consolidations Reduce Loans Held by Local Banks

Mortgages held in Washington have declined due to bank closures and mergers with out-of-state banks. The year 1997 signified a major decline in the amount of residential mortgage loans earning interest in Washington. In that year, several large banks closed their Washington headquarters including Bank of America, U.S. Bank of Washington, KeyBank, and First Interstate Bank of Washington.

Exhibit 31 – Percent of U.S. Loans Paying Interest to WA Banks (One to Four Family Residential Mortgages)



Source: Federal Deposit Insurance Corporation (FDIC).

Mortgage-Backed Security Market Emerges

At the time of enactment of the deduction in 1970, loan availability was highly dependent on borrowers making loan payments. Borrowers would pay interest and principal to local banks which would then use those funds to make loans to other borrowers. Now, loan availability is less dependent on local repayment of loans since most loans are quickly sold on the secondary mortgage market. Today, 87 percent of all first mortgages on home purchases in Washington are sold on the secondary market, and banks now use income from reselling the loan to finance new loans nationwide.

Short-term residential construction loans are also eligible for the deduction if the land is zoned residential and the builder commits or is required to build non-transient residential housing. Residential construction loans do not sell on the secondary mortgage market, but are retained by the originating bank.

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 state the specific public policy objective of this tax preference.

Documents from the period of enactment suggest the original purpose was to encourage Washingtonians to buy homes by making loans more available and less expensive. A letter in 1971 from the Department of Revenue to Senator Hubert Donohue, Chair or the Senate Revenue and Taxation Committee, stated that the purpose of the deduction was:

> *…to stimulate the residential housing market by making residential loans available to home buyers at lower cost.*

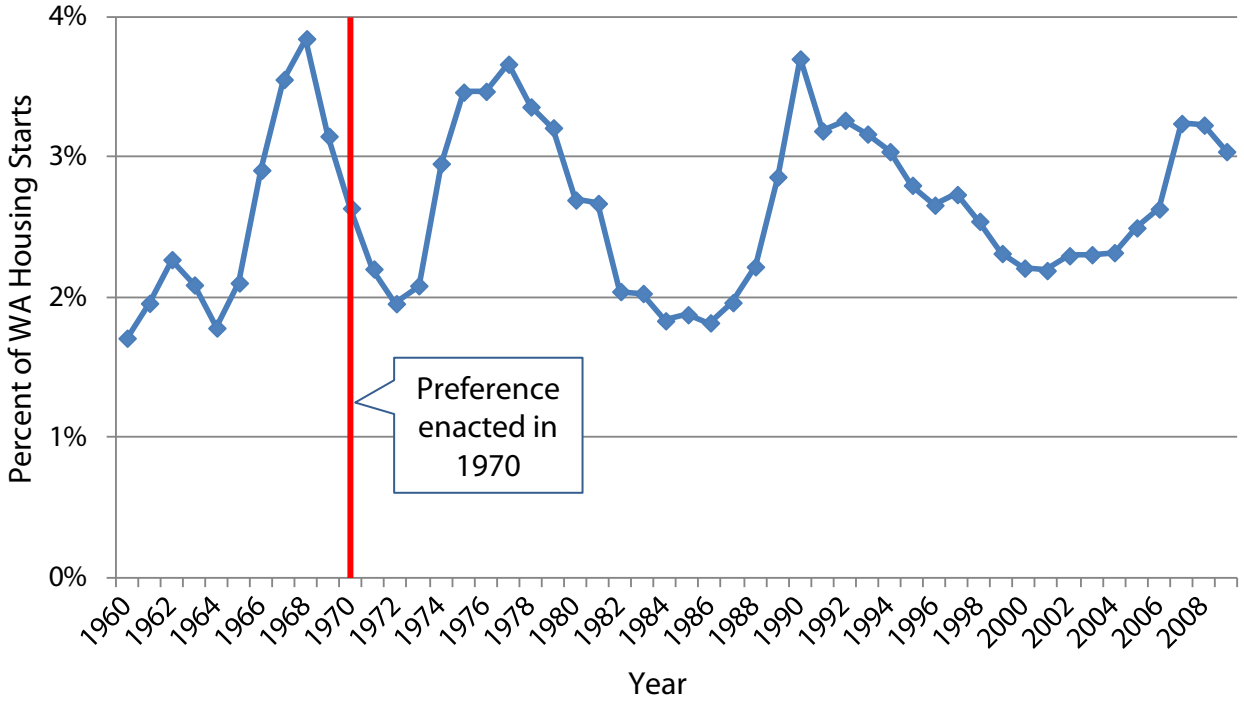
While this objective was originally articulated by DOR, it was subsequently referred to as the public policy objective by the Washington State Supreme Court in two cases, *Security Pacific v. DOR (2002)* and *HomeStreet v. DOR (2009)*. When the Legislature amended the preference in response to the *HomeStreet* opinion, it did not use this opportunity to clarify the public policy objective.

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

It is not clear from the quantitative data whether the deduction has contributed to the achievement of the implied public policy objective.

JLARC analyzed historical banking, interest rate, and homeownership data, and could find no conclusive evidence that the deduction increased loan availability or decreased loan costs in Washington. For instance, Washington housing starts, measured by new housing permits, have fluctuated considerably both before and after enactment of the preference, making it difficult to conclude whether the deduction had an effect on homeownership. See Exhibit 32, below.

Exhibit 32– Unclear if WA Housing Starts are Influenced by the Deduction (WA Housing Starts as a Percent of U.S.)



Source: JLARC analysis of U.S. Census Bureau data, 1966-2009.

On the other hand, changes in the lending industry and the economy appear to have had a significant impact on locally available loans and loan cost.

The Legislature created the deduction in an era when local banks held their own loans and used payments to fund new loans in the community. Most loans are now sold on the secondary market and do not stay in the community to generate new loans. Also, most loans in Washington are made by out-of-state owned and operated banks, and Washington loans are not dependent on local availability of funds.

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

There is no evidence that continuation of the tax preference will contribute to the implied public policy objective of making residential loans available to Washington home buyers at lower cost.

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

A mortgage interest deduction for banks may no longer be an effective mechanism for achieving the implied public policy objective of increasing loan availability and decreasing loan costs in Washington. The deduction tends to benefit banks that do not sell mortgages on the secondary market. Today, the majority of banks do sell loans on the secondary market.

If the Legislature wanted to target the borrower more directly, it could structure a tax preference based on taxes paid by borrowers.

Beneficiaries

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

Currently, there are 111 bank and thrift institutions that make residential mortgage loans in Washington, according to banking data. An estimated 70 percent of the deduction benefits banks headquartered out of the state and 30 percent benefits banks headquartered in Washington. See Exhibit 33, below.

Exhibit 33 – Estimated Deduction Taken for First Mortgage Interest

Location of Headquarters	Interest on Loans Secured by 1st Liens	Percent of Total	Number of Banks
Out of State (estimated)	$1,842,000,000	70%	25
Washington (actual)	$787,000,000	30%	86
Total	$2,629,000,000	100%	111

Source: JLARC Estimate based on 2009 FDIC deposits and call report data. Interest income earned by out-of-state banks is not broken down by location of the loan. Instead, JLARC estimated this interest based on the percentage of Washington branch deposits to all U.S. deposits for each institution.

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

JLARC could find no evidence of unintended beneficiaries.

Revenue and Economic Impacts

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

The beneficiaries of the B&O tax deduction for first mortgages saved an estimated $56.6 million in state taxes in Fiscal Year 2010. Beneficiary tax savings in the two years of the 2011-2013 Biennium are estimated to be $172.6 million. (See Exhibit 34.)

Exhibit 34 – Beneficiary Tax Savings from B&O Tax Deduction for First Mortgages

Fiscal Year	Banks, Savings & Loans, Credit Unions, etc.	Mortgage Companies	Total
2009	$39,400,000	$12,600,000	$52,100,000
2010	$42,900,000	$13,700,000	$56,600,000
2011	$53,500,000	$17,100,000	$70,600,000
2012	$63,000,000	$20,100,000	$83,100,000
2013	$67,800,000	$21,700,000	$89,500,000
2011-13 Biennium	**$130,800,000**	**$41,800,000**	**$172,600,000**

Source: JLARC analysis of FDIC call and thrift reports, Federal Reserve Board Survey of Consumer Finances, DOR tax returns, and projections of U.S. home sales and prices provided by the Economic and Revenue Forecast Council.

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?

JLARC cannot determine the overall impact on the economy if the preference were terminated.

Termination of the tax preference would have some negative effect on the income of financial businesses that make mortgage loans in Washington. The B&O tax on a 15-year $250,000 mortgage loan at a fixed 5percent interest rate would be $225 in the first year. If the lender sold the loan, tax would only apply to the portion of interest retained for servicing the loan.

The cost of lending is determined by a wide variety of factors including the Treasury bill rate. Therefore determining the impact of the exemption on the economy is not possible.

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

There would be no change in the distribution of tax liability. Both in-state and out-of-state banks would pay higher B&O taxes.

Other States

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

Washington is the only state to offer a statewide deduction for income specifically derived from interest on loans secured by first mortgages or trust deeds. However, West Virginia has an identical deduction for municipal business and occupation taxes. Almost all other states use net income or net worth to tax financial institutions and do not provide a deduction for interest.

Recommendation

Because it is unclear whether the original public policy objective applies, given changes in the lending industry and the rise in the secondary mortgage market, the Legislature should clarify the public policy objective of the first mortgage interest deduction.

Legislation Required:	Yes
Fiscal Impact:	Depends on the legislation

INTERSTATE BRIDGES (PROPERTY AND OTHER TAXES)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**JLARC Recommendation**
Provides an exemption from Washington property taxes and all other state taxes to other states for bridges and bridge approaches over rivers or bodies of water forming interstate boundaries.	The Legislature did not specifically state the public policy objective of the preference. The implied public policy objective is to avoid paying Oregon property taxes on Washington-owned interstate bridges by exempting Oregon-owned bridges.	$29 million in 2011-13 Biennium	**Continue**: Because Oregon is not currently taxing Washington on Washington-owned bridges.

INTERSTATE BRIDGES (PROPERTY AND OTHER TAXES)

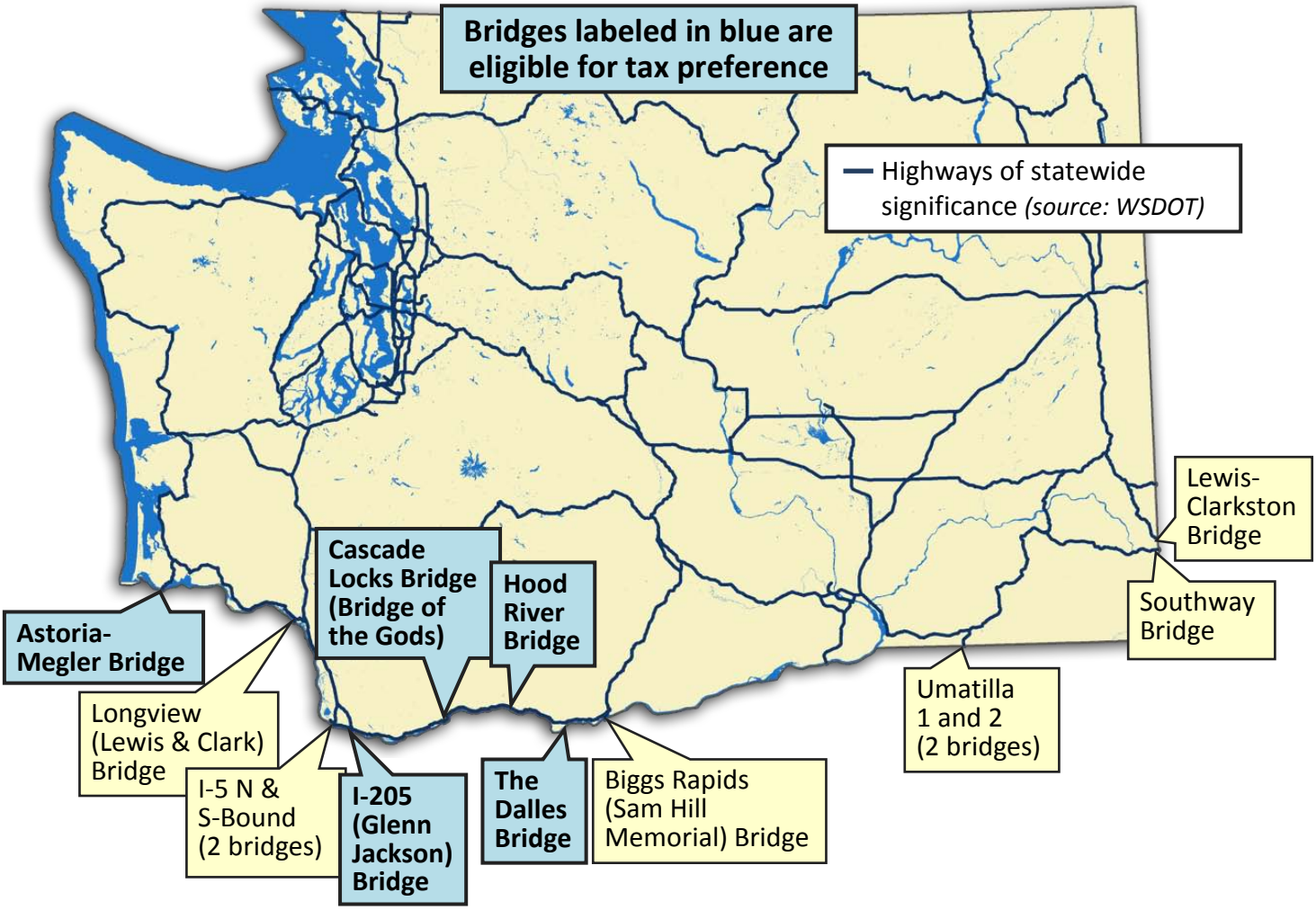
Report Detail

Current Law

This tax preference grants an exemption to other states from Washington property taxes and all other state taxes for bridges and bridge approaches over rivers or bodies of water forming interstate boundaries. The bridge must be constructed or acquired and operated by another state or their municipalities. The other state must also provide the same exemption to Washington.

Thirteen bridges cross rivers bordering Washington and adjoining states. The tax exemption applies to five interstate bridges crossing the Columbia River that are owned and operated by Oregon. See Exhibit 35, below.

Exhibit 35 – 13 Bridges Cross Rivers Bordering Washington and Adjoining States



Sources: Trans-Columbia River Interstate Bridge Studies, HistoryLink.org and Spanning Washington: Historic Highway Bridges of the Evergreen.

The tax exemption does not apply to the two interstate bridges crossing into Idaho and six bridges crossing into Oregon because they were either built jointly by Washington and neighboring states or their municipalities, or they are owned by Washington.

See page A3-5 in Appendix 3 for the current statute, RCW 84.36.230.

Legal History

From 1899 to 1947, private businesses constructed most of the bridges connecting Washington with neighboring states, and operated them as toll bridges. As private businesses, the bridge companies paid property taxes on the value of the bridge property. During this time, the one publicly constructed bridge—the first interstate bridge over the Columbia River between Vancouver, Washington, and Portland, Oregon—was built cooperatively by Clark and Multnomah Counties in 1917.

1937 The Legislature created the Washington Toll Bridge Authority to construct toll bridges and approaches "where advantageous and practical."

1945 The Legislature gave the Washington Toll Bridge Authority the authority to acquire interstate bridges and ferries. Oregon had passed a similar law in 1941.

1947 The Washington Toll Bridge Authority purchased the bridge at Longview (Lewis and Clark Bridge).

1949 According to press reports, the Columbia County assessor in Oregon billed Washington State for property taxes on the Oregon portion of the newly acquired Lewis and Clark Bridge. The previous owner of the bridge, a private business, had paid taxes to Oregon and Columbia County, Oregon for the Oregon portion of the bridge. The Washington Toll Bridge Authority voted to withhold payment until the assessment could be reduced, but the Oregon Tax Commission upheld the assessment.

The Oregon Legislature granted a tax exemption for any bridge owned by another state, but delayed implementation for five years.

In the same year, the Washington Legislature provided other states an exemption from all taxes for bridges over water borders with Washington, but only if the other state provided a similar exemption to Washington State and municipal governments.

1951 Oregon established a reciprocal agreement exempting Washington-owned interstate bridges from Oregon property taxes. Washington and Oregon agreed to split the property tax bill for the unpaid assessment on the Lewis and Clark Bridge.

There have been no substantive changes in the tax exemption since enactment.

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 of this tax preference.

JLARC has concluded that the implied public policy objective is to avoid paying Oregon property taxes on Washington-owned interstate bridges by exempting Oregon-owned bridges.

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

The public policy objective is being achieved. Washington and Oregon are currently not imposing property tax on each other's interstate bridges. Although Oregon repealed its reciprocal exemptions in 2007, Oregon Department of Revenue officials have stated this repeal was inadvertent. Neither Oregon nor Idaho is levying a tax on Washington-owned bridges.

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

Continuation of the tax preference may be necessary to achieve the public policy objective because there are no other statutory provisions that would exempt Oregon-owned interstate bridges from Washington property taxes. Under the Federal Highway Act, states and municipalities own interstate bridges and not the federal government. Washington state-owned property is exempt from property tax, but tax is owed on property owned by another state unless specifically exempted in statute.

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

The public policy objective is being achieved.

Beneficiaries

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

Oregon state, county, and municipal governments, and other authorities in Oregon that impose property taxes are the beneficiaries of the tax exemption for interstate bridges. Five interstate bridges that cross water borders between Oregon and Washington are owned by Oregon, and, in theory, would be taxed if not for the exemption.

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

JLARC found no evidence of unintended beneficiaries.

Revenue and Economic Impacts

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

Oregon governments saved $12.8 million in property taxes in Fiscal Year 2010 from the exemption. Those savings grow to $29 million in the 2011-13 Biennium. The estimated savings are based on calculation of replacement costs for the Washington portion of interstate bridges owned by Oregon and its municipalities.

Exhibit 36 – Estimated Oregon Tax Savings from Interstate Bridge Exemption

Fiscal Year	State Property Tax	Local Property Tax	Total
2009	$2,600,000	$10,900,000	$13,500,000
2010	$2,400,000	$10,400,000	$12,800,000
2011	$2,600,000	$11,100,000	$13,700,000
2012	$2,700,000	$11,600,000	$14,300,000
2013	$2,700,000	$12,100,000	$14,800,000
2011-13 Biennium	**$5,300,000**	**$23,700,000**	**$29,000,000**

Source: JLARC analysis based on information from Washington Department of Transportation, the Department of Revenue property tax estimation model, and the Economic and Revenue Forecast Council.

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?

Oregon and Washington have exempted each other's bridges from taxation for 60 years. Based on this long-standing relationship, even if Washington repealed its exemption, it is unclear that either state would assess taxes on interstate bridge property. Oregon officials stated that the repeal of their reciprocal exemption in 2007 had been an error. So far, Washington has not been presented with a tax bill from Oregon.

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

Other property tax payers in Washington would pay less in property taxes in the event that Washington imposed property tax on Oregon's bridges. Under the property tax system, adding property to the tax rolls shifts a portion of taxes off currently paying property owners and onto the owners of the newly taxable 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?

For this preference, JLARC limited its review of other states to Oregon and Idaho. The tax exemption applies to five interstate bridges between Oregon and Washington. Oregon inadvertently repealed its reciprocal exemption in 2007, but currently does not impose a tax on Washington bridges. The two interstate bridges crossing rivers into Idaho are owned by Washington, and this exemption does not apply.

Recommendation

Because Oregon is not currently taxing Washington on its bridges, the Legislature should continue the property tax exemption for interstate bridges.

Legislation Required: No

Fiscal Impact: None

INVESTMENT OF BUSINESSES IN RELATED ENTITIES (BUSINESS & OCCUPATION TAX)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**JLARC Recommendation**
Provides a B&O tax deduction for two types of investments in related entities: 1) Dividends and distributions paid by subsidiaries to parent entities; and 2) Interest on loans between certain affiliated entities if the total investment and loan income is less than 5 percent of gross receipts of the parent business annually.	The Legislature did not specifically state the public policy objective of the preference. However, by adopting the preference, the Legislature indicated it wanted to exempt income earned by a business from investing in its own subsidiaries and in intercompany loans. These investments are not considered engaging in business for B&O tax purposes.	$14.4 million in 2011-13 Biennium	**Continue**: Because the preference is meeting the implied public policy objective of not treating income from intercompany investments in affiliates as a business activity.

INVESTMENT OF BUSINESSES IN RELATED ENTITIES (BUSINESS & OCCUPATION TAX)

Report Detail

Current Law

This tax preference provides a business and occupation (B&O) tax deduction for certain types of investments that businesses make in related entities.

Deductions are allowed for two types of investment income:

1) Income of parent firms paid by subsidiaries in the form of "dividends" in the case of corporations or "distributions of capital" in the case of partnerships and limited liability companies (LLCs); and

2) Interest on loans between subsidiaries and parents or between subsidiaries of a common parent, but only if the total investment and loan income is less than five percent of annual gross receipts of the business claiming the deduction.

   For example, a parent company makes a loan to a subsidiary, and the subsidiary repays the loan with interest. The parent may deduct the interest income from its gross income for B&O tax purposes as long as the interest income is less than 5 percent of the parent's annual income.

The deduction is available to both financial and nonfinancial businesses. Financial businesses engage in banking, lending, or security activities. Nonfinancial businesses may also take a separate broad deduction for all income from investments (except for the 5 percent limitation on loan income.) JLARC reviewed this tax preference in 2009.

See page A3-5 in Appendix 3 for the current statutes, RCW 82.04.4281(1)(b) and (c).

Legal History

1933 Lawmakers adopted a temporary tax imposed on the privilege of engaging in business activities, including financial and nonfinancial business activities.

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

1935 As part of the 1935 Revenue Act, the Legislature created the business and occupation tax, containing the majority of the business activities included in the 1933 act. The Revenue Act also provided a deduction from the B&O tax for investment income by nonfinancial businesses on amounts derived from *"investments or the use of money as such."* The language of this deduction remained essentially unchanged until 1970.

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

The deduction included the investment income of these businesses. At this point until 1970, tax law exempted all investment income of both financial and nonfinancial businesses.

1966 The Tax Commission ruled that a sale of goods and services between related entities is not an investment and the payment is taxable if it is guaranteed and not dependent on making a profit. For instance, payment made for labor and services by one partner to another partner in a construction project is taxable if the payment is made whether or not the project earns a profit.

1970 After Congress repealed a long-standing prohibition against taxing the income of national banks, the Legislature imposed the B&O tax on the gross income of national and state banks and other financial institutions.

In the same bill, the Legislature enacted an exemption for a specific type of investment income: "amounts derived as dividends by a parent from its subsidiary corporations" that applied to financial and nonfinancial businesses.

2002 The Legislature added the deduction to "distributions from the capital account," a term applied to profits returned to partnerships and LLCs.

In addition, the Legislature extended the deduction for amounts derived from interest on loans between subsidiary and parent entities and between subsidiaries of a common parent, but only if the total investment and loan income was less than five percent of the annual gross income of the parent business.

2010 The Legislature allowed DOR to apply a 35 percent penalty when businesses claim the deduction for a transaction that is a "tax avoidance" transaction. The three types of tax avoidance transactions stated in statute are:

1) Transfer of funds in a joint venture between a construction contractor and the owner that is a guaranteed payment for purchase of services;
2) Income received from an unaffiliated entity that would otherwise be taxable and moved to an affiliated entity that is exempt; and
3) Transfers of title or other ownership interest in tangible personal property to another entity over which the business has control.

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 explicitly state the public policy objective of these preferences.

However, by adopting this tax preference, the Legislature by its action indicated it wanted to exempt income earned by a business from investing in its own subsidiaries and in intercompany loans. These investments are not considered engaging in business for B&O tax purposes.

In a 1986 determination, DOR gave its interpretation of the Legislature's intention: "not to tax the flow of capital between parent and subsidiary corporations. In the case of the flow of funds from subsidiaries to parent, this legislative intent applies whether or not the flow is by way of dividends or interest."

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

By providing this deduction, the Legislature is accomplishing its objective of not taxing income derived by a business investing in subsidiaries or by parent-to-subsidiary or subsidiary-to-subsidiary loans.

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

Continuation of the tax preference would allow beneficiaries to invest proceeds of the business in related entities.

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

The public policy objective is being fulfilled.

Beneficiaries

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

The beneficiaries of the tax preference are the Washington businesses that are owners and partners of subsidiary companies.

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

JLARC found that there could be unintended beneficiaries of the tax preference. In 2010, the Legislature gave DOR the authority to identify and impose a 35 percent penalty on certain "tax avoidance" transactions that some businesses had been using to inappropriately claim 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?

Beneficiaries of the tax preference saved an estimated $6.5 million in Fiscal Year 2010. The beneficiary tax savings are expected to grow to $14.4 million in the two-year period of the 2011-13 Biennium.

This estimate uses data from the 2008 DOR Exemption Study which is based, in part, on taxpayer audit data. No other source of information exists. Data is not available from federal income tax

returns because subsidiary and parent entities file a combined return and do not report intercompany transactions.

Exhibit 37 – Estimated Beneficiary Tax Savings

Year	Corporations
2009	$6,300,000
2010	$6,500,000
2011	$6,800,000
2012	$7,000,000
2013	$7,400,000
2011-13 Biennium	$14,400,000

Source: DOR 2008 Exemption Study.

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?

JLARC cannot determine what impact termination of the tax preference would have on employment and the economy.

If the tax preference were terminated, nonfinancial businesses would still be eligible for a deduction for all types of investment income (see the 2009 JLARC review of investments of nonfinancial businesses). Financial businesses would not be eligible for this deduction on intercompany investments and would pay higher taxes if the preference were terminated.

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

There would be no change in the distribution of tax liability for nonfinancial businesses receiving income from related entities. Financial businesses would pay higher B&O taxes on intercompany income.

Other States

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

Washington is the only state without a corporate income-tax that allows a full deduction for dividends and returns of capital received from subsidiaries and certain interest on intercompany loans.

Thirty-eight states with a corporate income tax allow a full or partial deduction of dividends depending on the share of ownership interest. Interest on loans is not reported in states that require combined reporting of parents and affiliates.

Recommendation

Because this tax preference is meeting the public policy objective of not treating income from intercompany investments in affiliates as a business activity, the Legislature should continue the B&O tax deduction for dividends and distributions of capital paid to parents, and for interest on loans between affiliated entities.

Legislation Required: No

Fiscal Impact: None

LAUNDRY SERVICES FOR NONPROFIT HEALTH CARE FACILITIES (SALES TAX)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**JLARC Recommendation**
Provides a sales tax exemption to nonprofit health care facilities for purchases of laundry services.	The Legislature did not specifically state the public policy objective of the preference. When enacted, the preference provided a specific, targeted sales tax exemption for cooperative nonprofit associates formed by nonprofit hospitals to operate a central laundry facility for hospital members. Documents from this time note the purpose was to reduce member hospitals' laundry costs and assure a standard of laundry quality and cleanliness. JLARC infers the public policy purpose for the 1998 expansion of the preference was to reduce the cost of outsourced laundry services for all nonprofit health care facilities.	$8.8 million in 2011-13 Biennium	**Continue**: Because the implied public policy objective of reducing costs for outsourced laundry services for nonprofit health care facilities is being achieved.

LAUNDRY SERVICES FOR NONPROFIT HEALTH CARE FACILITIES (SALES TAX)

Report Detail

Current Law

This preference exempts sales of laundry services to nonprofit health care facilities from sales tax. Sales tax generally applies to certain services defined as retail sales, including services for cleaning, altering, or repairing tangible personal property.

"Laundry service" is defined in the Department of Revenue's administrative rule to include laundering, cleaning, dying, and pressing items such as clothing, linens, bedding, towels, curtains, drapes, and rugs. It also includes incidental mending or repair. The Department's administrative rule notes the term "nonprofit health care facilities" means "facilities operated by nonprofit organizations providing diagnostic, therapeutic, convalescent, or preventative inpatient or outpatient care services" and includes, but is not limited to, nonprofit hospitals, nursing homes, and hospices.

Excluding these laundry services from the definition of a retail sale also affects laundry services' classification for business and occupation (B&O) tax purposes. Income earned from the laundry services provided to nonprofit health care facilities is taxed under the catch-all service and other activities B&O tax classification (at a higher rate of 1.8 percent), not the retailing classification (at a lower rate of 0.471 percent).

See page A3-6 in Appendix 3 for the current statute, RCW 82.04.050(2)(a).

Legal History

1935 The Legislature passed the Revenue Act of 1935, creating the retail sales tax and the companion use tax. At the time, sales tax applied only to sales of goods, not to the provision of services.

1939 The Legislature amended the definition of "sale at retail" to include services performed to tangible personal property, making labor and services to repair, install, clean, decorate, or alter tangible personal property subject to sales tax when performed in Washington. The legislation provided some sales tax exemptions for services, but none for laundry services to certain parties.

1968 A taxpayer wrote to the Tax Commission seeking guidance on the tax liability of a cooperative nonprofit association formed by several hospitals for the purpose of operating a central laundry facility for the hospital members. Around the same time, another taxpayer wrote to the Commission regarding the taxability of laundry charges made to nursing homes. The Commission instructed both parties that charges for laundry services were subject to retail sales tax. Both responses from the Tax Commission recommended that the writers seek a specific sales tax exemption for laundry services from the 1969 Legislature.

1969 The Tax Commission assisted in drafting proposed legislation to provide a sales tax exemption for certain hospital laundry services. A bill was introduced but did not pass.

1973 The Legislature passed a bill excluding from the definition of retail sale "sales of laundry services to **members by nonprofit associations composed exclusively of nonprofit hospitals.**" The Department of Revenue (formerly the Tax Commission) worked with stakeholders and legislators to narrowly structure the exemption in the form of an exclusion from the definition of retail sale.

Because such laundry services were no longer retail sales, the gross receipts were taxed under the catch-all service and other activities B&O classification at a higher rate (at the time, 1.0 percent) than the lower retailing B&O tax rate (at the time, 0.44 percent). The preference was also structured for only services performed for member hospitals, so that any laundry services performed for nonmembers would not qualify for the exemption.

1998 The Legislature expanded the preference by allowing the sales tax exclusion for sales of laundry services **by any laundry service provider for any nonprofit health care facility.**

Proponents of the bill testified that private hospital laundry services (they noted there were four businesses in the state that specialized in this business) could not compete with the one operating nonprofit laundry cooperative because of the price advantage given by the preference. Legislative records noted the primary sponsor and bill proponents claimed the bill would "level the playing field" and provide "a fair and competitive market." The proponents claimed the loss of retail sales tax would be partly recaptured by a higher B&O tax paid by the laundry providers (an increase from 0.471 percent to 1.5 percent), which was noted as "a good trade off."[11] The Department of Revenue estimated a net reduction in tax receipts of $92,000 in FY 1999 and $215,000 for the 1999-01 Biennium.

Public Policy Objectives

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

Original 1973 Legislation

The Legislature did not specifically state the public policy objective when the preference was initially enacted.

However, the original tax preference provided a specific, targeted sales tax exemption for cooperative nonprofit associations formed by nonprofit hospitals to operate a central laundry facility for its hospital members. Department of Revenue documents from this time note the purpose was to reduce the nonprofit hospital members' hospital laundry costs and to assure a standard of laundry quality and cleanliness.

[11] Senate and House bill reports, HB 2566.

1998 Expansion of the Preference

The Legislature also did not state a public policy objective for the preference with its expansion in 1998. The result of the expansion is that it broadened the providers that could provide tax-free laundry services **and** the beneficiaries who could purchase tax-free laundry services to include any nonprofit health care facility. JLARC infers the public policy purpose was to reduce the cost of outsourced laundry services for all nonprofit health care facilities.

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

Because nonprofit health care facilities realize a reduction in their costs for outsourced laundry charges in the sales tax they do not pay, there is evidence the implied public policy objective has been met. Beneficiaries save an estimated statewide average 8.9 percent sales tax rate on their purchases of laundry services.

Beneficiaries

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

Beneficiaries of the preference are nonprofit health care facilities that contract with and pay for laundry services provided by an outside laundry service. JLARC is unable to determine the specific health care facilities that make use of this preference.

The term "nonprofit health care facilities" is not statutorily defined for excise tax purposes. The Department of Revenue's administrative rule states the term includes "facilities operated by nonprofit organizations providing diagnostic, therapeutic, convalescent, or preventative inpatient or outpatient care services" and includes, but is not limited to, nonprofit hospitals, nursing homes, and hospices. The Washington Healthcare Facilities Authority's administrative rule WAC 247-04-020 lists 44 types of facilities that are health care facilities, spanning the health care spectrum.

There are currently 42 nonprofit hospitals in Washington out of 96 listed by the Washington Hospital Association. Out of more than 230 nursing homes in the state, about 40 are nonprofit. It is unclear how many other nonprofit health care facilities might qualify for or use this preference to purchase laundry services.

Revenue Impacts

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

JLARC estimates that beneficiaries saved $4.0 million in FY 2010. Estimated beneficiary savings in the 2011-2013 Biennium are about $8.8 million. See Exhibit 38, on the following page.

Exhibit 38 – Estimated Beneficiary Savings – Laundry Services for Nonprofit Health Care Facilities (in $ millions)

FY	State Sales Tax	Local Sales Tax	Total Sales Tax
2009	$2.9 M	$1.1 M	$4.0 M
2010	$2.9 M	$1.1 M	$4.0 M
2011	$3.0 M	$1.1 M	$4.1 M
2012	$3.1 M	$1.2 M	$4.3 M
2013	$3.3 M	$1.2 M	$4.5 M
2011-13 Biennial Total	**$6.4 million**	**$2.4 million**	**$8.8 million**

Source: JLARC analysis of DOR Tax Return data FY09 & FY10, accredited laundry services and NAICS 812331 and 812332 reporting under service B&O classification. Growth factors using health services job growth estimates for FY11-12.

It should be noted that the aggregate impact the state would realize if the preference were terminated would be less than the taxpayer savings noted in Exhibit 38. While beneficiaries would pay retail sales tax on outsourced laundry services, laundry service providers would in turn pay a lower B&O tax rate – the retailing B&O tax at a 0.471 rate instead of the service and other activities B&O tax, currently at a 1.8 percent rate.

According to Modern Healthcare magazine, laundry services are now the third most outsourced service for health care facilities nationally and have the fastest growth in outsourcing of healthcare facility services. JLARC asked the Washington State Hospital Association (WSHA) whether it was aware of a trend toward outsourcing laundry services in Washington. WSHA industry representatives responded they were not aware of any trend one way or another.

Recommendation

Because the public policy objective of reducing costs for outsourced laundry services for nonprofit health care facilities is being achieved, the Legislature should continue the preference.

Legislation Required: No.

Fiscal Impact: None.

LIMITED INCOME PROPERTY TAX DEFERRAL (PROPERTY TAX)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**JLARC Recommendation**
Allows taxpayers with less than $57,000 of disposable income to defer one half of the property taxes or special assessments due on their primary place of residence.	The Legislature stated in the enacting legislation that the intent of the preference is to: "(a) provide a property tax safe harbor for families in economic crisis; and (b) prevent existing homeowners from being driven from their homes because of overly burdensome property taxes."	$270,891 in 2009-11 Biennium (to be repaid with interest)	**Review and clarify**: Because the intended beneficiaries of this preference are not clear in light of the recent economic recession, the Legislature should clarify the preference to define "families in economic crisis" and identify measurable evaluation criteria.

LIMITED INCOME PROPERTY TAX DEFERRAL (PROPERTY TAX)

Report Detail

Current Law

The preference allows taxpayers with less than $57,000 of disposable income to defer half of the property taxes or special assessments due on their primary place of residence.

To qualify, the taxpayer must have owned the residence for five years, have fire and casualty insurance, and have already paid half of the annual property taxes or special assessments. The cumulative amount that any taxpayer may defer is limited to 40 percent of the equity value in the home. Therefore, taxpayers who owe more than their homes are worth (i.e., "negative equity") are not able to take this deferral.

Taxes deferred under this preference become a lien on the taxpayer's property and accrue interest based on an average of federal short-term rates. These rates have varied from a high of 7 percent for deferrals taken in 2008 to a low of 3 percent for those taken in 2010. Taxpayers may repay the deferred amount and interest at any time, but these amounts become due when:

- the residence is sold;
- the residence is condemned;
- the taxpayer moves; or
- the taxpayer dies (unless a qualified surviving spouse elects to continue).

County treasurers issue annual tax statements to property owners in mid-February. Generally, owners must pay at least one-half of the tax by April 30, and the remainder by October 31. Under this preference, eligible households may defer the half due in October, but only if they have already paid the half due in April. Since its enactment in November 2007, taxpayers have been able to elect the deferral three times: October 2008, October 2009, and October 2010.

See page A3-6 in Appendix 3 for the current statute, RCW 84.37.030.

Legal History

2001 The voters passed Initiative 747, which limited property tax increases.

2007 In early November the Washington State Supreme Court invalidated Initiative 747 since the initiative text had not reflected then-current law.[12] In late November the Governor called a special session of the Legislature to re-enact I-747's limit on property tax increases and also to provide a property tax deferral to households under the median income. The Legislature enacted the property tax deferral for qualified households with less than $57,000 in

[12] *Wash. Citizens Action of Wash. v. State*, 162 Wn.2d 142 (2007).

disposable income. The bill also required taxpayers seeking to defer special assessments to have first opted for any available installment payment plans. The Legislature stated "an increasing number of economic and financial pressures [were] causing hardships to many homeowners" in Washington.[13]

2010 The Legislature expanded the preference by allowing taxpayers to qualify for the deferral without first opting for any available installment payment plans on special assessments.

2011 The Legislature reduced the Department of Revenue's appropriation in the 2011-13 Biennial Operating Budget by the amount used to reimburse counties for deferrals, under the assumption that this preference would be terminated. However, the preference was not terminated and remains in effect.

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 stated in the enacting legislation that the intent of the limited income property tax deferral program is to: "(a) provide a property tax safe harbor for families in economic crisis; and (b) prevent existing homeowners from being driven from their homes because of overly burdensome property taxes."[14]

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

The preference is making temporary tax relief available to qualified households making under $57,000. As discussed in more detail on the following page, there are 181 actual participants out of an estimated 425,000 potential participants statewide. It is unclear the extent to which the preference is providing a "property tax safe harbor for families in economic crisis," since the Legislature did not define "economic crisis" and did not identify specific criteria to use when evaluating the preference.

It is unknown to what extent the tax preference has contributed to preventing "homeowners from being driven from their homes." The effectiveness of the tax preference is dependent on the specific economic conditions and decisions of each participating household.

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

Continuation of the tax preference will continue to provide temporary tax relief for qualified families that elect to take the deferral. The effectiveness of the tax preference to keep families in their homes will continue to depend on the specific economic conditions and decisions of each household.

[13] 2007 sp.s. c 2 § 1(1).

[14] 2007 sp.s. c 2 § 1(2).

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

Because the Legislature did not define "families in economic crisis," JLARC is unable to determine whether the public policy objectives are being fulfilled or if modification of the preference is needed.

Beneficiaries

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

Eligible taxpayers are Washington homeowners who have owned their home for more than five years, have less than $57,000 in disposable income, and have paid the first half of their property taxes. Over the three years of the program, 181 actual beneficiaries in 19 counties have elected to take the deferral. Of these, 30 households have since repaid the deferred amount with interest. See Exhibit 39 below.

Exhibit 39 – Most Participants Have Taken the Deferral One Time

Times Household Has Taken the Deferral	Households (Deferral Not Yet Repaid)	Households (Deferral Repaid)	Total Households
One Time	101	26	127
Two Times	37	3	40
Three Times	13	1	14
Total Households	**151**	**30**	**181**

Source: JLARC analysis of DOR data.

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

JLARC found no evidence that the tax preference is providing unintended benefits to other entities.

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?

Since taxpayers must eventually repay all taxes deferred under this preference, there are no taxpayer savings overall. The state will eventually experience an overall gain in revenue, since taxpayers will pay interest on the amounts deferred. As of March 2011, the deferrals have accrued $24,598 in interest, of which $2,497 has been repaid. JLARC will not attempt to forecast future deferral amounts due to the low participation rate; small fluctuations in the economy, property values, or program awareness could have a substantial impact on the accuracy of any estimate. See Exhibit 40 on the following page for amounts deferred and repaid through Fiscal Year 2011.

Exhibit 40 – Deferrals Exceed Repayments in the Initial Years of the Program

Fiscal Year	Amount Deferred	Amount Repaid	Deferrals Less Repayment
2009	$89,275	$5,821	$83,454
2010	$162,526	$35,958	$126,568
2011	$187,658	$43,335*	$144,323*
2009-11 Biennium	**$350,184**	**$79,293***	**$270,891***

* Projected estimate based on actual amounts received as of March 16, 2011.

Source: JLARC analysis of Department of Revenue data.

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 terminated, homeowners would not be able to defer taxes in future years. Unless the Legislature also modified the provisions that govern repayment, current beneficiaries that have already deferred property taxes would not be affected.

In 2010 there were approximately 57,000 foreclosures in Washington. If the tax preference had been terminated, the 181 participants would have been unable to defer their property taxes. While the lack of a deferral may have had a significant impact on an individual household, it would have had a minimal impact on the statewide foreclosure rate, economy, or employment in Washington.

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

If terminated, there would be no change in the distribution of liability for payment of state taxes. During the deferral period, the State Treasurer pays the taxpayer's deferred share of property taxes and special assessments to the appropriate county treasurers out of the State General Fund. When repayment is due, the taxpayer remits the deferred amount plus interest to the State General Fund. There is no impact on the property taxes of nonparticipants, so termination would not affect the distribution of liability.

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?

Similar to Washington, three other states and the District of Columbia provide a deferral of annual property taxes based on a household income threshold. See Exhibit 41 below.

Exhibit 41 – Three Other States and D.C. Have Similar Property Tax Deferrals

State	Income Threshold	Interest	Taxes Deferrable
Alaska	Federal Poverty Guidelines	0%	100% (at local discretion)
District of Columbia	$50,000	8%	100%
Florida	Eligible for Florida's homestead credit	Tied to investment yields (7% max)	5% of household income
Washington	$57,000	Tied to Federal rates (3%-7% in 2008-10)	50%
Wyoming	$55,875 (in 2010)	4%	50%

Source: JLARC analysis of CCH data and state government websites.

Additional Questions

The Legislature instructed JLARC to answer the following questions pursuant to RCW 84.37.902.

What is the effectiveness of the property tax deferral program in assisting families in economic distress in remaining in their homes? What is the effectiveness of the program in decreasing the default rate on residential mortgages for the statewide population within the income threshold of the program?

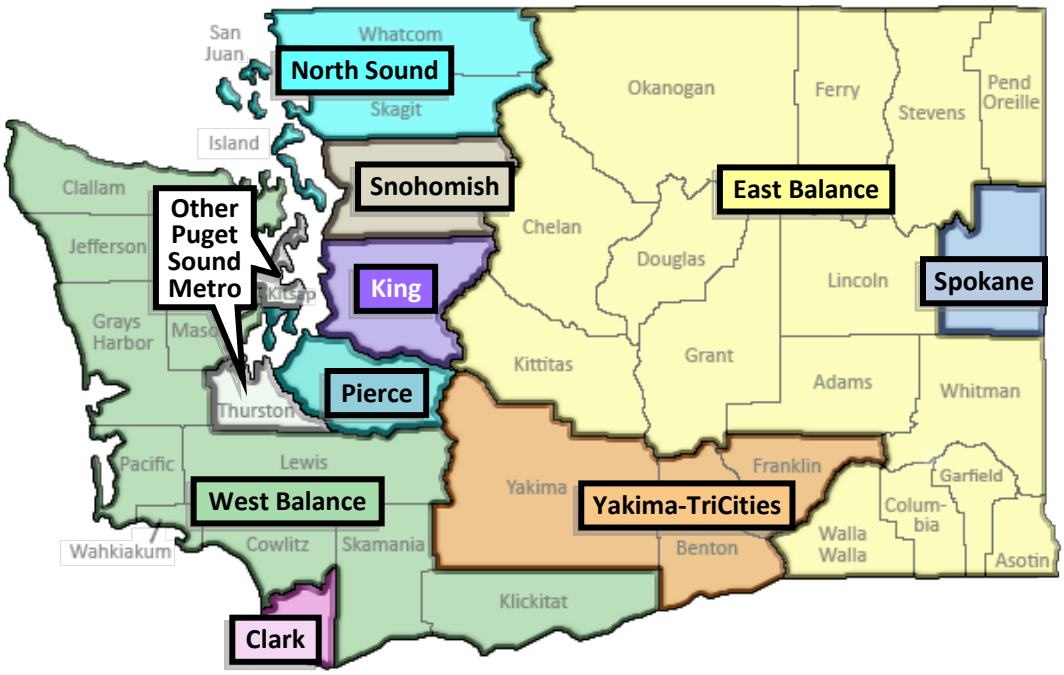
It is unclear exactly how effective the deferral program has been, since the Legislature did not define economic distress, and statistics are not readily available. Whether any specific household would have defaulted on its residential mortgage without the deferral is based on that household's individual circumstances and decisions.

Foreclosures have risen sharply following the economic downturn, but participation in the program remains significantly lower than expected in the fiscal note. The preference is not available to homeowners whose outstanding mortgage debt exceeds their property values. Even if all 181 participants would have defaulted without the deferral, they would have had a minimal effect on Washington's 2010 default rate of approximately 57,000 foreclosures.

What is the number of potential participants per thousand population by geographic region? What is the ratio of actual participants to potential participants by region?

To answer questions related to geographic region, JLARC used the regions in the Office of Financial Management's Washington State Population Survey. See Exhibit 42 on the following page.

Exhibit 42 – Geographic Regions from the Washington State Population Survey



Source: OFM.

To estimate the number of potential deferral participants, JLARC used OFM's Washington State Population Survey to determine the approximate number of home-owning households in Washington with an income of less than $57,000. To adjust this estimate for households that would not qualify for the deferral, JLARC subtracted a proportional amount of households estimated to have defaulted on their mortgages, to have negative equity in their homes, or to have purchased a home within the last five years. See Exhibit 43 below.

Exhibit 43 – Participation Rates Are Low Across Washington State (2008-2010)

Region	Potential Participants Per Thousand Pop.	Estimated Potential Participants	Actual Participants	Participation Rate
North Sound	79	33,000	11	0.03%
Snohomish	39	28,000	24	0.09%
King	42	81,000	41	0.05%
Pierce	51	43,000	14	0.03%
Other Puget Sound Metro	48	24,000	25	0.10%
West Balance	112	53,000	13	0.02%
Clark	53	23,000	36	0.16%
Spokane	109	51,000	14	0.03%
Yakima-TriCities	90	43,000	1	0.00%
East Balance	89	46,000	2	0.00%
Statewide	**63**	**425,000**	**181**	**0.04%**

Source: JLARC analysis of data from DOR, the OFM Washington State Population Survey, the American Community Survey, the Washington Center for Real Estate Research, RealtyTrac, CoreLogic, and the Federal Financial Institutions Examination Council (Home Mortgage Disclosure Act).

What is the ratio of average annual household property taxes for participants to average annual income of participants by geographic region?

Exhibit 44, below, provides details on the average property taxes and annual income of deferral participants by geographic region.

Exhibit 44 – Ratio of Participant's Taxes to Income is 10% Statewide, but Varies by Location

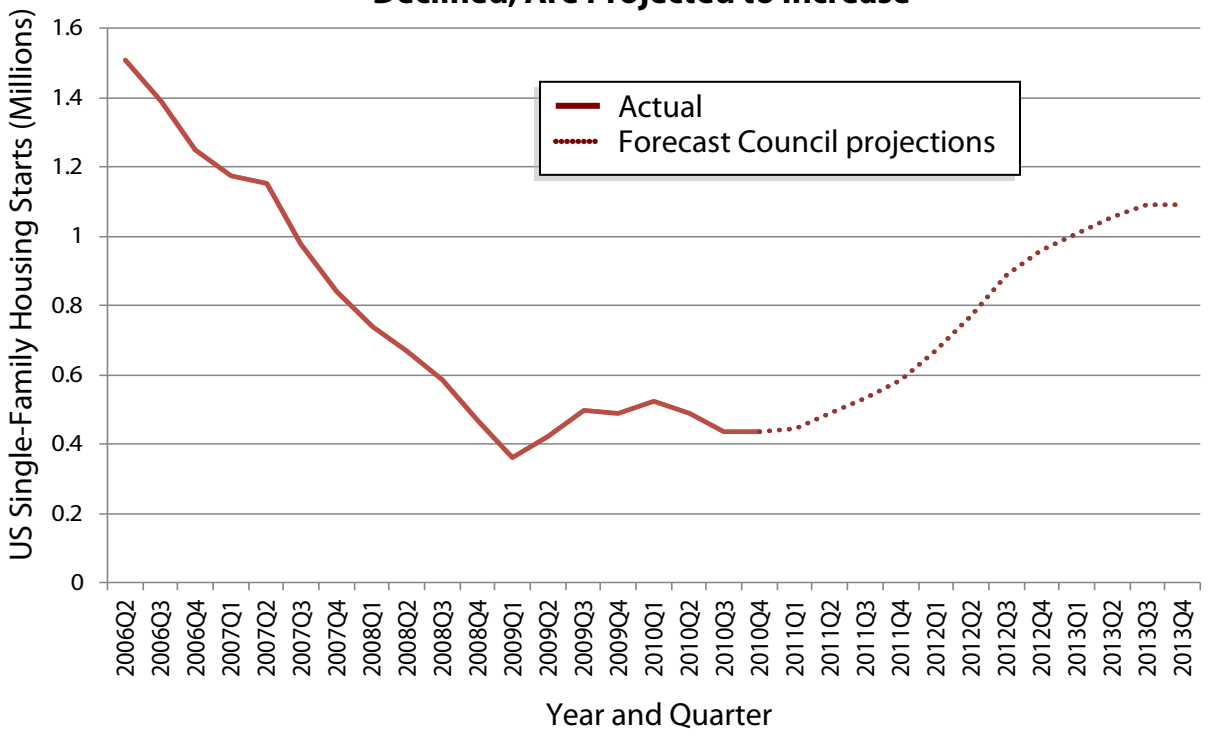
Survey Region	Number of Participants	Avg Participant Property Taxes	Avg Participant Income	Ratio of Average Taxes to Income
North Sound	11	$2,598	$33,251	8%
Snohomish	24	$3,660	$41,708	9%
King	41	$5,334	$33,208	16%
Pierce	14	$3,891	$33,887	11%
Other Puget Sound Metro	25	$2,865	$37,466	8%
West Balance	13	$2,214	$34,873	6%
Clark	36	$3,334	$31,441	11%
Spokane	14	$2,146	$31,145	7%
Yakima-TriCities	1	$2,070	$40,919	5%
East Balance	2	$5,008	$25,495	20%
Statewide	**181**	**$3,603**	**$34,544**	**10%**

Source: JLARC analysis of DOR data using OFM Survey Regions.

What are the economic conditions in the housing and lending markets for the prior three years and the forecasted economic conditions for the current biennium and the next succeeding biennium?

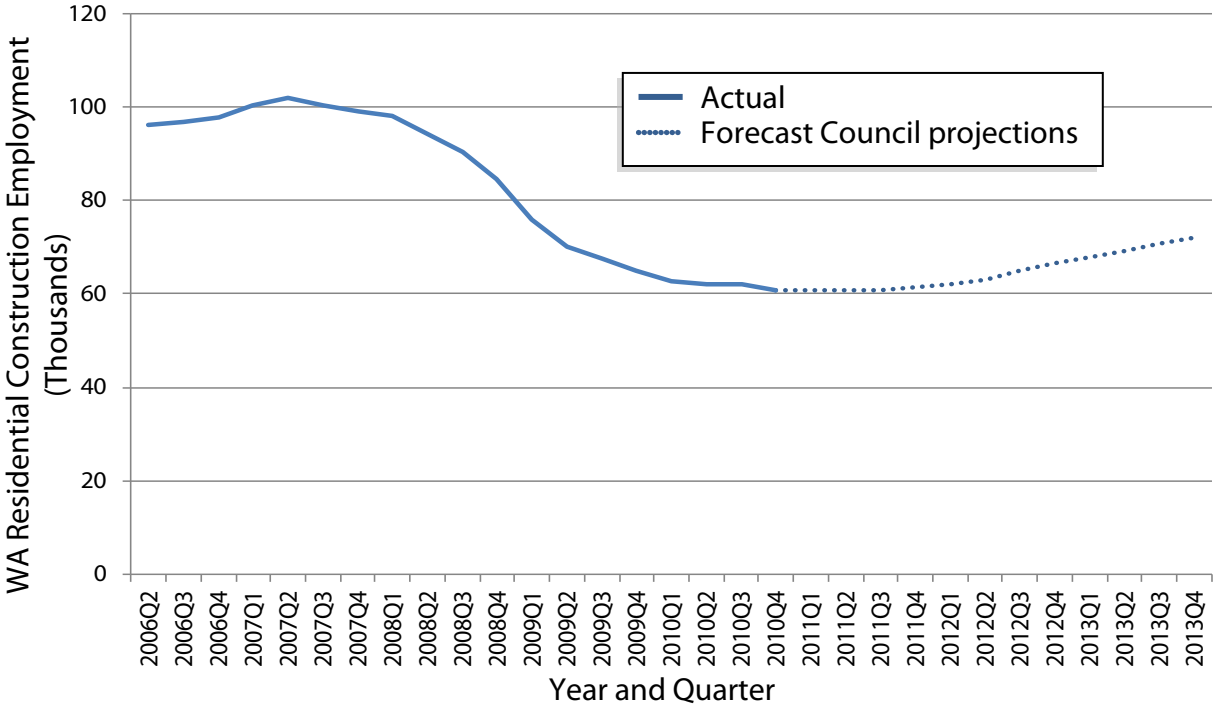
The economic conditions in the housing and lending markets have significantly declined in the past three years as a part of the housing market collapse and the economic downturn. Conditions are not expected to return to pre-recession levels in the next biennium. See Exhibits 45, 46, and 47 on the following pages.

Exhibit 45 – US Single-Family Housing Starts Have Declined, Are Projected to Increase



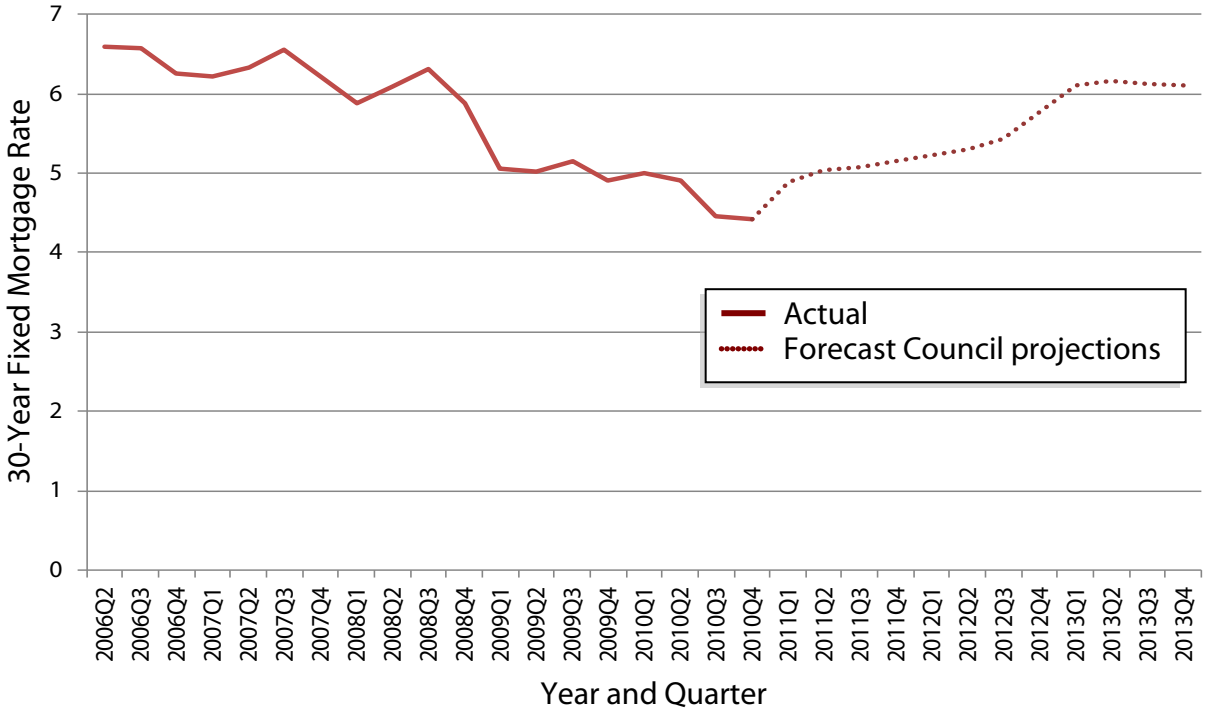
Source: Economic and Revenue Forecast Council.

Exhibit 46 – Washington Residential Construction Employment Has Declined, Is Projected to Increase



Source: Economic and Revenue Forecast Council.

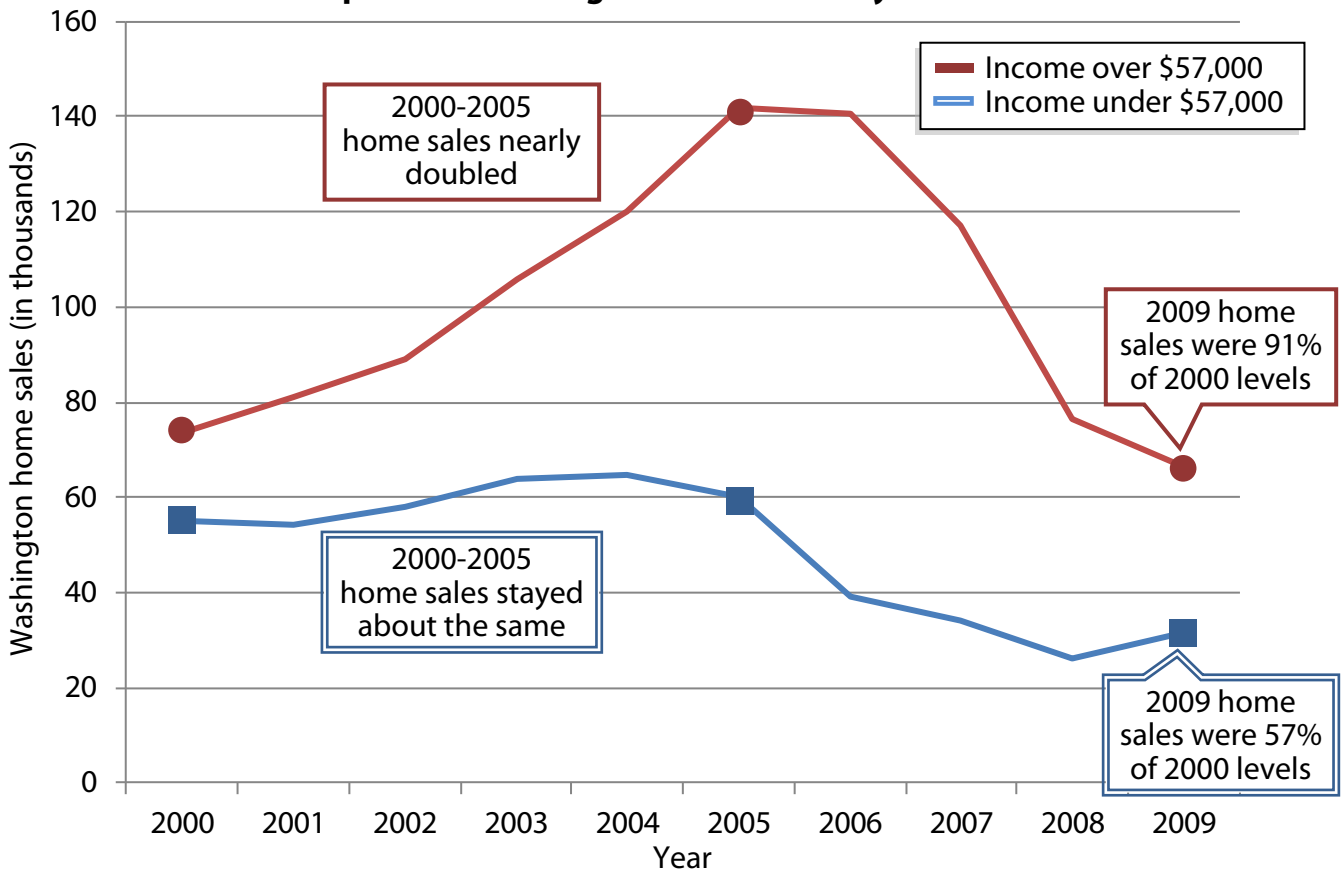
Exhibit 47 – The US 30-Year Fixed Mortgage Rate Has Declined, Is Projected to Increase



Source: Economic and Revenue Forecast Council.

While the housing boom was largely confined to households making over $57,000, the subsequent housing crash also significantly impacted households making under this threshold. The number of home sales among households making under $57,000 remained roughly the same between 2000 and the peak of the housing boom in 2005. In contrast, the number of home sales for households making over $57,000 nearly doubled from 2000 to 2005. Home sales for both groups, however, fell by more than half between their respective peaks and 2009. In 2009, home sales among households making over $57,000 were 91 percent of 2000 levels, while home sales among limited income households were 57 percent of 2000 levels. See Exhibit 48 on the following page.

Exhibit 48 – The Housing Bubble Had Different Impacts to Washington Home Sales by Income



Source: JLARC analysis of data from the Washington Center for Real Estate Research and the Federal Financial Institutions Examination Council (Home Mortgage Disclosure Act).

What are the annual costs specific to the administration of the program? What are the total annual costs of the program?

JLARC's estimate of local administrative costs is based on the fiscal note prepared by the Department of Commerce. The fiscal note estimated that the ongoing administrative costs to county assessors would be $34 per applicant. To date there have been 249 successful applications from 181 participants and 14 unsuccessful applications to the deferral program.

The actual administrative costs for the Department of Revenue (DOR) include staff time, lien filing fees, software updates, and rulemaking expenses.

Since deferral amounts must be repaid with interest, the state's deferral costs are offset by liens on the taxpayer's property. Annual costs are offset by any interest payments made in a given year. Additionally, accrued interest will offset costs in future years; as of March 2011, $22,101 in accrued interest had not yet been repaid. The net annual cost is therefore state and local administrative costs less any interest repayments. See Exhibit 49 on the following page.

Exhibit 49 – Ongoing Annual Costs for State and Local Governments

Fiscal Year	DOR Admin Costs	Estimated Local Admin Costs	Interest Repaid	Total Net Costs	Amount Deferred
2009	$180,920	$2,074	($161)	$182,833	$89,275
2010	$43,112	$3,230	($612)	$45,730	$162,526
2011	$37,464	$3,638	($2,439)*	$38,663*	$187,658
2009-11 Biennium	**$80,576**	**$6,868**	**($3,051)***	**$84,393***	**$350,184**

* Projected estimate based on actual amounts received as of March 16, 2011.

Source: JLARC analysis of DOR data and CTED cost estimates.

Recommendation

Because the intended beneficiaries of this preference are not clear in light of the recent economic recession, the Legislature should clarify the preference to define "families in economic crisis" and identify measurable evaluation criteria.

Legislation Required: Yes

Fiscal Impact: None

MEAT PROCESSORS (BUSINESS & OCCUPATION TAX)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**JLARC Recommendation**
Provides a preferential B&O tax rate to businesses that slaughter, break, or process perishable meat products, and wholesalers of perishable meat products.	The Legislature did not specifically state the public policy objective of the preference. Historic documents and legislative action suggest two implied policy objectives: 1) To lower costs for meat packing businesses for the purpose of allowing Washington to compete favorably with competitor states and to retain these industries in the state. 2) To treat Washington food processors consistently under the tax law. Initiative 1107 stated a public policy objective similar to the Legislature's purpose to allow meat processors to compete. The Initiative repealed legislation that would have provided more consistent tax treatment of Washington food processors.	$30.5 million in 2011-13 Biennium	**Review and clarify**: Because it is unclear what the public purpose is for providing differential tax treatment of meat processors compared to other food processors.

MEAT PROCESSORS (BUSINESS & OCCUPATION TAX)

Report Detail

Current Law

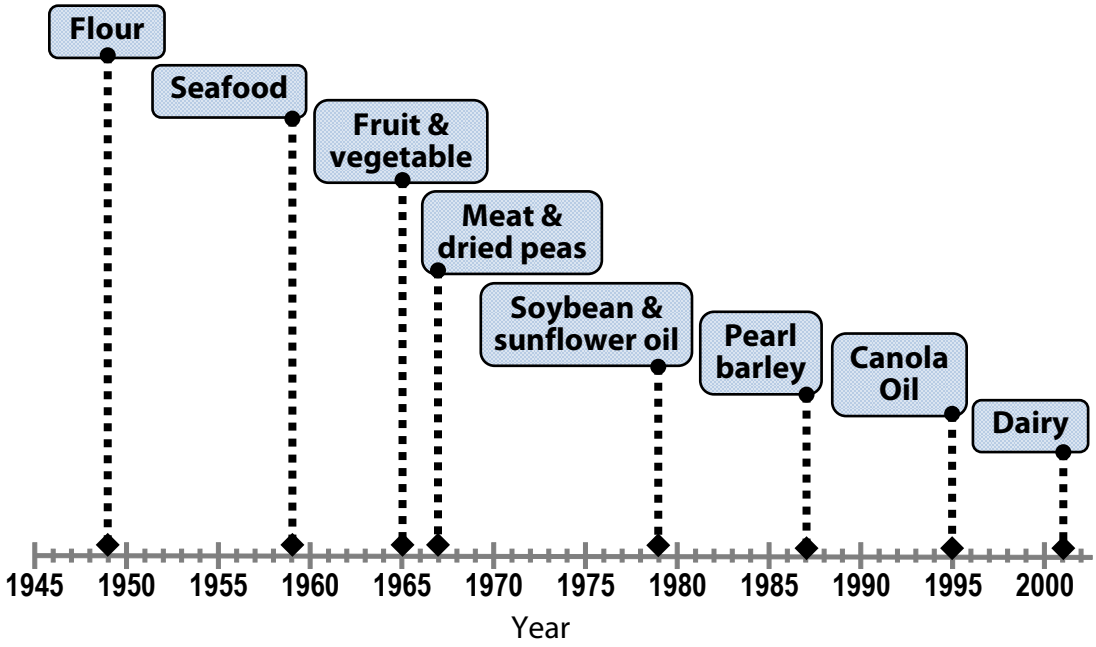
This tax preference provides a preferential business and occupation (B&O) tax rate of 0.138 percent to businesses that slaughter, break, or process perishable meat products, and wholesalers of perishable meat products. Without the tax preference, perishable meat processors and wholesalers would pay B&O tax at the general manufacturing rate of 0.484 percent.

See page A3-7 in Appendix 3 for the current statute, RCW 82.04.260(4).

Legal History

The Legislature has provided preferential B&O tax rates to processors of several fresh or unprocessed food products over the years. Processors of flour received the first preferential B&O rate in 1949, followed by seafood processors in 1959, and fresh fruit and vegetable processors in 1965. Processors of perishable meat received a lower B&O tax rate in 1967, along with processors of dried peas. Soybean oil, sunflower oil, pearl barley, canola oil, and dairy product processors received preferential tax rates in subsequent years. See Exhibit 50, below. (JLARC reviewed tax preferences for flour and oil processors in 2009 and for fruit, vegetable, dairy and seafood processors in 2010.)

Exhibit 50 – History of Preferential Tax Rates for Washington Food Processors



Source: JLARC analysis of tax law.

1967 The Legislature provided a preferential tax rate of 0.33 percent for the processing and/or wholesaling of perishable meat products. These processors had previously paid at the general manufacturing rate of 0.44 percent.

1971 DOR issued a rule that allowed **retailers** of perishable meat products to pay the preferential B&O tax rate (the statute had referenced processors and wholesalers).

1983 The Legislature disallowed the preferential tax rate for retailing of perishable meat products that had been granted by agency rule.

1985 The Legislature lowered the B&O tax rate for meat processors twice in the same act to 0.275 percent in 1985 and again to 0.125 percent in 1987.

1998 The Legislature gave the same preferential B&O tax rate of 0.138 percent to all food processors who had been subject to different preferential B&O tax rates.

1999 DOR denied the tax preference to a processor that included chicken as an ingredient in an end-product.

2003 DOR denied the tax preference to a processor of non-perishable meat by-products such as hides and tallow.

2005 The Washington State Supreme Court extended the tax preference to processors of non perishable meat ingredients. In *Agrilink Foods v. DOR,* the Court ruled that the preferential B&O tax rate is also available to processors of canned meat products where meat is an ingredient as long as the process starts with a perishable meat product.

2010 The Legislature in 2ESSB 6143 limited the Court's ruling in *Agrilink* as part of a revenue-raising package that increased taxes and narrowed tax preferences for a number of products and business activities. The Legislature limited the *Agrilink* decision by specifying that meat processing qualifies for the preferential tax rate if the end-product is one of the following:

- Perishable meat product;
- Nonperishable meat product comprised exclusively or primarily of animal carcass by weight or volume, which has been manufactured by dehydration, curing, or smoking; or
- Meat by-products such as hides, tallow, and meat meal derived in part from animals and manufactured in a rending plant.

Processors of canned meat products owed the manufacturing B&O tax at the rate of 0.484 percent. Wholesalers received the preferential rate only if they sold these specific perishable meat products.

2010 In November, the voters approved Initiative 1107 which repealed portions of the 2010 revenue package. As part of the repeal, the language of the tax preference no longer specified that the end-product had to contain perishable meat.

Other Relevant Background

B&O tax rates for the different types of food products varied until 1998 when the Legislature established the same preferential rate for all food processors at 0.138 percent. Fruit and vegetable processors received an additional temporary B&O tax exemption in 2005, and seafood and dairy processors received an additional temporary exemption in 2006. The temporary exemptions will revert to the 0.138 percent in Fiscal Year 2013, consistent with the rate for other food processors. See Exhibit 51 below.

Exhibit 51 – History of B&O Tax Rates for Food Processing

FY	Action	Meat	Fruit & Veg	Flour & Oil	Seafood	Dairy
1967	Meat processors get preferential rate	0.330%	0.300%	0.125%	0.125%	0.44%
1983	Permanent 10% surtax enacted	0.363%	0.330%	0.138%	0.138%	0.484%
1985	Meat processors' rate reduced	0.275%	0.330%	0.330%	0.138%	0.484%
1987	Meat processors' rate reduced further	0.125%	0.330%	0.330%	0.138%	0.484%
1998	Legislature applies consistent rate to certain food processors	0.138%	0.138%	0.138%	0.138%	0.484%
2001	Dairy processors get preferential rate	0.138%	0.138%	0.138%	0.138%	0.138%
2005	Fruit & vegetable processors exempted. Court extends preferential rate to processors of perishable end-products.	0.138%	Exempt	0.138%	0.138%	0.138%
2006	Seafood & dairy processors exempted	0.138%	Exempt	0.138%	Exempt	Exempt
2010	Legislature raises rate for perishable end-products; but action reversed by initiative	0.138%	Exempt	0.138%	Exempt	Exempt
2013	Temporary exemptions expire	0.138%	0.138%	0.138%	0.138%	0.138%

Note: Temporary surtaxes not shown. Rate changes are highlighted in green.

Source: JLARC analysis of tax law.

Laws providing these preferential tax rates generally specify certain requirements for both the type of end-product and the type of wholesale activities eligible for the tax preference. Unlike other food processors, however, the requirements for meat end-products and perishable meat wholesale activities are unspecified under current law. See Exhibit 52 on the following page.

Exhibit 52 – Eligibility Requirements Differ for Washington Food Processors

Processors	Eligible End-Products	Eligible Wholesale Activities
Flour and Oil	Flour; pearl barley; soybean, sunflower, or canola oil, meal or by-product	Wholesalers not eligible
Seafood	Must remain in raw, raw frozen, or raw salted state	Wholesaler must sell to purchaser that transports the goods out of state in the "ordinary course of business"
Dairy	Dairy products defined in Food & Drug Administration regulations	Wholesaler must sell to purchaser that transports the goods out of state in the "ordinary course of business"
Fruit and Vegetable	Fruit or vegetable, proportion in final product **unspecified**	Must be sold by the processer to a purchaser who transports the goods out of state in the "ordinary course of business"
Meat	**Unspecified**	**Unspecified**

Source: JLARC analysis of tax law.

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 specifically state the public policy objectives of this tax preference.

Historical documents and legislative action suggest two implied policy objectives:

1) To lower costs for meat packing businesses for the purpose of allowing Washington to compete favorably with competitor states and to retain these industries in the state.
2) To treat Washington food processors consistently under the tax law.

Initiative 1107 stated a public policy objective similar to the Legislature's purpose to allow meat processors to compete. The Initiative repealed legislation that would have provided more consistent tax treatment of Washington food processors.

To Lower Costs and Retain Meat Processing Industry

Newspaper articles leading up to legislative rate reductions in 1967 and 1985 reported on the flight of the meat packing industry from Washington to Oregon. Oregon and Idaho impose corporate net income taxes, which at the time could tax meat packers less than under Washington's B&O tax.

To Treat Washington Food Processors Consistently

In 1998, the Legislature established the same preferential B&O tax rate of 0.138 percent for food processers, taxing all the food processors consistently.

The other aspects of consistent treatment relate to which end-products and wholesaling activities are eligible for the preference. Although rejected by voters in Initiative 1107, the 2010 Legislature in 2ESSB 6143 clearly stated its intent to narrow application of this tax preference to certain specified

types of end-products, as it has for other food products. The Legislature required that meat end-products "must be a perishable meat product; a nonperishable meat product that is comprised primarily of animal carcass by weight or volume, other than a canned meat product; or a meat by-product." The different treatment for meat product wholesalers and other food product wholesalers remains in law as a result of the Initiative.

Initiative 1107's finding stated that the 2010 legislation (2ESSB 6143) "imposed new or higher taxes on many common food and beverage products, increasing the tax burden on Washington consumers and businesses." Also, the Initiative stated that the tax increases "hurt Washington food and beverage producers and retail businesses by making their products more costly and less competitive." The Initiative repealed the 2010 provisions that would have made the tax treatment of meat processors and wholesalers more consistent with the tax treatment of other food processors and wholesalers.

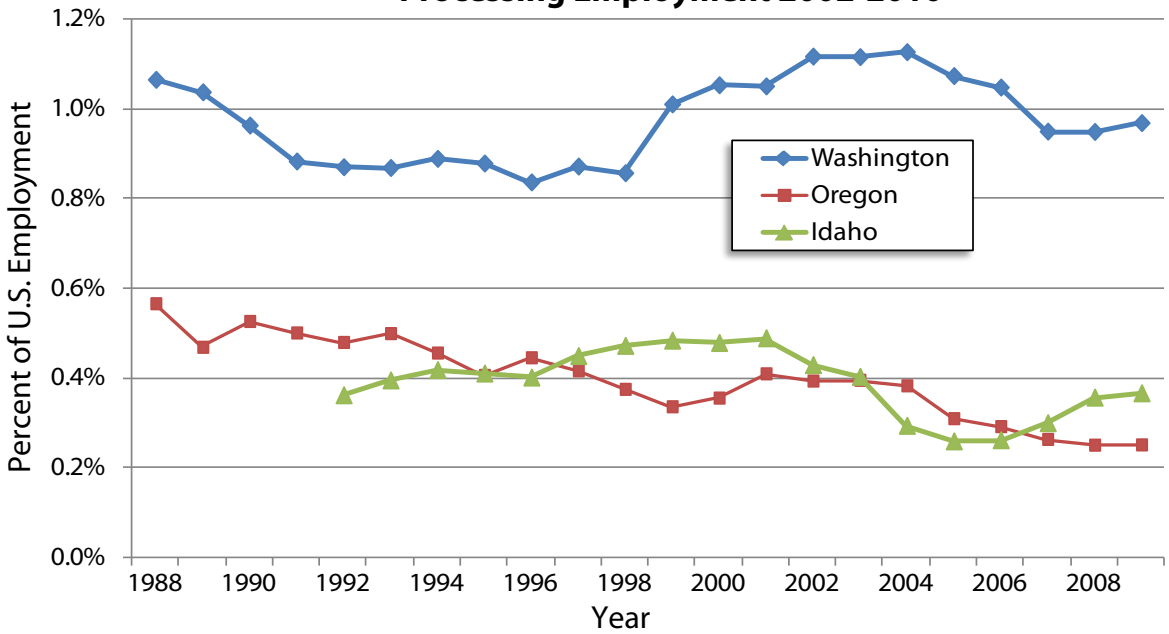
What evidence exists to show that the tax preference has contributed to the achievement of any of these public policy objectives?

JLARC is unable to determine from the evidence if the tax preference: 1) has had an effect on retaining the meat processing industry in Washington; and 2) whether the policy objective of treating food processors consistently is still applicable.

Evidence of Lower Costs and Retention of Meat Processing Industry

The tax preference is reducing costs for the meat processors by providing preferential tax rates. Also, Washington has retained its position relative to the U.S. and to neighboring states of Oregon and Idaho. However, JLARC cannot isolate what, if any, impact the preference has had on the industry's business retention and growth. Exhibit 53, below illustrates Washington share of employment relative to Idaho and Oregon.

Exhibit 53 – WA has Retained Share of US Meat Processing Employment 2002-2010



Source: Bureau of Labor Statistics, covered employment, 1988-2009; employment statistics for Idaho begin in 1992.

Evidence of Consistent Treatment of Washington Food Processors

It is unclear whether the public policy objective of applying consistent treatment to food processors is still applicable. If it is, then the preference is partially meeting the objective by providing the same preferential rates to processors of perishable meat and other Washington food processors. However, it is unclear what the policy objective was for broadening the preference for meat end-products and for perishable meat wholesalers. Unlike for other processed food products, statute does not specify end-products and wholesale activities that are eligible for this exemption.

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

JLARC cannot determine if the continuation of the tax preference will have an effect on retention of meat processing businesses in the future.

If the legislative intent is to provide consistent tax treatment to all food processors, then the current version of the tax preference is not meeting this objective. This is because the preferential rates apply to unspecified meat end-products and to unspecified perishable meat wholesale activities.

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

If the Legislature wants to treat meat processors consistently with other food processors, it could specify which end-products qualify. The Legislature could also amend the statutes to require that wholesale sales of perishable meat products qualify for the preferential rate if the product is sold to a purchaser that transports the goods out of state in the ordinary course of business. This language would be consistent with statutes providing preferential rates to fruit, vegetable, seafood and dairy processors. However, it is unclear if ensuring consistent treatment is still the Legislature's public policy purpose.

Beneficiaries

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

In Fiscal Year 2010, an estimated 218 businesses benefited from the tax preference. The value of sales subject to the preferential tax rate totaled $4.2 billion. A majority of beneficiaries are meat product wholesalers with 59 percent of total sales. Exhibit 54, on the following page, provides detail on beneficiaries.

Exhibit 54 – Most Beneficiaries are Wholesalers of Meat Products

Industry	Number of Businesses	Income from Meat Products	Percent of Total
Farm product wholesalers	8	$69,600,000	2%
Meat product wholesalers	144	$2,508,700,000	59%
Meat slaughtering and processing	66	$1,642,100,000	39%
Total	**218**	**$4,220,400,000**	**100%**

Source: JLARC analysis of DOR tax returns for Fiscal Year 2010.

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

The tax preference applies to manufacturers of unspecified meat end-products. In response to a 2005 court ruling, the 2010 Legislature narrowed the tax preference. However, this legislation was overturned by a citizens' initiative.

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?

Processors and wholesalers of perishable meat products saved an estimated $14.6 million in Fiscal Year 2010. For the two-year period of the 2011-2013 Biennium, beneficiaries are expected to save $30.5 million. Tax savings are calculated as the difference between the preferential rate and the general manufacturing rate times the estimated tax base.

Exhibit 55 – Beneficiary Tax Savings for Perishable Meat Processors

Fiscal Year	Preferential Rate (0.138%)	Manufacturing Rate (0.484%)	Beneficiary Tax Savings (Difference)
2008	$5,100,000	$17,800,000	$12,700,000
2009	$6,000,000	$21,100,000	$15,100,000
2010	$5,800,000	$20,400,000	$14,600,000
2011	$5,800,000	$20,300,000	$14,500,000
2012	$6,000,000	$21,100,000	$15,100,000
2013	$6,100,000	$21,500,000	$15,400,000
2011-13 Biennium	**$12,100,000**	**$42,600,000**	**$30,500,000**

Source: JLARC analysis of DOR tax returns and forecasted growth in Washington food processing employment.

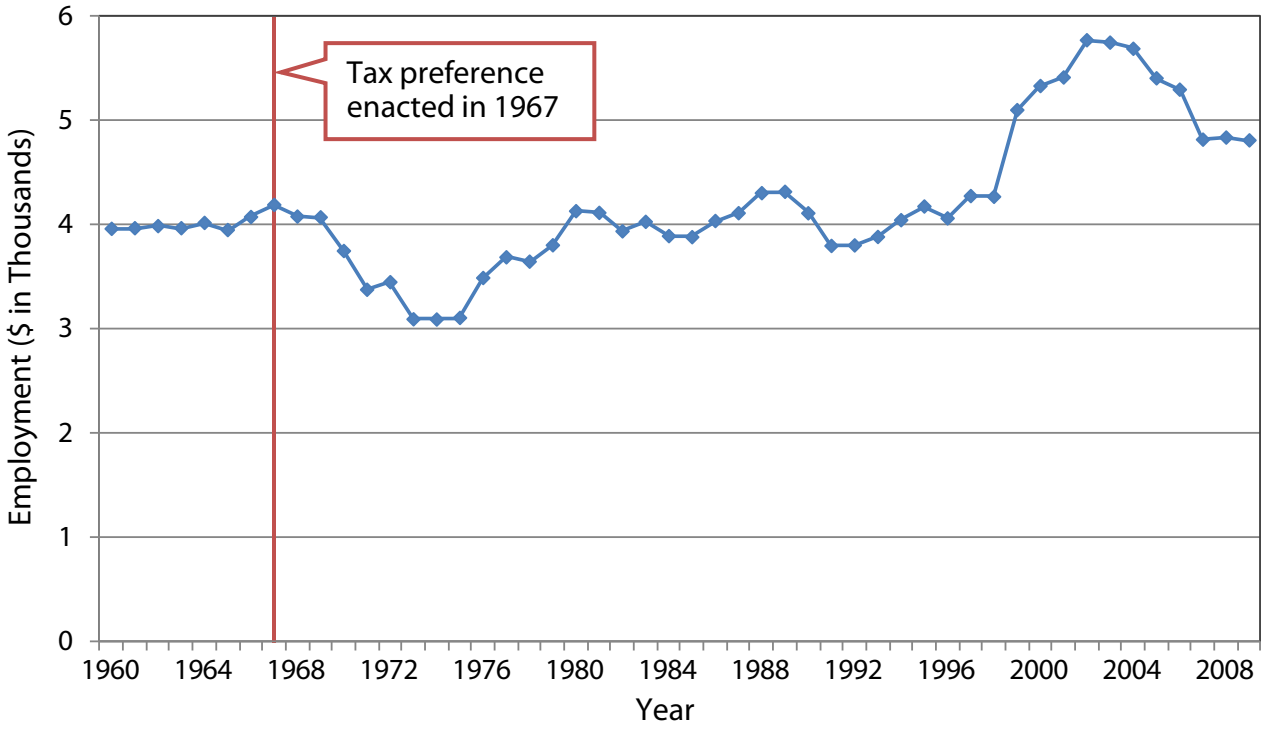
If the tax preference were to be terminated, what would be the negative effects on the taxpayers who currently benefit from the tax preference and the extent to which the resulting higher taxes would have an effect on employment and the economy?

JLARC is unable to determine the long-run effect on the economy and employment if the tax preference were to be terminated.

In the short-run, termination would increase costs for businesses engaged in processing and wholesaling perishable meat products. The impact of a tax increase would fall more heavily on the beef slaughtering industry which tends to have lower profit margins than other industries eligible for the tax preference such as poultry processing. According to the U.S. Department of Agriculture, the meat processing industry has trended toward fewer, larger firms and toward vertical integration of growing, slaughtering, and packaging operations with greater control over markets. However, JLARC cannot determine if a tax increase would be passed on to consumers in the form of higher prices or absorbed by the industry.

Employment in the meat processing industry has varied since passage of the tax preference in 1967, but has trended upward until the last few years. JLARC is unable to draw conclusions about the impact of the tax preference on employment and the economy. See Exhibit 56.

Exhibit 56 – Meat Processing Employment has Varied Since Enactment



Source: Employment Security Department statistics on covered employment, 1960 – 2009.

Other States

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

Unlike Washington, most states impose a corporate net income tax as their primary business tax. In general, corporate net income taxes provide specific credits and deductions instead of preferential rates for specific industries. JLARC could not find any other state that gave a tax preference specifically for processors or wholesalers of perishable meat.

Recommendations

Because it is unclear what the public purpose is for providing differential tax treatment of meat processors compared to other food processors, the Legislature should clarify the public policy purpose for this preference.

Legislation Required:	Yes
Fiscal Impact:	Depends on legislation enacted

MUNICIPAL SEWER CHARGES (BUSINESS & OCCUPATION TAX)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**JLARC Recommendation**
Provides municipalities/cities a B&O tax deduction for amounts paid to other cities or governmental entities for sewage transfer, treatment, or disposal services they provide.	The Legislature did not specifically state the public policy objective of the preference. A Department of Revenue report states the preference's purpose was to eliminate taxing both the collection and the transfer/treatment/disposal of sewage when multiple utilities are involved in providing sewer services.	$3 million in 2011-13 Biennium	**Review and clarify**: Because it is unclear whether the purpose of the preference is to only avoid the pyramiding effect of the B&O tax or to completely eliminate taxation of sewage transfer, treatment, and disposal activities.

MUNICIPAL SEWER CHARGES (BUSINESS & OCCUPATION TAX)

Report Detail

Current Law

This preference allows municipalities/cities to deduct from their income that is subject to B&O tax amounts the cities pay to other cities or governmental agencies (such as public utility districts) for sewage interception, treatment, or disposal services they provide. (See Exhibit 57 on the following page.)

Sewage collection and sewage treatment activities are subject to two different types of excise tax treatment.

Sewage collection involves collecting sewage and carrying it via sewers, drains, and pipes to a point for transfer for treatment or disposal. This collection activity is taxed under the public utility tax.

Income earned from the **further transfer, treatment, or disposal of sewage** is subject to business and occupation (B&O) tax under the service and other activities classification.

See page A3-7 in Appendix 3 for the current statute, RCW 82.04.432.

Legal History

This legal history discusses both this preference and a separate but related B&O tax preference because the JLARC recommendation addresses them in tandem.

1933 In response to a revenue shortfall, the Legislature adopted a temporary tax imposed on the privilege of engaging in business activities for the period August 1933 through July 1935. The new tax applied to a wide range of business activities including manufacturing, wholesaling, retailing, services, and utilities. Municipalities conducting such business activities were subject to tax in the same manner as privately owned utilities or businesses conducting the same activities.

1935 The Legislature passed the Revenue Act of 1935, establishing much of the current state tax structure. As part of the 1935 act, the Legislature created the business and occupation (B&O) tax, which generally extended the business activities tax imposed temporarily in 1933. Income from sewage collection, transfer, and treatment was taxed under the catch-all service and other activities classification.

1967 The Legislature provided a specific B&O tax deduction to municipal utilities and other public corporations that collect sewage for amounts paid to another municipal corporation or other governmental agency for sewage transfer, treatment, or disposal.

1970 The Legislature enacted a separate B&O tax deduction for income received by a political subdivision from another political subdivision as payment for services rendered, if the income from the services would otherwise be taxed under the service and other activities

classification. While sewage collection, transfer, and treatment services were not explicitly mentioned, in application the deduction applied to income from these services, as well.

With this legislation, both municipal providers and receivers of sewage transfer, treatment, and disposal services received a B&O tax deduction for this activity.

1985 The Legislature shifted the taxability of collecting sewage and refuse from the service and other activities B&O tax to the public utility tax. New classifications and rates were established for sewage collection and refuse collection.

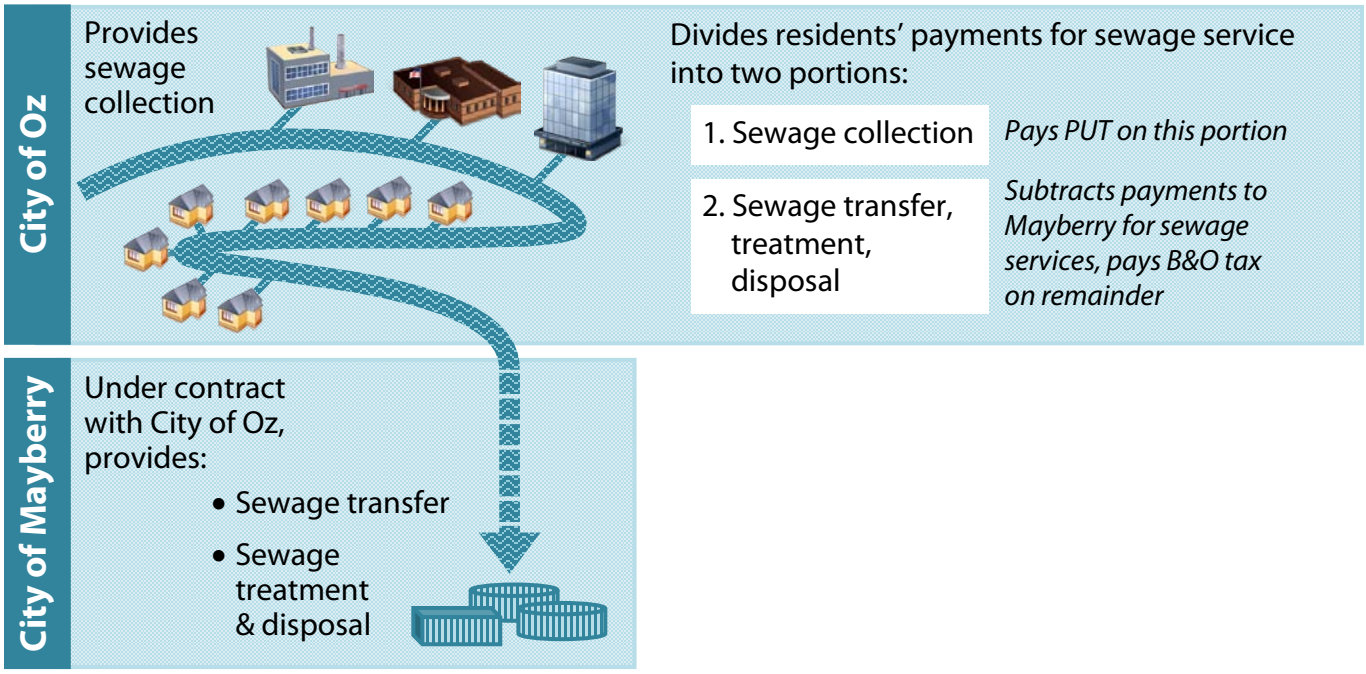
Other Relevant Information

How RCW 82.04.432 works

Exhibit 57, below, illustrates how the preference works. The City of Oz operates a sewage collection utility for its residents. Rather than invest in its own treatment facilities, Oz contracts with the City of Mayberry to provide sewage transfer, treatment, and disposal services to Oz. When Oz reports to the Department of Revenue, it must break down the total sewage charges it collects from residents into: 1) a sewage **collection** portion, and 2) a portion representing **transfer** income for moving the waste to Mayberry for further treatment and disposal.

Oz pays public utility tax on the sewage collection income portion. For the other portion, Oz can deduct from the gross income subject to B&O tax any payments it made to Mayberry for sewage transfer, treatment, and disposal services Mayberry provides.

Exhibit 57 – How the Municipal Sewer Charge Preference Works



Source: JLARC analysis of RCW 82.04.432.

Activity is Untaxed Due to Additional Preference

In 1970, the Legislature provided a deduction for any income received by local governments/ political subdivisions from other local governments/political subdivisions where the income would be taxable under the service and other activities B&O tax classification (RCW 82.04.4291).

In the case of municipal sewer services, the B&O deductions provided under RCWs 82.04.432 and 82.04.4291 work so the income attributable to transferring, treating, and disposing of sewage is not taxed at all under the B&O tax.

Continuing the example on the previous page, per RCW 82.04.432, Oz deducts from the income reported for B&O tax the amounts it paid to Mayberry to transfer, treat, and dispose of Oz's sewage. Then, per RCW 82.04.4291, Mayberry deducts from its income reported for B&O tax the payment it received from another political subdivision (Oz) because the income is subject to service and other activities B&O tax. According to the Department of Revenue, the purpose of the deduction under 82.04.4291 is to allow local governments to perform services for other local governments (such as computer operations, accounting) without incurring a B&O tax liability.

Public Policy Objectives

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

The Legislature did not provide a public policy objective when it enacted the preference.

A Department of Revenue report states the preference's purpose was to eliminate taxing both the collection and the transfer/treatment/disposal of sewage (pyramiding) when multiple utilities are involved in providing sewer services. The report further notes the preference was largely intended for King County's Wastewater Treatment Division and the surrounding cities that contract with it.

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

This preference does eliminate pyramiding of B&O tax by not taxing amounts paid by cities to other cities/government agencies for sewage transfer, treatment or disposal. However, due to the separate preference passed later in 1970, income from municipal sewage transfer, treatment, or disposal is not taxed at all.

It is unclear whether the Legislature intended to only remove pyramiding taxation or to completely eliminate all taxation of this activity.

Beneficiaries

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

Beneficiaries of the tax preference are cities/municipalities that pay other cities or municipal agencies to transfer, treat, or dispose of their sewage.

Publicly owned wastewater treatment facilities must obtain permits from the Department of Ecology. According to the latest Ecology data, 298 permits have been issued statewide. Of those, about 265 are for municipalities. It is unknown how many of these cities actually contract with another city or government agency to transfer, treat, or dispose of their sewage.

Revenue Impacts

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

JLARC estimates beneficiaries saved $1.3 million in Fiscal Year 2010 due to this preference. The savings estimated for the 2011-13 Biennium are $3 million. See Exhibit 58, below.

Exhibit 58 – Estimated Beneficiary Savings for Municipal Sewer Treatment Payment B&O Deduction

FY	Service & Other Activities B&O Rate	Taxpayer Savings (in millions)
2009	1.5%	$1.2 M
2010	1.55%	$1.3 M
2011	1.8%	$1.5 M
2012	1.8%	$1.5 M
2013	1.8%	$1.5 M
2011 – 13 Biennial Total	**1.8%**	**$3.0 million**

Source: JLARC examination of DOR tax return data FY08-10, cities reporting line 0499 deductions. Growth factor calculated using estimated population growth per ERFC Nov 2010 Revenue Forecast, Table A5.1.

Recommendation

The Legislature should clarify whether the purpose of the B&O deduction for municipal sewer service payments is to only avoid the pyramiding effect of the B&O tax, or to completely eliminate taxation of sewage transfer, treatment, and disposal activities.

Legislation Required: Possibly

Fiscal Impact: Possibly

NONPROFIT BLOOD AND TISSUE BANKS (PROPERTY TAX)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**JLARC Recommendation**
Exempts blood and tissue banks and their administrative offices from property tax.	The Legislature did not specifically state the public policy objective of the preference. Based on the legal history of how the taxation of hospital-like services has evolved, the implied public policy objective is to provide support for organizations that: are nonprofit benevolent and charitable entities, and provide services traditionally performed in hospitals, but that are now performed outside the hospital setting.	$6.1 million in 2011-13 Biennium	**Continue**: Because the exemption for blood and tissue banks is consistent with the public policy objective to reduce costs for nonprofit organizations performing hospital-like services.

NONPROFIT BLOOD AND TISSUE BANKS (PROPERTY TAX)

Report Detail

Current Law

This preference exempts from property taxes nonprofit blood and tissue banks and their administrative offices. To receive the exemption, the blood and tissue banks must qualify as a charitable organization under federal law and must register with the U.S. Food and Drug Administration (FDA).

Organizations must also meet the following requirements to receive the exemption:

1) **Blood banks** must be primarily in the business of collecting, preparing, and processing blood.
2) **Tissue banks** must be primarily in the business of recovering, processing, storing, labeling, packaging, or distributing human bone tissue, ligament tissue and similar musculoskeletal tissues, skin tissue, heart valve tissue, or human eye tissue.

Comprehensive cancer centers are explicitly excluded from the blood and tissue bank exemption because they have their own property tax exemption.

Statutes require organizations to file a statement annually with the Department of Revenue certifying that all income and donations have been applied to operating or maintaining the facility, or to capital expenditures. They must file an annual renewal declaration before March 31st each year.

The blood and tissue banks are also entitled to a business and occupation (B&O) tax exemption on their gross income, and sales and use tax exemptions on purchases of medical supplies, chemicals, or materials. The focus of this review is on the property tax exemption. The B&O and sales and use tax exemptions for blood and tissue banks are scheduled for review in 2013.

See page A3-7 in Appendix 3 for the current property tax statutes, RCWs 84.36.035 and 82.04.324.

Legal History

Before the Legislature specifically exempted blood banks from the property tax, hospitals collected and supplied most of the blood needed for transfusions. Nonprofit hospitals had been exempt from the property tax since Territorial days.

1854 The first Territorial Legislature enacted a property tax exemption for "benevolent, charitable, literary, or scientific" institutions, various government properties, schools, cemeteries, and public libraries from the tax base. Though not explicitly stated, the exemption applied to nonprofit hospitals.

1891 The Legislature provided a specific property tax exemption for hospitals supported by charities or by public appropriation, or that devoted all income and profits to charitable purposes.

1945 Blood banks began emerging in Washington after World War II. Most blood banks claimed the property tax exemption for hospitals even though they did not have provisions for licensing, inspection, or financial reporting required by the exemption for hospitals.

1948 The American Red Cross began establishing blood collection facilities as part of a nationwide program. The Legislature had earlier exempted the Red Cross from the property tax in 1945.

1971 The Department of Revenue completed a study required by the Legislature that found a lack of uniformity among the 39 counties in taxing the property of nonprofits. DOR attributed the disparity to lack of adequate staff in the assessors' offices, vague statutes and court decisions, no statutory requirement to apply for renewal of exemption status, and, until 1970, the lack of an administrative appeals process for determining taxability of nonprofits at the state level.

The Pierce County Assessor stated in testimony that he had placed the Tacoma-Pierce County Blood Bank on the property tax roll in response to the Department's study because he found no statutory basis for the exemption.

In the same year, the Legislature enacted a specific tax exemption for property owned by nonprofit blood banks. The new exemption affected four existing blood banks.

1995 The Legislature expanded the exemption to include bone and tissue banks, and organizations that performed research on blood, bone, or tissue. The same bill also provided a B&O tax exemption on the gross income of blood, tissue, and bone banks, and sales and use tax exemptions for purchases of medical supplies, chemicals, or materials.

2003 The Fred Hutchinson Cancer Research Center appealed to the Thurston County Superior Court after the Department of Revenue denied its exemption from B&O and sales and use taxes under the 1995 definition of "bone and tissue banks." (While the tax preference under review grants a property tax exemption, the definitions of "bone and tissue banks" were located in the B&O tax statutes.) Cancer treatment centers received a property tax exemption (see Exhibit 59 on the next page), but unlike blood and tissue banks, they owed B&O tax.

The Thurston County Superior Court ruled that the 1995 act violated the "one subject" provision of the state Constitution. As a result of the court ruling, bone and tissue banks no longer received a property tax exemption as they had since 1995.

2004 The Legislature re-enacted the exemption for tissue banks. The new law allowed the blood and tissue banks an exemption if they qualified as a nonprofit charitable organization under federal tax law. Blood and tissue banks also had to be registered with the FDA. Unlike the 1995 law that was overturned in 2003, the exemption was not provided to organizations that performed research on blood, bone, or tissue.

Other Relevant Background

Early in Washington history, hospitals performed most health-related services. As early as Territorial days, Washington exempted hospitals from taxation under the property tax. In later years, segments of the health care industry began to form separate entities physically located outside hospitals that performed hospital-like services. Examples of such providers are nursing homes and kidney dialysis centers.

Many of these entities were organized as nonprofits. The Legislature adapted statutes to reflect these changes in the industry by exempting health-related organizations as long they organized as nonprofits. The Legislature has a long tradition of supporting nonprofit organizations that provide services that had traditionally been provided by hospitals. Exhibit 59 below illustrates this history:

Exhibit 59 – Property Tax Exemptions for Nonprofits Providing Hospital-Like Services

Exemption	Year Enacted
Nursing homes	1891
The Red Cross	1945
Blood banks	1971
Medical research centers	1975
Kidney dialysis centers	1987
Tissue banks	1995
Cancer treatment clinics	1997

Source: JLARC analysis of tax law.

Before World War II, hospitals collected and supplied most of the blood for transfusions. After the war, nonprofit blood banks, beginning with the American Red Cross, began emerging as separate facilities. Although nonprofit blood banks were not legally covered under an existing exemption, it appears they were claiming the hospital exemption until the Pierce County Assessor placed a blood bank on the county property tax rolls in 1971.

In Washington, there are five hospital blood and tissue related service centers registered with the FDA, compared to the 22 independent centers operated by nonprofit entities. The nonprofit blood and tissue banks collect blood for transfusions and tissue for skin grafts. See Exhibit 60, below.

Exhibit 60 – Washington Blood and Tissue Related Services Performed by Hospitals and Nonprofit Facilities

Type of Facility	Hospital	Non Profit Facilities	Total
Blood Bank	2	16	18
Tissue Bank	2	5	7
Distribution Center	1	1	2
Total	**5**	**22**	**27**

Source: U.S. Food and Drug Administration, online query, 2010.

Public Policy Objective

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

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

Based on the legal history of how the taxation of hospital-like services has evolved, JLARC has concluded that the implied public policy objective of the tax preference is to provide support for organizations that:

- Are nonprofit benevolent and charitable entities, and
- Provide services traditionally performed in hospitals, but that are now performed outside the hospital setting.

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

The evidence shows that nonprofit organizations are providing some services traditionally performed in hospitals and now in independent facilities.

While blood collection once took place almost entirely in hospitals, nonprofit blood banks have become the primary means of collecting, storing, and distributing blood for transfusions. In 1962, the U.S. reported 4,400 hospital blood banks, 123 community blood centers, and 55 American Red Cross Blood centers in the country. While comparable national figures on the number of facilities are not available for recent periods, non-hospital blood centers are now responsible for collecting 95 percent of the total blood units.

In 1995, the Legislature amended the exemption to include tissue and bone banks. After the court overturned the amendment in 2003, the Legislature re-enacted the exemption for tissue banks in the next legislative session. The Legislature also limited the exemption to nonprofits qualifying as charitable organizations under federal law and registered with the FDA. By these actions, the Legislature reaffirmed its intent to provide an exemption to blood and tissue banks.

Beneficiaries

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

The beneficiaries are the four nonprofit blood and tissue collection centers that own or lease 22 properties in Washington. The assessed real and personal property including property used for administrative purposes is estimated at $279 million. Red Cross blood collection facilities are not included as beneficiaries because these properties are exempted under a separate tax preference.

The largest of the four beneficiaries, the Puget Sound Blood Center, maintains 16 facilities comprising 77 percent of the property value for all exempt blood and tissue banks. JLARC estimated the dollar amount of undervalued properties because not all exempt properties are updated regularly on the county assessors' tax rolls. Also, JLARC estimated the value of personal property based on a survey conducted in 2007 by DOR. See Exhibit 61, below.

Exhibit 61 – Estimated Real and Personal Property Value of Exempt Blood and Tissue Banks

Non Profit Blood and Tissue Centers/Location	Assessed Value	Percent of Total	Type (Reported to FDA)
Cascade Regional Blood Services/ Pierce County	$4,600,000	1.6%	Community blood center
Inland Northwest Blood Center/ Spokane	$13,600,000	4.9%	Blood and tissue center
LifeCenter Northwest/ Bellevue	$46,400,000	16.6%	Recovering and screening of tissue
Puget Sound Blood Center/ Western Washington	$214,400,000	76.8%	Blood and tissue centers
Total real and personal property value	**$279,000,000**	**100.0%**	

Source: JLARC analysis of DOR data, county assessors' tax rolls, and DOR survey data from the 2008 Exemption Study.

Revenue Impacts

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

Beneficiaries of the property tax exemption saved an estimated $540,000 in state property taxes and $2.4 million in local property taxes in Fiscal Year 2010. They are expected to save $1.1 million in state property taxes and $4.9 million in local property taxes in the 2011-2013 Biennium. For property tax exemptions, savings to the beneficiary generally do not equal lost revenues to the state or local governments, because other property owners will pay higher taxes when property is taken off the tax rolls. See Exhibit 62, below.

Exhibit 62 – Estimated Blood and Tissue Banks—Beneficiary Tax Savings

Fiscal Year	Beneficiary Tax Savings		Total
	State	Local	
2009	$540,000	$2,300,000	$2,840,000
2010	$540,000	$2,380,000	$2,920,000
2011	$550,000	$2,410,000	$2,960,000
2012	$550,000	$2,440,000	$2,990,000
2013	$560,000	$2,540,000	$3,100,000
2011-13 Biennial Total	**$1,110,000**	**$4,980,000**	**$6,090,000**

Source: JLARC estimate based on DOR exempt property file and county assessors' rolls, and the property tax growth rates from the Economic and Revenue Forecast Council.

Recommendation

Because the exemption for blood and tissue banks is consistent with the public policy objective to reduce costs for nonprofit organizations performing hospital-like services, the Legislature should continue the property tax exemption for blood and tissue banks.

Legislation Required: No

Fiscal Impact: None

NONPROFIT DAY CARE CENTERS (PROPERTY TAX)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**JLARC Recommendation**
Exempts licensed nonprofit child day care centers from property tax.	The Legislature did not specifically state the public policy objective of the preference. JLARC infers the public policy objective is to support nonprofit organizations that provide social services to children and youth, consistent with long-standing legislative policy.	$15.8 million in 2011-13 Biennium	**Continue**: Because the preference is meeting the implied public policy objective of supporting nonprofit organizations that provide social services for youth.

NONPROFIT DAY CARE CENTERS (PROPERTY TAX)

Report Detail

Current Law

This tax preference provides a property tax exemption to licensed nonprofit child day care centers. A nonprofit child day care center is defined as an organization that "regularly provides child day care and early learning services for a group of children for periods of less than twenty-four hours."

See page A3-8 in Appendix 3 for the current statute, RCW 84.36.040(1)(a).

Legal History

1959 In the "child welfare" laws, the Legislature defined a "day nursery" as "an institution which provides care during the day for a group of children…whose own families are unable to provide this daytime care."

1967 The Legislature substituted the words "day-care center" for "day nursery" in the public assistance laws, and defined such a center as "an agency which regularly provides care for a group of children for periods of less than twenty-four hours."

1973 The Legislature enacted a property tax exemption for nonprofit day care centers. The legislation used the same definition of "day care center" as the definition in the public assistance laws adopted in 1967. The language of the property tax exemption has remained essentially unchanged since enactment.

2006 The Legislature placed responsibility for licensing and regulating child day care centers in the Department of Early Learning (DEL). "Child day care centers" were now defined in DEL statutes using the previous definition.

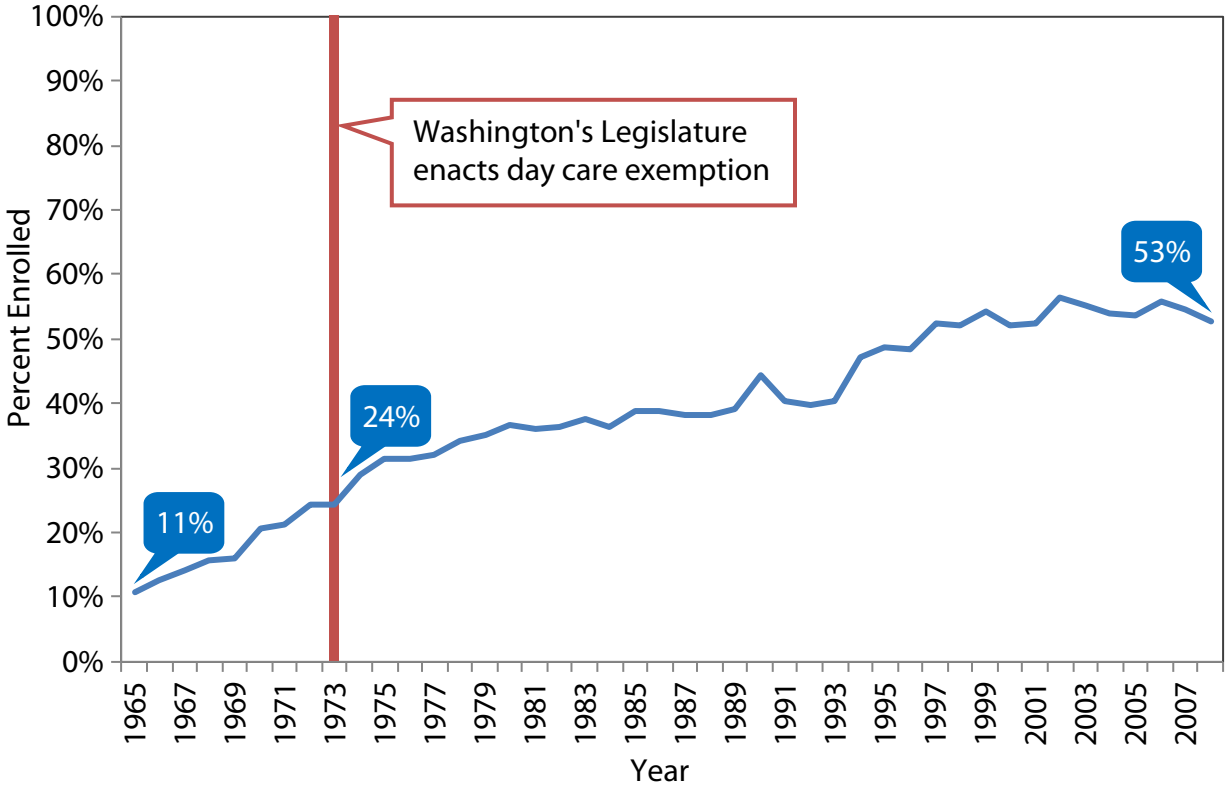
2010 The Legislature amended the definition in the day care center property tax exemption statute to mirror the definition of "child day care centers" used in the DEL statutes.

Other Relevant Background

The prevalence of child day care centers has grown along with the demand for child care from more women entering the labor force. Along with this growth came the demand for high quality and affordable day care, government programs to license and regulate day care, and government financial support.

Figures are not available to determine the growth in child day care centers before and after the exemption became law. National data shows that the percent of three-year olds enrolled in preschool grew from 11 percent in 1965 to 53 percent in 2007 as illustrated in Exhibit 63 below. This trend can be used as an indicator of the rise in demand for child care.

Exhibit 63 – Percent of U.S. 3-Year Olds Enrolled in Preschool Grew from11% in 1965 to 53% in 2008



Source: Digest of Education Statistics, National Center for Education Statistics, 2009.

Public Policy Objective

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

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

JLARC infers the public policy objective of the tax preference is to support nonprofit organizations that provide social services to children and youth, consistent with long-standing legislative policy as illustrated in Exhibit 64, below.

Exhibit 64 – Property Tax Exemptions for Certain Nonprofits Related to Providing Social Services to Children and Youth

Exemption	Year Enacted	Social Service
Orphanages	1891	Care of orphans
Nonsectarian organizations	1915	Character-building, benevolent, protective or rehabilitative services—all ages
Private schools and colleges	1925	Educational
Youth organizations	1933	Character-building organizations serving boys and girls under 18 years of age
Church camps	1971	Camps provided by nonprofit church, denomination, group of churches, or association of churches
Child day care centers	1973	Care of children during the day

Source: JLARC analysis of property tax law.

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

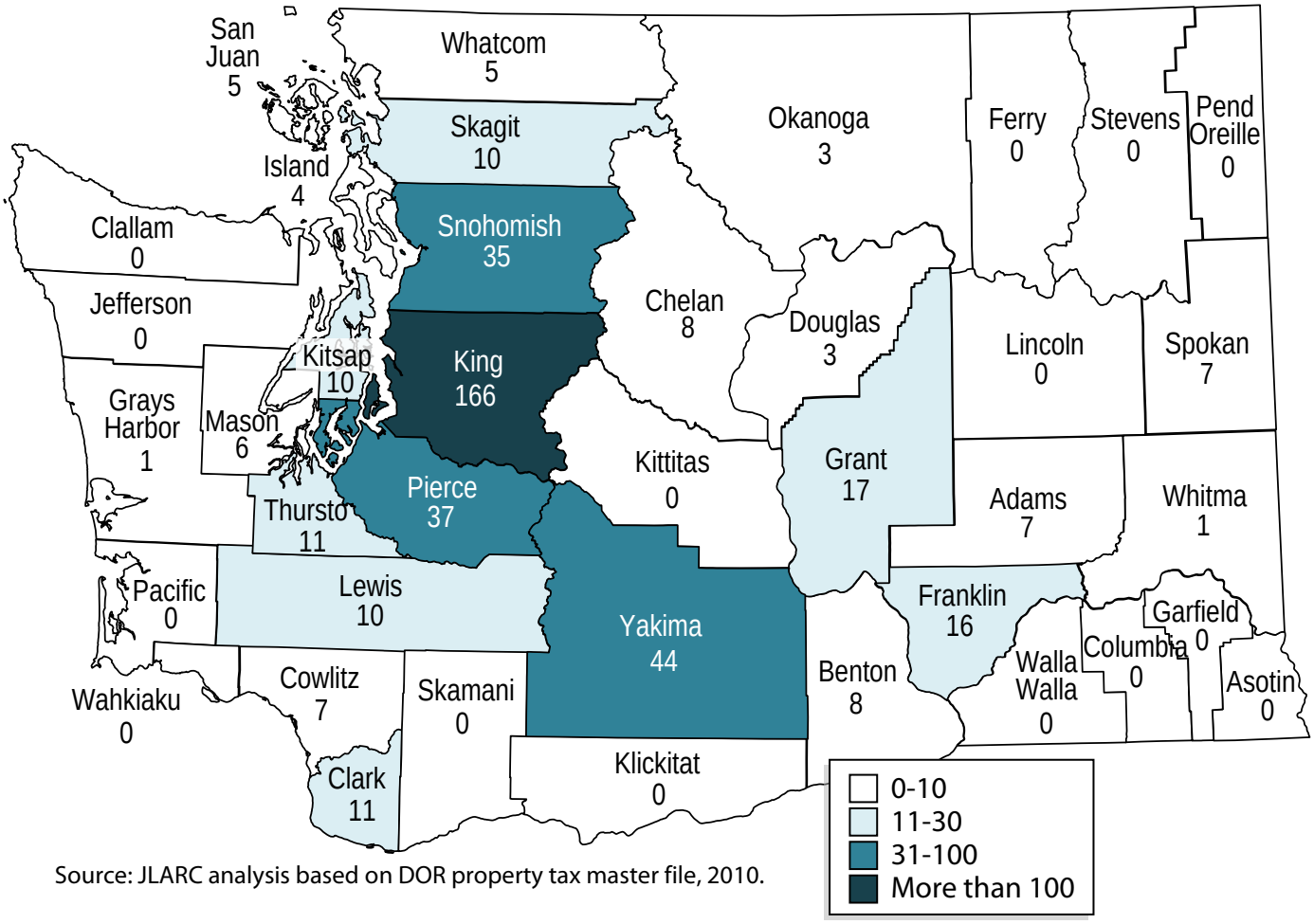
Evidence shows that children are receiving care in nonprofit day care centers and that the use of the preference is growing. DOR granted the child day care exemption to 110 organizations in 1990. Participation has grown to 241 in 2010.

Beneficiaries

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

The beneficiaries of the tax preference are the 241 nonprofit organizations that operate 432 nonprofit child day care facilities qualifying for the property tax exemption. Two-thirds of these centers are located in King, Pierce, Snohomish, and Yakima counties.

Exhibit 65 – Two-Thirds of Nonprofit Day Care Centers are Located in King, Pierce, Snohomish, and Yakima Counties



Source: JLARC analysis based on DOR property tax master file, 2010.

The top five nonprofit organizations in terms of the number of facilities are Montessori, the YMCA, Enterprise for Progress in the Community (EPIC), Community Day Schools, and Boys and Girls Clubs.

Revenue Impacts

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

Nonprofit organizations that operate child day care centers qualifying for the tax preference saved an estimated $7.6 million in state and local property taxes in Fiscal Year 2010. In the two-year period of the 2011-2013 Biennium, taxpayer savings are estimated to be $15.8 million. For property tax exemptions, savings to the beneficiary generally do not equal lost revenues to the state or local governments, because other property owners pay higher taxes when property is taken off the tax rolls. See Exhibit 66, below.

Exhibit 66 – Child Day Care Centers—Estimated Beneficiary Tax Savings

Fiscal Year	Beneficiary Tax Savings		Total
	State	Local	
2009	$1,300,000	$6,030,000	$7,330,000
2010	$1,310,000	$6,250,000	$7,560,000
2011	$1,320,000	$6,320,000	$7,640,000
2012	$1,340,000	$6,400,000	$7,740,000
2013	$1,350,000	$6,660,000	$8,010,000
2011-13 Biennial Total	**$2,690,000**	**$13,060,000**	**$15,750,000**

Source: JLARC analysis based on DOR exempt property file and county assessors' rolls, and the growth rates from the Economic and Revenue Forecast Council.

Recommendation

Because it is meeting the implied public policy objective of supporting nonprofit organizations that provide social services for children and youth, the Legislature should continue the property tax exemption for nonprofit child day care centers.

Legislation Required: No

Fiscal Impact: None

NONPROFIT SHELTERED WORKSHOPS (PROPERTY TAX)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**JLARC Recommendation**
Provides a property tax exemption for property owned and leased by nonprofit sheltered workshops for people with disabilities.	The Legislature did not specifically state the public policy objective of the preference. JLARC infers that the original public policy objective was to encourage employment of persons with disabilities in sheltered workshops. However, government social services laws are now intended to encourage employment of persons with disabilities in supported work environments, particularly in work settings along with persons without disabilities.	$ 4.4 million in 2011-13 Biennium	**Review and clarify**: Because public policy related to employment of people with disabilities has changed from the time the tax preference was enacted.

NONPROFIT SHELTERED WORKSHOPS (PROPERTY TAX)

Report Detail

Current Law

This tax preference exempts property owned and leased by nonprofit sheltered workshops for people with disabilities from the property tax. The property must be used primarily for manufacturing and handling, selling, or distributing goods constructed, processed, or repaired. Sheltered workshops qualify for the exemption if they are also used for commercial purposes such as selling at retail or wholesale.

Statute defines a sheltered workshop as a rehabilitation facility, or that part of a rehabilitation facility, where manufacture or handiwork takes place. The purpose of the sheltered workshop must be to:

1) Provide gainful employment or rehabilitation services to people with disabilities as an interim step in the rehabilitation process for those who cannot be readily absorbed in the competitive labor market or during such time as employment opportunities for them in the competitive labor market do not exist; or
2) Provide evaluation and work adjustment services for people with disabilities.

A sheltered workshop may qualify under a separate property tax exemption for nonprofit nonsectarian organizations if the facility is also used for rehabilitative services. However, any commercial use, except selling donated clothing, would disqualify a nonprofit from the nonsectarian exemption. JLARC reviewed the exemption for nonprofit nonsectarian organizations in 2007.

See page A3-8 in Appendix 3 for the current statute, RCW 84.36.350.

Legal History

Prior to enactment of the tax preference in 1970, employment of people with disabilities often consisted of piece work in sheltered workshops, and salvaging items and selling them in thrift shops. County assessors generally granted these facilities a property tax exemption for nonsectarian religious organizations. When organizations that had no religious affiliations began operating sheltered workshops, some county assessors taxed the properties while others continued to exempt them.

In 1969, the Pierce County Assessor disqualified Goodwill Industries from the nonsectarian exemption because it had no religious affiliation. The next year, the Legislature enacted a separate property tax exemption for property owned and leased by nonprofit sheltered workshops.

In the 1970s, lawmakers in Washington and at the national level adopted policies to encourage employment in workshops for people with disabilities. In the 1980s and 1990s, both state and national policy shifted toward encouraging employers to hire persons with developmental disabilities in a variety of supported work settings, particularly work sites in which persons without disabilities are employed.

Federal Law

In the 1970s, national efforts to employ persons with disabilities focused on sheltered workshops where products were manufactured and sold.

1971 Congress required the federal government to purchase supplies or services from organizations for the blind and persons with disabilities under certain circumstances.

1977 The National Labor Relations Board ruled that a sheltered workshop was not required to engage in collective bargaining because the union's bargaining demands would "risk a harmful intrusion on the rehabilitative process."

In the 1980s, Congress began accepting a policy of employing persons with disabilities in "supported work" settings.

1984 Amendments to the Developmental Disabilities Act defined "supported work" as "paid employment which…is conducted in a variety of settings, particularly work sites in which persons without disabilities are employed." This definition marks a turning point in policy related to the employment of persons with disabilities.

1986 Congress amended the Fair Labor Standards Act by authorizing employers, after receiving a certificate from the U.S. Department of Labor, to pay special minimum wages based on the productive capacity of the worker. The changes were intended to increase employment opportunities for the disabled.

1990 The Americans with Disabilities Act gave civil rights protection to persons with disabilities in the areas of employment, public accommodations, state and local government services, and telecommunications.

Washington Law

Reflecting national trends, Washington lawmakers in the 1970s first attempted to encourage employment of workers with disabilities in sheltered workshops through tax incentives.

1970 The Legislature granted property tax relief to property owned and used by nonprofit sheltered workshops. The statute defined a "sheltered workshops" as a "rehabilitation facility, or that part of a rehabilitation facility operated by a nonprofit organization, where any manufacture or handiwork is carried on." In the same bill, sheltered workshops were also provided a business and occupation (B&O) tax exemption.

1973 In a separate statute, the Legislature amended the property tax exemption for nonprofit nonsectarian organizations. Nonprofit organizations no longer had to have a religious purpose in order to qualify for the nonsectarian exemption. The Legislature also added "rehabilitative social services" to the list of qualifying uses of the property. At this point, sheltered workshops could qualify for either exemption if the property was not used for commercial purposes.

1975 The Legislature exempted from the property tax the inventory owned by the sheltered workshop that is for sale or lease, raw materials, and finished products. (Business inventories became generally exempted from property tax starting with 1984 tax payments.)

The exemption for sheltered workshops remained unchanged from 1975 until the present. In the 1990s, separate social service laws regarding employment of persons with disabilities followed the national policy shift to supported work.

1992 The Department of Social and Health Services (DSHS) revised county guidelines to include strategies for promoting community inclusion and employment for adults with disabilities.

1997 The Legislature set up a program for hiring persons with disabilities in supported employment positions in state agencies.

2004 DSHS adopted a policy to assist persons with disabilities in finding employment in the open labor market before any other day services are considered. Counties were given two years to plan and prepare, and the policy was implemented in July 2006.

Public Policy Objective

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

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

JLARC infers that the original public policy objective of the tax preference was to encourage employment of persons with disabilities in sheltered workshops. However, the state and federal government have changed policies related to employment of persons with disabilities. Instead of encouraging segregated employment in sheltered workshops, government social services laws are now intended to encourage employment of persons with disabilities in supported work environments, particularly in work settings along with persons without disabilities.

It is not clear whether the tax preference conflicts with other public policy shifts toward employing persons with disabilities in supported work environments.

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

It is not known whether the exemption is achieving its public policy objective because it is not clear whether the tax preference conflicts with other public policy shifts towards encouraging employment of people with disabilities in supported work environments.

Beneficiaries

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

The beneficiaries are the 49 organizations that are claiming the sheltered workshop exemption for 139 properties. The top ten beneficiaries in terms of assessed property value carry on a variety of activities including light manufacturing, assembling, recycling, packing, providing mail services, and operating retail thrift stores. See Exhibit 67, on the following page.

Exhibit 67 – Top Ten Beneficiaries of Property Tax Exemption for Sheltered Workshops Based on Assessed Property Value

Organization	Type of Activity	Assessed Value
Firland Sheltered Workshop	Manufacturing	$114,593,200
Goodwill Industries	Thrift store	$37,679,445
Lighthouse for the Blind	Manufacturing	$7,999,900
Morningside	Office services	$5,715,400
Skills Inc.	Manufacturing	$5,060,900
Salvation Army	Thrift store	$3,971,200
Seattle Drug and Narcotic Center	Recycling	$3,674,700
Deseret Industries	Thrift store	$3,667,300
AtWork	Packaging, assembly, etc.	$2,795,000
Centerforce	Mail services, assembly, etc.	$2,459,800

Source: JLARC analysis of DOR Exempt Property file, 2010, county assessors' property tax rolls, and organization websites. Note: Assessed value may not be current on tax rolls.

Revenue Impacts

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

The beneficiaries of the property tax exemption for sheltered workshops saved $2 million in Fiscal Year 2010 in state and local property taxes and are expected to save $4.4 million in the two-year period of the 2011-13 Biennium. For property tax exemptions, savings to the beneficiary generally do not equal lost revenues to the state or local governments, because other property owners will pay higher taxes when property is taken off the tax rolls. See Exhibit 68, below.

Exhibit 68 – Sheltered Workshops—Estimated Beneficiary Tax Savings

Fiscal Year	Beneficiary Tax Savings		Total
	State	Local	
2009	$327,000	$1,429,000	$1,756,000
2010	$366,000	$1,641,000	$2,007,000
2011	$392,000	$1,758,000	$2,150,000
2012	$397,000	$1,784,000	$2,181,000
2013	$401,000	$1,856,000	$2,257,000
2011-13 Biennial Total	$798,000	$3,640,000	$4,438,000

Source: JLARC analysis based on DOR exempt property file, county assessors' property tax rolls, DOR's property tax estimating model, and growth rates from the Economic and Revenue Forecast Council.

Recommendation

Because public policy related to employment of the disabled has changed from the time the tax preference was enacted, the Legislature should clarify the public policy objective of the property tax exemption for sheltered workshops.

Legislation Required:	Yes
Fiscal Impact:	Depends on Legislation

OPEN SPACE ADDITIONAL TAX (PROPERTY TAX)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**JLARC Recommendation**
Provides certain exemptions to the additional tax owed when an owner removes private property from an "open space" designation (referred to as the Current Use Program).	The Legislature did not specifically state the public policy objective of the preference. JLARC infers that the Legislature intended to avoid penalizing owners in certain circumstances: 1) For circumstances beyond the control of the owner; 2) Where the change in use is compatible with the purpose of the Current Use Program; and 3) Where the property becomes fully exempt from property taxation upon transfer to a church or upon qualifying under a new property exemption.	$3.9 million in 2011-13 Biennium	**Continue**: Because the preference is achieving the implied public policy objective of avoiding penalizing property owners that remove property from current use under certain circumstances.

OPEN SPACE ADDITIONAL TAX (PROPERTY TAX)

Report Detail

Current Law

These tax preferences allow certain exemptions to the additional tax owed when an owner removes private property such as farm and agricultural land from an "open space" designation (referred to as the Current Use Program).

Upon applying for classification under the Current Use Program, the owner agrees to maintain the land in open space for at least ten years. Removing the property from current use normally makes the property owner subject to payment of back taxes, interest, and penalties. However, there are some instances where the back taxes are not due, which constitute this preference.

Current Use Program and Additional Taxes

The Current Use Program provides for property valuation on the basis of "current use" for three types of property: 1) timber, 2) farm and agricultural lands, and 3) other open space. Most other property is valued at potential use of the property or "highest and best use." Current use valuation is usually lower than highest and best use valuation, resulting in lower property taxes.

Ordinarily when land is withdrawn from current use, owners must pay an additional tax. The additional tax is equal to the difference between the current use value and highest and best use value times the number of years the property has been in current use up to a maximum of seven years. Back taxes are multiplied by a compounded interest rate of 1 percent plus a 20 percent penalty. Penalties, but not taxes and interest, are waived if advance notification of the change is given and the property has been in the current use program for at least ten years.

The additional tax is distributed to the taxing districts in which the land is located, and interest and penalties are distributed to the county.

Exemption from Additional Tax (The Tax Preferences)

Additional tax is not imposed if removal of the property from the Current Use Program is a result of one of the following 12 actions:

(a) Land is transferred to a government entity in exchange for other land located within the state of Washington;

(b) Land is taken through eminent domain or sold to an entity with the power of eminent domain;

(c) Land use changes because of a natural disaster;

(d) Present use of the land is disallowed because of an official action to change zoning restrictions, for example under the Growth Management Act;

(e) Land is transferred to a church;

(f) Property interests are acquired by a state agency or certain nonprofit organizations in order to conserve land for future use;

(g) Removal of land classified as farm and agricultural land on which housing for employees and/or the principal place of residence is sited;

(h) Removal of land from classification after enactment of a statutory exemption that qualifies the land for exemption;

(i) The creation, sale, or transfer of a forestry riparian easement;

(j) The creation, sale, or transfer of a conservation easement of private forest lands within unconfined channel migration zones or containing critical habitat for threatened or endangered species;

(k) The sale or transfer of land within two years after the death of an owner who held at least a 50 percent interest in the land if the land has been assessed and valued under timber land continuously since 1993; and

(l) Removal of land because it was classified in error through no fault of the owner.

See page A3-9 in Appendix 3 for the current statutes, RCW 84.34.108(6).

Legal History

1968 Voters approved Amendment 53 to the state Constitution, allowing for the valuation of farms, agricultural lands, standing timber and timberlands, and other open space lands based on the current use of the property, rather than the highest and best use. Open space lands are to be used for "enjoyment of their scenic or natural beauty."

1970 A new statute implemented the Current Use Program. The law provided for payment of additional tax if the owner withdrew the land from classification. Additional tax was waived if the change in use resulted from the sale of land within two years after the death of the owner of 50 percent or more of the property.

The Legislature added several other exceptions to the additional tax from 1973 to 2009 as follows:

1973 Transfer to a government entity in a land exchange; taking of the land through eminent domain; a natural disaster; official action disallowing use of land; and transfer to a church;

1983 Acquisition of property interests by government agencies or nonprofit organizations for the purpose of conservation, protection, and preservation for open space purposes;

1992 Transfer of the property for the purpose of farm worker and operator housing;

1999 Transfer due to the enactment of a property tax exemption for which the land qualifies; and transfer for the purpose of forest riparian and conservation easements;

2009 Classification of the property in error through no fault of the owner; and removal resulting from creation, sale, or transfer of a conservation easement on private forest land within unconfined channel migration zones or containing critical habitat for threatened or endangered species.

Other Relevant Background

Description of the Current Use Program

The Legislature provided a clear declaration of the purpose for the Current Use Program:

> *…to maintain, preserve, conserve and otherwise continue in existence adequate open space lands for the production of food, fiber and forest corps, and to assure the use and enjoyment of natural resources and scenic beauty for the economic and social well-being of the state and its citizens.*

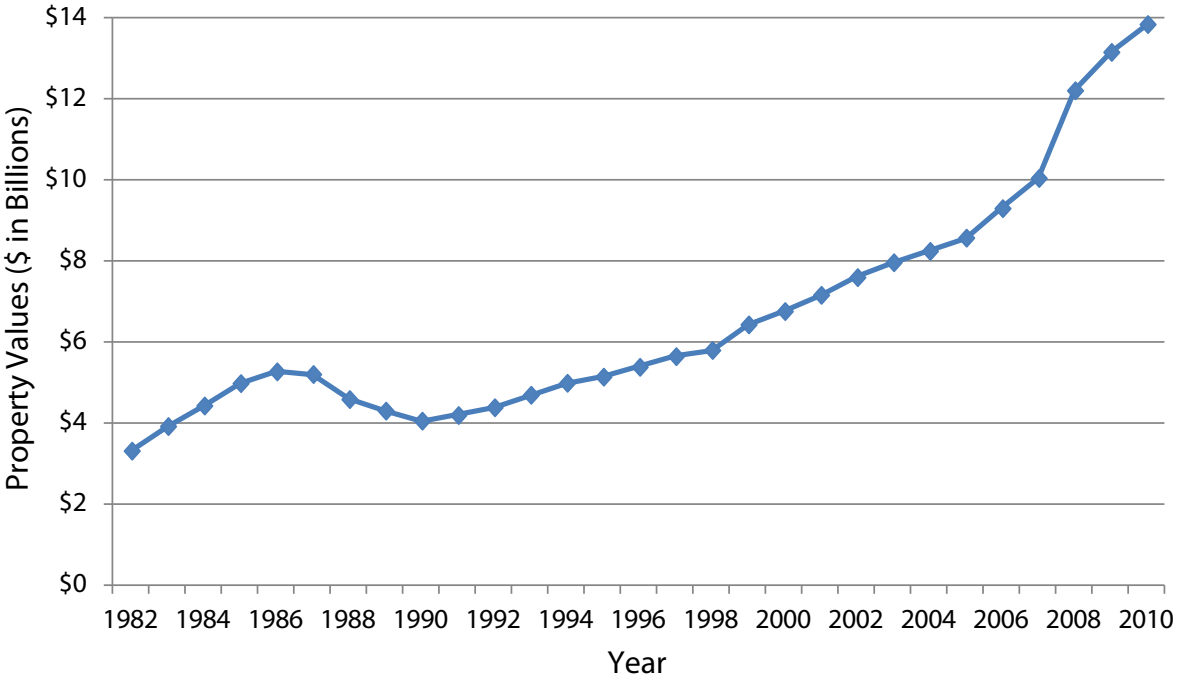
Qualifications for the three types of property in the Current Use Program are as follows.

1) Farm and agricultural land generally must be:
    - 20 or more acres in agricultural use,
    - Five or more acres, but less than 20 acres, with annual income from agricultural uses of $200 or more per acre for three out of five years, or
    - Less than five acres with annual income from agricultural use of $1,500 for three out of five years.
2) Timber land must be five or more acres devoted primarily to the growth and harvest of forest crops.
3) Other open space land must be areas set aside to protect preserve, enhance, promote, and retain open space lands.

Current use valuation for property tax purposes differs depending on the classification. Value for farm and agricultural land is based on a net cash rental value of comparable lands in the same area. Timber land values are developed by the Department of Revenue based on the certain land characteristics.

Currently, 11.5 million acres are enrolled in the Current Use Program in Washington with 98 percent of the acreage in the farm and agriculture classification. In 2010, the current use valuation reduced the taxable value of property by $14 billion. In the last three decades, value removed from the rolls due to current use classification has grown from $3 billion to $14 billion. Because the growth in property tax levies is limited to 1 percent, taxes are shifted onto other taxpayers when value is removed from the rolls.

Exhibit 69 – Property Value Not Taxed Under Open Space Classification



Source: DOR Property Tax Statistics, 1982 to 2010.

Public Policy Objective

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

While stating a clear public policy purpose for current use classification, the Legislature did not state a public policy objective for these tax preferences.

JLARC infers that the Legislature intended to avoid penalizing owners in certain circumstances when private property is removed from the Current Use Program. The implied public policy objectives of the exemptions fall into three categories. Exceptions are provided: 1) for circumstances beyond the control of the owner; 2) where the change in use is compatible with the purpose of the Current Use Program; and 3) where the property becomes fully exempt from property taxation upon transfer to a church or upon qualifying under a new property exemption.

The following exhibit designates the implied public policy objective for each exemption from the additional tax.

Exhibit 70 – Three Categories for Exemptions from Additional Tax

Reason for Change in Use	Beyond Control of Owner	Compatible with Current Use	Fully Exempt (Qualifies for New Exemption or Transfers to Church)
Transfer of land after death of an owner	X		
Transfer to a govt. entity in land exchange	X		
Taken through eminent domain	X		
Natural disaster	X		
Official action disallowing use of land	X		
Transfer to a church			X
Acquired by certain entities for public use		X	
Qualifies under a new exemption			X
Farm worker and operator housing		X	
Transfer of forest riparian easement		X	
Transfer of forest conservation easement		X	
Classified in error	X		

Source: JLARC analysis of tax law.

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

The public policy objective is achieved because assessors are waiving additional tax for circumstances set forth by the Legislature.

Beneficiaries

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

Beneficiaries of the tax preferences are private owners of property that is removed from the current use program due to circumstances beyond their control, where the land is removed for a purpose compatible with the current use program, or where the property becomes fully exempt upon transfer to a church or under a newly enacted exemption.

Revenue Impacts

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

Beneficiaries of the tax preference saved an estimated $1.9 million in property taxes in 2010 and are expected to save a two-year total of $3.9 million for the 2011-13 Biennium. See Exhibit 71, below.

Exhibit 71 – Current Use Additional Tax Exemption
Estimated Beneficiary Tax Savings

Fiscal Year	Beneficiary Tax Savings		Total
	State	Local	
2009	$340,000	$770,000	$1,110,000
2010	$350,000	$1,520,000	$1,870,000
2011	$350,000	$1,530,000	$1,880,000
2012	$350,000	$1,550,000	$1,900,000
2013	$360,000	$1,620,000	$1,980,000
2011-13 Biennium	**$710,000**	**$3,170,000**	**$3,880,000**

Source: JLARC analysis based on a 2007 and partial 2011 survey of county assessors by DOR, and property tax growth rates from the Economic and Revenue Forecast Council.

DOR is currently updating the Tax Exemption Study for publication in January 2012. To estimate the impact on this tax exemption for the study, the Department is conducting a new survey of the county assessors. A more representative estimate of taxpayer savings should be available following completion of this survey.

Recommendation

The Legislature should continue the tax preference because it is achieving the public policy objective of avoiding penalizing property owners that remove property from the current use under certain circumstances as follows:

1) **Removal is beyond control of the owner;**
2) **The change in use is compatible with the Current Use Program; or**
3) **The property is transferred to a church or qualifies under a new exemption.**

Legislation Required: No

Fiscal Impact: None

REAL ESTATE EXCISE TAX EXEMPTIONS (REAL ESTATE EXCISE TAX)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**JLARC Recommendation**
The preferences specifically exclude 13 types of property transfers or sales from the definition of a taxable "sale" for real estate excise tax purposes.	The Legislature did not specifically state the public policy objective of the preference. JLARC assumes these exclusions from the definition of what is a taxable "sale" for real estate excise tax purposes may function to define the tax and its base.	$1.4 billion in 2011-13 Biennium	**Continue**: Because the preferences are meeting the implied public policy objective of defining the tax base for application of the real estate excise tax.

REAL ESTATE EXCISE TAX EXEMPTIONS (REAL ESTATE EXCISE TAX)

Report Detail

Current Law

Real estate excise tax (REET) is a tax on the sale of real property. "Real property" is bare land or anything affixed to the land. REET is typically paid by the seller of residential or commercial real property, although the buyer is liable if the seller does not pay the tax. REET also applies to transfers of controlling interests (50 percent or more) in entities that own property in the state.

REET has a state and local tax component. The state rate is consistent through the state, but the local rate can vary, depending on the rates and taxes adopted by a local city or county.

Under the statute that defines a taxable "sale" for REET purposes, the following transactions (with their enactment dates) are specifically excluded from the definition of sale and therefore not assessed REET:

a) Transfer by gift, devise, or inheritance *(1951)*

b) Transfer of any leasehold interest other than a lease with an option to purchase (*1951*)

c) Cancellation/forfeiture of a vendee's interest in a contract for the sale, whether or not the contract contains a forfeiture clause, or deed in lieu of foreclosure of a mortgage *(1955)*

d) Partition of property by tenants in common by agreement or resulting from a court decree (*1955)*

e) Assignment of property or interest in property from one spouse/domestic partner to the other spouse/domestic partner per terms of divorce or dissolution of state registered domestic partnership or in fulfillment of property settlement agreement *(1955*)

f) Assignment/transfer of a vendor's interest in a contract for sale, even though accompanied by a conveyance of the vendor's interest in the property (*1951*)

g) Transfers by appropriation/decree in condemnation proceedings by the U.S., state, or any political subdivision thereof, county or city (*1951*)

h) Mortgage or other transfer of a property interest just to secure a debt *(1951*)

i) Any transfer/conveyance pursuant to a deed of trust/court order of sale in any mortgage, deed of trust, or lien foreclosure proceeding or upon execution of a judgment, or deed in lieu of foreclosure to satisfy a mortgage/deed of trust *(1953)*

j) Conveyance to the FHA or VA by a mortgagee pursuant to a FHA or VA contract of insurance or guaranty *(1953)*

k) A transfer to comply with lease or contract terms where REET has been paid or where the lease/contract was entered into prior to when REET was first imposed (*1951*)

l) Sale of any grave or lot in an established cemetery *(1951)*

m) Sale by the United States, the state, or any political subdivision *(1951)*

In addition to the preferences provided in RCW 82.45.010(3)(a)-(m), four additional REET exclusions are provided in RCW 82.45.010(3)(n)-(q). These preferences currently appear on the 10-year JLARC review schedule as follows: (n) sales to RTAs – 2015; (o) no change in beneficial owner – 2020; (p) IRS transfers – 2013; and (q) manufactured home communities – 2016.

See page A3-10 in Appendix 3 for the current statute, RCW 82.45.010 (3)(a) – (m).

Legal History

April

1951 At the close of the 1st Special Session, the Legislature approved several new taxes, including a county-level real estate excise tax "for the support of the common schools" and a 4 percent corporate net income tax. The REET was designed to shift more of the costs to fund schools from the state general fund to the local level. County commissioners were authorized to levy an excise tax on real estate sales not to exceed 1 percent of the sale amount. The tax proceeds were to be placed in a county school fund and used exclusively for the support of the common schools.

The Legislature included the new REET and new corporate income taxes in the same bill as the 1951-53 biennium appropriations, although various parties questioned the constitutionality of this action. Within days after the 1st Special Session's end, five lawsuits were filed.

Aug

1951 The State Supreme Court declared the corporate net income tax unconstitutional.[15] Because of this, the new REET was ruled unconstitutional, as well. The Court also ruled that the appropriations included in the bill imposing invalidated taxes were unconstitutional because the bill contained two subjects - a tax and an appropriation. Without the new taxes or a budget, the Governor called the Legislature back in September for a 2nd Special Session.

Sept

1951 During the 2nd Special Session, the Legislature adopted a revised real estate excise tax to replace the one invalidated in August. In the new legislation, the REET was to be administered by counties on sales of real property within the county. The rate was 1 percent, with 0.5 percent of the tax amount retained by the county for administrative costs. Revenues were earmarked to support local schools, reducing the amount of funds the Legislature had to provide to local schools through school equalization grants. When enacted, eight types of transfers were specifically excluded from the definition of a "sale."

1953 A number of bills to repeal or change the REET's application were introduced, but failed to pass the Legislature.

However, the Legislature added two more REET exemptions: one for transfers due to deeds of trust or sales ordered in foreclosures to satisfy a debt; another for conveyances to the FHA or VA by a mortgagee pursuant to a FHA or VA contract of insurance or guaranty. Also, the

[15] *Power, Inc. v. Huntley*, 39 Wn.2nd 191 (1951).

legislation increased the amount counties were allowed to keep for administration costs to 1 percent of the receipts.

1955 The Legislature added three more exclusions from REET for transfers due to : 1) cancellations of an interest in a sale; 2) partitions per a contract/agreement by tenants in common; and 3) transfers of property interest due to a divorce.

1978 The State Supreme Court affirmed a trial court judgment and determined in *Seattle School District No. 1 v. State* that it was the state's "paramount duty to . . . make ample provision for the education of all children."[16] The court held that funding basic education was the responsibility of the state, not local governments.

1980 The Legislature transferred the overall REET administration responsibilities from counties to the state level, with the state Department of Revenue. County treasurers would continue to collect the tax on real property transfers and counties would still keep 1 percent of the tax receipts to defray their costs. The tax proceeds were deposited in a special account in the general fund for exclusive use in the support of the common schools. The 1980 legislative changes took effect September 1, 1981, when the Department took over REET administration.

1982 The Legislature added two surtaxes, increasing the state tax rate to 1.07 percent. In addition, two local option real estate taxes were authorized: 0.25 percent for capital purposes and 0.5 percent in lieu of the second 0.5 percent local sales tax.

1987 The Legislature repealed the conveyance tax, a tax of $1 for each $500 of equity in real estate or other instruments conveyed to another person by the owner. In its place, the REET rate was raised an equivalent amount, so that the state rate increased from 1.07 to 1.28 percent.

1990 The Legislature authorized two more local option REET taxes: a 1 percent county tax for conservation areas and a 0.25 percent city/county tax for certain capital projects.

1993 The exception from tax for sales of real estate **to** a governmental entity was repealed, leaving only sales **by** a governmental entity exempt from REET. In addition, REET was extended to transfers of controlling interests (50 percent or more) in entities that own real property in Washington, an effort to counter the practice of structuring commercial or industrial real estate transactions to avoid the tax.

2002 The Legislature established a 1 percent local tax for affordable housing.

2005 The Legislature removed the provision dedicating the state portion of REET proceeds solely for funding common schools. The stated intent was to expand the constitutional definition of general state revenues to enable the funds to be used to increase state assistance for local school construction using state bonding authority. The Legislature also made major revisions to how REET was administered, including establishing an electronic payment system, applying a $5 fee to each REET affidavit to pay for upgrading county processing systems, and increasing the county administrative fee from 1 to 1.3 percent. These administrative revisions became effective July 1, 2006.

[16] *Seattle School District No 1 v. State,* 90 Wn.2d 476, 585 P.2d 71 (1978).

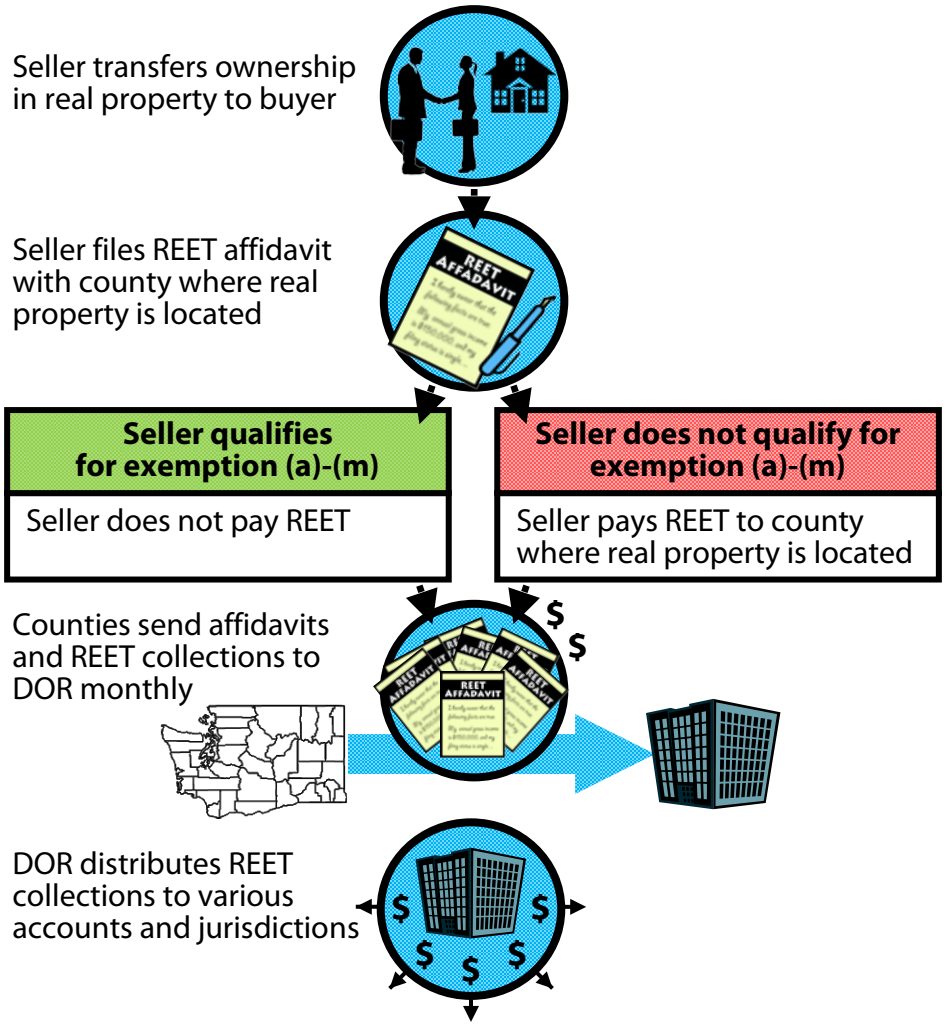
2010 The Legislature passed a bill to close loopholes and clarify ambiguities in real estate excise tax application regarding transfers of controlling interests in real property.

2011 The Legislature passed 2SHB 1362 to protect and help homeowners avoid unnecessary foreclosures. As part of this bill, "total consideration" was redefined in REET law to not include amounts of any relocation assistance provided to the transferor when a transfer is made by deed in lieu of foreclosure to satisfy a deed in trust.

Other Relevant Background

REET is paid directly to the county where the property is located, except for transfers of controlling interest, which are reported and paid directly to the Department of Revenue. The seller files an affidavit with the county, which collects the tax, distributes the state and local shares, and keeps a percentage for their administrative costs. If the transfer qualifies for one of the exemptions noted in RCW 82.25.010(3)(a)-(m), the seller must provide the reason for exemption on the affidavit. Exhibit 72, below, illustrates the REET filing process.

Exhibit 72 – Real Estate Excise Tax Process



Source: JLARC analysis of RCW 82.45.010(3)(a)-(m).

Exhibit 73, below, details the REET preferences currently under review and provides an explanation and/or a specific example of each exclusion.

Exhibit 73 – REET Preferences with Explanations and/or Example Transactions

82.45.010 (3)(a) – (m) Exclusions		Explanation and/or Example
a	Gift, device, inheritance	Transactions that do not represent market transactions, where no consideration is given, such as a transfer from joint owners to only one of the owners
b	Leasehold interest transfer other than lease with an option to purchase	Rental or sublease of lease. When the option is exercised, it becomes a sale
c	Cancellation of interest in sale, no matter if contract has forfeiture or deed in lieu of foreclosure clause	Transaction related to the debt on real property, not the real property itself, such as perfecting the property interest or transferring an ownership interest in property to a bank as part of a foreclosure proceeding
d	Partition by tenants in common per agreement or decree	Tenants in common agree that certain tenants will be assigned particular tracts within the jointly-owned property
e	Assignment of property through divorce, property settlement	Division of property due to a dissolution or divorce
f	Assignment/transfer of vendor's interest in contract	Sale of mortgages, not the sale of the real property or an interest in it
g	Transfer per government condemnation process	Eminent domain; a forced sale due to a governmental order
h	Transfer of interest to secure debt	Second mortgages; sales of mortgages
i	Transfer per to deed of trust/sale ordered in foreclosure to satisfy debt	Foreclosures
j	Conveyance to FHA/VA per FHA/VA insurance or guaranty	Federal government exercising its right under federal insurance
k	Transfer where REET already paid or lease/contract began prior to 1951	99 year leases
l	Grave/cemetery lot sale	Sales or acquisitions of grave/cemetery lots
m	Transfer by U.S., state, city, county government	Property acquired from a U.S., state, or local governmental entity

Source: JLARC analysis of RCW 82.45.010(3)(a)-(m).

Current Real Estate Excise Taxes

A number of real estate excise taxes are currently authorized in statute. Some are imposed statewide, others imposed by certain counties and/or cities that have voted to apply the tax to real property transfers/sales. Exhibit 74, below, provides detail on these taxes.

Exhibit 74 – State and Local Option REET - Rates, Purposes, and Imposition

Levied by	Statute	Rate *	Purpose	Where Imposed
State	82.45.060	1.28%	General fund; portions to local public works and city/county assistance	Statewide
Cities, counties	82.46.010(2)	up to 0.25%	Finance capital improvements	134 cities, 20 counties
Cities, counties	82.46.035(2)	up to 0.25%	Finance capital project in comprehensive plan	132 cities, 19 counties
Cities, counties	82.46.010(3)	up to 0.5%	General purposes; cannot be imposed if tax in 82.14.030(2) is imposed	1 city (Asotin)
Counties	82.46.070	up to 1.0%	Acquire, maintain conservation areas	San Juan County
Counties	82.46.075	0.50%	Acquire, construct, operate low income/special needs affordable housing	Restricted to San Juan County, but not imposed

Source: JLARC analysis of DOR 2010 Tax Reference Manual, DOR REET state & local tax rate sheet.

* The combined state and local rate in most areas in the state is either 1.53 or 1.78 percent. The highest REET combined state and local rate is 2.78 percent in Friday Harbor.

The state portion of real estate excise tax collections is distributed per statute into several accounts, as noted in Exhibit 75, below.

Exhibit 75 – State REET Receipt Distributions for FY 2010

State Treasurer Account	2010 Distributions
General fund	$379.6 million
Public works assistance	$25.0 million
City/county assistance	$6.6 million
Housing trust fund	$0.7 million
Total	**$412.9 million**

Source: DOR Tax Statistics Report, 2010, Table 5C, pg 14.

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 specifically state the public policy objectives in any of the statutes that implemented the tax exemptions.

However, JLARC assumes these exclusions from the definition of what is a taxable "sale" for real estate excise tax purposes may function to define the tax and its base. Tax base defining theory states that at the time legislatures develop a tax, they will define the elements that will be subject to tax and the elements excluded. Since the first eight exceptions were part of the 1951 legislation enacting the REET and the other five were enacted during the next two legislative sessions, the implied public policy objective was to define the tax base for REET.

Real estate excise tax is a tax on transfers or sales of real property. According to the Department of Revenue, to be subject to REET, a transfer/sale must be a:

1) transfer of ownership or interest in real property;
2) that is voluntary; and
3) where consideration (payment) or relief from debt is provided in exchange for transfer of an interest or ownership in the property.

Each of the exclusions from the definition of "sale" in (a) – (k) detail a specific transfer of interest in real property, but without any consideration, payment, or transfer of a debt component. The exclusions in (l) and (m) differ in that they are sales, as consideration is provided in these transactions. However, the Legislature made a public policy decision to not subject sales of graves/lots in cemeteries or sales by state or local government entities to the tax. It should be noted that sales by the U.S. government are constitutionally prohibited from state taxation.

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

Most of these preferences have not been substantively changed since they were enacted, even though the real estate excise tax has been altered and amended on numerous occasions. The Legislature clarified in 1993 that the tax was not paid on sales by a government entity, but sales to a government entity would require the seller to pay REET. Because real property transfers that fall within one of the 13 preferences are not subjected to REET, the preferences are achieving their objective of defining the real estate excise tax base.

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

Continuing the preferences will continue to fulfill the public policy objective of defining the tax base.

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

The public policy objective is being fulfilled.

Beneficiaries

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

Beneficiaries of the preferences are persons or entities that own real property and that transfer ownership in that property under one of the 13 transactions specifically exempted from the definition of "sale" under (a) – (m).

In examining REET affidavits filed electronically with the Department of Revenue for the period CY2010, JLARC found that exempt transactions accounted for approximately 51 percent of the total real property transfers/sales reported. The percentage remained the same, whether using a calendar year or fiscal year basis. Exhibit 76, below, illustrates this percentage split.

It should be noted, the data examined is only a portion of all REET transactions. This is because not all counties have initiated electronic affidavit filing and affidavits are not required to be filed for the following exemptions: (b) leasehold interest transfers not in (a); (f) assignment/transfer of vendor's interest in contract; (h) transfer of interest to secure a debt; (k) transfer where REET previously paid or prior to tax; and (l), grave/cemetery lot sale.

Of the exempt transactions reviewed, over one-half consisted of transfers due to foreclosure transactions. The number of foreclosure transactions reflected in 2010 affidavit details is higher than that from prior REET exemption data. The Department of Revenue notes that gifts, devices, and inheritances have consistently been the most common exemption, followed by foreclosure transactions.

Exhibit 76 – Top Four REET Exemptions Taken in CY 2010

RCW 82.45.010(3)		Percent of all CY10 exemptions
1	(i) Transferred by deed of trust/sale from foreclosures	51%
2	(a) Gift, device, inheritance	22%
3	(m) Government sales	13%
4	(e) Division per divorce	10%
5	All other	4%
Total Exemptions		**100%**

Source: JLARC analysis of DOR electronically filed REET affidavits by county for CY2010. Data on exemptions under 82.45.010(3)(b), (f), (h), (k), and (l) not available.

To what extent are the tax preferences providing unintended benefits to entities other than those the Legislature intended?

JLARC found no evidence of unintended beneficiaries.

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?

JLARC estimates that beneficiaries saved $623 million in Fiscal Year 2010 due to these preferences. Estimated beneficiary savings for the 2011-2013 Biennium are $1.4 billion. See Exhibit 77, below.

Exhibit 77 – Estimated Beneficiary Savings ($ in Millions)

Fiscal Year	State REET	Local REET	Total REET Exemptions
2010	$486.8 M	$ 136.3 M	$623.1 M
2011	$529.7 M	$148.3 M	$678.1 M
2012	$529.7 M	$148.3 M	$678.1 M
2013	$529.7 M	$148.3 M	$678.1 M
2011-13 Biennial Total	**$1.1 Billion**	**$296.7 M**	**$1.4 Billion**

Source: JLARC analysis of DOR electronically filed REET affidavits for 22 counties in CY10. JLARC estimated savings for 17 nonreporting counties by applying exempt to taxable ratio determined from 22 reporting counties to each county's CY10 REET collections. JLARC could not determine a method to estimate growth in REET preferences, so maintained the 2011 preference value throughout the following biennium.

To determine the estimated beneficiary savings for these preferences, JLARC analyzed REET affidavits submitted to the Department of Revenue by counties using the Department's electronic filing system for the period January through December 2010. JLARC examined sales and exemptions reported in each county, REET amounts paid, REET exemptions noted, and the value of the exempt transactions to determine the taxpayer savings. Not all counties file REET affidavits electronically. For the 17 counties not filing affidavits electronically, JLARC estimated the value of REET exemptions using actual CY10 REET collections by county and a ratio of exempt to taxable transactions.

While 22 counties submitted electronic affidavit information to the Department in 2010, only eight counties filed electronically for all 12 months. JLARC found that King County had the most REET transactions, the greatest amount of REET paid, and the largest number and greatest value of exempt transactions due to the preferences.

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?

JLARC cannot determine the overall impact on the economy if the preferences were terminated.

Terminating the preferences would broaden the real estate excise tax base and likely increase REET tax collections for the state, counties, and cities. However, since a sale requires that valuable consideration be exchanged for an interest/ownership in real property for the tax to apply, there could be problems in applying the tax to all transactions now covered by the preferences, since many of these transactions do not involve valuable consideration or a market level payment being made. It would be difficult for counties or sellers/transferors of property now exempted from tax to determine value on these transactions, as they may not have a market value attached to them.

If the preferences were terminated, it is unclear whether the increased REET collections would equal estimated beneficiary savings noted in Exhibit 77, due to potential changes in behavior and difficulties assigning taxable values.

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

There would be no effect on distribution of taxes if the tax preferences were repealed. Additional taxpayers would be required to pay real estate excise tax.

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?

The District of Columbia and 35 states (including Washington) impose a tax analogous to Washington's real estate excise tax.

The structure of the tax in other states may make such exemptions unnecessary. For example, many states only impose the tax at the recording of a deed. In cases where a deed may not be required, such as with cemetery lots, an explicit statutory exemption would not be necessary.

JLARC's findings for explicit statutory exemptions are noted in Exhibit 78, below.

Exhibit 78 – Real Estate Tax Exemptions Provided in Other States

Exemption	Number of States
(a) Gift/Inheritance	26
(b) Other Interest	9
(c) Forfeiture	4
(d) Partition	10
(e) Divorce	22
(f) Seller Switch	2
(g) Condemnation	18

Exemption	Number of States
(h) Mortgage/Secure Debt	29
(i) Foreclosure	17
(j) Fed Housing/Veterans	2
(k) Already Paid	6
(l) Cemetery Lots	13
(m) Government Sales	31

Source: JLARC analysis of CCH data 37-051.

Recommendation

Because the preferences are meeting the implied public policy objective of defining the tax base for application of the real estate excise tax, the Legislature should continue the preferences.

Legislation Required: No

Fiscal Impact: None

RENEWABLE ENERGY MACHINERY (SALES & USE TAX)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**JLARC Recommendation**
Provides sales and use tax exemptions for renewable energy machinery and equipment used directly in generating electricity from wind, sun, fuel cells, biomass energy, tidal or wave energy, geothermal resources, anaerobic digestion, and technology that converts otherwise lost energy from exhaust, or landfill gas into electricity.	The Legislature did not specifically state the public policy objective of these preferences; however, it did make the preferences temporary. JLARC infers that the Legislature's public policy objective was to encourage and support generation of electricity using renewable energy sources on a temporary basis.	$40.8 million in 2011-13 Biennium	**Allow to expire**: Because the Legislature intended the exemptions to be temporary and did not provide performance goals to guide any other assessment of performance.

RENEWABLE ENERGY MACHINERY (SALES & USE TAX)

Report Detail

Current Law

This preference provides a sales and use tax exemption for renewable energy machinery and equipment used directly in generating electricity from wind, sun, fuel cells, biomass energy, tidal or wave energy, geothermal resources, anaerobic digestion, and technology that converts otherwise lost energy from exhaust, or landfill gas into electricity. The purchaser of the equipment must develop a facility capable of generating at least one thousand watts. One thousand watts, or one kilowatt, of electricity is the amount needed to illuminate ten 100 watt light bulbs. The exemptions encompass installation labor and services, as well as the electrical generation machinery and equipment.

From July 1, 2009, to June 30, 2011, purchasers of qualifying renewable energy machinery and equipment receive a full exemption from sales and use taxes. From July 1, 2011, to June 30, 2013, the exemptions are reduced to 75 percent of the state and local sales or use tax paid. Beginning in 2011, the exemption will be handled as a refund – taxpayers must remit the tax upon purchase or use of the renewable energy machinery and equipment, and then apply to the Department of Revenue (DOR) for a refund. The purchaser may not apply for a refund more than once per quarter and must keep records to allow DOR to determine the consumer's eligibility for the exemption.

The tax preferences expire on July 1, 2013.

See pages A3-11 and A3-13 in Appendix 3 for the current statutes, RCW 82.08.962 and RCW 82.12.962.

Legal History

This history addresses the current preferences as well as their predecessors.

1935 The Legislature created the sales tax and companion use tax that applied to retail sales or use of tangible personal property in Washington. No exemptions were provided for renewable energy machinery and equipment.

1996 The Legislature exempted from retail sales and use taxes machinery and equipment used directly in generating electricity from wind or sun energy until June 30, 2005. These tax preferences were enacted with a requirement that the machinery and equipment be capable of generating at least 200 kilowatts of electricity. The purchaser was required to provide the seller with an exemption certificate and DOR with a copy of the certificate within 60 days of the sale or use of the machinery or equipment.

1998 The Legislature added machinery and equipment using landfill gas to the qualifying renewable energy sources used to generate electricity.

1999 The Legislature removed the requirement that the purchaser of the renewable energy machinery or equipment provide DOR with a copy of the exemption certificate within 60

days of the sale or use of machinery or equipment. The Legislature no longer required the seller to keep a duplicate certificate or summary of exempt sales.

2001 The Legislature extended the expiration date for the sales and use tax exemptions from June 30, 2005, to June 30, 2009. The legislation decreased the required energy output capabilities of the machinery and equipment from 200 kilowatts (200,000 watts) to 200 watts. The Legislature also added fuel cells to the list of qualifying renewable energy sources, but only for the sales tax exemption.

2003 The Legislature included labor and services to install renewable energy machinery and equipment under the sales and use tax exemptions.

2004 The Legislature added fuel cells to the use tax exemption to be consistent with the 2001 retail sales tax exemption for electricity generated from fuel cells.

2009 The Legislature allowed these earlier preferences to expire. It then passed a new bill that included temporary sales and use tax exemptions for machinery and equipment used directly in generating electricity from certain renewable sources. The labor and services to install the machinery and equipment were also exempted. The required electricity generation was increased to 1,000 watts.

Exhibit 79, below summarizes the legal history and shows when sales and use tax exemptions for machinery and equipment to produce electricity from various renewable sources were enacted.

Exhibit 79 – Sales and Use Tax Exemptions for Renewable Energy Machinery

Energy Source Exempted	Year Exemption in Effect							Years Exempt until Expires June 2013
	1996	1998	1999	2001	2003	2004	2009	
Wind	✓	✓	✓	✓	✓	✓	✓	17
Solar	✓	✓	✓	✓	✓	✓	✓	17
Landfill gas		✓	✓	✓	✓	✓	✓	15
Fuel cells				Sales Only	Sales Only	✓	✓	12
Biomass							✓	4
Tidal or wave							✓	4
Geothermal							✓	4
Anaerobic digestion							✓	4
Lost energy from exhaust							✓	4
Installation labor & services					✓	✓	✓	10
Required electricity generation.	>=200 kilowatts	>=200 kilowatts	>=200 kilowatts	>=200 watts	>=200 watts	>=200 watts	>=1,000 watts	

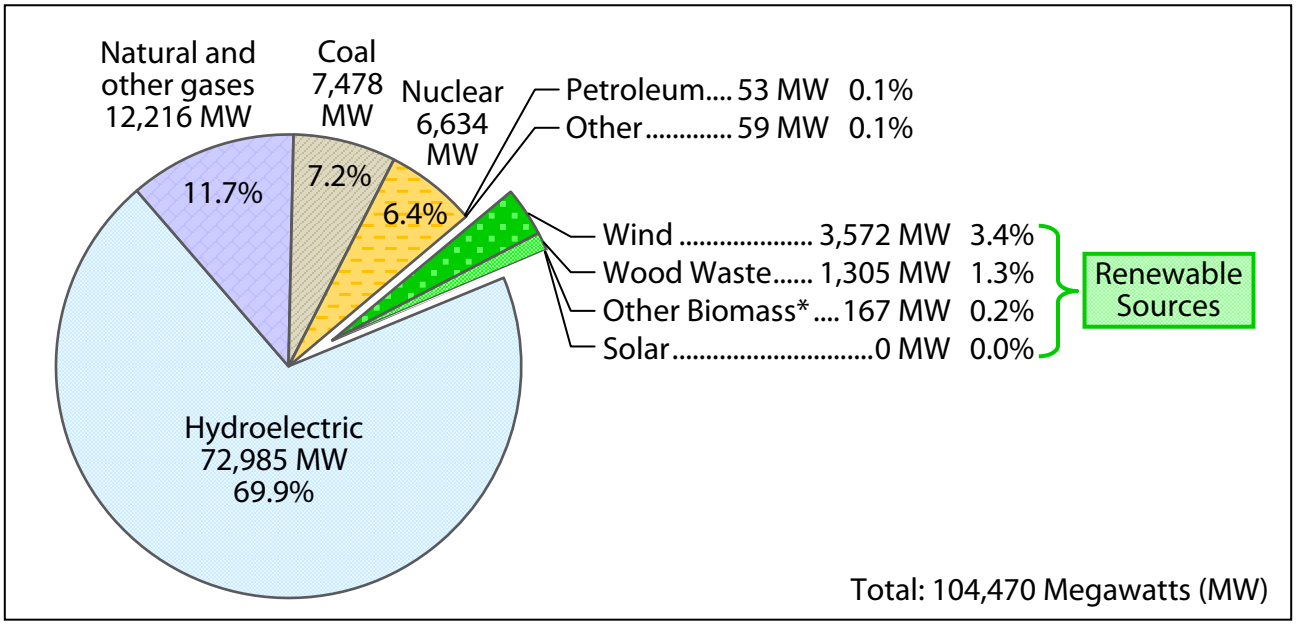
Source: JLARC analysis of state statutes.

Other Relevant Background

Electricity Produced in Washington Comes from a Variety of Sources

The electricity produced in Washington comes from a variety of sources. As shown in Exhibit 80 below, hydropower represented more than two-thirds of the electricity produced in Washington in 2009. Other renewable energy sources, like wind and biomass, accounted for less than 5 percent of Washington's electricity production.

Exhibit 80 – 2009 Energy Sources of Washington Electricity: A Small Percentage Comes from Renewable Sources



* Includes municipal solid waste, landfill gas, and anaerobic digestion.

Source: JLARC analysis of US Department of Energy, Energy Information Administration data.

Renewable Sources of Electricity

The Northwest Power and Conservation Council estimates that in the next 20 years, the Pacific Northwest electricity industry will need to add nearly 7,000 megawatts of power. The geographic opportunities for hydropower are considered by the Council to be fully developed, and other renewable resources will be part of meeting future needs in the region.

Wind Energy – Since 2001, electricity generated from wind projects has been the fastest growing source of electricity in Washington. According to the Northwest Power and Conservation Council, in 2006 and 2007, almost three-quarters of the new capacity of electricity was wind generation. Currently there are 14 wind farms in Washington.

Biomass Energy – There are many different types of biomass resources currently being used and potentially available to produce electricity. This includes energy from burning wood waste, such as hog fuel and sawmill residuals, primary crops and residues harvested or collected directly from the land, the gases that result from the anaerobic digestion of animal manures or organic materials, and the gases that are produced from landfill waste.

Wood waste is Washington's largest biomass source of renewable electric energy. As of April 2008, Washington had 28 biomass fueled electricity generating plants. Ten of these are lumber and paper mills that generate electricity for their own operations. The other 18 generate electricity for commercial sale. Over the past several years, the amount of electricity generated by utilities using wood biomass has been declining.

Other sources of biomass energy include landfill gas and anaerobic digestion. Electricity from landfill gas has remained relatively flat over the past several years. Anaerobic digestion has not produced any electricity for commercial sale.

Solar Energy – Solar energy is a renewable energy which makes use of the radiated heat and light from the sun. There is one 0.5 MW capacity solar farm in Washington that began operation in 2007.

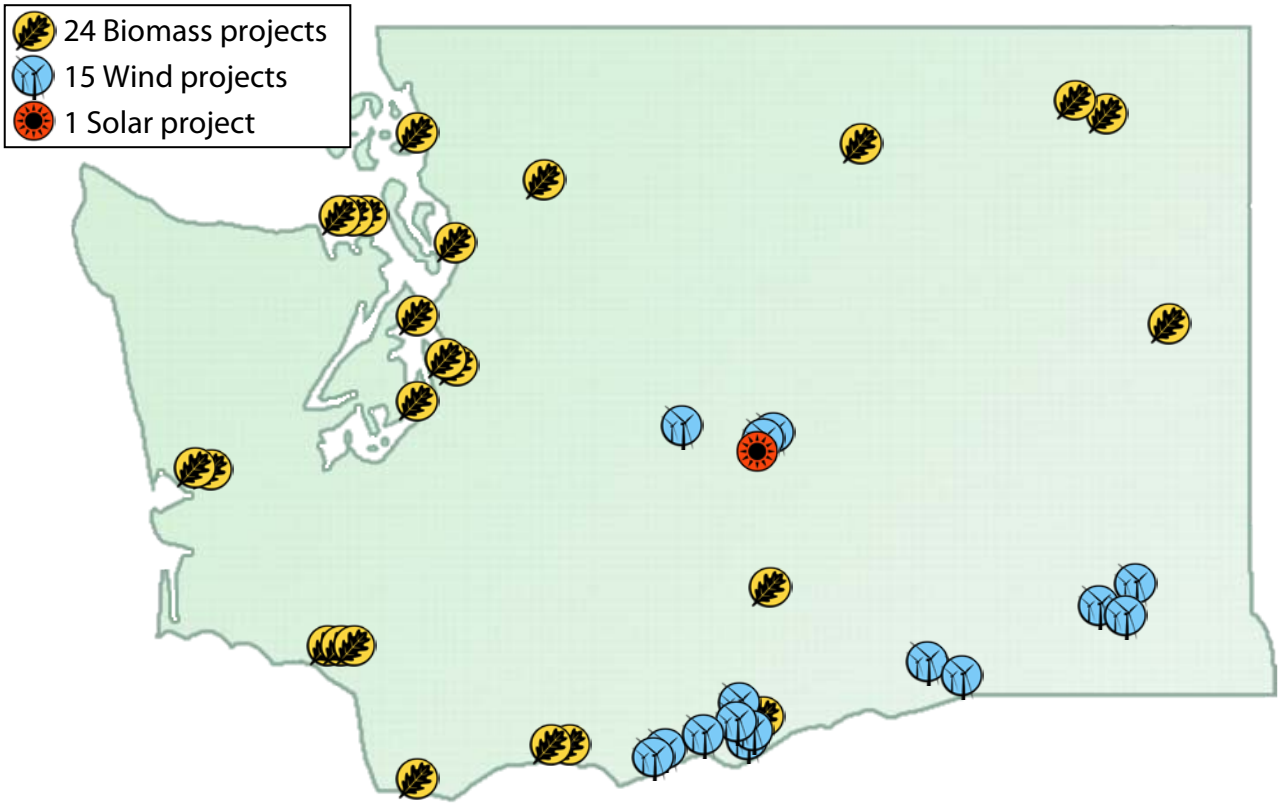
Fuel Cells – A fuel cell is a mini power plant that produces electricity without combustion and pollution. Chemical energy is converted directly into electrical energy and heat when hydrogen fuel is combined with oxygen from the air. There are 20 sites in Washington using fuel cells to produce electricity for internal use, but JLARC could not locate any utilities currently producing electricity in Washington using fuel cells.

Geothermal – Geothermal energy comes from the original formation of the planet, from radioactive decay of minerals, from volcanic activity, and from solar energy absorbed at the earth's surface. No major producers of electricity using geothermal energy are currently located in Washington. However, a few sites in Washington have been verified through drilling where geothermal power generation may be possible.

Tidal and Wave – No commercial production of electricity using tidal or wave energy is currently occurring in Washington.

Exhibit 81 on the following page shows the locations in 2009 where renewable energy was being generated in amounts greater than 25 megawatts.

Exhibit 81 – Projects Generating More than One Megawatt of Electricity Using Renewable Energy



Source: Northwest Power and Conservation Council.

2006 Initiative Requires Utilities to Use Renewable Resources

In November 2006, Washington voters approved Initiative 937, the Energy Independence Act. Washington is one of 29 states that have enacted similar "Renewable Portfolio Standards" requiring that electric power producers obtain a certain percentage of their power from renewable resources. However, different from other states, Washington excludes hydropower from the list of acceptable sources of renewable energy.

The initiative requires electric utilities with 25,000 or more customers to use eligible renewable resources or acquire equivalent renewable energy credits, or a combination of both, to meet the following annual targets:

(i) At least three percent of its load by January 1, 2012, and each year thereafter through December 31, 2015;
(ii) At least nine percent of its load by January 1, 2016, and each year thereafter through December 31, 2019; and
(iii) At least fifteen percent of its load by January 1, 2020, and each year thereafter.

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 state any public policy purposes when it created the first sales and use tax exemptions for renewable energy machinery and equipment in 1996, nor did it make any statements of purpose in any of the bills amending or replacing the original statute.

However, based on the legal history and what was happening with electricity generation in the years prior to the enactment of the first renewable energy tax exemptions, JLARC infers that the Legislature's public policy objective was to encourage and support generation of electricity using renewable energy sources on a temporary basis.

Preferences Intended To Be Temporary

The Legislature included this sales and use tax exemption for renewable energy machinery and equipment in a bill that provided numerous other environmental tax preferences. The Legislature made a decision about the end date for each preference. For some preferences, such as livestock nutrient incentives and an incentive related to radioactive waste cleanup, the Legislature chose to have no expiration dates. Other preferences in the same bill have specific expiration dates, and the dates vary. For example, sales and use tax exemptions related to hog fuel have the same 2013 expiration date as these renewable energy machinery and equipment preferences. The Legislature provided a 2015 expiration date for a biomass energy preference, and expiration dates of 2018 and 2020 for different solar incentives. Given the construction of the bill, JLARC assumes the Legislature made a deliberate choice to make these renewable energy machinery and equipment exemptions temporary.

No Performance Goals Established

An assessment of a preference's contribution to reaching a desired goal could assist the Legislature in determining whether to extend an expiration date for a temporary preference. In 2008, JLARC conducted a review of the sales and use tax exemptions for renewable energy machinery and equipment and recommended that, "The Legislature should implement reporting requirements and criteria on which to evaluate the tax exemptions and reevaluate the wattage threshold limit to ensure there are not unintended beneficiaries." The 2009 legislation did increase the wattage limit from 200 watts to 1,000 watts, but the Legislature did not set any performance expectations.

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

Since enactment of the original tax preferences for wind and solar in 1996, there has been an increase in the number of wind farms operating in Washington. However, JLARC could find no definitive evidence that the tax exemptions were instrumental in bringing the wind farm businesses to Washington. The electricity generated by utilities using other types of renewable energy, as shown in Exhibit 82, on the following page, have not materialized.

Exhibit 82 – Electricity Installed Capacity in Washington
Average Megawatts by Energy Source

Energy Source	2002	2003	2004	2005	2006	2007	2008	2009
Wood waste	124.3	148.3	180.4	138.8	159.3	169.8	135.5	105.9
Wind	2.2	14.2	17.4	20.4	70.3	192.7	392.8	304.1
Landfill gas	8.5	8.4	9.3	8.0	7.0	5.0	1.0	0
Solar	0	0	0	0	0	0.5	0.5	0.5
Fuel cells	0	0	0	0	0	0	0	0
Tidal or wave energy	0	0	0	0	0	0	0	0
Geothermal	0	0	0	0	0	0	0	0
Anaerobic digestion	0	0	0	0	0	0	0	0
Total Renewable	135.0	170.9	207.1	167.2	236.6	367.5	529.3	410.0

Source: JLARC analysis of Northwest Power and Conservation Council data.
Note: Each average megawatt can power 700 homes for a year.

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

It is uncertain as to the extent that continuation of the tax preferences will promote the generation of energy from renewable resources. In 2004, approximately 1.4 percent of electricity generated in Washington came from renewable sources. In 2007, this figure increased to 3.3 percent. The Legislature has not established any specific performance goals for the preferences.

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

Currently, data is not being collected that might help in determining if possible tax incentive adjustments could be made. Starting in July 2011, DOR should have tax remittance data that might improve the available information related to use of the tax exemptions.

Beneficiaries

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

The beneficiaries of the sales and use tax exemptions are utilities, businesses, and individuals that purchase renewable energy machinery and equipment that will be used directly in the production of a minimum of 1,000 watts (one kilowatt) of electricity.

Because the tax preference is a sales and use tax exemption, DOR records have some information from in-state sellers of renewable energy machinery and equipment, but they do not contain information about beneficiaries – the purchasers of the renewable energy machinery and equipment.

Information about potential future beneficiaries is limited to electric power plants that have been proposed or are in the planning stage. Exhibit 83 below shows the number of power plants that are planned or proposed, but not yet under construction, in Washington by the type of energy source and the installed capacity in megawatts that could be generated if the plants are built.

Exhibit 83 – Electric Power Plant Development Activity in Washington

Energy Source	Number of Planned and Proposed Sites	Megawatts
Wind	16	2,229
Wood waste	4	150
Solar	1	75
Landfill gas	1	26
Tidal or wave energy	2	4
Fuel cells	0	0
Geothermal resources	0	0
Anaerobic digestion	0	0
Totals	24	2,484

Source: JLARC analysis of Northwest Power and Conservation Council data (10/01/10).

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

JLARC did not identify any unintended beneficiaries of these tax exemptions.

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?

Past and future beneficiary savings from exempt purchases of renewable energy machinery and equipment by businesses and individuals are difficult to ascertain because little information is available for the non-utility producers of electricity from renewable resources.

Fiscal Year 2010 DOR tax records show 15 in-state sellers of renewable energy equipment reporting exempt sales. These sales totaled $1,631,183. The taxpayer savings amounted to $145,446. Since use tax is not collected, DOR does not have any data about taxpayer savings resulting from purchases of renewable energy machinery and equipment out-of-state.

Exhibit 84, on the following page, shows DOR estimates of beneficiary savings for Fiscal Years 2011 through 2013. The beneficiary savings decrease in Fiscal Years 2012 and 2013, when the exemptions are 75 percent of the sales or use tax owed on the renewable energy machinery or equipment. More information may become available after July 2011 when the tax exemptions take the form of a tax remittance.

Exhibit 84 – DOR Forecast of Retail Sales and Use Tax Beneficiary Savings on Renewable Energy Equipment

Year	State Tax	Local Tax	Total Tax
FY 2011	$19.3 M	$6.8 M	$26.1M
FY 2012	$14.9 M	$5.2 M	$20.1 M
FY 2013	$15.3 M	$5.4 M	$20.7 M
2011-13 Biennial Total	**$30.2 M**	**$10.6 M**	**$40.8 M**

Source: DOR Calculations for SB 6170 Fiscal Note, 4/23/2009.

JLARC cannot determine the economic impacts of the tax exemptions; there is some information available regarding possible jobs created by development of renewable energy.

The Pew Charitable Trust found in a 2010 study that the number of jobs in America's clean energy economy grew nearly two and a half times faster than overall jobs between 1998 and 2007. Jobs in the renewable energy sector grew at a national rate of 9.1 percent while traditional jobs grew by only 3.7 percent.

The Washington State Employment Security Department estimates there are about 45,000 total green economy jobs in Washington (1.6 percent of total in-state employment). However, most of these jobs are involved in energy efficiency and pollution reduction. About 2,000 of these jobs are directly involved in renewable energy development and production. The bulk of employment associated with most renewable projects relates to the manufacturing of component parts (e.g., wind turbines and solar panels) and especially for the design and construction of renewable energy facilities. Once erected, most renewable energy facilities operate with a relatively small number of operations and maintenance employees.

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?

JLARC cannot determine the overall impact on the economy if the preferences were terminated.

If the exemptions are allowed to expire, purchasers of renewable energy machinery and equipment would pay sales or use tax. This would be taxpayers either beginning new or expanding existing renewable energy operations. The sales and use tax would be one factor in their decision about developing or expanding the renewable energy generation. As shown earlier in Exhibit 83, there are 24 planned or proposed power plants that might be impacted by the termination of the tax exemption.

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

Since this tax preference is an exemption from the retail sales and use tax, there would be no change in the distribution of tax liability.

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?

The US Department of Energy, along with the Interstate Renewable Energy Council and North Carolina Solar Center, have a database of federal, state, territorial, and local financial incentives for renewable energy.

JLARC examined sales and use tax incentives related to renewable energy machinery and equipment and found considerable variation among states and territories in the eligible renewable energy sources, the amount or level of tax incentive, and the applicable sectors (e.g., commercial, residential, agriculture). Exhibit 85 below shows which of the 56 states and territories, in addition to Washington, offer sales and use tax incentives for machinery and equipment used to produce electricity, and which do not. Puerto Rico (PR) is the only other state or territory to provide tax incentives for all sources of renewable energy.

Exhibit 85 – Sales Tax Exemptions for Renewable Energy in Other States and Territories

Energy Source	Number of States	States with Sales Tax Exemptions
Wind	22	AZ, CO, CT, ID, IL, IA, KY, ME, MD, MA, MN, NE, NV, NM, OH, RI, SD, UT, VT, WA, WI, WY, PR
Solar	20	AZ, CO, FL, ID, IA, KY, MD, MA, MN, NV, NJ, NM, NY, OH, RI, UT, VT, WA, WI, WY, PR
Landfill gas	10	ID, KY, NV, NM, OH, UT, VT, WI, WA, WY, PR
Fuel cells	7	ID, NV, NM, SC, VT, WA, WY, PR
Biomass	12	CO, GA, ID, KY, NV, NM, OH, UT, VT, WA, WI, WY, PR
Geothermal	12	CO, CT, ID, MD, MA, NV, NM, RI, UT, VT, WA, WY, PR
Anaerobic digestion	6	NV, NM, UT, VT, WA, WI, PR
Lost energy from exhaust	5	CO, KY, NM, VT, WA, PR
Tidal or wave	1	WA, PR
States with no sales tax exemptions	28	AL, AK, AR, CA, DE, HI, IN, KS, LA, MI, MS, MO, MT, NH, ND, OK, OR, PA, TN, TX, VA, WV, DC, American Samoa, Guam, Northern Mariana Islands, Palau, Virgin Islands

Source: JLARC analysis of US Department of Energy, Database of State Incentives for Renewables and Efficiency.

Recommendation

Because the Legislature intended the exemptions to be temporary and did not provide performance goals to guide any other assessment of performance, the Legislature should allow the sales and use tax exemptions on renewable energy machinery and equipment to expire.

Legislation Required: No

Fiscal Impact: None

REPAIRED GOODS DELIVERED OUT-OF-STATE (SALES TAX)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**JLARC Recommendation**
Provides a sales tax exemption to nonresidents for: materials that become a component part of items repaired, installed, cleaned, altered, or improved; and labor charges for items repaired, installed, cleaned, or altered	The Legislature did not specifically state the public policy objective of the preference. The implied public policy objective was to remove the disincentive created by the sales tax in order to make Washington merchants who repair, clean, install, etc., items for nonresidents more competitive with business in neighboring states.	$0 in 2011-13 Biennium	**Terminate**: Because Washington's adoption of destination-sourcing for sales tax has made this preference unnecessary.

REPAIRED GOODS DELIVERED OUT-OF-STATE (SALES TAX)

Report Detail

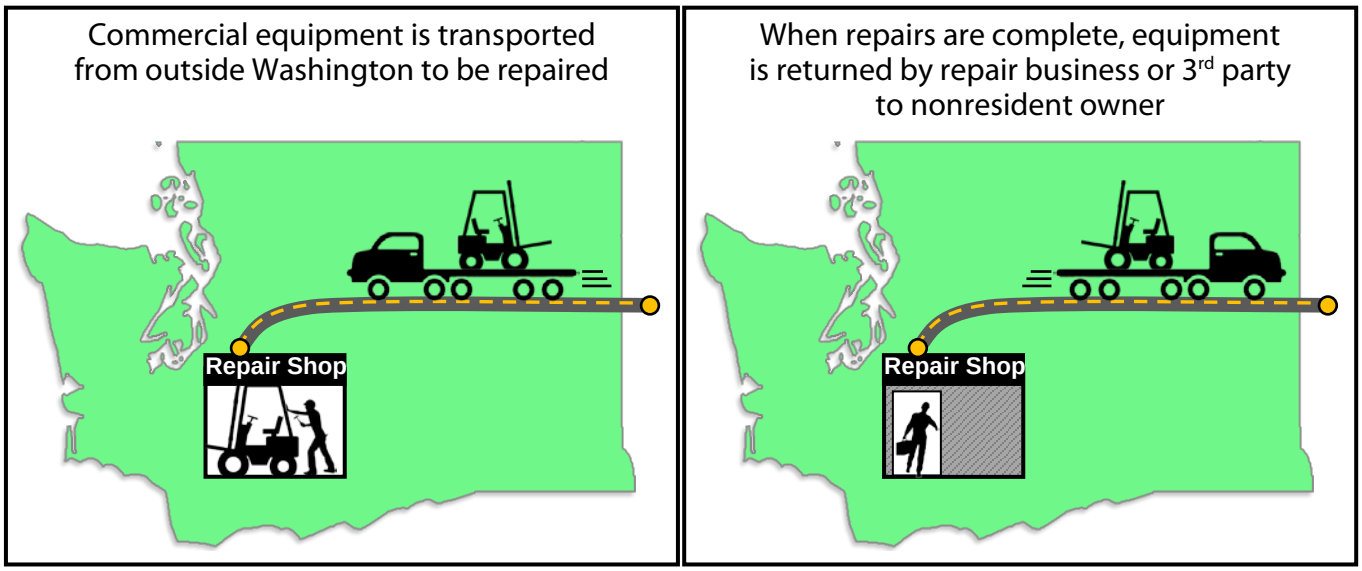
Current Law

This preference provides a sales tax exemption to nonresidents for the following:

- Materials that become a component part of items repaired, installed, cleaned, altered, or improved, and
- Labor charges for items repaired, installed, cleaned, altered, or improved.

The exemption is provided when the item is delivered by the seller or a common or private carrier to the nonresident outside the state. The preference applies to a wide range of services, from alterations made to personal clothing to repair parts and labor performed on commercial machinery or transportation equipment. Exhibit 86, below, provides an example of a situation addressed by this preference.

Exhibit 86 – Commercial Equipment Repaired In-state and Delivered to a Nonresident Out-of-State



Source: JLARC interpretation of RCW 82.08.0265.

See page A3-14 in Appendix 3 for the current statute, RCW 82.08.0265.

Legal History

1935 The Legislature passed the Revenue Act of 1935, creating the retail sales tax and companion use tax which applied to sales of tangible personal property. There was only a state tax; no local sales or use taxes were imposed at this time. Services performed to tangible personal

property, such as repair, installation, or cleaning, were not defined as retail sales at the time and so were not subject to sales tax.

1939 The Legislature amended the definition of "sale at retail" to include services performed to tangible personal property, making labor and services to repair, install, clean, decorate, or alter tangible personal property subject to sales tax when performed in Washington.

The Tax Commission published administrative Rule 173, stating its policy on retail services performed in-state on tangible personal property owned by nonresidents that was subsequently delivered out-of-state. The rule specifically stated that charges for repair or other services were subject to sales tax and B&O tax "since a taxable event, namely, the repair or alteration thereof, is wholly performed within this state" and noted "the taxable event is a local activity and in itself does not involve interstate or foreign commerce."

1940-1958 Although Rule 173 clearly stated that retail services performed and parts installed in-state on nonresidents' property were subject to Washington's sales tax, Washington businesses and nonresident customers questioned whether taxing such transactions was restricted due to the interstate commerce clause. Tax Commission personnel were inconsistent in administering the tax, since at times they instructed businesses to not charge sales tax on retail services performed on nonresident property that was delivered out-of-state.

In letters to the Tax Commission, Washington merchants along the Idaho and Oregon borders complained the policy caused them "undue hardship" and created a "competitive problem," as neither Idaho nor Oregon had a sales tax at the time. The Tax Commission acknowledged the problem, but noted it could not waive the requirement to collect sales tax to make Washington businesses more competitive. The Commission stated:

> The problem, as we see it, is not one which can be solved by interpretation of the statute. It lies basically in the fact that Washington imposes a retail sales tax while its neighboring states do not. If a solution is to be found it must come from the legislature that imposed the tax in the first instance.[17]

1959 The Legislature enacted a specific nonresident sales tax exemption for tangible personal property that becomes a component part of tangible personal property in the course of installing, repairing, cleaning, etc., and also exempted charges for labor and services rendered in providing such services, but only when the seller delivers the property to the nonresident or the property is delivered via common or private carrier.

1970 The Legislature authorized cities and counties to impose a local sales/use tax of 0.5 percent for the purpose of providing a means by which cities and counties could finance essential services. The local sales/use tax was structured so that retail services were deemed to have occurred (and were sourced for sales tax purposes) at the location where the services were primarily performed. This preference exempted qualifying repair services from the local sales tax just as it exempted them from the state sales tax.

[17]Letter from James R. Stanford, Tax Commission Assistant Secretary, to taxpayer, 7/28/1955.

2007 The Legislature enacted the Streamlined Sales and Use Tax Agreement. As part of this comprehensive legislation, which standardized Washington's sales tax laws with other states' sales tax laws, Washington changed its sales tax sourcing from an origin-based to a destination-based system. Beginning July 1, 2008, retail sales of tangible personal property and retail services performed on such property were sourced for sales tax purposes according to the location where the purchaser took delivery of (received) the goods. This meant that repaired goods that were delivered by the retailer to a nonresident outside the state were now exempt from Washington's state and local sales tax by definition, under destination sourcing.

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 specifically state the public policy objective of this preference.

The implied public policy objective was to remove the disincentive created by the sales tax in order to make Washington merchants who repair, clean, install, etc., items for nonresidents more competitive with businesses in neighboring states.

Prior to the preference being enacted, Washington merchants near the Idaho and Oregon borders that repaired, installed, cleaned, etc., tangible personal property owned by nonresidents complained of a competitive disadvantage, because Washington imposed a sales tax on services performed to tangible personal property. Prior to 1959, neither Idaho nor Oregon had enacted a state sales tax.

Unlike the nonresident sales tax exemption provided in RCW 82.08.0273 (separately reviewed by JLARC in 2011), the preference has never been limited to only residents from jurisdictions with a sales tax of less than 3 percent. However, enabling Washington merchants to compete for nonresident customers from states with no sales tax appears to have been a concern at the time the exemption was established. In addition to this preference, an exemption for nonresidents purchasing boats in Washington (RCW 82.08.0266) was passed in the same bill in 1959. JLARC is also reviewing this preference in 2011 in a separate report.

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

The preference appears to have met its implied public policy objective prior to Washington's change to destination sales tax, but the preference is no longer necessary.

When the preference was enacted in 1959, Washington had only a state sales tax with no local component. When the Legislature authorized local cities and counties to impose local sales/use taxes in 1970, the location of the sale (for local tax calculation and distribution purposes) was determined by the place where the repair services were primarily performed. Under origin-based sourcing, this was a Washington location.

However, when Washington adopted destination-based sales tax sourcing as part of the Streamlined Sales and Use Tax legislation, sales tax sourcing changed from the origin of the sale/service to the location where the buyer took delivery of or received the property. Washington's adoption of destination-based sourcing, effective July 1, 2008, has made this preference unnecessary. Because the buyer takes possession of the goods at a location outside the state, these transactions are now sourced as interstate deliveries and are exempt from Washington's sales tax.

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

If this preference is terminated, the implied public policy objective will be accomplished through other means. Charges for repair, cleaning, etc., services are now determined by the location where the buyer takes delivery of the goods. When repaired property is delivered to a buyer outside the state, the sale is exempt from Washington sales tax as an interstate sale.

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

Because the law has changed, this preference is no longer necessary.

Beneficiaries

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

The beneficiaries of this preference are nonresident individuals and out-of-state businesses that bring property into Washington for cleaning, repair, alteration, etc. The preference exempts from sales tax labor charges for repair, cleaning, etc., and charges for any component parts installed as part of the repair, cleaning, etc., services, so long as the property is delivered to the buyer outside the state. Department of Revenue data shows that the largest beneficiaries are owners of commercial equipment that is repaired in-state and delivered to the owner outside the state.

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

JLARC could find no evidence of unintended beneficiaries. Although the residents and businesses located in states bordering Washington are the most likely intended beneficiaries, the Legislature did not specifically limit the exemption to just contiguous states, nor did it limit the exemption to natural persons.

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?

Prior to July 1, 2008, beneficiaries saved approximately $10.7 million in Fiscal Year 2008 on retail services performed and parts installed in Washington that were delivered to them outside the state.

After the change to destination-based sourcing, no taxpayer savings are associated with this preference. See Exhibit 87, below.

Exhibit 87 – Estimated Beneficiary Savings - Repaired Goods Delivered to Nonresidents Out-of-State (in Millions)

Fiscal Year	State Sales Tax (.065)	Local Sales Tax	Total Sales Tax
2006	$8.5 M	$2.7 M	$11.2 M
2007	$7.2 M	$2.3 M	$9.5 M
2008	$8.1 M	$2.6 M	$10.7 M
2009	***No taxpayer savings*** *These transactions are not taxed due to destination sourcing.*		
2010			
2011			
2012			
2013			

Source: DOR tax return data, FY06 – 08 NAICS codes 811* (excluding auto repairs under 8111* and 8123* (repair and cleaning services); 04 and 23 deductions.

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 was terminated, neither Washington businesses performing such services nor their out-of-state customers would be impacted. Washington now uses the destination where the buyer receives the goods to determine for sales tax purposes where the sale is located. Because it applies only to transactions where the seller delivers the goods to the nonresident buyer at a location outside the state, this preference is no longer necessary. All of these transactions are now sourced to an out-of-state location for sales tax purposes and are exempt from Washington's retail sales tax as interstate sales.

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

Terminating the preference would not change the distribution of 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?

Of the 45 states that impose a sales tax, 24 exempt repair services (labor costs) regardless of the purchaser's residency. Out-of-state deliveries would not be taxable in states that use a form of destination-based sourcing similar to the Streamlined Sales and Use Tax Agreement (SSUTA).

There are currently 20 full member states of the SSUTA. Of the 20 full member states, 10 tax repair labor services. In addition to Washington, JLARC found five other states that specifically exempt repairs to property used outside of the state: Connecticut, Louisiana, New Jersey, Oklahoma, and Tennessee.

Recommendation

Because Washington's adoption of destination-sourcing for sales tax has made this preference unnecessary, the Legislature should terminate the retail sales tax exemption for labor and material charges on goods repaired, installed, cleaned, altered, etc., in Washington and delivered to nonresidents out-of-state.

Legislation Required: Yes

Fiscal Impact: None

Sales of Goods to Certain Nonresidents for Use Outside the State (Sales Tax)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**JLARC Recommendation**
Provides a sales tax exemption on purchases of certain goods for use outside the state to nonresidents from states, possessions, or territories of the U.S. or Canadian provinces or territories that do not impose a sales, use, value-added or similar tax at a rate of 3 percent or more.	The Legislature did not specifically state the public policy objective of the preference. JLARC infers that the preference was intended to support Washington retailers by removing a disincentive for residents of states with a sales tax of less than 3 percent to purchase goods in Washington.	$58 million in 2011-13 Biennium	**Continue**: Because the preference is meeting its implied public policy objective of removing a disincentive for residents from states with a sales tax of less than 3 percent to purchase goods in Washington.

SALES OF GOODS TO CERTAIN NONRESIDENTS FOR USE OUTSIDE THE STATE (SALES TAX)

Report Detail

Current Law

This preference exempts qualified nonresidents from paying sales tax on specific purchases they make in Washington. As described below, application of the preference depends on a number of different factors, including what is purchased, where it is used, and the tax policies in place where the purchaser resides.

In terms of purchases, **the preference applies to**:

- Purchases of tangible personal property, digital goods, and digital codes, and
- Parts or other tangible personal property installed by the seller while repairing, cleaning or altering motor vehicles, trailers, or campers in Washington.

  The charges for the parts or property installed must:

  - Be separately stated from labor or installation charges, and
  - Not exceed the seller's stated retail price or (if not available) the seller's cost for the parts.

The purchases must be for use outside the state.

The exemption does not apply to:

- **Retail services**, such as lodging, cleaning or repair services, or amusement or recreational services, or
- **Items used or consumed within Washington**, such as meals or beverages, goods sold to military personnel stationed in Washington, or goods sold to students attending school in the state.

The preference applies only to residents of states, possessions or territories of the U.S., or Canadian provinces or territories that do not have any of the taxes listed below at a rate of 3 percent or more:

- Retail sales or use tax,
- Value added tax,
- Gross receipts tax on retailing activities, or
- Any other generally applicable tax.

If the state, province, possession or territory imposes such a tax, residents may still qualify if Washington residents are allowed a similar exemption for purchases in their jurisdiction.

The buyer must provide to the seller either:

- Valid picture identification (driver's license or identification card), or
- Authorized exemption certificate (such as streamlined exemption certificate).

The exemption is at **the seller's discretion** – sellers are not required to make tax-exempt sales to eligible nonresidents.

As noted in Exhibit 88, below, the preference currently applies only to residents of the states, U.S. possessions, and Canadian provinces and territories noted below.

Exhibit 88 – Qualifying States, Possessions, and Provinces for Nonresident Sales Tax Exemption as of July 1, 2011

States	U.S. Possessions	Canadian Provinces
Alaska	American Samoa	Alberta
Colorado		Northwest Territories
Delaware		Nunavut
Montana		Yukon Territory
Oregon		
New Hampshire		

Source: Department of Revenue information.

See page A3-14 in Appendix 3 for the current statute, RCW 82.08.0273.

Legal History

1935 The Legislature enacted the retail sales tax and companion use tax. At this time, sales tax applied to retail sales of tangible personal property in Washington. No exemptions were provided for goods sold and delivered in Washington to nonresidents for use outside the state.

1963 The Tax Commission internally explored the fiscal impact and potential problems of providing a sales tax exemption to nonresidents. It concluded an exemption would "result in substantial revenue loss" and noted that "nonresident" would need to be defined clearly, as well as the types of qualifying purchases. The Commission estimated such an exemption would be used most extensively on the Idaho and Oregon borders (neither state had a sales tax at that time). The Commission also predicted additional sales tax revenue loss due to fraud by Washington residents trying to use the exemption or having nonresident friends or family purchase for them.

1965 The Legislature provided a temporary sales tax exemption for sales of goods to any nonresident for use outside the state, when the nonresidents purchased a $1 permit from the Tax Commission certifying that they: 1) were bona fide residents of another state, U.S. possession, or foreign country, and 2) agreed to give the Tax Commission access to records to assure the purchases were not first substantially used in Washington.

Although not specified in the law, the Commission interpreted the exemption to apply to both individuals and corporations. The exemption was initially limited to a two-year period beginning June 1, 1965, and expiring July 1, 1967.

Historical documents note the exemption was very popular on the Oregon and Idaho borders. Newspaper articles of the time report the exemption instigated a "sales tax border war" between Idaho and Washington, as the exemption was passed just months before Idaho's new 3 percent sales tax took effect on July 1, 1965. According to newspaper reports, Idaho was worried about Idaho residents avoiding its new sales tax by purchasing items tax-free in Washington and that Washington's exemption could lead to a repeal of Idaho's sales tax at the 1966 general election.

1966 The Tax Commission studied the nonresident exemption and found that nonresident permit use was strong, and that the sales tax loss and fraud by Washington residents were not as great as initially feared. Spokane was the top location for permit use, followed by Walla Walla, Seattle, and Longview. The permits were used most by Oregonians, followed by Idaho residents. Exempt sales in Vancouver were less than anticipated.

1967 The Legislature eliminated the July 1, 1967, expiration date, making the sales tax exemption permanent. However, the legislation restricted the preference to only nonresidents from states, possessions, or Canadian provinces that did not impose a sales or use tax of 3 percent or more or, if the locality had a sales/use tax of over 3 percent, that allowed Washingtonians exemption based on residency. This eliminated foreign residents except some Canadians and made British Columbia (B.C.) and Idaho residents ineligible. Permits had to be renewed annually, but all other requirements from the 1965 law remained.

1982 The Legislature increased the permit fee from $1 to $5 and directed the Department of Revenue to conduct a study on the financial impact resulting from the use of nonresident permits. The Department's 1982 Nonresident Permit Study concluded that nonresident permits reduced state and local government tax revenue. It noted the permits were intended to stimulate business in border cities and counties at the cost of some lost state and local sales tax revenue. The study noted "Whether the loss in state tax revenue is deemed to be a reasonable cost to stimulate business activity in some areas of the state is a question of legislative policy."

1983 The Legislature increased the statewide state sales tax rate from 5.4 percent to 6.5 percent, but left the tax rate in four designated "border counties" at 5.4 percent. "Border county" was defined so the lower rate applied only to Clark, Cowlitz, Skamania, and Klickitat Counties, all counties near Portland's commercial center. The legislation was quickly challenged in the courts.

1984 In November, the State Supreme Court ruled in *Bond v. Burrows*[18] that a lower sales tax rate in border counties violated Article 11, section 9, of the state Constitution, requiring that state taxes be uniform throughout the state. The Court ordered the 6.5 percent rate be collected in the four border counties beginning January 1, 1985.

[18] *Bond v. Burrows* (103 Wn.2d 153, 690 P.2d 1168) 1984.

1988 The Legislature repealed the nonresident permit and instead required nonresidents to show two pieces of identification proving nonresidence. The Legislature further changed the exemption to:

- Allow the vendor discretion in granting the exemption;
- Increase penalties for misuse or knowingly allowing fraudulent purchases; and
- Hold both the purchaser and vendor liable for collection action costs.

1993 The Legislature reduced the documentation requirement from two pieces of identification to one with the purchaser's home address. Also, as part of the 1993 1st Special Session revenue enhancement package, the Legislature narrowed the exemption to apply only to qualifying nonresidents in contiguous states, possessions, or provinces. In effect, this would have limited the exemption at this time to just Oregon.

Governor Lowry vetoed narrowing the exemption, citing concerns with the constitutionality of distinguishing between residents of contiguous and noncontiguous states and the potential for lawsuits. In his veto message, he asked the Department to develop legislation for consideration during the 1994 Legislative Session that addressed the proponents' concerns and avoided potential constitutional problems. JLARC could not find record of such legislation being introduced in 1994.

2007 The Legislature expanded the exemption to include separately stated charges for parts (but not labor) installed during vehicle, trailer or camper repair or cleaning, if the charge does not exceed either the seller's publicly stated price for the part or the seller's cost for it. The exemption does not apply if the seller makes a single, non-itemized charge for both labor and parts.

2009 As part of a larger effort to tax digital goods and codes as tangible personal property, the Legislature expanded the exemption to include purchases of digital goods and digital codes by eligible nonresidents.

2010 The Legislature authorized qualifying nonresidents to use the Streamlined Sales Tax Exemption Certificate in lieu of valid identification proving nonresident status.

In June, the Department issued a notice stating that residents of British Columbia qualified for the nonresident exemption effective July 1, 2010, due to B.C.'s adoption of a harmonized sales tax. On June 30, Whatcom County and Bellingham filed for legal action against the Department of Revenue.

A Skagit County Superior Court judge issued a preliminary injunction on July 16, requiring the Department to notify retailers that sales tax exemptions should not be granted to residents of British Columbia and five other Canadian provinces that impose a harmonized sales tax. A harmonized sales tax is a value-added tax that is a single, blended combination of the provincial sales tax and goods and services tax. The Department issued an Advisory on July 19, advising retailers not to grant the exemption to residents of British Columbia, Nova Scotia, New Brunswick, Newfoundland and Labrador, Ontario, and Quebec.

2011 The Legislature enacted SB 5763, clarifying that the nonresident sales tax exemption does not apply to residents from U.S. states, territories or possessions, or Canadian provinces or

territories if the government imposes a sales, use, value added, B&O, or other generally applicable tax of 3 percent or more. This meant that residents of B.C. and other Canadian provinces that impose a harmonized sales tax must now pay sales tax for purchases in Washington. The law took effect July 1, 2011.

Other Relevant Background

The "Border Tax Problem"

Economic literature suggests that Washington's state and local sales tax rates, combined with bordering states with no sales tax (Oregon) or a lower rate (6 percent with no local tax in Idaho) creates a "border tax problem." Most border tax discussions and solutions focus on the revenue loss and inequities resulting from Washington residents who live near the border shopping outside the state to avoid paying Washington sales tax. This preference involves a different border tax issue – taking away the disincentive created by Washington's sales tax for nonresidents from low or no tax states so that they will purchase goods here.

The British Columbia issue

In Canada, three types of taxes may be imposed on sales of goods by the federal and/or provincial governments:

- ***Provincial sales tax (PST)***, levied by some provinces.
- ***Goods and services tax (GST)***, a 5 percent, value-added tax levied by the federal government that applies to all provinces.
- ***Harmonized sales tax (HST)***, a value-added tax that is a single, blended combination of the PST and GST that is used in British Columbia (B.C.) , Ontario, and the Atlantic provinces of New Brunswick, Newfoundland and Labrador, and Nova Scotia.

Every province except Alberta has implemented a PST or HST. The Yukon Territory, Northwest Territories, and Nunavut only collect the GST and do not impose a HST or territorial sales tax.

Quebec was the first province to adopt a HST in 1992; the Atlantic Provinces followed in 1997. The Department of Revenue determined at that time that residents of these provinces qualified for the preference.

Prior to July 1, 2010, B.C. imposed a 7 percent PST and a 5 percent federal GST. Effective July 1, 2010, both B.C. and Ontario adopted a "harmonized sales tax" of 12 percent - a consolidation of a 7 percent provincial VAT and a 5 percent federal GST. On June 8, 2010, the Department of Revenue issued a press release stating that B.C. residents would qualify for the nonresident sales tax exemption as of July 1. This followed the Department's prior policy applied to Quebec and the Atlantic provinces in the 1990s.

The Department of Revenue and the Attorney General's Office determined that despite its name, the HST was not a sales or use tax, but instead a value added tax. They concluded that since this preference applied to nonresidents from locations with a **sales or use tax** of 3 percent of more, and B.C. and Ontario **no longer had** a sales or use tax but instead a VAT, residents from those Canadian provinces were entitled to the qualified nonresident exemption beginning July 1, 2010.

Whatcom County and the City of Bellingham countered that B.C.'s VAT remained a retail sales tax, regardless of its name. They feared extending the exemption to B.C. residents would decrease the local sales tax revenue realized in their jurisdictions. On June 30, 2010, Bellingham and Whatcom County filed a lawsuit against the Department, seeking a temporary restraining order. Additionally, a number of area retailers sought to intervene in the lawsuit, seeking to remove the temporary restraining order and opposing issuance of a preliminary injunction.

On July 16, 2010, a Skagit County Superior Court judge issued a preliminary injunction requiring the Department to inform retailers that residents of the six Canadian provinces with HSTs did not qualify for the exemption until final determination in the litigation. Three days later, the Department issued an advisory noting just that.

During the 2011 Legislative Session, SB 5763 was signed into law and took effect July 1, 2011. The amended law expands the qualifying requirements for the exemption by adding that the nonresident's home state, province, possession, or territory cannot impose a sales, use, *value added*, *gross receipts tax on retailing activities, or similar generally applicable tax* of 3 percent or more. The result is that residents of B.C. and the other Canadian provinces with HSTs must pay sales tax on goods purchased in Washington.

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 specifically state a public policy objective when the preference was initially enacted on a temporary basis in 1965, nor has the Legislature stated one in subsequent years.

The exemption appears to be intended to support Washington retailers by removing a disincentive for nonresidents from no or low sales tax states to purchase goods in Washington. Similar preferences are provided for sales of vessels to nonresidents (reviewed by JLARC in 2011), and sales of farm equipment and of vehicles to nonresidents (both reviewed by JLARC in 2010).

In its 1982 study of nonresident permits, the Department of Revenue noted that providing a sales tax exemption may "level the playing field" so Washington retailers are not at a disadvantage when selling to nonresidents from states with a lower or no sales tax. The study also asserted that by enacting such a preference, the Legislature made the decision to forego state and local sales tax revenue in exchange for increased retail business activity.

A series of historical documents, newspaper articles, and legislative hearing testimony suggests this preference was intended to encourage residents of states with no sales tax, particularly Oregonians, to purchase goods from Washington retailers. When the preference was initially enacted in 1965, Oregon, Alaska, and Idaho imposed no sales taxes, although Idaho enacted a 3 percent sales tax later that year. The 1967 change limiting the exemption to residents of states with sales tax rates of less than 3 percent disqualified Idaho and British Columbia residents (until the HST issue arose in 2010). In court documents, former state officials stated that public policy objective was to take away the disincentive for nonresidents, particularly Oregonians, to buy goods from Washington retailers.

Earlier legislative actions give some indication that the Legislature was targeting Oregon residents with this tax preference. The Legislature has previously passed bills to provide a lower sales tax rate or no sales tax along the Oregon border, but the legislation was invalidated by a court or vetoed. In 1983, the Legislature increased the state sales tax rate in all but four designated "border counties," all around the Portland commercial center, only to have the legislation struck down as unconstitutional by the state Supreme Court. Ten years later, in 1993, the Legislature passed a bill that narrowed the exemption to apply only to qualifying nonresidents in contiguous states, possessions, or provinces, effectively limiting the exemption to Oregon. This legislation was vetoed by the Governor.

While prior legislative action indicates that the Legislature may have wanted to limit the preference to just Oregonians, recent 2011 changes did not follow that pattern. Senate hearing testimony for SB 5763 noted this preference was intended for residents of locations with no sales tax, such as Oregon, Montana, and Alberta. In addition, a bill was introduced that would have added the same qualifying restrictions as SB 5763, but would have further restricted the preference to apply only when the buyer took possession of the goods in a Washington county that was adjacent to another state, effectively limiting the exemption to Oregon. This bill did not receive a hearing.

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

The preference appears to be achieving the objective of removing a disincentive for certain nonresidents to purchase goods in Washington. Department of Revenue tax return data shows qualifying exempt transactions between $273 million and $296 million for Fiscal Years 2008, 2009, and 2010. However, it is unclear how many of these sales transactions would have occurred absent this preference.

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

Continuing the preference will continue to support Washington retail establishments by removing the disincentive for nonresidents from no or low sales tax locations to purchase goods in Washington. As noted in earlier Tax Commission/Department of Revenue studies, that encouragement is tempered by a loss of potential state and local sales tax revenue, the value of which JLARC cannot measure.

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

The preference appears to be fulfilling the public policy objective. The Legislature modified the preference in 2011 to ensure that nonresidents from Canadian jurisdictions with value added taxes, such as British Columbia, do not qualify for the preference.

Beneficiaries

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

Direct beneficiaries of the preference are residents from states, U.S. territories and possessions, and Canadian provinces and territories with a sales tax, use tax, VAT, gross receipts tax on retailing activities, or a similar generally imposed tax of less than 3 percent or no such tax. The Department of Revenue estimates the largest group to be Oregonians, followed by Alaskans, Montanans, and Alberta residents. Tourists are not intended to be primary beneficiaries, since many of their purchases (hotels, restaurant meals, amusement and recreational activities) are not exempted by the preference.

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

JLARC could find no evidence of unintended beneficiaries.

Revenue and Economic Impacts

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

Certain nonresidents of states, provinces, territories and possessions of the U.S. and Canada saved an estimated $27 million in Fiscal Year 2009 based on over $295 million in in-state retail purchases. See Exhibit 89, below.

Exhibit 89 – Estimated Beneficiary Savings – Qualified Nonresident Sales Tax Exemption ($ in Millions)

Fiscal Year	State Sales Tax	Local Sales Tax	Total Tax
2008	$18.2 M	$5.8 M	$24.0 M
2009	$19.2 M	$7.8 M	$27.0 M
2010	$17.8 M	$6.6 M	$24.4 M
2011	$18.7 M	$7.0 M	$25.7 M
2012	$20.4 M	$7.6 M	$28.0 M
2013	$21.9 M	$8.1 M	$30.0 M
2011-13 Biennial Total	**$42.3 M**	**$15.7 M**	**$58.0 M**

Source: JLARC analysis of FY08 - FY10 DOR tax returns using NAICS codes 44* and 45*, excluding auto, boat, mail order, electronic & direct sales reporting 0123 deduction. Growth using ERFC Nov. 2010 Report Table 3.4, taxable retail sales.

Past studies by independent sources and the Department of Revenue noted that merchandise selection is a key factor in determining where people shop. In border areas where the largest city is in Washington, these studies found the Washington location attracts nonresident buyers, since they have few alternative shopping options, for example, Benton, Cowlitz, Spokane, and Walla Walla

counties. However, King County consistently has the most qualifying nonresident sale transactions of any location. Though not a border county, it is a large metropolitan area and its retail selection may make it a popular shopping destination for nonresidents, including Alaskans. It is unclear how the preference impacts retail sales made in Washington locations like King County, with plentiful retail outlets.

Washington's retail trade was severely impacted during the recession that began in 2008. Thus, the figures noted in Exhibit 89 on the previous page are lower than qualifying sales from prior years.

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?

JLARC cannot determine the overall impact on the economy if the preference were terminated.

If the tax preference were terminated, nonresidents that currently benefit from the preference would no longer be able to purchase and receive goods in Washington without paying sales tax. These nonresidents would have the following choices:

- Continue to buy and receive goods in Washington, but they would have to pay Washington sales tax. Since the tax would be paid by nonresidents, Washington residents would not bear any additional tax burden if the preference were terminated. B&O tax collection would remain unaffected.
- Continue shopping in Washington, but instead of receiving the goods in state, have them shipped directly out of state. This would exempt the purchases from Washington sales tax as interstate sales. This would continue to remove the disincentive created by the sales tax for certain nonresidents, though retailers would bear an increased burden of shipping goods to their customers. Retailers might choose to charge the clients for the shipping (which might discourage purchases) or absorb the delivery costs, thereby increasing their costs of doing business. Washington would realize no change in sales tax collections in this scenario. However, B&O tax collections could be reduced, as interstate sales are also exempt from B&O tax.
- Choose not to shop in Washington. This could impact the overall sales by Washington retail outlets. If the level of retail activity drops, B&O tax collections could be reduced.

The overall impact of terminating the preference would likely not be uniform across the state. Along the Oregon border near the Portland metropolitan area, a reduction in retail sales to nonresidents could occur. Economic studies have found that sales in these locations are sensitive to changes in price.[19, 20] If the exemption were repealed, nonresidents near Portland may be less likely

[19] Lorrie Brown, *The Effects of Tax Rate Differences on Retail Trade in Washington Border Counties*, Department of Revenue, June 5, 1990.

[20] John H. Beck, *The Border Tax Problem in Metropolitan and Nonmetropolitan Areas of Washington*, Western Tax Review 10 (Winter 1991): 15- 35.

to purchase goods from Washington retailers, as they have access to many of the same goods without the sales tax nearby, in their home state.

However, in other border counties, eliminating the exemption could result in a gain in state revenue and not greatly impact Washington-based businesses. Nonresidents living near Cowlitz, Benton, Spokane, and Walla Walla counties have fewer retail options near their homes. The aggregate impact of such a change is not known.

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

Terminating the preference would not impact the distribution of tax liability. Nonresidents that currently are exempt would have to pay sales tax on goods they purchase and receive in the state.

Other States

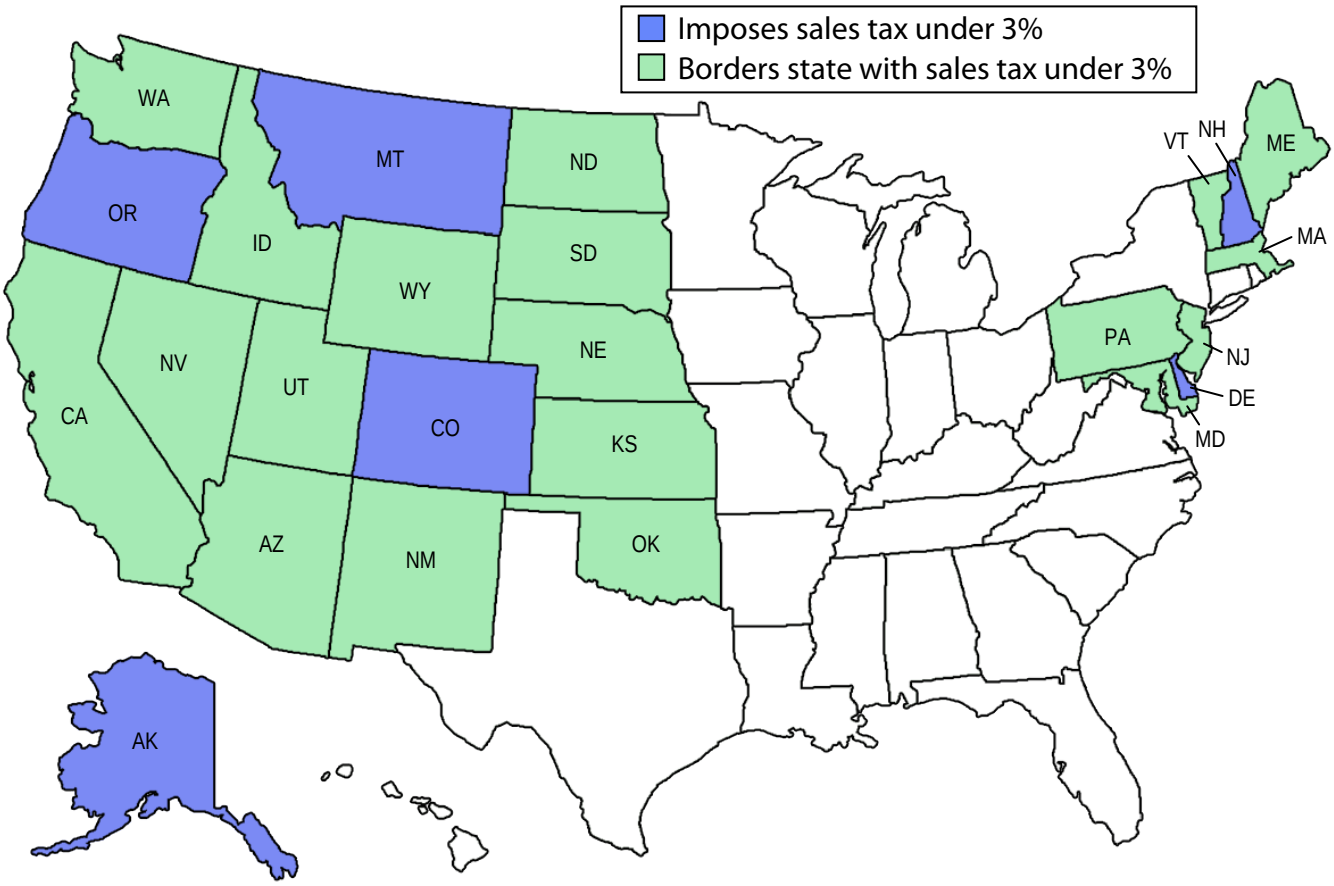
Do other states have a similar tax preference and what potential public policy benefits might be gained by incorporating a corresponding provision in Washington?

JLARC could not find any other state that exempts purchases to nonresidents based on the sales tax imposed in the nonresident's home state.

There are five states that do not impose a state sales tax: Alaska, Delaware, Montana, New Hampshire, and Oregon. Thirteen states border these states that do not impose a sales tax: Washington, Idaho, Nevada, California, Wyoming, North Dakota, South Dakota, Maryland, New Jersey, Pennsylvania, Vermont, Massachusetts, and Maine. Colorado imposes a state sales tax rate of 2.9 percent and is bordered by 7 states: Wyoming, Nebraska, Kansas, Oklahoma, New Mexico, Arizona and Utah. However, North Dakota does provide a refund of sales taxes to Canadian residents for taxable purchases over $25.

Most other states do not have population centers analogous to Portland and Vancouver: two cities across the border from each other, with the larger in the state without a sales tax. Without a cross-border population to attract into the taxing state (such as Vancouver and Portland), and without a sufficiently large retailing sector to accommodate incoming demand, there is little incentive to provide a tax preference for nonresidents. See Exhibit 90 on the following page for a map of states with low sales tax rates and their bordering states.

Exhibit 90 – U.S. States With Sales Tax Under 3% and Their Bordering States



Source: JLARC analysis of CCH data on state sales taxes.

Recommendation

Because the preference is meeting its public policy objective of removing a disincentive for nonresidents from no or lower tax locations to purchase goods in Washington, the sales tax exemption for certain nonresidents should be continued.

Legislation Required: No

Fiscal Impact: None

SALES OR USE TAX PAID IN ANOTHER STATE (USE TAX)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**JLARC Recommendation**
Provides a use tax credit against sales and use tax owed in Washington on tangible personal property or certain services for the amount of "legally imposed" sales or use tax paid to another state, possession, territory, or commonwealth of the U.S. or any political subdivision of such, or any foreign country.	The Legislature did not specifically state the public policy objective of the preference. However, the preference is linked to Washington's membership in the Multistate Tax Commission and the Legislature's passage of the Multistate Tax Compact in 1967. Both of these actions were undertaken to provide a structure for states to work cooperatively on multistate tax issues and to avoid duplicative taxation of multistate taxpayers.	$1million in 2009-11 Biennium	**Continue**: Because the tax preference is meeting its implied objective of avoiding duplicative taxation to multistate taxpayers.

SALES OR USE TAX PAID IN ANOTHER STATE (USE TAX)

Report Detail

Current Law

This preference provides a use tax credit against any use tax owed in Washington on tangible personal property or certain services for the amount of "legally imposed" sales or use tax paid to another state, possession, territory or commonwealth of the U.S. or any political subdivision of such, or any foreign country or political subdivision of such.

Use tax normally applies to tangible personal property, extended warranties, or digital products/services that are used in Washington when Washington's retail sales tax was not paid at the time of purchase or acquisition. This includes goods and services purchased in other states or countries. The use tax credit is available to any business or individual. Documentation proving sales/use tax was paid to another government entity must be kept by the person and be available for review.

In contrast to the use tax credit, when sales tax is owed in Washington, there is no credit available for sales or use tax paid to another jurisdiction. For example, a person who leases a vehicle outside of Washington may have paid sales tax to another state on the entire lease amount. If the person moves to Washington, sales tax is due on each lease payment. Washington law does not provide a reciprocal credit against sales tax owed for sales or use tax paid to another state or country.

A related preference providing a use tax exemption for nonresidents' personal property (RCW 82.12.0251) was previously reviewed by JLARC in 2010.

See page A3-16 in Appendix 3 for the current statute, RCW 82.12.035.

Legal History

1935 The Legislature passed the Revenue Act of 1935, enacting the retail sales tax and companion use tax. The act provided a specific credit against any compensating (use) tax owed for a tax levied by any other state on the sale or use of tangible personal property in an amount less than the Washington use tax due.

1936 The Tax Commission published rules and regulations relating to the Revenue Act of 1935, explaining that for any goods subject to use tax, if sales or use tax was paid in any other state, it may be deducted from the Washington use tax.

March
1937 The Legislature repealed the statute that provided a credit against use tax for sales or use tax paid in another state, so businesses and individuals now had to pay the Washington use tax.

April
1937 The U.S. Supreme Court ruled on a Washington case that was brought before the Court prior to the March 1937 change in state law. In *Henneford v. Silas Mason Co.*, the Court upheld the constitutionality of Washington's use tax as it applied to machinery and

equipment brought into the state by an out-of-state contractor working on the Grand Coulee Dam. The Court noted the use tax did not discriminate against interstate commerce, as it was a tax on the use of goods after commerce had ended, and that it was equally applied so that anyone that had paid a use or sales tax in another state was provided an offsetting credit against Washington use tax owed.[21]

1964-1967 After a comprehensive Congressional study on state taxation of multi-state businesses, business interests lobbied Congress to pass an Interstate Taxation Act (also known as "The Willis Bill"), which would have limited the taxes states could impose on multi-state businesses engaged in interstate commerce. Washington's Tax Commission determined that the state would suffer large business and occupation and sales tax revenue losses if the federal legislation passed. The federal legislation was not enacted.

1967 Washington's Legislature passed two separate bills addressing credits for use taxes. In one bill, the Legislature enacted a credit (RCW 82.12.035) against use tax owed on goods put to use in Washington equal to any sales or use tax paid on the same goods by the same user to another state, political subdivision thereof, or the District of Columbia when the tax was paid **prior to use of the goods in Washington.**

To address concerns raised by the Willis Bill and to help maintain states' authority to determine their own tax policy within U.S. Constitutional limits, several states joined together to create the Multistate Tax Commission (MTC). In another bill, Washington's Legislature ratified the Multistate Tax Compact, making Washington a party to the Compact. The Compact's stated purpose was to:

1. Facilitate proper determination of state and local tax liability of multi-state taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes;
2. Promote uniformity or compatibility in significant components of tax systems;
3. Facilitate taxpayer convenience and compliance in the filing of tax returns and other phases of tax administration; and
4. Avoid duplicative taxation.

A very similar use tax credit to that in RCW 82.12.035 was included as part of the Multistate Compact in RCW 82.56.010, Article V(1). The two credits differed in that the MTC credit did not require the tax be paid prior to use of the goods in Washington.

1987 The Legislature extended the credit in RCW 82.12.035 to apply to sales/use tax paid to any foreign country or political subdivision thereof prior to use of the goods in Washington.

1996 **T**he U.S. Supreme Court ruled in *Oklahoma Tax Commission v. Jefferson Lines Inc.*[22] that it was constitutional for a state to impose a sales tax on the full fare price of bus tickets sold for interstate travel. After this ruling, the Legislature extended the use tax credit to sales/use tax

[21] *Henneford v. Silas Mason Co.,* 300 U.S. 537, (1937).

[22] *Oklahoma Tax Commission v. Jefferson Lines* (93-1677), 514 U.S. 175 (1995).

paid in another state, political subdivision, or foreign country for certain services defined in Washington law as retail sales.

2002 The Legislature extended use tax to services for installing, repairing, cleaning, altering, imprinting, or improving goods of or for consumers when the services are performed outside of Washington and the goods are subsequently used in-state. Previously, such services were not subject to use tax. The Legislature also extended the use tax credit to apply to sales/use tax paid to the out-of-state locality where the services were performed.

2005 The Legislature extended sales and use tax to apply to extended warranties. The legislation also extended the use tax credit to include sales/use tax paid on extended warranties purchased out-of-state and subsequently used in Washington.

2008 As part of comprehensive streamlined sales tax legislation, the Legislature clarified the credit applies to possessions, territories, and commonwealths of the United States.

2009 The Legislature extended the credit to sales/use tax paid to another state for digital goods, digital code, digital automated services, or services related to accessing prewritten software. In addition, to resolve the conflict between use tax credits in RCW 82.12.035 and the Multistate Tax Compact, Article V, the Legislature amended RCW 82.12.035 to no longer require that the sales/use tax had to be paid "prior to use" in Washington. The requirement was changed to allow the credit against a sales or use tax "legally imposed" by the other state or political body.

Other Relevant Background

History

From 1937 to 1967, the law did not provide a use tax credit for sales or use tax paid on goods to another state. The Tax Commission, in numerous letters and memorandums from the 1940s through the 1960s, explained its position that a credit was not required. The Commission noted that Washington's use tax did not amount to "double taxation" because a sales tax imposed by another state was a tax on **the sale** of goods, while Washington's use tax was on **the privilege of using** goods in Washington. Each tax was an excise tax imposed by different taxing jurisdictions and for different purposes.

However, by the mid-1960s, this position was being questioned at a state and national level. In a January 1966 letter to an individual, Governor Evans noted:

> I agree that tax credit should be given against the sales or use tax when the same tax is paid in another state. However, this has not been generally true in the past. I am working with other states at the present time to assure this credit throughout the country; and am particularly working with Oregon and Idaho. It will require legislative action. . . I am, however, confident that insofar as the state of Washington is concerned, the situation will be changed by the next legislative session.[23]

[23] Letter from Governor Dan Evans to Taxpayer, 1/24/1966.

Additionally, a May 1966 memorandum from the Tax Commission Chairman to Governor Evans noted that a specific criticism directed toward many states, including Washington, by the Willis Committee Report involved a lack of credit against use tax in one state where goods were purchased and sales tax paid at the time of original purchase in another state. The Tax Commission "strongly recommended" passage of such a credit. In various letters from the Tax Commission to individuals, the purpose of the preference was to prevent duplicative tax payments on the same goods.

The Multistate Tax Commission

In the early 1960s, there was a movement by multistate businesses to lobby Congress to study state taxation of interstate businesses. Following a congressional study, businesses also lobbied to enact the Willis bill, limiting the states' power to tax multi-state businesses. Documents indicate that the Willis bill was opposed by several states. State studies indicated it would cost them hundreds of millions of tax dollars if passed, and Washington estimated that it would lose large amounts of B&O and sales tax revenue if the bill passed.

The states responded by creating a multi-state organization to address unfair state taxation. Washington was a key member in forming the Multistate Tax Commission, with Tax Commission Director George Kinnear elected as its first president. The Legislature passed the Multistate Tax Compact in 1967. The Willis bill did not pass through Congress.

There are currently 20 MTC Compact member states, as well as other sovereign, associate, and project member states. Only three states – Delaware, Nevada, and Virginia - are not members.

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 of this tax preference.

However, the preference is linked to Washington's membership in the Multistate Tax Commission and the Legislature's passage of the Multistate Tax Compact (Chapter 82.56 RCW) in 1967. Both of these actions were undertaken to provide a structure for states to work cooperatively on multistate tax issues and to avoid duplicative taxation of multistate taxpayers.

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

Washington now allows a credit be taken against use tax owed for sales/use tax paid to another state or country for goods, services, extended warranties, and digital products purchased in another state. Thus, the objective of avoiding duplicative taxes is being met.

To what extent will continuation of the tax preference contribute to this public policy objective?

Continuing the preference will avoid duplicative tax applications for multi-state businesses and individuals that purchase goods outside the state and use them in Washington.

If the public policy objective is not being fulfilled, what is the feasibility of modifying the tax preference for adjustment of the tax benefits?

The public policy objective is being met.

Beneficiaries

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

The beneficiaries include multi-state and international businesses that conduct business in Washington and Washington residents who purchase and pay sales/use tax on goods out-of-state. Generally, this credit is used by businesses for machinery, equipment, and supplies purchased outside the state and brought into Washington for use. Individuals use the credit for property that must be registered and/or licensed with the state and upon which they owe use tax, such as automobiles, trailers, motor homes, and boats. They could also use it for other goods or services purchased outside the state upon which another state's sales/use tax was paid.

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

JLARC was unable to identify any unintended beneficiaries.

Revenue and Economic Impacts

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

Beneficiaries of this credit must report and pay the use tax owed on goods or services purchased out-of-state to the Department of Revenue. The Department assumes most beneficiaries of the preference are businesses; they are more likely to pay use tax because they are registered with the Department and subject to audit review. JLARC was able to examine business use of the preference. While individuals pay use tax on tangible personal property that must be licensed with the state, they are much less likely to pay use tax on other goods or services they purchase outside the state. Use tax payment and credit records for individuals are not maintained in a manner that allows JLARC to examine them.

The Department of Revenue has estimated the beneficiary savings (the amount of use tax that is not paid due to the credit) for this preference at approximately $169 million in Fiscal Year 2008 and over $174 million in Fiscal Year 2009. Based on actual total of credits reported to the Department via business excise tax returns, JLARC estimates the beneficiary savings for Fiscal Years 2009 and 2010 at approximately $400,000 and $650,000, respectively. The wide differentiation between these figures illustrates the difficulty in estimating the taxpayer savings for this preference. JLARC did not identify an alternative method for estimating taxpayer savings.

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?

JLARC cannot determine the overall impact on the economy if this preference were terminated. If the use tax credit provided by this preference were terminated, the use tax credit provided in the Multistate Tax Compact (RCW 82.56.010, section V) would remain in effect, although the credit might apply more narrowly. This could result in fewer multi-state businesses and individuals receiving credit against Washington use tax owed for property purchased out of state. Terminating the credit entirely could result in constitutional challenges in court.

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

There would be no change in tax distribution.

Other States

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

There are 45 states, including Washington, that impose a use tax on out-of-state purchases. Like Washington, all of these other states grant a credit for sales/use taxes paid in other states. Unlike Washington, 12 states require the other states to have a reciprocal agreement before granting the credit.

Like Washington, Minnesota specifically includes taxes paid to foreign countries as eligible for the credit. Maine, New York, and Ohio grant the credit for taxes paid to out-of-state "taxing jurisdictions." Indiana and Massachusetts specifically include U.S. territories and possessions, while Wisconsin specifically excludes Puerto Rico and U.S. territories.

Recommendation

Because the tax preference is meeting its implied objective of avoiding duplicative taxation to multistate taxpayers, the Legislature should continue the use tax credit for sales or use tax paid on goods or services purchased outside the state.

Legislation Required:	No
Fiscal Impact:	None

SHARED REAL ESTATE COMMISSIONS (BUSINESS & OCCUPATION TAX)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**JLARC Recommendation**
Removes B&O pyramiding by providing real estate brokers participating in the closing of a real estate sale to pay B&O tax on their share of commissions. Also exempts sales agents if the broker has paid tax.	The Legislature did not specifically state a public policy objective for this preference. The Legislature, through its actions, demonstrated that it did not want to impose the "pyramiding" effect of the B&O tax on the commission shared with real estate agents and with other real estate firms. It is not clear why the Legislature provided a tax preference to the real estate industry and not to other businesses with similar broker-agent and cooperating broker relationships.	$36 million in 2011-13 Biennium	**Review and clarify**: Because it is not clear why the Legislature granted a tax preference to real estate brokers and agents and not to other businesses with similar broker-agent and cooperating broker relationships.

SHARED REAL ESTATE COMMISSIONS (BUSINESS & OCCUPATION TAX)

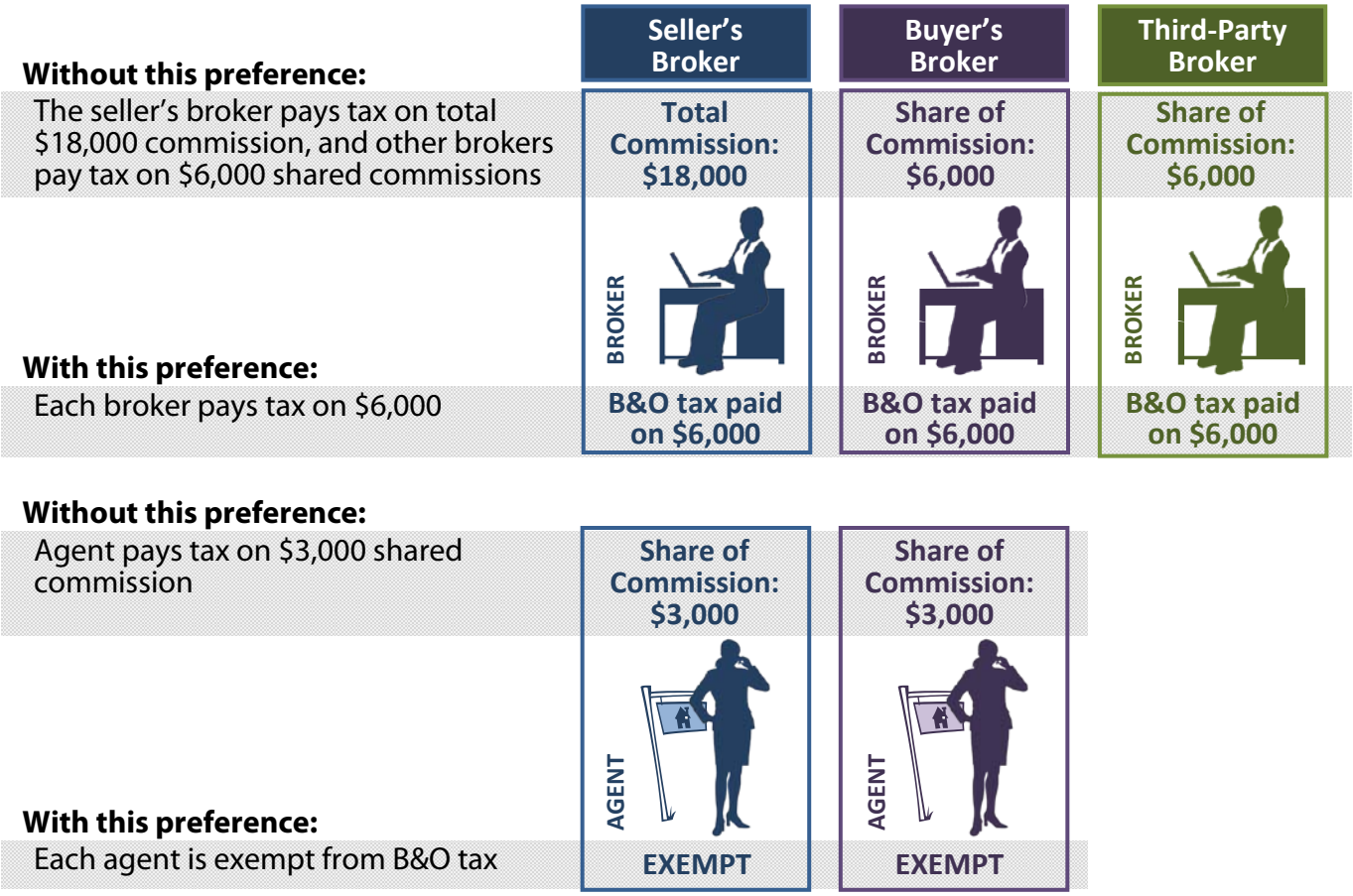
Report Detail

Current Law

Generally, the business and occupation (B&O) tax is owed on gross receipts on transactions at each stage of producing a product or service. This is by design in the B&O tax and known as "pyramiding." In the real estate industry, multiple transactions take place between the broker and agent that represent the seller, and the broker and agent that represent the buyer. There may also be other brokers involved in sales transactions such as referral brokers or marketing brokers. Commissions are typically distributed to each broker by the escrow agent, and brokers share their commissions with their agents.

Under current law, the buyer's and seller's brokers, and other third-party brokers (such as a referral broker) participating in the closing of a real estate sale pay tax on their respective share of a commission. When the tax is paid by the brokers, their agents are exempt from tax on their share of commissions. See Exhibit 91, below.

Exhibit 91 – Real Estate Sales Involve Multiple Transactions



Source: JLARC analysis of tax law.

The law, in effect, prevents the commissions shared with real estate brokers and agents from being taxed more than once. That is, it avoids the usual "pyramiding" of the B&O tax.

See page A3-16 in Appendix 3 for the current statute, RCW 82.04.255.

Legal History

This legal history also includes information on the history of taxation of agents and brokers of the insurance and investment industries because they share a similar broker-agent relationship with real estate businesses. The tax treatment of all three types of business hinges on two primary issues:

1) Are salespersons/agents independent contractors or employees for tax purposes?
2) Should commissions shared with other real estate firms be taxed at each transaction of sharing a commission?

Except for a year-and-a-half period beginning in 1969, real estate agents have been treated as exempt employees of brokers, and brokers pay tax only on their respective shares of the commission. Unlike other businesses that pay tax on gross receipts at each stage of providing a service, real estate businesses pay tax once on a the original commission payment.

1935 The Legislature created the business and occupation (B&O) tax that imposed a tax on the privilege of engaging in business activities in Washington. Brokers in general owed tax on the gross commissions they received, while their salespersons qualified as employees. Employees are exempt from the B&O tax.

The Tax Commission explicitly stated in rule that insurance and investment brokers were taxable on gross commissions without deductions for commissions paid to agents. However, brokers who shared commissions with other brokers were allowed a deduction. The Commission rules did not address real estate brokers and agents.

1945 The Legislature created the unemployment insurance law. A section of the law defined salespersons, agents, and brokers that sold real estate, insurance, and investments to be independent contractors "to the extent [they] are compensated by commission." Independent contractors were not considered employees and were liable for payroll taxes. The Governor vetoed this section.

1947 The Legislature reversed the Governor's 1945 action by re-enacting the vetoed section of the unemployment insurance law. The law now required salespersons, agents, and brokers of real estate, insurance, and investments to pay payroll tax on their commissions.

Following the session, the Tax Commission issued a new rule. The rule allowed the originating real estate broker (for example, the seller's broker) to deduct commissions shared with a broker that cooperated in the sale (for example, the buyer's broker). Rather than the seller's broker paying tax on the total commission, both brokers paid tax on their respective shares of the commission. Insurance and investment brokers received essentially the same tax treatment.

Thus, the Tax Commission continued to treat agents of all three professions as employees making them exempt from paying the B&O tax.

1950 The U.S. Court of Appeals held that real estate agents are independent contractors for the purpose of federal tax.[24]

1969 Acknowledging that its 1947 rule had no basis in law, DOR issued a new rule eliminating the deduction for commissions paid by real estate brokers to their agents, and began a program to register and tax agents on their commissions. At the same time, DOR initiated a similar program to register and tax insurance agents.

1970 The Legislature granted the same exempt status to real estate businesses that had been provided by DOR rule before 1969. This action resolved longstanding issues over the tax status of real estate brokers and agents:

- Are salespersons/agents independent contractors or employees for tax purposes? The new law treated real estate agents as employees for tax purposes, exempting the agent's share of a commission from B&O taxation.
- Should commissions shared with other real estate firms be taxed twice? The law allowed the originating broker (e.g., the buyer's broker) and a cooperating broker (e.g., the seller's broker) to pay tax on their respective shares of the commission. Without this provision, the originating broker would pay tax on the gross commission, and the cooperating broker would pay tax on the shared commission. The shared commission would be taxed twice.

The Legislature did not provide insurance and investment brokers and agents with the same tax treatment as real estate brokers and agents. DOR began registering and taxing insurance agents on their commission, and the Department also did not allow a deduction from gross commissions of the broker. JLARC could not determine if investment brokers were taxed on gross commissions at the time.

1972 The Washington Court of Appeals in *Davenport v. Department of Revenue* overruled a tax assessment on commissions of real estate agents covering the time period between the 1969 DOR rule and the effective date of the 1970 law. The court reasoned that a real estate brokerage office is "a group of individuals acting as a unit," and that the B&O tax could be assessed only once against a single real estate commission.

The Court also stated that by silently acquiescing with the tax deduction for shared commissions over a period of 30 years and by quickly reversing DOR's 1969 rule, the Legislature gave evidence that it did not intend to tax real estate commission income twice.[25]

Over a period of years, the Legislature rejected a number of proposals attempting to provide insurance and investment businesses the same "anti-pyramiding" tax treatment as real estate businesses. The courts, as well, in several key cases, denied these businesses the same preferential tax treatment as real estate businesses. However, the Legislature reduced the B&O tax rate for insurance businesses relative to the general service B&O rate charged to real estate and investment businesses.

[24] *Dimmitt-Rickhoff-Bayer Real Estate Co. v. Finnegan*, IRS, 179 F.2d 882; 1950 U.S. App. LEXIS 4063.

[25] *Davenport v. The Department of Revenue*, 6 Wn. App. 581 (1972).

1983 The Legislature granted a preferential B&O tax rate to insurance businesses. Persons selling insurance paid at a rate of 1.1 percent compared to 1.5 percent for other services such as real estate and investment services.

1992 The state Supreme Court in *Impecoven v. Department of Revenue* ruled that insurance businesses are not entitled to the same tax treatment as real estate businesses. The court reasoned that the Legislature gave evidence of its intent to provide special tax treatment to real estate businesses and had rejected proposals to give the same special treatment to insurance businesses.[26]

1993 DOR provided examples of charges brokers are paid by real estate agents that are taxable even though the charges are based on a percentage of commission. These include office space, telephone, advertising, multiple listing service, and office supplies.

2005 The Legislature reduced the B&O tax rate for insurance businesses to 0.484 percent compared to the 1.5 percent rate charged investment and real estate businesses.

2006 The state Court of Appeals ruled in *KMS v. Seattle* that investment agents are not entitled to the same tax treatment as real estate agents. The case involved a Seattle city B&O tax preference for real estate agents patterned after the state's B&O tax preference. In both *Impecoven* and *KMS,* the court determined that DOR and its predecessor the Tax Commission had allowed real estate brokers to deduct commissions paid to salespersons and the Legislature had acquiesced.[27]

2011 The Legislature extended the B&O tax preference to commissions paid to third-party real estate brokers participating in the sale. Previously, DOR considered the payment to a third-party broker to be a fee for services and required the initial brokers to pay tax on their share of commissions without deduction for the share of commission paid to a third-party broker.

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

[27] *KMS financial Services v. The City of Seattle,* 135 Wn. App. 489 (2006).

Other Relevant Background

The broker-agent relationship is common to other types of professional businesses such as insurance and stock brokerages. Generally, both the managing brokers and the salespersons (agents) are required to have professional licenses. Sales persons are typically considered independent contractors, rather than employees, and they are paid on a commission basis. However, insurance and stock brokers pay B&O tax on gross commissions without deduction for commissions shared with agents. In these other industries, brokers are taxed on gross commissions and agents are taxed again on their share of the commission. Exhibit 92, below, illustrates the different taxed amounts.

Exhibit 92 – Businesses with Similar Broker-Agent Relationships are Taxed Differently

Type of Sales Activity	Broker's Commission	Commission Shared with Agent	Taxable Income		Total Income Taxed
			Broker	Agent	
Real Estate	$18,000	$6,000	$18,000	$0	**$18,000**
Insurance	$18,000	$6,000	$18,000	$6,000	**$24,000**
Investments	$18,000	$6,000	$18,000	$6,000	**$24,000**

Source: JLARC analysis of tax law. Average commission rates derived from MLS and federal studies.

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 tax preference.

However, the Legislature though its actions demonstrated that it did not want to impose the "pyramiding" effect of the B&O tax on the commission shared with real estate agents and with other real estate firms. Both the Legislature and the courts have denied this tax treatment for insurance businesses and stockbrokers.

The Legislature clearly specified the intended beneficiaries to be the real estate industry, but the legislation did not state the underlying objective. It is not clear why the Legislature provided a tax preference to the real estate industry and not to other businesses with similar broker-agent and cooperating broker relationships.

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

It is not clear why the Legislature provided a tax preference to the real estate industry and not to other businesses with similar broker-agent and cooperating broker relationships.

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

The public policy objective is not clear.

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

The public policy objectives are not clear.

Beneficiaries

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

The beneficiaries of the tax preference are: 1) the originating brokers who share real estate commissions with other real estate firms, and 2) the real estate agents who do not pay tax on the share of commissions they receive. The Department of Licensing currently lists 23,000 active real estate agents and 8,500 brokers. According to the U.S. Economic Census conducted in 2007, Washington's real estate industry earned a total of $2.3 billion in commissions.

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

JLARC found no evidence that the preference is providing unintended benefits to entities other than those the Legislature intended. According to testimony from taxpayers, there are instances where DOR audits have found where the preference had been claimed by originating brokers for commissions shared with third-party brokers providing referral and other services. However, the Legislature amended statute to grant the tax preference for commissions paid to third-party brokers in 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?

Originating brokers and their agents saved an estimated $11.2 million in B&O taxes in Fiscal Year 2010. They are expected to save a two-year total of $36 million in the 2011-13 Biennium. Commissions are calculated from 2007 Census figures for Washington.

The estimate of beneficiary tax savings is derived from a variety of data sources. According to government studies, gross commissions are between 5 and 7 percent of the selling price. Buyers are represented by their own broker (the cooperating broker) 64 percent of the time. Agents typically receive commissions of between 1 and 2 percent of the selling price. The estimate for third-party brokers is from the DOR fiscal note on the 2011 legislation allowing the preferential tax treatment. See Exhibit 93, below.

Exhibit 93 – Estimates of Beneficiary Tax Savings

Fiscal Year	From Sharing Commissions with Cooperating Brokers	From Sharing Commissions with Third-Party Brokers	Tax Savings to Agents	Total Tax Savings
2009	$5,550,000	Taxed until 2012	$5,550,000	$11,100,000
2010	$5,580,000		$5,580,000	$11,200,000
2011	$6,660,000		$6,660,000	$13,300,000
2012	$8,100,000	$900,000	$8,100,000	$17,100,000
2013	$9,000,000	$900,000	$9,000,000	$18,900,000
2011-13 Biennium	**$17,100,000**	**$1,800,000**	**$17,100,000**	**$36,000,000**

Source: JLARC analysis based on data from the 2007 U.S. Economic Census, Employment Security, Multiple Listing Service, Federal Trade Commission, U.S. Department of Justice, DOR fiscal note on SB 5083 (2011), and growth factors provided by the Revenue and Economic Forecast Council.

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?

JLARC cannot determine the overall impact on the economy if the preference were terminated.

Terminating the tax preference might be challenged on the basis of the *Davenport* case which established that a real estate office is a "unit" taxable once on a single commission. If the Legislature structured the tax to overcome the *Davenport* decision, originating brokers and agents, who are the primary beneficiaries, would pay higher B&O taxes.

Research shows that while the real estate industry is highly competitive, there is little variation in commission rates regardless of local market conditions, housing prices, or the cost or effort required to sell a home. The Government Accountability Office, the Justice Department, and the Federal Trade Commission have investigated price competition in the real estate industry and concluded that competition is based on factors unrelated to price, such as quality, reputation or level of service. This evidence suggests that agents and brokers might choose to absorb the tax in the form of reduced income.

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

There would be no effect on the distribution of tax liability. Originating brokers and agents would pay higher B&O taxes.

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?

Unlike Washington, almost all other states impose a corporate net income tax. Net income taxes do not pyramid like Washington's B&O tax, and business expenses are generally deductible. Therefore, states with net income taxes do not require a preference to avoid double taxation of real estate commissions.

Ohio has a Commercial Activities Tax (CAT) that is imposed on gross receipts, similar to Washington's business & occupation tax. The Ohio CAT excludes commissions paid to real estate agents from a broker's gross receipts.

Recommendation

Because it is not clear why the Legislature granted a tax preference to real estate brokers and agents and not to other businesses with similar broker-agent and cooperating broker relationships, the Legislature should clarify the B&O tax preference for shared real estate commissions.

Legislation Required:	Yes
Fiscal Impact:	Depends on legislation

STATE-CHARTERED CREDIT UNIONS (BUSINESS & OCCUPATION TAX)

Report Summary			
What the Preference Does	**Public Policy Objective**	**Estimated Beneficiary Savings**	**JLARC Recommendation**
Provides a B&O tax exemption for state-chartered credit unions.	The Legislature did not explicitly state the public policy objective for this preference. JLARC infers the Legislature may have originally had two objectives: 1) To remove an incentive for state-chartered credit unions to become federal credit unions, so that they would remain under state regulation; and 2) To support credit unions because they were originally formed to serve low-income groups underserved by commercial banks.	$60.9 million in 2011-13 Biennium	**Continue**: Because the B&O exemption removes an incentive for state credit unions to become federal credit unions and thus leave the state system of regulation.

STATE-CHARTERED CREDIT UNIONS (BUSINESS & OCCUPATION TAX)

Report Detail

Current Law

This tax preference exempts state-chartered credit unions from the business and occupation (B&O) tax. Credit unions are nonprofit cooperative associations governed by a volunteer board of directors that is comprised of credit union members. Membership is limited to groups with "common bonds" of occupation or association, or within a well-defined neighborhood, community, or rural district.

See page A3-17 in Appendix 3 for the current statute, RCW 82.04.405.

Legal History and Public Policy Objective

1916 Federal law exempted state and federal credit unions from U.S. income taxes.

1933 The Legislature adopted laws for the organization and supervision of state credit unions. The authorizing statute limited a credit union's membership to groups "having a common bond of occupation or association, or to groups within a well defined neighborhood, community or rural district." The statute limited lending powers of state credit unions to making personal loans, and loans secured by second mortgages of real estate situated within the state, but not first mortgages. Loans had to be paid within one year. Personal loans were to be given preference.

1934 Congress passed the Federal Credit Union Act authorizing the formation of federally-chartered credit unions in the states.

1959 Congress exempted federal credit unions from most taxation by the states, including business taxes, and sales and use taxes.

1969 Congress reversed long-standing prohibitions and allowed states to tax national banks, but not federally-chartered credit unions. Washington had exempted state banks and credit unions from state B&O taxes in order to remove a competitive disadvantage relative to their federal counterparts.

1970 The Legislature repealed the B&O exemption for national and state banks and other financial institutions. However, in the same bill, the Legislature provided this B&O tax exemption for state-chartered credit unions. With this exemption, Washington retained the same B&O tax treatment for state-chartered credit unions as federal law provided to federally-chartered credit unions.

In subsequent years, the Legislature expanded the powers of state credit unions beyond those granted in 1933. See Exhibit 94, below.

Exhibit 94 – Expansion of Powers Granted to State Credit Unions 1933-2011

Powers – Ability to Provide:	Date Granted
Short-term personal loans	1933
Short-term loans secured by second mortgages	1939
Short-term loans secured by first mortgages	1947
Farmers Home Administration loans	1975
Checking accounts ("share drafts"), loans on business buildings	1981
Membership of groups with multiple common bonds	1984
Branch services	1984
Longer term loans (real estate 15 years, personal loans 12 years)	1984
Business loans (limited to lower of 12.25 percent of assets or 1.75 times net worth, unless DFI approves)	1989
Loans with terms set by credit union board policies (no statutory limit)	1994
Insurance broker services	2001
Depository for public funds	2010

Source: JLARC analysis of federal and state credit union laws.

1998 The Legislature extended the B&O tax exemption for credit unions to credit unions chartered in other states.

2006 The Legislature allowed a use tax exemption for assets acquired as a result of a merger with or conversion to a state-chartered credit union. This action by the Legislature eliminated a disincentive for other credit unions to convert to a Washington state-chartered credit union.

Other Relevant Background

State-chartered credit unions have unique characteristics that distinguish them from federally chartered credit unions and from commercial banks. Credit unions can choose to be chartered by the state or the federal government, and they can also choose to change charters (known in the industry as "flipping"). Since 2003, three federal credit unions converted to state credit unions and four state credit unions converted to federal credit unions.

State-Chartered Credit Unions Compared to Federally-Chartered Credit Unions

State-chartered and federally-chartered credit unions have differences and similarities in governance, tax status, and powers.

Governance: State credit unions are supervised by the Department of Financial Institutions (DFI), while federally-chartered credit unions are supervised by the National Credit Union Administration (NCUA), an independent federal agency. Both state and federal credit unions in Washington are federally insured.

Tax Status: Federal law prohibits states from imposing most taxes on federal credit unions. In Washington, state credit unions are exempt from the B&O tax, but they pay sales tax and use tax, except for use tax when converting from federal to state charter, or upon merger with a state credit union.

Powers: State-chartered credit unions and federally-chartered credit unions have many powers in common. However, state credit unions can serve a broader field of membership.

Credit Unions Compared to Commercial Banks

Credit unions are nonprofit cooperatives with volunteer boards. Commercial banks are in business for profit. Credit unions cannot sell shares of stock like commercial banks but must instead rely on retained earnings to build capital. Credit unions are exempt from B&O tax on gross income. Commercial banks pay B&O tax on gross income less deductions for first mortgage interest on non-transient residential property and income from investments in federal, state and municipal obligations. (Both tax preferences are reviewed in 2011.)

The Legislature has expanded the field of membership and the financial services credit unions may offer to the point where credit unions may compete with some commercial banks, most notably with smaller community banks. Credit unions are gaining market share of consumer deposits. Credit unions may make business loans in competition with commercial banks, but are limited to making business loans to the lower of 12.25 percent of their assets or 1.75 times their net worth, unless approved for expanded business lending by DFI. Of the 65 Washington credit unions currently in operation, seven have expanded business loan authority.

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 explicitly state the public policy objective for providing a B&O tax exemption to state-chartered credit unions. JLARC infers the Legislature may have originally had two objectives:

1) To remove an incentive for state-chartered credit unions to become federal credit unions so they would remain under state regulation; and
2) To support credit unions because they were originally formed to serve low-income groups underserved by commercial banks.

Removing an Incentive to Become a Federal Credit Union

JLARC infers from historical documents that the original public policy objective was to give state-chartered credit unions the same B&O tax exemption as federally chartered credit unions so they would not "flip" charters and would remain under state regulation. State-chartered credit unions could avoid the state tax by becoming federal credit unions.

Serving Low-Income or Underserved

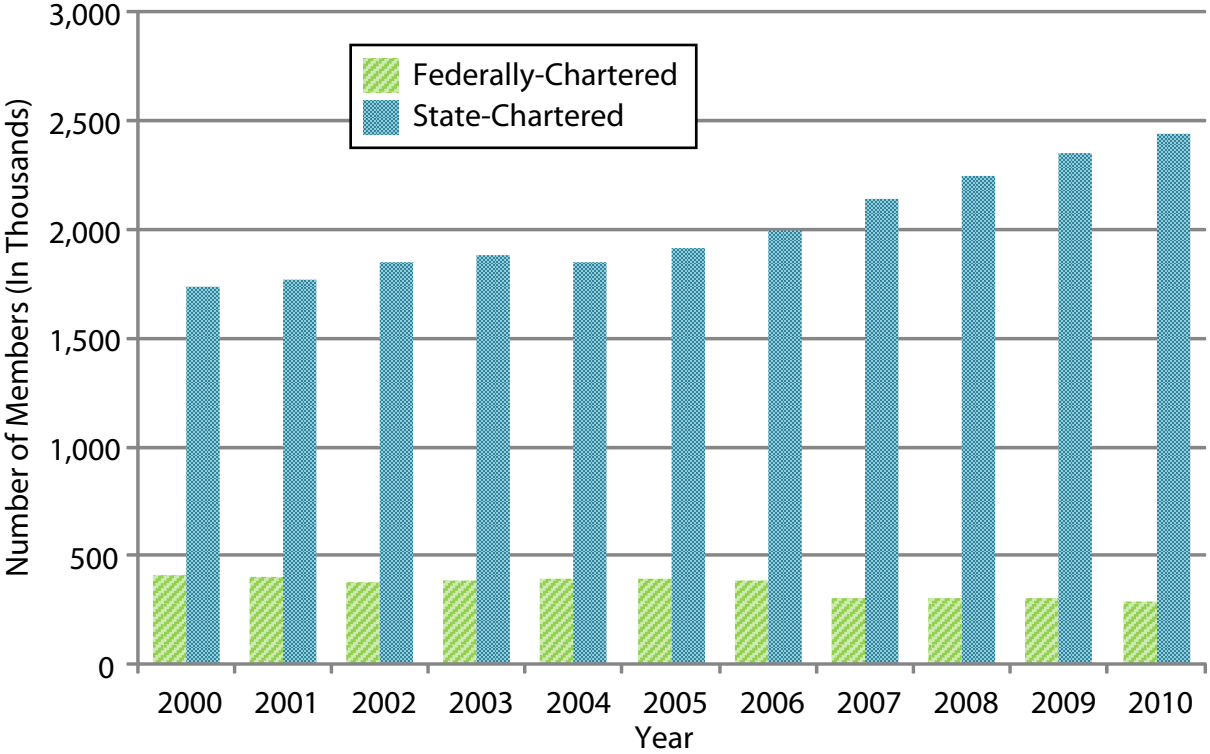
Both the federal and state statutes authorizing the formation of credit unions suggest that an underlying purpose of credit unions was to serve low-income or underserved populations.

Under the Federal Credit Union Act, credit unions have a public purpose: "to make more **available to people of small means** credit for provident purposes through a national system of cooperative credit." Similarly, the state's 1933 authorizing statute defined a credit union as a nonprofit cooperative formed for the purpose of "promoting thrift among its members and **creating a source of credit** for them at legitimate rates of interest for provident, productive and educational purposes." Governor Dan Evans expressed his support for extending the exemption for state credit unions in 1970 reasoning that credit unions "primarily provide financial assistance to low income people."

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

With regard to the first objective, in the past several years the number of state chartered credit unions has stayed about the same. However, membership in Washington state-chartered credit unions is growing while membership in federally chartered credit unions is declining. See Exhibit 95, below.

Exhibit 95 – Membership in State Credit Unions Growing



Source: JLARC analysis of NCUA data, 2000-2010.

With regard to the second public policy objective of serving the underserved or people with lower incomes, credit unions may continue to serve these populations, but that is no longer their sole focus. The discussion in the remainder of this review focuses on the first public policy objective.

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

Continuation of the tax preference will provide state credit unions the same B&O tax treatment as provided to federal credit unions, thus removing an incentive for them to leave the state regulated system. Federal credit unions have a greater state tax advantage, however. Federal credit unions are also exempt from state sales and use taxes.

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

The public policy objective is being fulfilled.

Beneficiaries

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

The beneficiaries are the 65 Washington state-chartered credit unions serving 2,400,000 members. The top five credit unions in terms of the number of members hold 46 percent of all state credit union membership. The largest, Boeing Employees Credit Union, holds 28 percent of all state credit union membership.

Exhibit 96 – Five State Credit Unions Hold 46% of all Membership

Credit Union	Membership	Percent of Total
Boeing Employees Credit Union	673,540	28%
Washington State Employees Credit Union	169,643	7%
Gesa Credit Union	98,006	4%
Spokane Teachers Credit Union	93,347	4%
HAPO Community Credit Union	87,906	4%
Total Top Five	**1,122,442**	**46%**
All Other State Credit Unions	1,320,559	54%
Total Membership	**2,443,001**	**100%**

Source: JLARC analysis of NCUA data, 2010.

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

JLARC found no evidence that the tax preference is providing benefits to entities other than those intended by the Legislature. The law is written clearly to apply to state-chartered credit unions.

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?

State-chartered credit unions saved an estimated $23.5 million in B&O taxes in Fiscal Year 2010. The beneficiary tax savings for the two-year period in the 2011-13 Biennium is expected to be $60.9 million. See Exhibit 97, below.

Exhibit 97 – Estimated State Credit Union B&O Tax Savings

Fiscal Year	Gross Income	B&O Effective Tax Rate	Beneficiary Tax Savings
2009	$1,582,236,756	0.015	$23,700,000
2010	$1,513,389,935	0.0155*	$23,500,000
2011	$1,560,915,027	0.018	$28,100,000
2012	$1,641,901,532	0.018	$29,600,000
2013	$1,740,660,712	0.018	$31,300,000
2011-2013 Biennial Total			**$60,900,000**

*Reflects partial year of rate increase beginning 5/1/2010.

Source: JLARC analysis of National Credit Union Association data. Growth based on WA wage and employment projections.

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, state-chartered credit unions would have an incentive to apply for federal charters to avoid the state B&O tax.

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

If the exemption were repealed, there would be no effect on the distribution of liability of payment of state taxes. State-chartered credit unions would either pay B&O tax or avoid the tax by becoming federally chartered credit unions.

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?

Unlike Washington, most states impose a corporate net income tax as their primary business tax. Since non-profit credit unions are exempt from federal income tax, credit unions are generally exempt under state net income taxes as well. However, some states elect to impose a separate franchise or gross income tax on financial institutions in lieu of or in addition to the corporate net income tax.

Recommendation

Because the B&O exemption removes an incentive for state credit unions to become federal credit unions and thus leave the state system of regulation, the Legislature should continue the exemption.

Legislation Required: No

Fiscal Impact: None

APPENDIX 1 – SCOPE AND OBJECTIVES

2011
FULL
TAX PREFERENCE
PERFORMANCE
REVIEWS

SCOPE AND OBJECTIVES

OCTOBER 2010

STATE OF WASHINGTON

JOINT LEGISLATIVE AUDIT AND REVIEW COMMITTEE

STUDY TEAM
Mary Welsh
Dana Lynn
Peter Heineccius

PROJECT SUPERVISOR
Keenan Konopaski

LEGISLATIVE AUDITOR
Ruta Fanning

Joint Legislative Audit & Review Committee
1300 Quince St. SE
Olympia, WA 98504-0910
(360) 786-5171
(360) 786-5180 Fax

Website:
www.jlarc.leg.wa.gov
e-mail:
barbara.neff@leg.wa.gov

Why a JLARC Study of Tax Preferences?

Engrossed House Bill 1069 (2006) established the Citizen Commission for Performance Measurement of Tax Preferences and directed it to develop a schedule for periodic review of the state's tax preferences. The bill also directed the Joint Legislative Audit and Review Committee (JLARC) to conduct the periodic reviews.

Background

Tax preferences are exemptions, exclusions, or deductions from the base of a state tax; a credit against a state tax; a deferral of a state tax; or a preferential state tax rate. The state has more than 590 tax preferences.

Recognizing the need to assess the effectiveness of these tax preferences in meeting their intended objectives through an orderly process, the Legislature established the Citizen Commission for Performance Measurement of Tax Preferences. The Commission's role is to develop a schedule for the performance review of all tax preferences at least once every ten years. The ten-year schedule is to be revised annually.

Omitted from review are several categories of tax preferences identified by statute (e.g., tax preferences required by constitutional law). Any tax preference that the Commission determines is a critical part of the structure of the tax system may also be omitted.

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

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

This document identifies the scope and objectives for the first category: full tax preference reviews. JLARC is to review tax preferences according to the schedule developed by the Commission, and consistent with guidelines set forth in statute.

Brief Description	RCW Citation	Year Enacted
1. Interstate bridges	84.36.230	1949
2. Extracted fuel	82.12.0263	1949
3. Real estate excise tax exemptions	82.45.010(3)(a)-(m)	1951
4. Boats sold to nonresidents	82.08.0266; 82.08.02665	1959
5. Repaired items delivered to other states	82.08.0265	1959
6. Purchases by certain nonresidents	82.08.0273	1965
7. Processors of meat	82.04.260(4)	1967
8. Aircraft fuel tax; exported, commercial use	82.42.030; 82.42.070	1967
9. Credit for tax paid to other states	82.12.035	1970
10. Credit unions; state chartered	82.04.405	1970
11. Shared real estate commissions	82.04.255	1970
12. Dividends from subsidiaries	82.04.4281	1970
13. Interest on real estate loans	82.04.4292	1970
14. Limited income property tax deferral	84.37.030	2007
15. Renewable energy machinery	82.08.962; 82.12.962	2009

Full Study Objectives

In response to the legislative directive, the study will answer, for each tax preference, the following questions (unless the commission determines that the tax preference review should be conducted as an expedited review):

Public Policy Objectives:

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

Beneficiaries:

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

Revenue and Economic Impacts:

7. What are the past and future tax revenue and economic impacts of the tax preference to the taxpayer and to the government if it is continued? (This includes an analysis of the general effects of the tax preference on the overall state economy, including the effects on consumption and expenditures of persons and businesses within the state.) (RCW 43.136.055(h))
8. If the tax preference were to be terminated, what would be the negative effects on the taxpayers who currently benefit from the tax preference and the extent to which the resulting higher taxes would have an effect on employment and the economy? (RCW 43.136.055(f))
9. If the tax preference were to be terminated, what would be the effect on the distribution of liability for payment of state taxes? (RCW 43.136.055(i))

Other States:

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

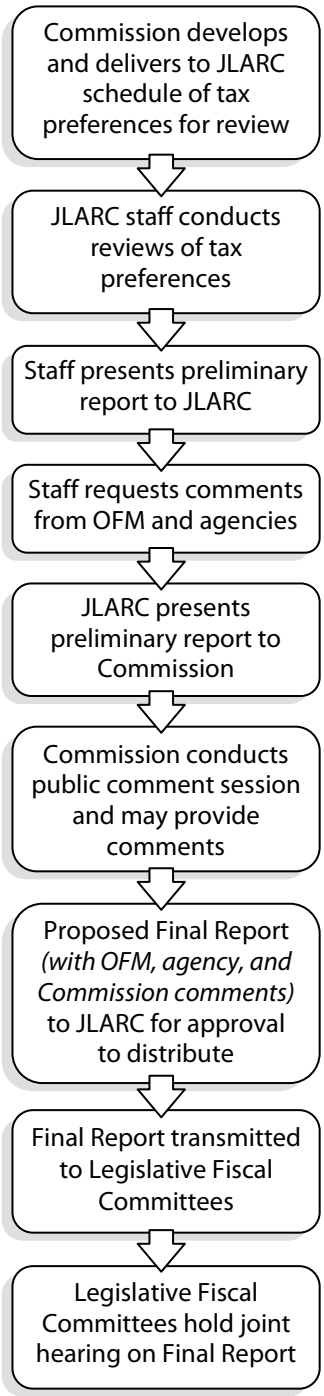
Timeframe for the Study

A preliminary audit report will be presented at the July 2011 JLARC meeting and at the August 2011 meeting of the Commission. A final report will be presented to JLARC in November 2011.

JLARC Staff Contact for the Study

Mary Welsh	(360) 786-5193	mary.welsh@leg.wa.gov
Dana Lynn	(360) 786-5177	dana.lynn@leg.wa.gov
Peter Heineccius	(360) 786-5123	peter.heineccius@leg.wa.gov

Tax Preference Review Process



2011
EXPEDITED TAX PREFERENCE PERFORMANCE REVIEWS

SCOPE AND OBJECTIVES

OCTOBER 2010

STATE OF WASHINGTON
JOINT LEGISLATIVE AUDIT AND REVIEW COMMITTEE

STUDY TEAM
Mary Welsh
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Keenan Konopaski

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Joint Legislative Audit & Review Committee
1300 Quince St. SE
Olympia, WA 98504-0910
(360) 786-5171
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Website:
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Why a JLARC Study of Tax Preferences?

Engrossed House Bill 1069 (2006) established the Citizen Commission for Performance Measurement of Tax Preferences and directed it to develop a schedule for periodic review of the state's tax preferences. The bill also directed the Joint Legislative Audit and Review Committee (JLARC) to conduct the periodic reviews.

Background

Tax preferences are exemptions, exclusions, or deductions from the base of a state tax; a credit against a state tax; a deferral of a state tax; or a preferential state tax rate. The state has more than 590 tax preferences.

Recognizing the need to assess the effectiveness of these tax preferences in meeting their intended objectives through an orderly process, the Legislature established the Citizen Commission for Performance Measurement of Tax Preferences. The Commission's role is to develop a schedule for the performance review of all tax preferences at least once every ten years. The ten-year schedule is to be revised annually.

Omitted from review are several categories of tax preferences identified by statute (e.g., tax preferences required by constitutional law). Any tax preference that the Commission determines is a critical part of the structure of the tax system may also be omitted.

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

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

This document identifies the scope and objectives for the second category: expedited tax preference reviews. JLARC is to review tax preferences according to the schedule developed by the Commission, and consistent with guidelines set forth in statute. For the expedited tax preferences JLARC is to provide recommendations to (1) continue, (2) modify, (3) add an expiration date and conduct another review prior to the expiration date, or (4) terminate the preference. JLARC may also recommend accountability standards for future reviews of tax preferences.

Expedited Study Scope

The following tax preferences were recommended by the Citizen Commission as being subject to an expedited review :

Brief Description	RCW Citation	Year Enacted
1. Municipal sewer charges	82.04.432	1967
2. Interest on government obligations	82.04.4293	1970
3. Sheltered workshops	84.36.350	1970

Expedited Study Scope (cont'd.)

Brief Description	RCW Citation	Year Enacted
4. Blood, bone & tissue banks	84.36.035	1971
5. Church camps	84.36.030(2)	1971
6. Display items for trade shows	82.12.0272	1971
7. Open space compensating tax exemptions	84.34.108(6)	1973
8. Day care centers	84.36.040(1)(a)	1973
9. Hospital laundry services	82.04.050(2)(a)	1973
10. Hog fuel sales to produce electricity	82.08.956; 82.12.956	2009

Expedited Study Objectives

In response to the legislative directive, the study will answer, for each tax preference, the following questions:

Public Policy Objectives:

11. What are the public policy objectives that provide a justification for the tax preference? Is the purpose or intent of the tax preference clear?
12. Is there any readily available evidence related to the achievement of any of these public policy objectives?

Beneficiaries:

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

Revenue and Economic Impacts:

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

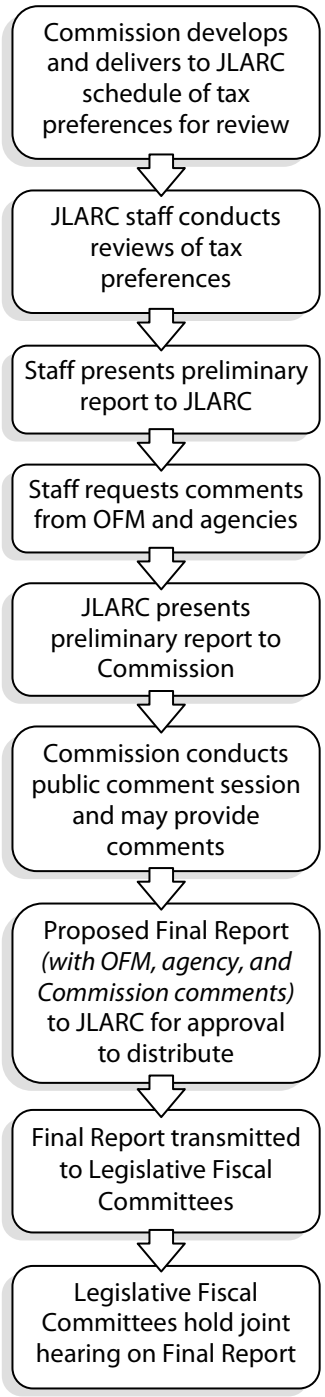
Timeframe for the Study

A preliminary audit report will be presented at the July 2011 JLARC meeting and at the August 2011 meeting of the Commission. A final report will be presented to JLARC in November 2011.

JLARC Staff Contacts for the Study

Mary Welsh (360) 786-5193 mary.welsh@leg.wa.gov
Dana Lynn (360) 786-5177 dana.lynn@leg.wa.gov
Peter Heineccius (360) 786-5123 peter.heineccius@leg.wa.gov

Tax Preference Review Process



APPENDIX 2 – AGENCY RESPONSES

Agency responses will be included in the final report.

APPENDIX 3 – CURRENT LAW

Aircraft Fuel Tax, Export and Commercial Use (Aircraft Fuel Tax)

82.42.030

(1) The provision of RCW 82.42.020 imposing the payment of an excise tax on each gallon of aircraft fuel sold, delivered or used in this state shall not apply to aircraft fuel sold for export, nor to aircraft fuel used for the following purposes: (a) The operation of aircraft when such use is by any air carrier or supplemental air carrier operating under a certificate of public convenience and necessity under the provisions of the Federal Aviation Act of 1958, Public Law 85-726, as amended; (b) the operation of aircraft for testing or experimental purposes; (c) the operation of aircraft when such operation is for the training of crews in Washington state for purchasers of aircraft who are certified air carriers; and (d) the operation of aircraft in the operations of a local service commuter: PROVIDED, That the director's determination as to a particular activity for which aircraft fuel is used as being an exemption under this section, or otherwise, shall be final.

(2) To claim an exemption on account of sales by a licensed distributor of aircraft fuel for export, the purchaser shall obtain from the selling distributor, and such selling distributor must furnish the purchaser, an invoice giving such details of the sale for export as the director may require, copies of which shall be furnished the department and the entity of the state or foreign jurisdiction of destination which is charged by the laws of that state or foreign jurisdiction with the control or monitoring or both, of the sales or movement of aircraft fuel in that state or foreign jurisdiction.

(3) For the purposes of this section, "air carrier" means an airline, air cargo carrier, air taxi, air commuter, or air charter operator, that provides routine air service to the general public for compensation or hire, and operates at least fifteen round-trips per week between two or more points and publishes flight schedules which specify the times, days of the week, and points between which it operates. Where it is doubtful that an operation is for "compensation or hire," the test applied is whether the air service is merely incidental to the person's other business or is, in itself, a major enterprise for profit.

[2005 c 341 § 4; 1989 c 193 § 4; 1982 1st ex.s. c 25 § 4; 1967 ex.s. c 10 § 3.]

82.42.070

The provisions of RCW 82.42.020 requiring the payment of an aircraft fuel excise tax on aircraft fuel shall not apply to aircraft fuel imported into the state in interstate or foreign commerce and intended to be sold while in interstate or foreign commerce, nor to aircraft fuel exported from this state, nor to aircraft fuel sold to the United States government or any agency thereof: PROVIDED, That exemptions granted under this section shall be null and void unless full conformance is made with the requisite administrative procedure set forth for procuring such exemptions under rules and regulations of the director promulgated under the provisions of this chapter. Except as provided in RCW 82.42.030, nothing in this chapter shall be construed to exempt the state or any political subdivision thereof from the payment of the aircraft excise fuel

tax provided in RCW 82.42.020. When setting up rules and regulations as provided for in RCW 82.42.040, the director shall provide for such refund procedure as deemed necessary to carry out the provisions of this chapter, and full compliance with such provisions shall be essential before receipt of any refund thereunder.

[1982 1st ex.s. c 25 § 6; 1971 ex.s. c 156 § 4; 1967 ex.s. c 10 § 7.]

Boat Sales to Nonresidents/Foreign Residents (Sales Tax)

82.08.0266

The tax levied by RCW 82.08.020 shall not apply to sales to nonresidents of this state for use outside of this state of watercraft requiring coast guard registration or registration by the state of principal use according to the Federal Boating Act of 1958, even though delivery be made within this state, but only when (1) the watercraft will not be used within this state for more than forty-five days and (2) an appropriate exemption certificate supported by identification ascertaining residence as required by the department of revenue and signed by the purchaser or his agent establishing the fact that the purchaser is a nonresident and that the watercraft is for use outside of this state, a copy of which shall be retained by the dealer.

[1999 c 358 § 5; 1980 c 37 § 33. Formerly RCW 82.08.030(15).]

82.08.02665

The tax levied by RCW 82.08.020 does not apply to sales of vessels to residents of foreign countries for use outside of this state, even though delivery is made within this state, but only if (1) the vessel will not be used within this state for more than forty-five days and (2) an appropriate exemption certificate supported by identification as required by the department of revenue and signed by the purchaser or the purchaser's agent establishes the fact that the purchaser is a resident of a foreign country and that the vessel is for use outside of this state. A copy of the exemption certificate is to be retained by the dealer.

As used in this section, "vessel" means every watercraft used or capable of being used as a means of transportation on the water, other than a seaplane.

[1999 c 358 § 6; 1993 c 119 § 1.]

Church Camps (Property Tax)

84.36.030(2)

(2) Property owned by any nonprofit church, denomination, group of churches, or an organization or association, the membership of which is comprised solely of churches or their qualified representatives, which is utilized as a camp facility if used for organized and supervised recreational activities and church purposes as related to such camp facilities. The exemption provided by this paragraph shall apply to a maximum of two hundred acres of any such camp as selected by the church, including buildings and other improvements thereon.

Display Items for Trade Shows (Use Tax)

82.12.0272

The provisions of this chapter do not apply in respect to the use of personal property held for sale and displayed in single trade shows for a period not in excess of thirty days, the primary purpose of which is to promote the sale of products or services.

[2009 c 535 § 616; 1980 c 37 § 70. Formerly RCW 82.12.030(20).]

Extracted Fuel (Use Tax)

82.12.0263

The provisions of this chapter shall not apply in respect to the use of fuel by the extractor or manufacturer thereof when used directly in the operation of the particular extractive operation or manufacturing plant which produced or manufactured the same.

[1980 c 37 § 62. Formerly RCW 82.12.030(12).]

Hog Fuel to Produce Energy (Sales & Use Tax)

82.08.956

(1) The tax levied by RCW 82.08.020 does not apply to sales of hog fuel used to produce electricity, steam, heat, or biofuel. This exemption is available only if the buyer provides the seller with an exemption certificate in a form and manner prescribed by the department. The seller must retain a copy of the certificate for the seller's files.

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

(a) "Hog fuel" means wood waste and other wood residuals including forest derived biomass. "Hog fuel" does not include firewood or wood pellets; and

(b) "Biofuel" has the same meaning as provided in RCW 43.325.010.

(3) This section expires June 30, 2013.

[2009 c 469 § 301.]

82.12.956

(1) The provisions of this chapter do not apply with respect to the use of hog fuel for production of electricity, steam, heat, or biofuel.

(2) For the purposes of this section:

(a) "Hog fuel" has the same meaning as provided in RCW 82.08.956; and

(b) "Biofuel" has the same meaning as provided in RCW 43.325.010.

(3) This section expires June 30, 2013.

[2009 c 469 § 302.]

Interest from State and Municipal Obligations (Business & Occupation Tax)

82.04.4293

In computing tax there may be deducted from the measure of tax by those engaged in banking, loan, security or other financial businesses, amounts derived from interest paid on all obligations of the state of Washington, its political subdivisions, and municipal corporations organized pursuant to the laws thereof.

[1980 c 37 § 13. Formerly RCW 82.04.430(12).]

Interest on Real Estate Loans (Business & Occupation Tax)

82.04.4292

(1) In computing tax there may be deducted from the measure of tax by those engaged in banking, loan, security or other financial businesses, interest received on investments or loans primarily secured by first mortgages or trust deeds on nontransient residential properties.

(2) Interest deductible under this section includes the portion of fees charged to borrowers, including points and loan origination fees, that is recognized over the life of the loan as an adjustment to yield in the taxpayer's books and records according to generally accepted accounting principles.

(3) Subsections (1) and (2) of this section notwithstanding, the following is a nonexclusive list of items that are not deductible under this section:

(a) Fees for specific services such as: Document preparation fees; finder fees; brokerage fees; title examination fees; fees for credit checks; notary fees; loan application fees; interest lock-in fees if the loan is not made; servicing fees; and similar fees or amounts;

(b) Fees received in consideration for an agreement to make funds available for a specific period of time at specified terms, commonly referred to as commitment fees;

(c) Any other fees, or portion of a fee, that is not recognized over the life of the loan as an adjustment to yield in the taxpayer's books and records according to generally accepted accounting principles;

(d) Gains on the sale of valuable rights such as service release premiums, which are amounts received when servicing rights are sold; and

(e) Gains on the sale of loans, except deferred loan origination fees and points deductible under subsection (2) of this section, are not to be considered part of the proceeds of sale of the loan.

(4) Notwithstanding subsection (3) of this section, in computing tax there may be deducted from the measure of tax by those engaged in banking, loan, security, or other financial businesses, amounts received for servicing loans primarily secured by first mortgages or trust

deeds on nontransient residential properties, including such loans that secure mortgage-backed or mortgage-related securities, but only if:

(a)(i) The loans were originated by the person claiming a deduction under this subsection (4) and that person either sold the loans on the secondary market or securitized the loans and sold the securities on the secondary market; or

(ii)(A) The person claiming a deduction under this subsection (4) acquired the loans from the person that originated the loans through a merger or acquisition of substantially all of the assets of the person who originated the loans, or the person claiming a deduction under this subsection (4) is affiliated with the person that originated the loans. For purposes of this subsection, "affiliated" means under common control. "Control" means the possession, directly or indirectly, of more than fifty percent of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting shares, by contract, or otherwise; and

(B) Either the person who originated the loans or the person claiming a deduction under this subsection (4) sold the loans on the secondary market or securitized the loans and sold the securities on the secondary market; and

(b) The amounts received for servicing the loans are determined by a percentage of the interest paid by the borrower and are only received if the borrower makes interest payments.

[2010 1st sp.s. c 23 § 301; 1980 c 37 § 12. Formerly RCW 82.04.430(11).]

Interstate Bridges (Property and Other Taxes)

84.36.230

Any bridge, including its approaches, over rivers or bodies of water forming interstate boundaries, which bridge has been constructed or acquired and is being operated by any foreign state bordering upon such common interstate boundary, or which has been constructed or acquired and is being operated by any county, city or other municipality of such foreign state, shall be exempt from all property and other taxes in the state of Washington, if the foreign state exempts from all taxation any bridge or bridges constructed or acquired and being operated by the state of Washington or any county, city or other municipality thereof.

[1961 c 15 § 84.36.230. Prior: 1949 c 224 § 1; Rem. Supp. 1949 § 11111-12.]

Investment of Businesses in Related Entities (Business & Occupation Tax)

82.04.4281(1)(b),(c)

(1) In computing tax there may be deducted from the measure of tax:

(b) Amounts derived as dividends or distributions from the capital account by a parent from its subsidiary entities; and

(c) Amounts derived from interest on loans between subsidiary entities and a parent entity or between subsidiaries of a common parent entity, but only if the total investment and loan income

[2007 c 54 § 9; 2002 c 150 § 2; 1980 c 37 § 2. Formerly RCW 82.04.430(1).]

Laundry Services for Nonprofit Health Care Facilities (Sales Tax)

82.04.050(2)(a)

(2) The term "sale at retail" or "retail sale" includes the sale of or charge made for tangible personal property consumed and/or for labor and services rendered in respect to the following:

(a) The installing, repairing, cleaning, altering, imprinting, or improving of tangible personal property of or for consumers, including charges made for the mere use of facilities in respect thereto, but excluding charges made for the use of self-service laundry facilities, and also excluding sales of laundry service to nonprofit health care facilities, and excluding services rendered in respect to live animals, birds and insects;

Limited Income Property Tax Deferral (Property Tax)

84.37.030

A claimant may defer payment of fifty percent of special assessments or real property taxes, or both, listed on the annual tax statement in any year in which all of the following conditions are met:

(1) The special assessments or property taxes must be imposed upon a residence that was occupied by the claimant as a principal place of residence as of January 1st of the year in which the assessments and taxes are due, subject to the exceptions allowed under RCW 84.36.381(1);

(2) The claimant must have combined disposable income, as defined in RCW 84.36.383, of fifty-seven thousand dollars or less in the calendar year preceding the filing of the declaration;

(3) The claimant must have paid one-half of the total amount of special assessments and property taxes listed on the annual tax statement for the year in which the deferral claim is made;

(4) A deferral is not allowed for special assessments, property taxes, or both, levied for collection in the first five calendar years in which the person owns the residence;

(5) The claimant who defers payment of special assessments or real property taxes, or both, listed on the annual tax statement under this section must also meet the conditions of RCW 84.38.030 (4) and (5);

(6) The total amount deferred by a claimant under this chapter must not exceed forty percent of the amount of the claimant's equity value in the claimant's residence; and

(7) The claimant may not defer taxes under both this chapter and chapter 84.38 RCW in the same tax year.

[2010 c 106 § 309; 2007 sp.s. c 2 § 2.]

Meat Processors (Business & Occupation Tax)

82.04.260(4)

(4) Upon every person engaging within this state in the business of slaughtering, breaking and/or processing perishable meat products and/or selling the same at wholesale only and not at retail; as to such persons the tax imposed is equal to the gross proceeds derived from such sales multiplied by the rate of 0.138 percent.

Municipal Sewer Charges (Business & Occupation Tax)

82.04.432

In computing the tax imposed by this chapter, municipal sewerage utilities and other public corporations imposing and collecting fees or charges for sewer service may deduct from the measure of the tax, amounts paid to another municipal corporation or governmental agency for sewerage interception, treatment or disposal.

[1967 ex.s. c 149 § 17.]

Nonprofit Blood and Tissue Banks (Property Tax)

84.36.035

(1) The following property shall be exempt from taxation:

All property, whether real or personal, belonging to or leased by any nonprofit corporation or association and used exclusively in the business of a qualifying blood bank, a qualifying tissue bank, or a qualifying blood and tissue bank, or in the administration of these businesses. If the real or personal property is leased, the benefit of the exemption shall inure to the nonprofit corporation or association.

(2) The definitions in RCW 82.04.324 apply to this section.

[2004 c 82 § 4; 1995 2nd sp.s. c 9 § 1; 1971 ex.s. c 206 § 1.]

82.04.324

(1) This chapter does not apply to amounts received by a qualifying blood bank, a qualifying tissue bank, or a qualifying blood and tissue bank to the extent the amounts are exempt from federal income tax.

(2) For the purposes of this section:

(a) "Qualifying blood bank" means a blood bank that qualifies as an exempt organization under 26 U.S.C. 501(c)(3) as existing on June 10, 2004, is registered pursuant to 21 C.F.R., part 607 as existing on June 10, 2004, and whose primary business purpose is the collection, preparation, and processing of blood. "Qualifying blood bank" does not include a comprehensive cancer center that is recognized as such by the national cancer institute.

(b) "Qualifying tissue bank" means a tissue bank that qualifies as an exempt organization under 26 U.S.C. 501(c)(3) as existing on June 10, 2004, is registered pursuant to 21 C.F.R., part

1271 as existing on June 10, 2004, and whose primary business purpose is the recovery, processing, storage, labeling, packaging, or distribution of human bone tissue, ligament tissue and similar musculoskeletal tissues, skin tissue, heart valve tissue, or human eye tissue. "Qualifying tissue bank" does not include a comprehensive cancer center that is recognized as such by the national cancer institute.

(c) "Qualifying blood and tissue bank" is a bank that qualifies as an exempt organization under 26 U.S.C. 501(c)(3) as existing on June 10, 2004, is registered pursuant to 21 C.F.R., part 607 and part 1271 as existing on June 10, 2004, and whose primary business purpose is the collection, preparation, and processing of blood, and the recovery, processing, storage, labeling, packaging, or distribution of human bone tissue, ligament tissue and similar musculoskeletal tissues, skin tissue, and heart valve tissue. "Qualifying blood and tissue bank" does not include a comprehensive cancer center that is recognized as such by the national cancer institute.

[2004 c 82 § 1; 1995 2nd sp.s. c 9 § 3.]

Nonprofit Day Care Centers (Property Tax)

84.36.040(1)(a)

(1) The real and personal property used by, and for the purposes of, the following nonprofit organizations is exempt from property taxation:

(a) Child day care centers as defined in subsection (4) of this section;

(4) For purposes of subsection (1) of this section, "child day care center" means a nonprofit organization that regularly provides child day care and early learning services for a group of children for periods of less than twenty-four hours.

Nonprofit Sheltered Workshops (Property Tax)

84.36.350

(1) The following property shall be exempt from taxation:

(a) Real or personal property owned and used by a nonprofit corporation in connection with the operation of a sheltered workshop for handicapped persons, and used primarily in connection with the manufacturing and the handling, sale or distribution of goods constructed, processed, or repaired in such workshops or centers; and

(b) Inventory owned by a sheltered workshop for sale or lease by the sheltered workshop or to be furnished under a contract of service, including raw materials, work in process, and finished products.

(2) Unless a different meaning is plainly required by the context, "sheltered workshop" means a rehabilitation facility, or that part of a rehabilitation facility operated by a nonprofit corporation, where any manufacture or handiwork is carried on and operated for the primary purpose of: (a) Providing gainful employment or rehabilitation services to the handicapped as an interim step in the rehabilitation process for those who cannot be readily absorbed in the competitive labor market or during such time as employment opportunities for them in the

competitive labor market do not exist; or (b) providing evaluation and work adjustment services for handicapped individuals.

[1999 c 358 § 17; 1975 1st ex.s. c 3 § 1; 1970 ex.s. c 81 § 1.]

Open Space Additional Tax (Property Tax)

84.34.108(6)

(6) The additional tax, applicable interest, and penalty specified in subsection (4) of this section shall not be imposed if the removal of classification pursuant to subsection (1) of this section resulted solely from:

(a) Transfer to a government entity in exchange for other land located within the state of Washington;

(b)(i) A taking through the exercise of the power of eminent domain, or (ii) sale or transfer to an entity having the power of eminent domain in anticipation of the exercise of such power, said entity having manifested its intent in writing or by other official action;

(c) A natural disaster such as a flood, windstorm, earthquake, or other such calamity rather than by virtue of the act of the landowner changing the use of the property;

(d) Official action by an agency of the state of Washington or by the county or city within which the land is located which disallows the present use of the land;

(e) Transfer of land to a church when the land would qualify for exemption pursuant to RCW 84.36.020;

(f) Acquisition of property interests by state agencies or agencies or organizations qualified under RCW 84.34.210 and 64.04.130 for the purposes enumerated in those sections. At such time as these property interests are not used for the purposes enumerated in RCW 84.34.210 and 64.04.130 the additional tax specified in subsection (4) of this section shall be imposed;

(g) Removal of land classified as farm and agricultural land under RCW 84.34.020(2)(f);

(h) Removal of land from classification after enactment of a statutory exemption that qualifies the land for exemption and receipt of notice from the owner to remove the land from classification;

(i) The creation, sale, or transfer of forestry riparian easements under RCW 76.13.120;

(j) The creation, sale, or transfer of a conservation easement of private forest lands within unconfined channel migration zones or containing critical habitat for threatened or endangered species under RCW 76.09.040;

(k) The sale or transfer of land within two years after the death of the owner of at least a fifty percent interest in the land if the land has been assessed and valued as classified forest land, designated as forest land under chapter 84.33 RCW, or classified under this chapter continuously since 1993. The date of death shown on a death certificate is the date used for the purposes of this subsection (6)(k); or

(l)(i) The discovery that the land was classified under this chapter in error through no fault of the owner. For purposes of this subsection (6)(l), "fault" means a knowingly false or misleading statement, or other act or omission not in good faith, that contributed to the approval of classification under this chapter or the failure of the assessor to remove the land from classification under this chapter.

(ii) For purposes of this subsection (6), the discovery that land was classified under this chapter in error through no fault of the owner is not the sole reason for removal of classification pursuant to subsection (1) of this section if an independent basis for removal exists. Examples of an independent basis for removal include the owner changing the use of the land or failing to meet any applicable income criteria required for classification under this chapter.

Real Estate Excise Tax Exemptions (Real Estate Excise Tax)

82.45.010(3)(a)-(m)

(3) The term "sale" does not include:

(a) A transfer by gift, devise, or inheritance.

(b) A transfer of any leasehold interest other than of the type mentioned above.

(c) A cancellation or forfeiture of a vendee's interest in a contract for the sale of real property, whether or not such contract contains a forfeiture clause, or deed in lieu of foreclosure of a mortgage.

(d) The partition of property by tenants in common by agreement or as the result of a court decree.

(e) The assignment of property or interest in property from one spouse or one domestic partner to the other spouse or other domestic partner in accordance with the terms of a decree of dissolution of marriage or state registered domestic partnership or in fulfillment of a property settlement agreement.

(f) The assignment or other transfer of a vendor's interest in a contract for the sale of real property, even though accompanied by a conveyance of the vendor's interest in the real property involved.

(g) Transfers by appropriation or decree in condemnation proceedings brought by the United States, the state or any political subdivision thereof, or a municipal corporation.

(h) A mortgage or other transfer of an interest in real property merely to secure a debt, or the assignment thereof.

(i) Any transfer or conveyance made pursuant to a deed of trust or an order of sale by the court in any mortgage, deed of trust, or lien foreclosure proceeding or upon execution of a judgment, or deed in lieu of foreclosure to satisfy a mortgage or deed of trust.

(j) A conveyance to the federal housing administration or veterans administration by an authorized mortgagee made pursuant to a contract of insurance or guaranty with the federal housing administration or veterans administration.

(k) A transfer in compliance with the terms of any lease or contract upon which the tax as imposed by this chapter has been paid or where the lease or contract was entered into prior to the date this tax was first imposed.

(l) The sale of any grave or lot in an established cemetery.

(m) A sale by the United States, this state or any political subdivision thereof, or a municipal corporation of this state.

Renewable Energy Machinery (Sales & Use Tax)

82.08.962

(1)(a) Except as provided in RCW 82.08.963, purchasers who have paid the tax imposed by RCW 82.08.020 on machinery and equipment used directly in generating electricity using fuel cells, wind, sun, biomass energy, tidal or wave energy, geothermal resources, anaerobic digestion, technology that converts otherwise lost energy from exhaust, or landfill gas as the principal source of power, or to sales of or charges made for labor and services rendered in respect to installing such machinery and equipment, are eligible for an exemption as provided in this section, but only if the purchaser develops with such machinery, equipment, and labor a facility capable of generating not less than one thousand watts of electricity.

(b) Beginning on July 1, 2009, through June 30, 2011, the tax levied by RCW 82.08.020 does not apply to the sale of machinery and equipment described in (a) of this subsection that are used directly in generating electricity or to sales of or charges made for labor and services rendered in respect to installing such machinery and equipment.

(c) Beginning on July 1, 2011, through June 30, 2013, the amount of the exemption under this subsection (1) is equal to seventy-five percent of the state and local sales tax paid. The purchaser is eligible for an exemption under this subsection (1)(c) in the form of a remittance.

(2) For purposes of this section and RCW 82.12.962, the following definitions apply:

(a) "Biomass energy" includes: (i) By-products of pulping and wood manufacturing process; (ii) animal waste; (iii) solid organic fuels from wood; (iv) forest or field residues; (v) wooden demolition or construction debris; (vi) food waste; (vii) liquors derived from algae and other sources; (viii) dedicated energy crops; (ix) biosolids; and (x) yard waste. "Biomass energy" does not include wood pieces that have been treated with chemical preservatives such as creosote, pentachlorophenol, or copper-chrome-arsenic; wood from old growth forests; or municipal solid waste.

(b) "Fuel cell" means an electrochemical reaction that generates electricity by combining atoms of hydrogen and oxygen in the presence of a catalyst.

(c) "Landfill gas" means biomass fuel, of the type qualified for federal tax credits under Title 26 U.S.C. Sec. 29 of the federal internal revenue code, collected from a "landfill" as defined under RCW 70.95.030.

(d)(i) "Machinery and equipment" means fixtures, devices, and support facilities that are integral and necessary to the generation of electricity using fuel cells, wind, sun, biomass energy, tidal or wave energy, geothermal resources, anaerobic digestion, technology that converts otherwise lost energy from exhaust, or landfill gas as the principal source of power.

(ii) "Machinery and equipment" does not include: (A) Hand-powered tools; (B) property with a useful life of less than one year; (C) repair parts required to restore machinery and equipment to normal working order; (D) replacement parts that do not increase productivity, improve efficiency, or extend the useful life of machinery and equipment; (E) buildings; or (F) building fixtures that are not integral and necessary to the generation of electricity that are permanently affixed to and become a physical part of a building.

(3)(a) Machinery and equipment is "used directly" in generating electricity by wind energy, solar energy, biomass energy, tidal or wave energy, geothermal resources, anaerobic digestion, technology that converts otherwise lost energy from exhaust, or landfill gas power if it provides any part of the process that captures the energy of the wind, sun, biomass energy, tidal or wave energy, geothermal resources, anaerobic digestion, technology that converts otherwise lost energy from exhaust, or landfill gas, converts that energy to electricity, and stores, transforms, or transmits that electricity for entry into or operation in parallel with electric transmission and distribution systems.

(b) Machinery and equipment is "used directly" in generating electricity by fuel cells if it provides any part of the process that captures the energy of the fuel, converts that energy to electricity, and stores, transforms, or transmits that electricity for entry into or operation in parallel with electric transmission and distribution systems.

(4)(a) A purchaser claiming an exemption in the form of a remittance under subsection (1)(c) of this section must pay the tax imposed by RCW 82.08.020 and all applicable local sales taxes imposed under the authority of chapters 82.14 and 81.104 RCW. The purchaser may then apply to the department for remittance in a form and manner prescribed by the department. A purchaser may not apply for a remittance under this section more frequently than once per quarter. The purchaser must specify the amount of exempted tax claimed and the qualifying purchases for which the exemption is claimed. The purchaser must retain, in adequate detail, records to enable the department to determine whether the purchaser is entitled to an exemption under this section, including: Invoices; proof of tax paid; and documents describing the machinery and equipment.

(b) The department must determine eligibility under this section based on the information provided by the purchaser, which is subject to audit verification by the department. The department must on a quarterly basis remit exempted amounts to qualifying purchasers who submitted applications during the previous quarter.

(5) This section expires July 1, 2013.

[2009 c 469 § 101.]

82.12.962

(1)(a) Except as provided in RCW 82.12.963, consumers who have paid the tax imposed by RCW 82.12.020 on machinery and equipment used directly in generating electricity using fuel cells, wind, sun, biomass energy, tidal or wave energy, geothermal resources, anaerobic digestion, technology that converts otherwise lost energy from exhaust, or landfill gas as the principal source of power, or to sales of or charges made for labor and services rendered in respect to installing such machinery and equipment, are eligible for an exemption as provided in this section, but only if the purchaser develops with such machinery, equipment, and labor a facility capable of generating not less than one thousand watts of electricity.

(b) Beginning on July 1, 2009, through June 30, 2011, the provisions of this chapter do not apply in respect to the use of machinery and equipment described in (a) of this subsection that are used directly in generating electricity or to sales of or charges made for labor and services rendered in respect to installing such machinery and equipment.

(c) Beginning on July 1, 2011, through June 30, 2013, the amount of the exemption under this subsection (1) is equal to seventy-five percent of the state and local sales tax paid. The consumer is eligible for an exemption under this subsection (1)(c) in the form of a remittance.

(2)(a) A person claiming an exemption in the form of a remittance under subsection (1)(c) of this section must pay the tax imposed by RCW 82.12.020 and all applicable local use taxes imposed under the authority of chapters 82.14 and 81.104 RCW. The consumer may then apply to the department for remittance in a form and manner prescribed by the department. A consumer may not apply for a remittance under this section more frequently than once per quarter. The consumer must specify the amount of exempted tax claimed and the qualifying purchases or acquisitions for which the exemption is claimed. The consumer must retain, in adequate detail, records to enable the department to determine whether the consumer is entitled to an exemption under this section, including: Invoices; proof of tax paid; and documents describing the machinery and equipment.

(b) The department must determine eligibility under this section based on the information provided by the consumer, which is subject to audit verification by the department. The department must on a quarterly basis remit exempted amounts to qualifying consumers who submitted applications during the previous quarter.

(3) Purchases exempt under RCW 82.08.962 are also exempt from the tax imposed under RCW 82.12.020.

(4) The definitions in RCW 82.08.962 apply to this section.

(5) This section expires June 30, 2013.

[2009 c 469 § 102.]

Repaired Goods Delivered Out-of-State (Sales Tax)

82.08.0265

The tax levied by RCW 82.08.020 shall not apply to sales to nonresidents of this state for use outside of this state of tangible personal property which becomes a component part of any machinery or other article of personal property belonging to such nonresident, in the course of installing, repairing, cleaning, altering, or improving the same and also sales of or charges made for labor and services rendered in respect to any installing, repairing, cleaning, altering, or improving, of personal property of or for a nonresident, but this section shall apply only when the seller agrees to, and does, deliver the property to the purchaser at a point outside this state, or delivers the property to a common or bona fide private carrier consigned to the purchaser at a point outside this state.

[1980 c 37 § 32. Formerly RCW 82.08.030(14).]

Sales of Goods to Certain Nonresidents for Use Outside the State (Sales Tax)

82.08.0273

*** CHANGE IN 2011 *** (SEE **5763.SL**) ***

(1) The tax levied by RCW 82.08.020 does not apply to sales to nonresidents of this state of tangible personal property, digital goods, and digital codes, when such property is for use outside this state, and the purchaser (a) is a bona fide resident of a state or possession or Province of Canada other than the state of Washington and such state, possession, or Province of Canada does not impose a retail sales tax or use tax of three percent or more or, if imposing such a tax, permits Washington residents exemption from otherwise taxable sales by reason of their residence, and (b) agrees, when requested, to grant the department of revenue access to such records and other forms of verification at his or her place of residence to assure that such purchases are not first used substantially in the state of Washington.

(2) Notwithstanding anything to the contrary in this chapter, if parts or other tangible personal property are installed by the seller during the course of repairing, cleaning, altering, or improving motor vehicles, trailers, or campers and the seller makes a separate charge for the tangible personal property, the tax levied by RCW 82.08.020 does not apply to the separately stated charge to a nonresident purchaser for the tangible personal property but only if the separately stated charge does not exceed either the seller's current publicly stated retail price for the tangible personal property or, if no publicly stated retail price is available, the seller's cost for the tangible personal property. However, the exemption provided by this section does not apply if tangible personal property is installed by the seller during the course of repairing, cleaning, altering, or improving motor vehicles, trailers, or campers and the seller makes a single nonitemized charge for providing the tangible personal property and service. All of the requirements in subsections (1) and (3) through (6) of this section apply to this subsection.

(3)(a) Any person claiming exemption from retail sales tax under the provisions of this section must display proof of his or her current nonresident status as provided in this section.

(b) Acceptable proof of a nonresident person's status includes one piece of identification such as a valid driver's license from the jurisdiction in which the out-of-state residency is claimed or a valid identification card which has a photograph of the holder and is issued by the out-of-state jurisdiction. Identification under this subsection (3)(b) must show the holder's residential address and have as one of its legal purposes the establishment of residency in that out-of-state jurisdiction.

(c) In lieu of furnishing proof of a person's nonresident status under (b) of this subsection (3), a person claiming exemption from retail sales tax under the provisions of this section may provide the seller with an exemption certificate in compliance with subsection (4)(b) of this section.

(4)(a) Nothing in this section requires the vendor to make tax exempt retail sales to nonresidents. A vendor may choose to make sales to nonresidents, collect the sales tax, and remit the amount of sales tax collected to the state as otherwise provided by law. If the vendor chooses to make a sale to a nonresident without collecting the sales tax, the vendor must examine the purchaser's proof of nonresidence, determine whether the proof is acceptable under subsection (3)(b) of this section, and maintain records for each nontaxable sale which shall show the type of proof accepted, including any identification numbers where appropriate, and the expiration date, if any.

(b) In lieu of using the method provided in (a) of this subsection to document an exempt sale to a nonresident, a seller may accept from the purchaser a properly completed uniform exemption certificate approved by the streamlined sales and use tax agreement governing board or any other exemption certificate as may be authorized by the department and properly completed by the purchaser. A nonresident purchaser who uses an exemption certificate authorized in this subsection (4)(b) must include the purchaser's driver's license number or other state-issued identification number and the state of issuance.

(c) In lieu of using the methods provided in (a) and (b) of this subsection to document an exempt sale to a nonresident, a seller may capture the relevant data elements as allowed under the streamlined sales and use tax agreement.

(5)(a) Any person making fraudulent statements, which includes the offer of fraudulent identification or fraudulently procured identification to a vendor, in order to purchase goods without paying retail sales tax is guilty of perjury under chapter 9A.72 RCW.

(b) Any person making tax exempt purchases under this section by displaying proof of identification not his or her own, or counterfeit identification, with intent to violate the provisions of this section, is guilty of a misdemeanor and, in addition, is liable for the tax and subject to a penalty equal to the greater of one hundred dollars or the tax due on such purchases.

(6)(a) Any vendor who makes sales without collecting the tax and who fails to maintain records of sales to nonresidents as provided in this section is personally liable for the amount of tax due.

(b) Any vendor who makes sales without collecting the retail sales tax under this section and who has actual knowledge that the purchaser's proof of identification establishing out-of-state residency is fraudulent is guilty of a misdemeanor and, in addition, is liable for the tax and subject to a penalty equal to the greater of one thousand dollars or the tax due on such sales. In addition, both the purchaser and the vendor are liable for any penalties and interest assessable under chapter 82.32 RCW.

[2010 c 106 § 215; 2009 c 535 § 512; 2007 c 135 § 2; 2003 c 53 § 399; 1993 c 444 § 1; 1988 c 96 § 1; 1982 1st ex.s. c 5 § 1; 1980 c 37 § 39. Formerly RCW 82.08.030(21).]

Sales or Use Tax Paid in Another State (Use Tax)

82.12.035

A credit is allowed against the taxes imposed by this chapter upon the use in this state of tangible personal property, extended warranty, digital good, digital code, digital automated service, or services defined as a retail sale in RCW 82.04.050 (2) (a) or (g), (3)(a), or (6)(b), in the amount that the present user thereof or his or her bailor or donor has paid a legally imposed retail sales or use tax with respect to such property, extended warranty, digital good, digital code, digital automated service, or service defined as a retail sale in RCW 82.04.050 (2) (a) or (g), (3)(a), or (6)(b) to any other state, possession, territory, or commonwealth of the United States, any political subdivision thereof, the District of Columbia, and any foreign country or political subdivision thereof.

[2009 c 535 § 1107; 2007 c 6 § 1203; 2005 c 514 § 108; 2002 c 367 § 5; 1996 c 148 § 6; 1987 c 27 § 2; 1967 ex.s. c 89 § 5.]

Shared Real Estate Commissions (Business & Occupation Tax)

82.04.255

*** CHANGE IN 2011 *** (SEE **5083.SL**) ***

Upon every person engaging within the state as a real estate broker; as to such persons, the amount of the tax with respect to such business shall be equal to the gross income of the business, multiplied by the rate of 1.5 percent.

The measure of the tax on real estate commissions earned by the real estate broker shall be the gross commission earned by the particular real estate brokerage office including that portion of the commission paid to salesmen or associate brokers in the same office on a particular transaction: PROVIDED, HOWEVER, That where a real estate commission is divided between an originating brokerage office and a cooperating brokerage office on a particular transaction, each brokerage office shall pay the tax only upon their respective shares of said commission: AND PROVIDED FURTHER, That where the brokerage office has paid the tax as provided herein, salesmen or associate brokers within the same brokerage office shall not be required to pay a similar tax upon the same transaction.

[1997 c 7 § 1; 1996 c 1 § 1; 1993 sp.s. c 25 § 202; 1985 c 32 § 2; 1983 2nd ex.s. c 3 § 1; 1983 c 9 § 1; 1970 ex.s. c 65 § 3.]

State-Chartered Credit Unions (Business & Occupation Tax)

82.04.405

This chapter shall not apply to the gross income of credit unions organized under the laws of this state, any other state, or the United States.

[1998 c 311 § 4; 1970 ex.s. c 101 § 3.]

2011 Tax Preference Performance Reviews Preliminary Reports

Citizen Commission for Performance Measurement of Tax Preferences

August 15, 2011

Mary Welsh, Dana Lynn, and John Woolley
JLARC Staff

Reminder of the Steps in the Process

- October of last year: Commission determined schedule for 2011
- JLARC staff prepared analysis
- **Jul**: Presented to JLARC
- **Aug**: Present to Commission
- **Sep**: Commission takes public testimony
- **Oct**: Commission adds any comments
- **Jan**: JLARC hears final report; joint hearing in Legislature

25 Detailed Tax Preference Reviews in 2011

	Number of Reviews	Beneficiary Savings Est.
Terminate	1	$0 M
Allow to expire	2	$44 M
Legislature review/ clarify intent	8	$616 M
Continue	14	$1,625 M
Total	**25**	**$2,285 M**

Information on 43 other preferences provided by DOR, included in separate volume

Summary of 25 Preferences in Report

Summary of 2011 Tax Preference Performance Reviews

What the Preference Does	Public Policy Objective	Estimated Beneficiary Savings	JLARC Recommendation
Repaired Goods Delivered Out-of-State (Sales Tax) / 82.08.0265			Detail on page 211
Provides a sales tax exemption to nonresidents for: materials that become a component part of items repaired, installed, cleaned, altered, or improved; and labor charges for items repaired, installed, cleaned, or altered	The Legislature did not specifically state the public policy objective of the preference. The implied public policy objective was to remove the disincentive created by the sales tax in order to make Washington merchants who repair, clean, install, etc., items for nonresidents more competitive with business in neighboring states.	$0 in 2011-13 Biennium	**Terminate:** Because Washington's adoption of destination-sourcing for sales tax has made this preference unnecessary.

14 Preferences with "Continue" Included in Report

Continue	1. Boat sales to nonresidents & foreign residents 2. Church camps 3. Display items for trade shows 4. Interest from state/municipal obligations 5. Interstate bridges 6. Investment of businesses in related entities 7. Laundry for nonprofit health care facilities 8. Nonprofit blood and tissue banks 9. Nonprofit day care centers 10. Open space compensating tax 11. Real estate excise tax exemptions 12. Sales to nonresidents for use out-of-state 13. Sales or use tax paid in another state 14. State-chartered credit unions

Eleven Preference Reviews Presented Today

Terminate	1. Repaired goods delivered out-of-state
Allow to expire	1. Hog fuel to produce energy 2. Renewable energy machinery
Review and clarify	1. Interest on real estate loans 2. Meat processors 3. Shared real estate commissions 4. Municipal sewer services 5. Extracted fuel 6. Aircraft fuel, exports & commercial use 7. Limited income property tax deferral 8. Nonprofit sheltered workshops

Repaired Goods Delivered Out-of-State (Sales Tax)

Pinball machine repair, Seattle

Television repair, Tacoma

Current Law – RCW 82.08.0265

Repaired Goods Delivered Out-of-State

- Provides nonresidents a sales tax exemption for:
  - Materials that become component part of items repaired, installed, cleaned, altered, or improved
  - Labor charges for items repaired, installed, cleaned, altered, or improved
- Goods must be repaired in WA and delivered to nonresident out-of-state

Current Law

Repaired Goods Delivered Out-of-State

Commercial equipment is transported from outside Washington to be repaired

When repairs are complete, equipment is returned by repair business or 3rd party to nonresident owner

Source: JLARC interpretation of RCW 82.08.0265.

Beneficiaries and Beneficiary Savings

Repaired Goods Delivered Out-of-State

Beneficiaries

- Nonresident individuals and businesses

Beneficiary savings

- $0 in 2011-13 Biennium

Background and Legal History

Repaired Goods Delivered Out-of-State

1935 Legislature enacted sales tax – applied to sales of tangible personal property

1939 Legislature extended sales tax to services performed to goods when services were performed in Washington

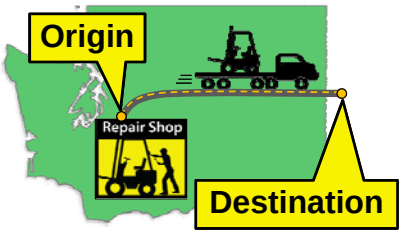
1959 Legislature enacted specific sales tax exemption for nonresidents for goods that become component part of goods repaired, installed, cleaned, or altered

Background and Legal History (cont.)

Repaired Goods Delivered Out-of-State

2008 When WA adopted Streamlined Sales & Use Tax, it changed how retail sales are sourced – from **origin** to **destination**. Retail sales/services now sourced to where purchaser receives goods

Now repaired goods delivered by retailer to nonresident outside the state are exempt from WA sales tax



Out-of-state delivery – no tax

Public Policy Objectives Not Stated

Repaired Goods Delivered Out-of-State

Implied objective was to remove disincentive created by the sales tax to help Washington retailers compete with businesses in bordering states

Were the Public Policy Objectives Achieved?

Repaired Goods Delivered Out-of-State

- Streamlined Sales and Use Tax legislation changed sales tax sourcing from the origin to the destination of the sale. Items delivered by repairer to owner out-of-state now sourced outside of WA
- This preference is no longer needed. Repaired items delivered outside of WA are tax-exempt interstate sales

Recommendation

Repaired Goods Delivered Out-of-State

Terminate

Washington's adoption of destination sourcing of sales tax made this preference unnecessary.

Hog Fuel to Produce Energy (Sales & Use Tax)

Current Law – RCWs 82.08.956 and 82.12.956

Hog Fuel Used to Produce Energy

- Provide sales and use tax exemptions for hog fuel used to produce electricity, steam, heat, or biofuel
- Exemptions expire June 30, 2013
- "Hog fuel" = wood waste, including forest-derived biomass but not including firewood or wood pellets

Beneficiaries and Beneficiary Savings

Hog Fuel Used to Produce Energy

Beneficiaries

- Washington facilities that use hog fuel to generate energy
- Data notes 18 facilities currently do so

Beneficiary savings

- $3.2 million in 2011-13 Biennium (JLARC estimate)

Background and Legal History

Hog Fuel Used to Produce Energy

2009 Legislature passed bill with several environmental tax incentives, including this sales/use tax exemption for hog fuel sold or used to generate electricity, steam, heat, or biofuel

Some of preferences in the bill had expiration dates, some did not. Legislature gave this preference a June 2013 expiration date

Legislature Specifies Expiration Dates

Hog Fuel Used to Produce Energy

	Jun 30 2013	Jun 30 2014	Jun 30 2015	Dec 1 2018	Jun 30 2020
Hog Fuel used to produce energy *(Sales/use tax exemption)*	●				
Renewable energy M&E *(Sales/use tax exemption)*	●				
Log hauling *(Reduced public utility tax rate)*	●				
Solar energy component manufacturing or wholesaling *(Reduced B&O tax rate)*		●			
Biomass energy harvesters *(B&O tax credit)*			●		
Forest derived biomass *(Sales tax exemption)*			●		
Gases/chemicals used to produce solar energy equipment *(Sales tax exemption)*				●	
Cost recovery program for renewable energy systems					●
Livestock nutrient equipment/facilities *(Sales/use tax exemption)*	*No expiration date*				
Radioactive waste cleanup *(Reduced B&O tax rate)*	*No expiration date*				

Public Policy Objectives Not Stated

Hog Fuel Used to Produce Energy

- Due to declining oil and natural gas prices at the time, Legislature may have intended to temporarily make hog fuel prices more competitive
- Preferences were in bill with many renewable energy tax incentives, some with expiration dates, some without
- Because this has expiration date, JLARC determined Legislature chose to make it temporary

Were the Public Policy Objectives Achieved?

Hog Fuel Used to Produce Energy

- Evidence not available to determine
- Legislature provided no performance goals to assess
  - DOR tax data shows 7 hog fuel sellers reporting qualifying sales
  - JLARC found no evidence indicating preferences have promoted use of hog fuel to generate energy

Recommendation

Hog Fuel Used to Produce Energy

Allow to expire

The Legislature intended the exemptions to be temporary and did not provide performance goals to guide any other assessment of performance.

Renewable Energy Machinery (Sales & Use Tax)

Ground source heat pump coils

Prototype wave energy device in Puget Sound

Current Law – RCWs 82.08.962 and 82.12.962

Renewable Energy Machinery

- Sales and use tax exemptions for renewable energy machinery and equipment (M&E) used directly in generating electricity from:

• Wind	• Landfill gas
• Sun	• Geothermal resources
• Fuel cells	• Anaerobic digestion
• Biomass	• Tidal or wave energy
	• Converting otherwise lost energy from exhaust

- Includes installation labor and services

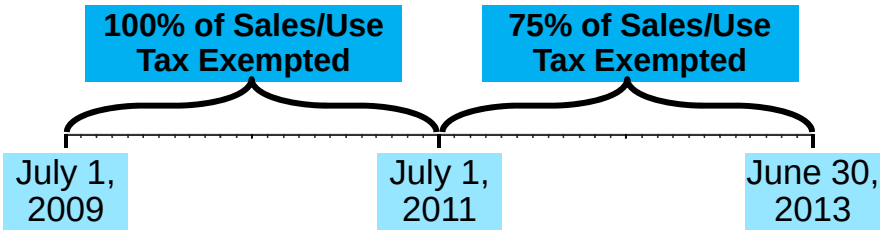
Current Law (cont.)

Renewable Energy Machinery

- Equipment purchaser must develop facility able to generate at least 1,000 watts

1,000 watts = electricity to illuminate ten 100 watt bulbs

- Value of preference reduces over time



- Preferences expire June 30, 2013

Beneficiaries and Beneficiary Savings

Renewable Energy Machinery

Beneficiaries

- Utilities, businesses, and individuals that purchase qualifying M&E to produce at least 1,000 watts of electricity

Beneficiary savings

- $40.8 million in 2011-13 Biennium (DOR estimate)

Background and Legal History

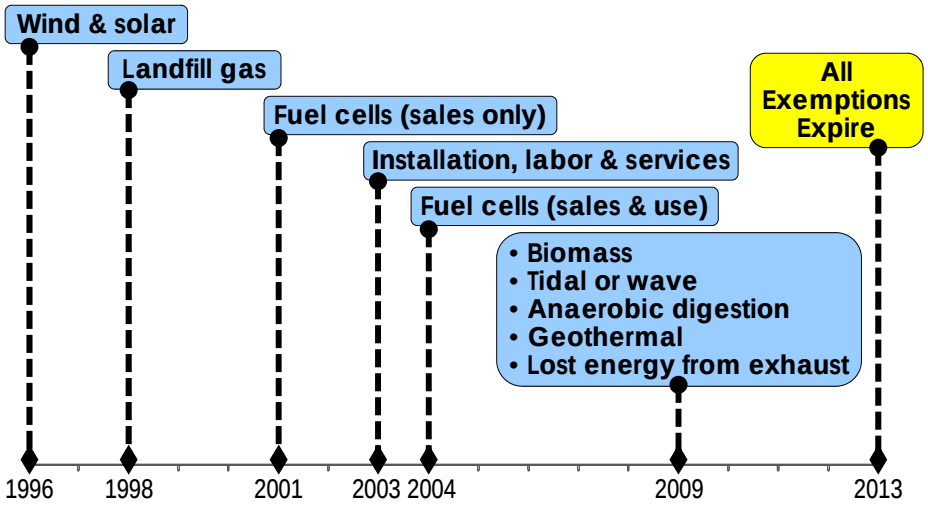
Renewable Energy Machinery

1996 Legislature enacted first sales/use tax exemptions for M&E used to produce electricity – for solar & wind energy to expire 6/30/2005. Had to generate at least 200,000 watts of electricity

After 1996 Other renewables added to exemption:

- 6/30/2005 exp date extended to 2013
- Minimum electricity changed to 200 watts (2001), then to 1,000 watts (2009)

Sales/Use Tax Exemptions for Electricity Production from Renewable Resources



Public Policy Objectives Not Stated

Renewable Energy Machinery

- JLARC determined objective was to encourage and support generating electricity using renewable resources on a temporary basis
- In 2009 bill creating this preference, other tax preferences were enacted. Some have specific expiration dates, others do not
- Because of this, JLARC determined Legislature specifically chose to make this preference temporary

Legislature Specifies Expiration Dates

Renewable Energy Machinery

	Jun 30 2013	Jun 30 2014	Jun 30 2015	Dec 1 2018	Jun 30 2020
Renewable energy M&E *(Sales/use tax exemption)*	●				
Hog Fuel used to produce energy *(Sales/use tax exemption)*	●				
Log hauling *(Reduced public utility tax rate)*	●				
Solar energy component manufacturing or wholesaling *(Reduced B&O tax rate)*		●			
Biomass energy harvesters *(B&O tax credit)*			●		
Forest derived biomass *(Sales tax exemption)*			●		
Gases/chemicals used to produce solar energy equipment *(Sales tax exemption)*				●	
Cost recovery program for renewable energy systems					●
Livestock nutrient equipment/facilities *(Sales/use tax exemption)*	*No expiration date*				
Radioactive waste cleanup *(Reduced B&O tax rate)*	*No expiration date*				

Were the Public Policy Objectives Achieved?

Renewable Energy Machinery

- Evidence not available to determine if preference is working to promote energy generation from renewable resources
  - Wind farm numbers have increased since 1996. No evidence indicating preferences played a part
- Electricity generated by other renewable resources has not materialized
- Legislature did not establish performance goals to measure objective achievement

Recommendation

Renewable Energy Machinery

Allow to expire

The Legislature intended the exemptions to be temporary and did not provide performance goals to guide any other assessment of performance.

Interest on Real Estate Loans (B&O Tax)

Rainier branch of Seattle First National Bank, 1938

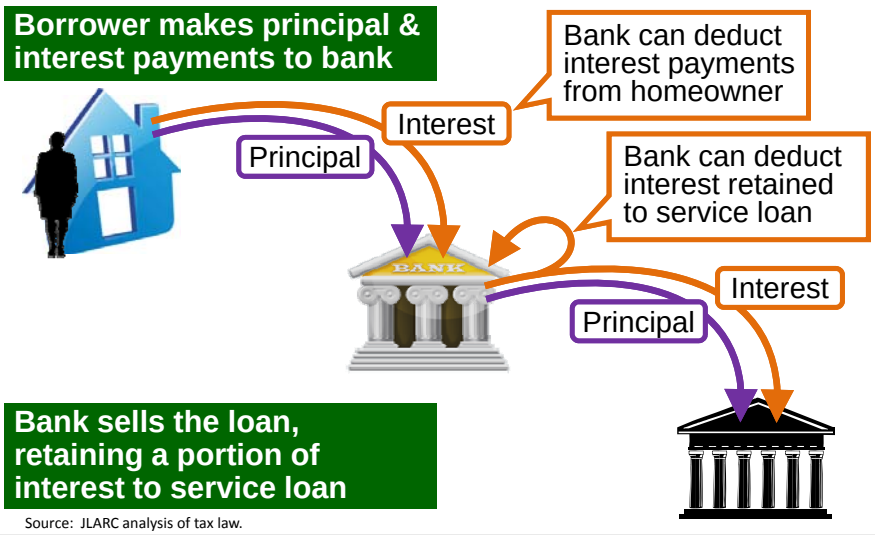
Current Law – RCW 82.04.4292

Interest on Real Estate Loans

- B&O tax deduction for financial businesses for interest on investments or loans primarily secured by:
  - First mortgages or trust deeds
  - On non-transient residential properties in Washington

Banks Can Deduct Interest Paid by the Borrower

Interest on Real Estate Loans



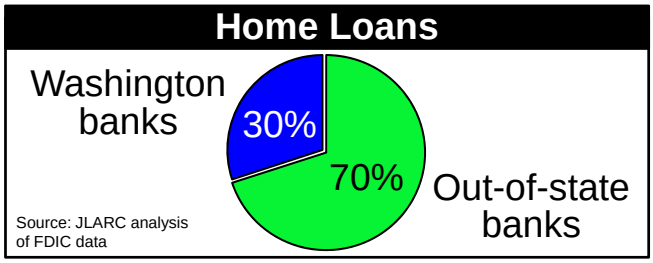
Source: JLARC analysis of tax law.

Beneficiaries and Beneficiary Savings

Interest on Real Estate Loans

Beneficiaries

- 111 financial businesses



Beneficiary savings

- $172.6 million for 2011-13 Biennium (JLARC estimate)

Background & Legal History

Interest on Real Estate Loans

1935 Interest earned on mortgages exempted from B&O tax as part of prohibitions against taxing banks

1969 Congress removed prohibition against taxing federal banks

1970 Legislature enacted B&O tax on state and federal banks

Interest on 1st mortgages remained exempt

Background & Legal History

Interest on Real Estate Loans

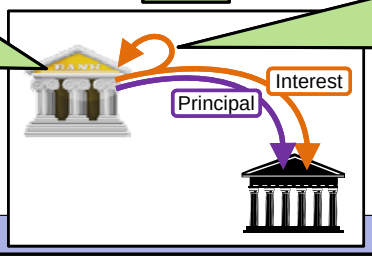
2009 *HomeStreet v. DOR* – interest retained by the lender to service a loan sold on the secondary market qualifies for the deduction

2010 Legislature clarified that the deduction provided in *HomeStreet* applied where:

Beneficiary originates the loan

and

Interest retained to service the loan is paid by the borrower



Public Policy Objective Not Stated

Interest on Real Estate Loans

- Historic documents suggest the original purpose was to encourage Washingtonians to buy homes by making loans more available and less expensive

Were the Public Policy Objectives Achieved?

Interest on Real Estate Loans

- No conclusive evidence that the deduction increased loan availability or decreased loan costs in Washington
- Rather, changes in the lending industry appear to have had an impact on WA loans:
  - 87% of WA mortgages are sold on the secondary market
  - 70% of WA mortgages are now made by out-of-state banks

Recommendation

Interest on Real Estate Loans

Review and clarify

Unclear whether original policy objective applies given changes in the lending industry.

Meat Processors (B&O Tax)

Meat processing assembly line, Tacoma

Current Law – RCW 82.04.260(4)

Meat Processors

- Provides a preferential B&O tax rate to:
  - Businesses that slaughter, break, or process perishable meat products; and
  - Wholesalers of meat products

Beneficiaries and Beneficiary Savings

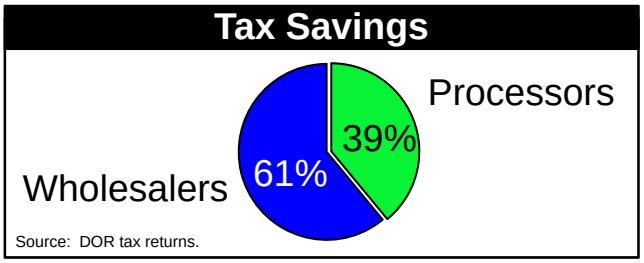
Meat Processors

Beneficiaries

- 218 processors and wholesalers

Beneficiary savings

- $30.5 million for 2011-13 Biennium (JLARC estimate)



Background & Legal History

Meat Processors

1967 Preferential rate for meat processors and wholesalers enacted

1998 Same preferential rate of 0.138% applied to food processors previously taxed at different preferential rates

2005 *Agrilink v. DOR* – processors of canned meat qualified for preferential rate

Background & Legal History

Meat Processors

2010 Legislature limited the *Agrilink* decision by specifying that:

- End-product must be perishable
- Exceptions for some meat by-products
- Canned meat did not qualify
- Wholesalers eligible only if they sold specified end-products

2010 Voters approved Initiative 1107 repealing the 2010 legislative changes

Public Policy Objective of Legislature
Public Policy Objective of Initiative

Meat Processors

- Implied objective of Legislature:
  - To allow WA meat processors to compete
  - To treat WA food processors consistently
- Stated objective under Initiative 1107:
  - To allow WA meat processors to compete
- Initiative repealed legislation that would have provided more consistent tax treatment:
  - Removed specifications on qualified end-products for processors and wholesalers

Legislature Intended to Treat Food Processors Consistently

Meat Processors

	Meat	Fruits Vegetables	Seafood Dairy
2012 Rate	0.138%	0.138%	0.138%
End Product	Unspecified	Unspecified	Specified
Wholesale Activities	Unspecified	Specified	Specified

Effect of Initiative 1107

Were the Public Policy Objectives Achieved?

Meat Processors

- No conclusive evidence that preference had an effect on retaining the meat processing industry in WA
- Tax treatment of food processors is inconsistent
- Unclear whether treating WA food processors consistently is still applicable

Recommendation

Meat Processors

Review and clarify

Unclear what the public purpose is for providing differential tax treatment of food processors.

Shared Real Estate Commissions (B&O Tax)

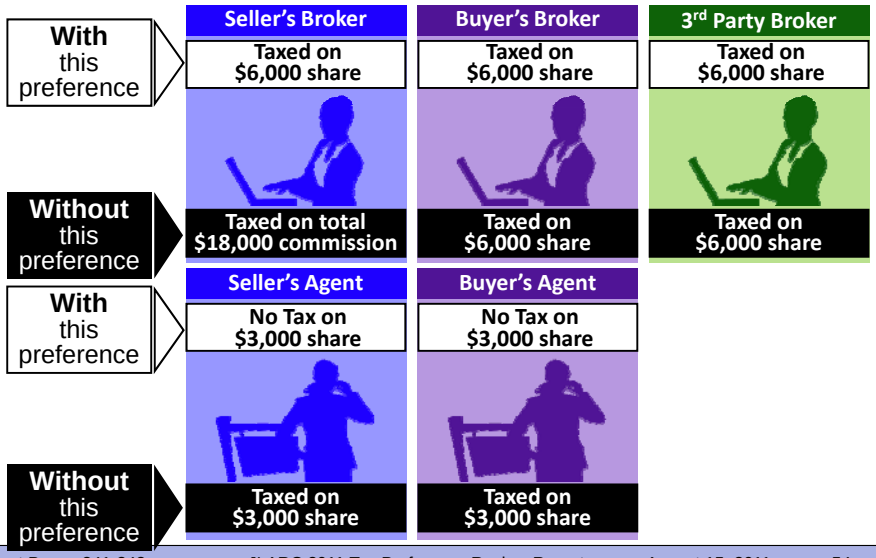
Current Law – RCW 82.04.255

Shared Real Estate Commissions

- B&O taxes gross income at each stage of producing a product or service, known as "pyramiding"
- This preference removes the "pyramiding" effect of the B&O tax on real estate brokers and their agents in two ways:
  1) Brokers cooperating in a sale pay B&O tax only on their share of commissions
  2) Agents are exempt when the tax is paid by the broker

Tax Treatment of $18,000 Commission on a Real Estate Sale

Shared Real Estate Commissions



Beneficiaries and Beneficiary Tax Savings

Shared Real Estate Commissions

Beneficiaries

- 23,000 active real estate agents and 8,500 brokers

Beneficiary tax savings

- $36 million for 2011-13 Biennium (JLARC estimate)

Background & Legal History

Shared Real Estate Commissions

1947 Tax preference enacted by Tax Commission rule

1969 DOR repealed 1947 rule and began taxing real estate agents on commissions

1970 The Legislature granted the same exemption to real estate businesses that had been provided by rule before 1969

Background & Legal History (cont.)

Shared Real Estate Commissions

2011 Legislature extended tax preference to commissions paid to third-party brokers cooperating in the sale

The Legislature has not provided these "anti-pyramiding" provisions to similar industries such as stock and insurance brokers

Public Policy Objective Not Stated

Shared Real Estate Commissions

- Unclear why the Legislature removed tax pyramiding for the real estate industry and not for other businesses with similar broker-agent and cooperating broker relationships

Were the Public Policy Objectives Achieved?

Shared Real Estate Commissions

- Unknown because the public policy objective is unclear

Recommendation

Shared Real Estate Commissions

Review and clarify

Unclear why the Legislature provided a tax preference to the real estate industry and not to other businesses with similar broker-agent and cooperating broker relationships.

Municipal Sewer Service Payments (B&O tax)

Duwamish Pumping Station construction,1967

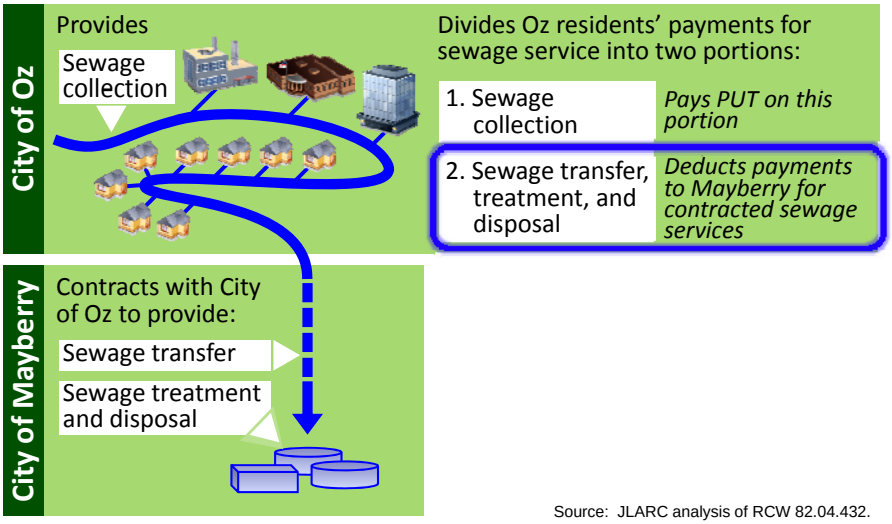
Current Law – RCW 82.04.432

Municipal Sewer Service Payments

- Allows municipalities/cities to deduct from B&O tax amounts **paid to other** cities/ government entities for contracted sewage transfer, treatment, or disposal
  - **Sewage collection** (collecting and carrying sewage to point for transfer for treatment/disposal) subject to public utility tax (PUT)
  - **Sewage transfer, treatment, and disposal** subject to B&O tax

Current Law

Municipal Sewer Service Payments



Source: JLARC analysis of RCW 82.04.432.

Beneficiaries and Beneficiary Savings

Municipal Sewer Service Payments

Beneficiaries

- Cities/municipalities that contract with other cities or government entities to transfer, treat, or dispose of their sewage

Beneficiary savings

- $3 million for 2011-13 Biennium (JLARC estimate)

Background & Legal History

Municipal Sewer Service Payments

1967 Legislature provided specific B&O tax deduction to cities for payments made to another government entity for contracted sewage transfer/ treatment/disposal services

1970 Legislature enacted a separate B&O tax deduction for income received by providers of transfer/treatment services

Now, neither providers nor receivers of contracted sewage treatment services taxed

Public Policy Objective Not Stated

Municipal Sewer Service Payments

- DOR report states purpose was to eliminate taxing both collection and transfer/treatment/disposal of sewage (pyramiding) when multiple utilities involved in providing sewer services
- Report notes largely intended for cities using King County Wastewater Treatment Center

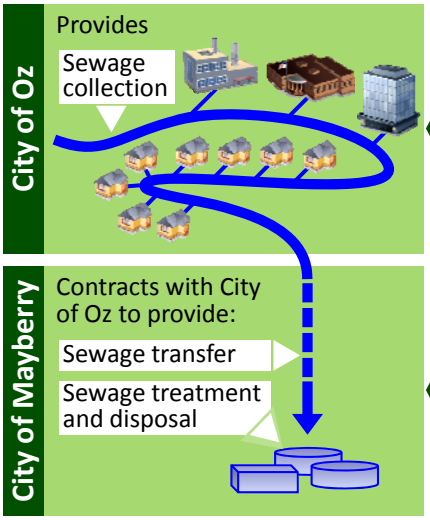
Were the Public Policy Objectives Achieved?

Municipal Sewer Service Payments

- Preference **does** eliminate B&O tax pyramiding by not taxing amounts paid by cities to other cities for sewage transfer, treatment, and disposal
- However, due to separate preference enacted in 1970, income from contracted sewage services not taxed at all
- Is unclear whether Legislature intended to only remove pyramiding or eliminate all taxation of these activities

Contracted Municipal Treatment Services Not Taxed

Municipal Sewer Service Payments



Oz deducts payments to Mayberry for contracted sewage services

Mayberry deducts payments from Oz for provided sewage services

Source: JLARC analysis of RCW 82.04.432.

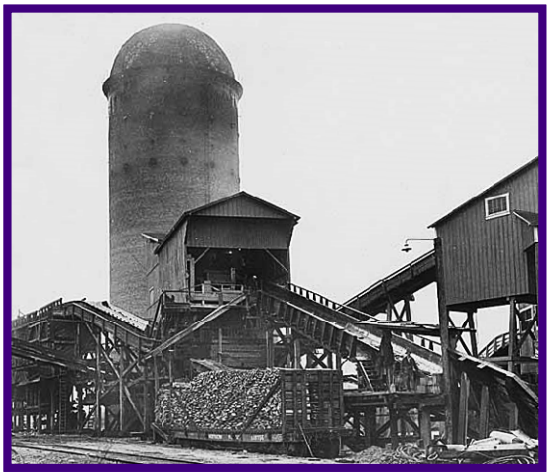
Recommendation

Municipal Sewer Service Payments

Review and clarify

The Legislature should clarify whether the purpose of the B&O deduction for municipal sewer service payments is to only avoid the pyramiding effect of the B&O tax, or to completely eliminate taxation of contracted sewage transfer, treatment, and disposal activities.

Extracted Fuel (Use Tax)



Hog fuel burner and bunkers, 1945

Oil refinery on Tacoma Tideflats,1964

Current Law – RCW 82.12.0263

Extracted Fuel

- Provides use tax exemption for fuel **produced and used by** an extractor/ manufacturer in the **same** extracting/ manufacturing operation that produced the fuel
  - Most common examples:
    - Petroleum fuels used in refineries
    - Hog fuel used by wood product manufacturers

Beneficiaries and Beneficiary Savings

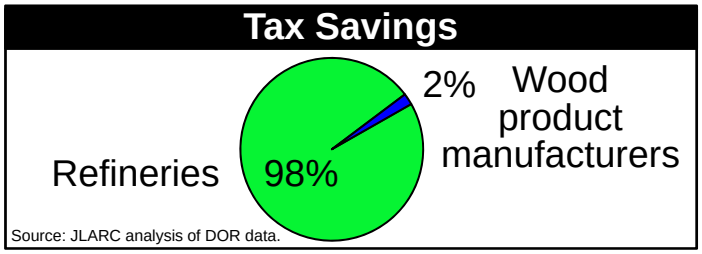
Extracted Fuel

Beneficiaries

- Refineries (5); wood product manufacturers

Beneficiary Savings

- $69.2 million in 2011-13 Biennium (JLARC estimate)



Background & Legal History

Extracted Fuel

Before

1948 Use tax applied to goods produced for commercial use & used internally by manufacturer. Tax Commission subjected byproducts produced and used by manufacturer to use tax

1948 In *Buffelin Lumber* case, WA Supreme Court held hog fuel produced & used by lumber manufacturer in manufacturing process not subject to use tax because was industrial use, not commercial use

Background & Legal History (cont.)

Extracted Fuel

1949 Legislature clarified that use tax applied to all products used by manufacturers, including byproducts they produced

Also provided a specific use tax exemption for fuel produced and used in same manufacturing activity

Public Policy Objective Not Stated

Extracted Fuel

- Unclear why this preference was provided
  - Possibly, Legislature wanted to tax by-products, but did not want to contradict *Buffelin* decision, **or**
  - Possibly, Legislature wanted to provide preference to certain manufacturers to support those industries, but made it narrow to apply only to fuel produced and used in same operation

Was the Public Policy Objective Achieved?

Extracted Fuel

- Because the public policy objective is unclear, it is difficult to determine if preference is achieving its intended objective
- Beneficiaries at time preference enacted were wood product manufacturers. Now refineries are the biggest beneficiaries

Recommendation

Extracted Fuel

Review and clarify

The public policy objective and intended beneficiaries are unclear.

Aircraft Fuel Tax, Export and Commercial Use

1967 – Test pilots prepare for the 737's maiden voyage

Mockup of the 737 interior

Current Law – Aircraft Fuel Tax

Aircraft Fuel Tax, Export & Commercial Use

- Aircraft fuel tax applies to all sales of aircraft fuel in Washington. Current rate $0.11/gallon
- All tax receipts go to WSDOT Aviation Division. Provides 96% of Division funding:
  - Airport Aid Grant Program
  - Aviation management/support
  - State-owned/managed airports
  - Statewide aviation system & land use planning
  - Air emergency search and rescue

Current Law - Exemptions

Aircraft Fuel Tax, Export & Commercial Use

- Statutes provide 8 exemptions from aircraft fuel tax for certain sales or uses

82.42.030	82.42.070
For export	For export
Commercial air carriers	U.S. government
Aircraft testing	Imported in interstate/ foreign commerce for sale in same
Training air crews	
Local commuter air service	

Beneficiaries and Beneficiary Savings

Aircraft Fuel Tax, Export & Commercial Use

Beneficiaries

- Purchasers for export, commercial airlines, U.S. Government
- These three make up 88% of exempt purchases in 2010

Beneficiary savings

- $299.9 million in 2011-13 Biennium (JLARC estimate)

Background & Legal History

Aircraft Fuel Tax, Export & Commercial Use

1967 Legislature enacted new aircraft fuel tax on sales of aircraft fuel in WA. Funds used to maintain local airports that do not receive federal (FAA) funding. Several exemptions provided in enacting statutes

1982 Exemption added for aircraft fuel used by local air commuter service providers

Background & Legal History

Aircraft Fuel Tax, Export & Commercial Use

- Originally, tax receipts seem to be intended to help maintain small/medium-sized airports that do not receive federal funding
- Several exemptions provided in enacting statutes to ensure persons that paid tax were ones that benefited from tax proceeds
- Now, in practice, tax receipts fund a number of other programs managed by WSDOT Aviation. Persons that benefit from these programs may not be the ones paying the tax

Public Policy Objective Not Stated

Aircraft Fuel Tax, Export & Commercial Use

1. Preferences likely structured so parties that paid aircraft fuel tax were the ones that benefited from expenditure of the tax proceeds, and
2. Comply with Constitutional prohibitions on states taxing goods in interstate/foreign commerce and on taxing federal government

Were the Public Policy Objectives Achieved?

Aircraft Fuel Tax, Export & Commercial Use

It appears aircraft fuel tax and preferences not fulfilling implied public policy objective

1. Receipts from tax now benefit more than just those who pay it
2. Exemptions addressing Constitutional concerns may be broader than necessary
   - Legislature may narrow and still comply with Constitution by providing credit for aircraft fuel taxes paid in other states

Recommendation

Aircraft Fuel Tax, Export & Commercial Use

Review and clarify

- When the Legislature originally enacted the aircraft fuel and related preferences, it appears the Legislature structured the preferences so the parties that benefited from the expenditures were the ones that paid the tax.
- However, parties that are exempt from paying the aircraft fuel tax now benefit from the expenditures of the tax receipts.

Limited-Income Property Tax Deferral

Current Law – RCW 84.37.030

Limited-Income Property Tax Deferral

- Allows homeowners with less than $57,000 in income to defer half of their property taxes
- Deferral limited to 40% of equity – thus homeowners with no equity are not able to take this deferral
- Deferred amounts accrue interest and are repayable when:
  - The residence is sold or condemned
  - The taxpayer moves
  - The taxpayer dies without a surviving spouse

Beneficiaries and Beneficiary Tax Deferrals

Limited-Income Property Tax Deferral

Beneficiaries

- 181 participants over three years

Beneficiary tax deferral

- $271,000 for 2009-11 Biennium (JLARC estimate)
- Amounts must be repaid with interest

Background & Legal History

Limited-Income Property Tax Deferral

2007 The Governor convened a special session to deal with property taxes

The Legislature enacted this property tax deferral for households under the median income

Public Policy Objective

Limited-Income Property Tax Deferral

- The Legislature stated that the intent of the preference is to:
  - *(a) provide a property tax safe harbor for families in economic crisis; and*
  - *(b) prevent existing homeowners from being driven from their homes because of overly burdensome property taxes*

Were the Public Policy Objectives Achieved?

Limited-Income Property Tax Deferral

- Unclear whether the preference is providing a "property tax safe harbor for families in economic crisis," since "economic crisis" is not defined
- Unknown whether the preference has contributed to preventing "homeowners from being driven from their homes"

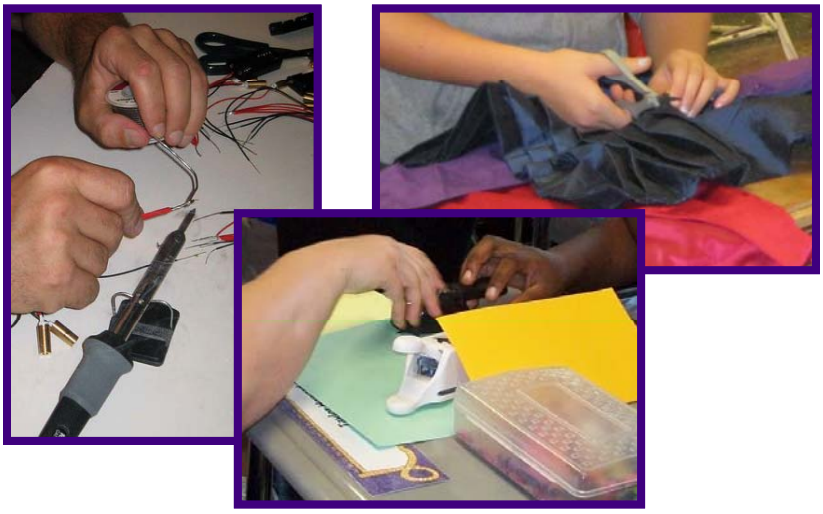
Recommendation

Limited-Income Property Tax Deferral

Review and clarify

Because the intended beneficiaries of this preference are not clear in light of the recent economic recession, the Legislature should clarify the preference to define "families in economic crisis" and identify measurable evaluation criteria.

Nonprofit Sheltered Workshops



Current Law – RCW 84.36.350

Nonprofit Sheltered Workshops

- Property tax exemption for property owned or leased by nonprofit sheltered workshops for people with disabilities
- Statute defines a sheltered workshop as a rehabilitation facility where "manufacture or handiwork" takes place

Beneficiaries and Beneficiary Tax Savings

Nonprofit Sheltered Workshops

Beneficiaries

- 49 nonprofit sheltered workshops are claiming the exemption

Beneficiary tax savings

- $4.4 million for 2011-13 Biennium (JLARC estimate)

Background & Legal History

Nonprofit Sheltered Workshops

1970 The Legislature granted a property tax exemption for property owned or leased by nonprofit sheltered workshops

In the same bill, the Legislature also provided sheltered workshops with a B&O tax exemption on their income

Public Policy Objective Not Stated

Nonprofit Sheltered Workshops

- Implied public policy objective is to encourage employment of people with disabilities in sheltered workshops
- However, state and federal laws now encourage employment of people with disabilities in:
  - Regular work environments
  - Along with people without disabilities

Were the Public Policy Objectives Achieved?

Nonprofit Sheltered Workshops

- Unknown because it is unclear whether tax preference conflicts with other public policy shifts toward employing persons with disabilities in regular work environments

Recommendation

Nonprofit Sheltered Workshops

Review and clarify

Public policy related to employment of people with disabilities has changed from the time the tax preference was enacted.

Next Steps

September 23	Tax Preference Commission conducts public hearing on reviews
October 11	Tax Preference Commission adopts comments on reviews
January 4, 2012	JLARC hears proposed final reports
January 2012	Joint Work Session, Senate and House Ways & Means Committees hear final reports

Contact Information

Mary Welsh
360-786-5193
mary.welsh@leg.wa.gov

Dana Lynn
360-786-5177
dana.lynn@leg.wa.gov

John Woolley
360-786-5184
john.woolley@leg.wa.gov

Visit JLARC's website at: www.jlarc.leg.wa.gov

CURRENT AND PROPOSED TAX PREFERENCE REVIEW SCHEDULE FOR 2012

#	RCWs	Brief Description	Year Enacted	Expiration Date	2009-11 State & Local Impact ($000)	Previously Scheduled Review Year	New Proposed Review Date
1	82.38.080	Fuel Use Exemptions (Fuel)	1971		$1,603,421	2012	2012
2	84.36.477; 84.36.510	Business Inventories (Property)	1974		$938,000	2012	2012
3	82.63.010; 82.63.030	High Technology Deferral (Sales & Use)	1994	1/1/2015	$145,712	2012	2012
4	48.14.020(1)	Annuities (Insurance Premium)	1979		$129,860	2012	2012
5	82.08.026; 82.12.023; 82.14.030(1)	Natural and Manufactured Gas (Sales & Use)	1989		$67,831	2012	2012
6	82.04.4452	High Technology R&D (B&O)	1994	1/1/2015	$61,228	2012	2012
7	82.04.260(6)	Charter and Freight Brokers (B&O)	1979		$49,463	2012	2012
8	82.29A.130(3)	Subsidized Housing (Leasehold Excise)	1976		$46,548	2012	2012
9	82.04.260(9)	Insurance Agents (B&O)	1983		$45,232	2013	2012
10	82.04.260(7)	Stevedoring (B&O)	1979		$20,387	2012	2012
11	82.08.0285; 82.12.0279	Ferry Boats (Sales & Use)	1977		$18,870	2012	2012
12	82.04.260(5)	Travel Agents (B&O)	1975		$17,433	2012	2012
13	82.04.062	Precious Metals and Bullion (Sales & Use)	1985		$16,634	2013	2012
14	48.32.145; 48.32A.125	Insurance Guarantee Funds (Insurance Premium)	1976		$13,485	2012	2012
15	82.04.050(10)	Federal Government Structure Labor (Sales & Use)	1975		$12,265	2012	2012
16	82.04.4298	Condominium Maintenance Fees (B&O)	1979		$10,030	2012	2012
17	82.29A.130(8)-(9)	Leases Under $250 Per Year or Short Term (Leasehold Excise)	1976		$9,461	2012	2012
18	82.08.0255(1)(a),(c); 82.12.0256(2)(a)	Urban Transit Fuel (Sales & Use)	1980		$7,919	2012	2012
19	82.04.4295	Manufacturing Completed In-State (B&O)	1977		$5,774	2012	2012
20	82.70.020	Commuting Programs (B&O)	2003	7/1/2013	$5,280	2012	2012
21	82.27.020(4)	Fish Tax Rates (Fish Tax)	1980		$5,020	2012	2012
22	82.75.010; 82.75.030	Biotechnology Deferral (Sales & Use)	2006	1/1/2017	$4,924	2014	2012
23	82.29A.020(1)	Manufacturing for Government (Leasehold Excise)	1976		$3,499	2012	2012
24	84.36.105	Cargo Containers (Property)	1975		$2,901	2012	2012
25	82.04.360(1)	Life Insurance Sales Employees (B&O)	1991		$1,720	2013	2012
26	48.14.022	Health Insurance by State Pool (Insurance Premium)	1987		$1,558	2012	2012
27	82.04.062	Precious Metals and Bullion (B&O)	1985		$1,277	2012	2012
28	82.04.294	Solar Energy and Silicon Manufacturing (B&O)	2005	6/30/2014	$795	2012	2012
29	82.04.337	Hops Processed and Exported (B&O)	1987		$758	2012	2012
30	82.04.327	Adult Family Homes (B&O)	1987		$748	2012	2012
31	82.08.0311; 82.12.0311	Horticultural Packing Materials (Sales & Use)	1988		$654	2012	2012
32	82.04.120(2)(a)	Seed Conditioning (B&O)	1987		$447	2012	2012
33	82.29A.120(1)	Credit for Excess Tax (Leasehold Excise)	1986		$379	2012	2012
34	82.32.065	Returned Motor Vehicles (Sales & Use)	1987		$363	2012	2012
35	82.08.034; 82.12.034	Used Floating Homes (Sales & Use)	1984		$351	2012	2012
36	84.36.080(2)	Historic Vessels (Property)	1986		$333	2012	2012
37	82.12.0284	Computers Donated To Schools (Sales & Use)	1983		$184	2012	2012
38	82.08.0299	Lodging for the Homeless (Sales & Use)	1988		$46	2012	2012

CURRENT AND PROPOSED TAX PREFERENCE REVIEW SCHEDULE FOR 2012

#	RCWs	Brief Description	Year Enacted	Expiration Date	2009-11 State & Local Impact ($000)	Previously Scheduled Review Year	New Proposed Review Date
39	84.33.086	Timber Tax Minimum (Timber)	1984		$12	2012	2012
40	82.04.4331	Health Insurance Claims (B&O)	1988		$0	2012	2012
41	82.21.040(1)-(4),(6)	Hazardous Substance Exemptions (Hazardous Substance)	1989		$0	2012	2012
42	82.23A.010(1)	Crude Oil (Petroleum Products)	1989		$0	2012	2012
43	82.23A.030(1)	Successive Use (Petroleum Products)	1989		$0	2012	2012
44	82.23A.030(2)	Domestic Use (Petroleum Products)	1989		$0	2012	2012
45	82.23A.030(4)	Fuel Used Before Tax Imposed (Petroleum Products)	1989		$0	2012	2012
46	82.23A.030(5)	Fuel Used to Process Petroleum Products (Petroleum Products)	1989		$0	2012	2012
47	82.23A.030(6)	Exported Petroleum Products (Petroleum Products)	1989		$0	2012	2012
48	82.23A.030(7)	Packaged Petroleum Products (Petroleum Products)	1989		$0	2012	2012
49	82.23A.040(1)	Fuel Exported in Fuel Tanks (Petroleum Products)	1989		$0	2012	2012
50	82.64.030(1)	Syrup Previously Taxed (Syrup)	1989		$0	2013	2012
51	82.64.030(2)	Syrup Exported (Syrup)	1989		$0	2013	2012
52	82.64.030(3)	Trademarked Syrup (Syrup)	1991		$0	2013	2012
53	82.64.030(4)	Syrup Purchased Before Tax Imposed (Syrup)	1989		$0	2013	2012
54	84.33.077	Public Timber Credit (Timber)	1983		$0	2012	2012
55	84.36.500	Conservation Futures (Property)	1984		$0	2012	2012
56	84.56.025	Delinquent Penalty Waivers (Property)	1984		$0	2012	2012
57	82.04.050(1)(a)(iv); 82.04.190(1)(d)	Ferrosilicon (Sales & Use)	1986		*	2012	2012
58	82.04.367	Student Loan Organizations (B&O)	1987		*	2012	2012
59	84.36.030(6)	Student Loan Organizations (Property)	1987		*	2012	2012
	82.08.0283; 82.12.0277	Medical Devices (Sales & Use)	1975		$246,585	2012	2014
	84.36.045	Medical Research and Training Facilities (Property)	1975		$9,905	2012	2014
	84.36.040(1)(f)	Dialysis Facilities (Property)	1987		$1,394	2012	2014
	82.04.100; 82.04.330	Christmas Tree Producers (B&O)	1987		$896	2012	2016
	82.04.213	Christmas Tree Inputs (Sales & Use)	1987		$784	2012	2016
	82.08.0296; 82.12.0296	Livestock Feed (Sales & Use)	1986		$210	2012	2016
	82.08.0294; 82.12.0294	Aquaculture Feed (Sales & Use)	1985		$136	2012	2016

Move from 2012 to later date
Move from later date to 2012
Top 22 sorted by fiscal impact

State of Washington

Citizen Commission for Performance Measurement of Tax Preferences

E-mail: lisa.hennessy@leg.wa.gov
www.citizentaxpref.wa.gov

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

Lily Kahng, *Vice Chair*
Seattle University Law School

James Bobst
Pacific Fibre Products

Stephen Miller
Washington Education Association

Paul Guppy
Washington Policy Center

Vacant
Chair, Joint Legislative Audit and Review Committee

Brian Sonntag
State Auditor

June 13, 2011

TO: Members of the Citizen Commission for Performance Measurement of Tax Preferences

FROM: Keenan Konopaski, Legislative Auditor

SUBJECT: **Follow-up Regarding 2012 Tax Preference Review Schedule**

At the May 20th meeting of the Commission, JLARC staff presented a draft proposal of 22 reviews for the 2012 review schedule. The Commissioners agreed to respond by May 31st with (a) any proposed changes to the schedule, and (b) any questions to be forwarded to the Department of Revenue to help in making a decision on what preferences to review. Recall that JLARC staff can conduct a maximum of 22 reviews per year with existing staff.

Chair Longbrake submitted proposed revisions along with questions for the Department. I did not receive any proposed revisions or questions from the other Commissioners. Chair Longbrake's proposal is listed below.

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(1) Chair Longbrake recommends the following 16 initially proposed by JLARC staff should be reviewed in 2012:

RCWs	Preference
82.63.010; 82.63.030	High Technology Deferral (Sales & Use)
82.04.4452	High Technology R&D (B&O)
82.04.260(6)	Charter and Freight Brokers (B&O)
82.04.260(9)	Insurance Agents (B&O)
82.04.260(7)	Stevedoring (B&O)
82.08.0285; 82.12.0279	Ferry Boats (Sales & Use)
82.04.260(5)	Travel Agents (B&O)
82.04.062	Precious Metals and Bullion (Sales & Use)
48.32.145; 48.32A.125	Insurance Guarantee Funds (Insurance Premium)
82.04.4298	Condominium Maintenance Fees (B&O)
82.29A.130(8)-(9)	Leases Under $250 Per Year or Short Term (Leasehold Excise)
82.08.0255(1)(a),(c); 82.12.0256(2)(a)	Urban Transit Fuel (Sales & Use)
82.04.4295	Manufacturing Completed In-State (B&O)
82.70.020	Commuting Programs (B&O)
82.27.020(4)	Fish Tax Rates (Fish Tax)
82.75.010; 82.75.030	Biotechnology Deferral (Sales & Use)

(2) Chair Longbrake recommends the following four preferences initially proposed by JLARC should undergo further discussion by the Commission before deciding to review in 2012. To assist with this discussion in August, Chair Longbrake has asked the Department of Revenue to answer the following questions:

RCWs	Preference	Question for DOR
82.38.080	Fuel Use Exemption (Fuel Tax)	Please explain why the 2008 Tax Exemption Study states repealing this would not likely result in increased revenue.
48.14.020(1)	Annuities (Insurance Premium Tax)	Please explain why the 2008 Tax Exemption Study states repealing this would not likely result in increased revenue.
82.08.026; 82.12.023; 82.14.030(1)	Natural & Manufactured Gas (Sales & Use Tax)	Would taxing natural and manufactured gas under the sales and use tax result in equivalent revenues?
82.04.050(12)	Federal Government and City/County Housing Authority Structure Labor (Sales & Use Tax)	The impact seems to include both federal government and housing authorities. Which of these can the state tax and which are prohibited from taxation by federal law, court cases, etc.?

(3) Chair Longbrake recommends the following two preferences initially proposed by JLARC should NOT be reviewed and stated the following rationale:

RCWs	Preference	Rationale for Not Reviewing
84.36.477; 84.36.510	Business Inventories (Property)	Generally, property tax exemptions result in a redistribution of the tax to existing property owners. Continuing or repealing them does not impact revenue.
82.29A.130(3)	Subsidized Housing (Leasehold Excise)	Support for low-income housing is a valid preference and repeal is unlikely to result in additional revenue.

(4) Chair Longbrake recommends potentially adding up to five other preferences to 2012 review list that were not initially proposed for review by JLARC:

RCWs	Preference
48.14.022	Health Insurance by State Pool (Insurance Premium)
82.04.062	Precious Metals and Bullion (B&O)
82.04.294	Solar Energy and Silicon Manufacturing (B&O)
82.04.337	Hops Processed and Exported (B&O)
82.04.360(1)	Life Insurance Sales Employees (B&O)

Note: the number of preferences that can be added to the 2012 review list from the group (4) above will depend upon how many of the preferences are removed from review from groups (2) and (3). The total that can be reviewed by JLARC in 2012 is limited to 22 preferences.

Finally, the Chair recommends including two agriculture-related exemptions in a future review year as part of a group of agriculture-related exemptions. This does not impact the review work in 2012.

The Commission will discuss potential revisions to the 2012 schedule at its August 15th meeting and approve the 10-year review schedule at the September 23rd meeting.

Department of Revenue's Response to Questions from Chair Longbrake Regarding Potential Reviews in 2012

Introduction

Chair Longbrake identified four tax preferences for further discussion by the Citizen Commission for Performance Measurement of Tax Preferences (Commission) before deciding whether or not to review the preferences in 2012. To assist with the discussion, he asked the Department of Revenue (Department) to answer four questions. Those questions and the Department's answers are provided below.

Fuel use exemption – Fuel Tax (82.38.080)

Q. Please explain why the 2008 Tax Exemption Study states that repealing this tax exemption would not likely result in increased revenue.

After further evaluation, the Department believes that some revenue would likely be realized by repealing RCW 82.38.080. The Department is currently working on the 2012 Exemption Study and will develop an estimate of how much revenue may be realized if this exemption is repealed.

Annuities (insurance premium tax) – 48.14.020(1)

Q. Please explain why the 2008 Tax Exemption Study states that repealing the exemption in RCW 48.14.050 for annuities from the insurance premiums tax would not likely result in increased revenue.

After further evaluation, the Department knows of no reason why revenues wouldn't be realized by repealing RCW 48.14.050. The Department is currently working on the 2012 Exemption Study and will develop an estimate of how much revenue may be realized if this exemption is repealed.

Natural & manufactured gas (sales and use tax) – 82.08.026; 82.12.023; 82.14.030(1)

Q. Would taxing natural and manufactured gas under the sales and use tax result in equivalent revenues?

Taxing natural and manufactured gas under the general sales and use tax instead of the brokered natural gas (BNG) use tax would not result in equivalent revenues. This change would result in increased revenues for the state, reduced revenues for cities/towns, and increased revenues for those local taxing jurisdictions that impose local sales and use taxes but not the BNG use tax.

Continued

Federal Government and City/County Housing Authority Structure Labor (sales & use tax) – 84.04.050(12)

Q. The impact seems to include both federal government and housing authorities. Which of these can the state tax and which are prohibited from taxation by federal law, court cases, etc.?

- The U.S. Constitution prohibits the state from directly taxing the federal government.
- Public entities are exempt from property tax under the state constitution.

Housing authorities are exempt from state and local taxes under RCW 35.82.210 and therefore could be required to pay sales or use taxes or other excise taxes, if RCW 35.82.210 were amended or repealed.