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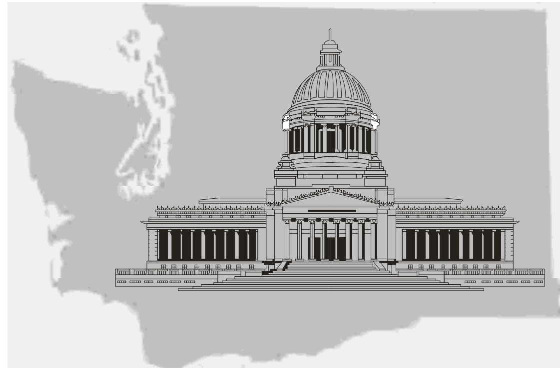

2008 Full Tax Preference Performance Reviews

Report 09-3

January 7, 2009

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

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

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Committee Approval

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

2008 FULL TAX PREFERENCE PERFORMANCE REVIEWS

REPORT 09-3

JANUARY 7, 2009

STATE OF WASHINGTON

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Report Summary

What Is a Tax Preference?

Tax preferences are exemptions, exclusions, or deductions from the base of a state tax; a credit against a state tax; a deferral of a state tax; or a preferential state tax rate. Washington has more than 550 tax preferences.

Why a JLARC Review of Tax Preferences?

Legislature Creates a Process to Review Tax Preferences

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

Citizen Commission Sets the Schedule

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

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

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

In September 2007, the Commission adopted its second ten-year schedule for the tax preference reviews. The schedule for 2008 includes a total of 37 statutes containing tax preferences: eight property tax, five public utility tax, five retail sales tax, four use tax, eleven business and occupation tax, three fuel tax, and one leasehold excise tax. Of these 37 statutes, the law required 17 tax preferences to have a full review process.

JLARC Staff Conduct the Tax Preference Reviews

JLARC's assignment from EHB 1069 is to conduct the reviews of tax preferences according to the schedule developed by the Commission and consistent with the guidelines set forth in statute. This report presents JLARC's reviews of the 17 tax preferences scheduled by the Commission for full review.

JLARC's Approach to the Tax Preference Reviews

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

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

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

Other States:

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

Methodology

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

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

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

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

Summary of the Results from JLARC's Reviews

The table on page 5 provides a summary of the results from JLARC's analysis of the tax preferences scheduled for full review in 2008. Of the 17 tax preferences included in this volume, this report recommends that the Legislature continue eleven tax preferences as they are, and continue two other tax preferences by extending their expiration dates with additional accountability requirements. The full report raises issues for the Legislature's consideration for four of the current tax preferences.

The table on page 6 provides a summary of JLARC's recommendations for the full reviews completed last year in 2007. Given the fact that these tax preference reviews are part of an ongoing examination of all state tax preferences in Washington, the 2007 recommendations for the full reviews are included in this 2008 full report.

Organization of This Report

This report includes 14 separate chapters for review of the 17 tax preferences. Each chapter consists of a review of one tax preference except for the chapter on electric generating equipment from renewable energy resources which reviews both the retail sales and use tax preferences together. Each chapter begins with a summary of the findings and recommendations from JLARC's analysis of the tax preferences. Then, each chapter provides additional detail, including additional information supporting the answers to the questions outlined in the law. Appendices provide the Scope and Objectives, agency and Tax Commission comments, and the text of current law for each preference.

Summary of Recommendations—2008 Full Tax Preference Reviews

Tax Preference	Year Enacted	RCW Citation	# of Claimants in 2007 ($ amount)	Summary of Recommendation
Private K-12 schools (p. 7)	1925	RCW 84.36.050(1)	248 ($16 million)	Legislature should continue the tax preference
Private colleges (p. 21)	1925	RCW 84.36.050(1)	69 ($32 million)	
Intangibles (p. 35)	1931	RCW 84.36.070	Unknown* ($9.9 billion)	
Commercial vessels (p. 61)	1931	RCW 84.36.080(1); RCW 84.40.036	2,500 ($900,000)	
Other ships and vessels (p. 75)	1931	RCW 84.36.090	236,036 ($32.8 million)	
Exported and imported fuel (p. 87)	1933	RCW 82.36.230; RCW 82.38.030	162 ($1.2 billion)	
Real estate sales (p. 99)	1935	RCW 82.04.390	Unknown* ($363 million)	
Credit losses (p. 121)	1935	RCW 82.04.4284	4,171 ($5 million)	
Insurance premiums (p. 153)	1935	RCW 82.04.320	1,729 ($360 million)	
Public utilities (p. 167)	1935	RCW 82.04.310	7,037 ($40 million)	
Electric generating equipment; renewable resources (p. 215)	1996	RCW 82.08.02567; RCW 82.12.02567;	Unknown* ($25 million)	Legislature should continue the tax preference, extend the expiration date, and add accountability requirement
Agricultural producers (p. 133)	1935	RCW 82.04.330; RCW 82.04.410	35,000 ($28.8 million)	Legislature should re-examine or clarify the intent of the tax preference*
Tax rate for urban trans. & vessels (p. 183)	1935	RCW 82.16.020 (1d&e)	2,015 ($6.2 million)	
Items used in interstate commerce (p. 201)	1949	RCW 82.08.0261	184 ($110 million)	

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

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

Summary of Recommendations – 2007 Tax Preference Reviews

Tax Preference	Year Enacted	RCW Citation	# of Claimants in 2006 ($ amount)	Summary of Recommendation
Churches, parsonages and convents (p. 31)	1854	RCW 84.36.020	5,137 ($66 million)	Legislature should continue the tax preference
Cemeteries (p. 57)	1854	RCW 84.36.020	196 ($7.4 million)	
Household goods (p. 69)	1935	RCW 84.36.110(1)	2.4 million ($341 million)	
Refund of fuel tax for exported fuel (p. 81)	1923	RCW 82.36.300 RCW 82.38.180(2)	89 ($1.3 million)	
Nonprofit hospitals (p. 7)	1886	RCW 84.36.040(1)(e)	45 ($47 million)	Legislature should re-examine or clarify the intent of the tax preference*
Nonsectarian organizations (p. 43)	1915	RCW 84.36.030(1)	651 ($17 million)	

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

PRIVATE K-12 SCHOOLS – SUMMARY

Current Law

State law exempts property owned or used by any nonprofit school or college for educational purposes or cultural or art education programs from state and local property taxes. The exemption pertains to both private K-12 schools and to private colleges and universities. This chapter reviews private K-12 schools. Another chapter in this volume reviews private colleges and universities.

The exempt property must not exceed 400 acres. In addition, the buildings and grounds must be designed for the educational, athletic, or social programs of the institution, the housing of students, religious faculty, and chief administrator, and athletic buildings. Other school facilities are exempt if the need for them exists only because of the presence of the school. The property must be principally designed to further the educational, athletic, or social functions of the school.

The property tax exemption for a nonprofit school is nullified if the property is used by an individual or organization that is not entitled to a property tax exemption, unless one of the following exceptions applies:

1. The property is used by students, alumni, faculty, staff, or other persons in a manner consistent with the educational, social, or athletic programs of the school;
2. The school may contract for food services for students, faculty, and staff, the operation of a bookstore on campus, and related maintenance, operational, or administrative services; or
3. The school may allow uses for monetary gain or to promote business activities for not more than seven days in a calendar year for each portion of the property. Sports or educational camp uses conducted by faculty members do not count against the seven days.

Any rent or donations received by the school for use of the property must be reasonable and not exceed maintenance and operation expenses. An inadvertent use of the property in a manner inconsistent with school purposes will not nullify the exemption, if the inadvertent use is not part of a pattern of use.

Another section of law (RCW 84.36.805) provides several more general restrictions for a property tax exemption:

- The property must be used exclusively for the actual operation of the activity for which the exemption is granted, however, the loan or rental of the property does not subject the property to tax if the rents are reasonable;
- The facilities must be available to all regardless of race, color, national origin, or ancestry; and
- The organization must be licensed or certified if required by law or regulation.

By rule (WAC 458-16-270), the Department of Revenue defines "schools and colleges" to include nonprofit educational institutions that are approved by the Superintendent of Public Instruction or whose students and credentials are accepted without examination by other schools and colleges and that offer students an educational program of a general academic nature.

Chapter 28A.195 RCW allows private schools to be approved by the state by annually submitting statements to the Superintendent of Public Instruction that certain minimum requirements are being met. However, private schools do not need to be approved to operate in Washington.

See Appendix 3 for the current law statute RCW 84.36.050(1).

Findings and Recommendations

This review evaluated the legal history, public policy objectives, economic and revenue impacts, and other states' tax preferences of the property tax exemption for private nonprofit schools. The audit determined the following:

Legislative History and Public Policy Objectives

- Private schools did not receive a property tax exemption when the new state Legislature passed its first laws in 1890 and 1891. The state Constitution provided several exemptions, based on public ownership. Other exemptions were left to the discretion of the Legislature. The state Supreme Court limited the ability of the Legislature to grant property tax exemptions to only "quasi-public" property such as charitable institutions, (privately-owned) public libraries, and cemeteries.
- The Legislature enacted the exemption for private schools in 1903. The Legislature included the restrictions that the property had to be used solely for education purposes and that the property had to be owned by a school that was supported in whole or part by gifts, endowments, or charity. The amount of property could not exceed ten acres. The income from endowments had to equal or exceed revenues from tuition.
- Over the years the Legislature has adopted many amendments to the exemption. The acreage limitation increased to 400 acres. The Legislature removed the restriction that income from endowments must equal or exceed tuition revenue. Allowable campus purposes now include buildings and grounds designed for classrooms, dormitories, housing for faculty and other employees, dining halls, parking lots, students unions and recreational buildings, athletic buildings, and other school facilities. The Legislature inserted the term "nonprofit" in 1973 and deleted the requirement that a school be supported in whole or part by gifts, endowments, or charity.
- The Legislature last visited the property tax exemption for schools in 2006. The exempted property no longer has to be used exclusively for campus purposes. However, with several exceptions, the property tax exemption is nullified if someone not otherwise entitled to a property tax exemption uses the property.

- The public policy objective in providing a property tax exemption to private nonprofit schools is to provide a subsidy to these schools. This objective is being met.

Beneficiaries

- There are 348 private nonprofit K-12 schools that are receiving a property tax exemption. These schools enrolled an estimated 67,000 students in 2006-07.

Revenue and Economic Impacts

- The value of exempted property is estimated to be $1.9 billion in 2007 for a total state and local property tax savings of $19 million. These savings are mostly shifted onto other taxpayers through higher levy rates.
- In future years the tax savings is expected to be about $25 million per year. Again, these savings are mostly shifted to other taxpayers.
- The economic impact of the property tax exemption for private nonprofit schools is the extent to which the exemption promotes education that otherwise would not occur. In general, the economic impacts of education are of two types:
    - Spending to provide students an education; and
    - The long-term impact to the state's economy due to students receiving an education and the state having a better educated workforce.

Other States

- All 50 states and the District of Columbia exempt nonprofit schools from property taxes. The states differ on whether the exemption is granted because of the owner of the property versus the use of the property. In some states the exemption is for property and buildings owned or used by schools, while in other states the exemption is for property used for educational purposes. In Washington it is both – the property must be owned or used by a nonprofit school for educational purposes. At least seven states appear to exempt schools of all types, both nonprofit and for-profit schools.

Recommendation

The Legislature should continue the property tax exemption for private, nonprofit schools.

Legislation Required: None.

Fiscal Impact: None.

PRIVATE K-12 SCHOOLS – REPORT DETAIL

Statutory History

When Washington became a territory in 1854, the territorial Legislature granted a property tax exemption to the real and personal property belonging to any religious society, or to any benevolent, charitable, literary, or scientific institution, to all real and personal property belonging to the territory or any county thereof, and to all school houses and school lands. The measure did not specifically mention private schools and it is not clear whether they would have been considered benevolent or charitable institutions.

The territorial Legislature rewrote the general property tax exemption periodically over the years. In 1886 it added an intent section for the property tax exemptions and specifically included institutions of learning, presumably including private schools. The exemption included a restriction on the amount of land that could be exempted:

> *Whereas religion, morality and knowledge being necessary for good government and happiness of mankind, there is further exempted all buildings or institutions of learning, … including the lands upon which such buildings are situated, not to exceed two acres, if within a city or town, and not exceeding eighty acres if not within a city or town.*[1]

Property tax exemptions were not without controversy in the late 1800s and the turn of the century. Typical of the arguments for and against were those used at the Washington State Constitutional Convention in 1889.[2] For example, those opposed to exempting churches from property tax charged that such an exemption would be a show of favoritism and would work an injustice to the taxpayer who would have to supply the deficit created. Those favoring exemption urged that churches were maintained purely for community benefit, and a tax levied upon them would be like taxing a public institution. Constitutional convention attendees discussed exemptions for churches, places of burial, institutions of public charity, public libraries, and personal property (up to a specified dollar amount). In the end, they left it to the Legislature to determine.

The new state Constitution of 1889 provided that all property was to be taxed, with exceptions. The Constitution exempted property of the United States, the state and local governments, including school districts, and such other property the Legislature selected. Public schools and colleges had an exemption provided in the Constitution. Private schools and colleges did not receive a property tax exemption when the Legislature passed its first laws in 1890.

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[1] 1886 Laws of Washington Territory, p. 47 §1.

[2] See "The Journal of the Washington State Constitutional Convention, 1889, with analytical Index by Q. S. Smith," edited by B. P. Rosenow, 1999.

Schools and colleges did not make the list in the second effort to modify exemptions in 1891. A state representative did make a motion on the House floor in 1891 to expand the exemption for state colleges to include all colleges. The amendment failed.

An 1897 Washington Supreme Court ruling helped shape the Legislature's creation of property tax exemptions. The Court ruled that the property exempted by the Legislature needed to be of a "quasi-public" nature.[3] The Court found a set of 1897 exemptions to be unconstitutional. The court provided examples of quasi-public property such as charitable institutions, public libraries, cemeteries, and similar classes of property where the use of the property is not strictly private. Instead the public has an interest in the property and its maintenance, and the property does not truly enter into competition with private property. Also, the use of the property benefits the state from a financial standpoint in that services are performed for which the state would otherwise be called upon to discharge.

The Legislature enacted the exemption for private schools and colleges in 1903.[4] The exemption applied to the real and personal property owned by any school or college that was supported in whole or part by gifts, endowments, or charity. The income from the gifts, endowments, or charity had to be devoted to the purposes of the institution. The school or college had to be open to all persons upon equal terms. The property had to be used solely for educational purposes and could not exceed ten acres. Any real estate owned by the institution that was leased for the purpose of deriving income was not exempt. Finally, the annual income from endowments had to equal or exceed revenues received from tuition. During passage in the Senate, one senator explained his vote by stating:

> *I doubt the act being constitutional; but, not being absolutely certain that the same is unconstitutional, and believing the bill to be meritorious, I vote aye.*[5]

Later the House added the amendments that restricted the exemption to ten acres, provided that leased land was not exempt, and required income from endowments to exceed revenues from tuition.

The next amendments occurred in 1925. Property used (but not necessarily owned) by a school or college could also be exempt. The acreage limitation increased to 40 acres for colleges. Before the exemption could be granted, the institution had to file an annual report with the county assessor listing all the property, the purpose for which it was used, revenue derived from the property, the number of students attending the institution, and the total revenues, by source, of the institution and how they were spent.

In 1931 and 1932, the King County assessor disallowed the property tax exemption for the Lakeside Day School, noting endowment income did not exceed tuition.[6] In deciding against the school, the state Supreme Court also took the opportunity to comment "That the [exemption statute] as a whole is poorly drafted and inconsistent in its provisions, is apparent enough at a

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[3] "Chamberlin v. Daniel," 17 Wash. 111 (1897); and "Buchanan v. Bauer," 17 Wash. 688 (1897).

[4] Chapter 183, Session Laws, 1903.

[5] "Journal of the Washington State Senate," 1903, page 305.

[6] "Lakeside Country Day School v. King County," 179 Wash. 588 (1934).

glance…" In 1933, the Legislature removed the requirement that the annual income from endowments needed to equal or exceed all income from tuitions. The Legislature also increased the acreage limitation for all schools and colleges to 40 acres and expanded the use of the property to include dormitories and community residences for teachers or employees.

The next set of major amendments came in 1955. The Legislature increased the 40 acre limitation to 100 acres. The property had to be used exclusively for college or campus purposes, and the Legislature removed the allowance for dormitories and community residences for teachers or employees.

The Legislature in 1970 expanded the acreage limitation to 400 acres. Legislation in 1971 defined college or campus purposes to include buildings and grounds designed for classrooms, dormitories, housing of faculty and other employees, dining halls, parking lots, student unions and recreational buildings, athletic buildings, and all other school or college facilities, the need for which would be nonexistent but for the presence of the school or college and which are designed to further the educational functions of the institution.

The Legislature rewrote the property tax exemption code in 1973. A number of inconsistencies had developed among the various exemptions over the years, and not all types of exempt property were treated in a similar manner. But more likely, what prompted the Legislature to act then was a state Supreme Court ruling that denied a property tax exemption to a nonprofit church-run home for the aged.[7]

The 1973 changes to the exemption for schools and colleges inserted the word "nonprofit" before school or college; deleted the requirement that they be supported in whole or in part by gifts, endowments, or charity; and removed the requirement that the entire income of the institution from gifts, endowments, and charity be devoted to the purposes of the institution. The Legislature deleted the specific requirement that these institutions be open to all persons on equal terms. However, in a general section of law regarding several property tax exemptions, the Legislature provided that facilities and services must be available to all regardless of race, color, national origin, or ancestry. The organization or corporation must also be duly licensed or certified, where such licensing or certification is required. The legislation revised the definition of what constituted college or campus purposes, and it eliminated the annual report to the county assessor.

In 1984, in a matter related to the Pilchuck Glass School, the Legislature expanded the concept of nonprofit school or college to include cultural and art education programs. Also, the Legislature removed the requirements that revenue derived from the property owned or used by the institution needed to be devoted exclusively to the support of the institution and established that property owned or controlled by the institution for the purpose of deriving revenue was not exempt from taxation.

The Legislature last visited the property tax exemption for schools and colleges in 2006. The Legislature provided that the exempted property no longer has to be used exclusively for college or campus purposes. However, the property tax exemption is nullified if the property is used by

[7] "Yakima First Baptist Homes v. Gray," 82 Wn 2d 295 (1973).

an individual or organization not entitled to a property tax exemption, unless one of the following exceptions applies:

1. The property is used by students, alumni, faculty, staff, or other persons in a manner consistent with the educational, social, or athletic programs of the school;
2. The school may contract for food services for students, faculty, and staff, the operation of a bookstore on campus, and related maintenance, operational, or administrative services; or
3. The school may allow uses for monetary gain or to promote business activities for not more than seven days in a calendar year for each portion of the property. Sports or educational camp uses conducted by faculty members do not count against the seven days.

Any rent or donations received by the school for use of the property must be reasonable and not exceed maintenance and operation expenses. An inadvertent use of the property in a manner inconsistent with school purposes will not nullify the exemption, if the inadvertent use is not part of a pattern of use.

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?

Two primary theories provide a rationale for a property tax exemption for nonprofit organizations: 1) the base-defining theory that holds that a charitable activity does not rise to the level of a taxable activity; and 2) the subsidy theory that holds that the state bestows an exemption because charities lessen the burdens of government. Given that private schools did not receive a property tax exemption until well after a decade of statehood, it is clear that the Legislature did think that private schools rose to a level of taxable activity. They were not charitable organizations that exclusively provided services to the poor. The subsidy theory is the more likely candidate for a public policy objective. The state wanted to encourage the activity of private schools as they provided a positive benefit to society, and they lessened the burden on government.

An example of use of the subsidy argument occurred in 1924. The Ku Klux Klan sponsored an initiative that would have prohibited parochial schools.[8] Arguments presented against the initiative in the voter's pamphlet included pointing out that there were 18,517 children receiving grammar school education in private schools at no cost to the state.[9] The average annual cost of instruction for each child in public schools was $120.03, and the cost of school buildings per child was $226.24. If the private school pupils were forced into the public schools, the argument

[8] Initiative Measure No. 49 actually would have required that all children between the ages of seven and 16 attend public schools. This would have affected all private schools, nondenominational as well as those established by the Episcopal, Methodist, Seventh Day Adventists, Lutheran, and Catholic churches.

[9] 1924 voter's pamphlet containing all measures referred to the people prepared by the Secretary of State.

went, it would cause an added tax burden of $6,411,833.59. The initiative was defeated 158,922 "for" to 221,500 "against."

Initially, the private school had to be supported in whole or part by gifts, endowments, or charity, and the income from endowments had to equal or exceed revenues from tuition. Today, these requirements have evolved to the requirement that the school be nonprofit.

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

There are 348 private nonprofit K-12 schools that are receiving a property tax exemption. These schools enrolled an estimated 67,000 students in 2006-07. Of these schools, 270 were approved by the state (enrolling 58,000 students), and 78 did not seek approval (enrolling an estimated 9,000 students). This is evidence that private nonprofit schools are benefiting from the property tax exemption and the public policy objective of subsidization is being met. Students enrolling in private schools rather than in public schools result in a savings to the state and local school districts.

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

It is unknown what the impact of the tax exemption has been on the operation and enrollment in private nonprofit schools. There are private schools that operate without the benefit of a property tax exemption. In 2006-07, 70 private for-profit schools enrolled 2,700 students and did pay property taxes. There may also be some private nonprofit schools that do not receive a property tax exemption.

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 of subsidizing private nonprofit schools to lessen the burden on the state is being fulfilled.

Beneficiaries

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

According to Department of Revenue records, the Department exempted 348 nonprofit K-12 schools in 2006. It is estimated that these schools enrolled 67,000 students in 2006-07.

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

No unintended benefits are apparent.

Revenue and Economic Impacts

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

JLARC estimates the real and personal property value of exempted private nonprofit schools in 2007 to be $1.9 billion and the tax savings to be $19 million.[10] This is a combination of $3.8 million in state property tax savings and $15.3 million in local property tax savings. These savings to the taxpayer are not a loss of revenues to state and local governments as the taxes are shifted onto other taxpayers. There may be some local taxing districts at the maximum levy rate that have a loss of tax revenues due to the tax exemption.

Exhibit 1 – Property Tax Savings by Private Nonprofit Schools (dollars in millions)

Calendar Year	Value	State Property Tax Savings	Local Property Tax Savings	Total Property Tax Savings
2007	$1,874	$3.8	$15.3	$19.1
2008	$1,987	$4.0	$16.1	$20.1
2009	$2,106	$4.6	$17.5	$22.1
2010	$2,232	$4.7	$18.8	$23.5
2011	$2,366	$4.9	$19.7	$24.6

Source: JLARC analysis using Department of Revenue square footage and construction cost assumptions.

The total taxpayer savings forecasted by JLARC is nearly $25 million in 2011.

The economic impact of the property tax exemption for schools is the extent to which the exemption promotes education, either in quantity or quality, that otherwise would not occur, were it not for the exemption. How much additional educational activity takes place in Washington because of the property tax exemption is not known. In general, however, the economic impacts of education are of two types: 1) the impact of spending to provide an education to the students by employing teachers and other staff, acquiring materials, and providing facilities in which to do the teaching, and 2) the impact of students receiving an education (investment in human capital) and the long-term improvement in the state's economy of having a better educated workforce and citizenry.

Public and private schools are substitute goods. Students may attend either one. Spending to provide the education follows the students. In both public and private education, teachers and other staff need to be hired, materials acquired, and facilities constructed. Overall, the impact on the economy between public and private school spending is likely to be equivalent. Expenditures

[10] This estimate is based on the 67,000 enrollments at the 348 schools that are receiving a property tax exemption. Prior assumptions utilized by the Department regarding average square feet per student and construction costs are used here as well. These assumptions on square foot and new construction costs likely overstate the value of the nonprofit schools.

per student are likely higher in the public sector than in the private sector.[11] However, the funds necessary to pay for the education expenditures need to come from some other portion of the economy. So while spending per student may have a greater direct economic impact if done in the public sector, withdrawing the necessary funding (through higher taxes) from other portions of the economy will be more detrimental.

As to the long-term impacts, the question is whether there is a difference in students' outcomes between public and private schools. Numerous studies have examined the differences in outcomes using a variety of methods, with the results being mixed. While researchers make an argument that private schools outperform public schools, the evidence is not so clear. While some studies indicate that private schools are more effective, other studies argue that there may be unseen selection issues involved, such as the encouragement provided by parents in the home. Thus, we cannot say that promoting private school education leads to a greater long-term economic impact. However, the availability of private schools give parents more options and, possibly, a better educational fit for their children. Also, the private schools may provide educational opportunities not available in public schools.

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 Legislature terminated the property tax exemption for private nonprofit schools, the costs of operations for these schools would increase. The private nonprofit schools would need to either increase tuition or reduce costs by cutting wages or services. This would cause a shift of some students from private schools to public schools. The overall impact on the economy would be netted out. As the students shifted, expenditures for education would shift from the private sector to the public sector. Also, as the private nonprofit schools paid more in property taxes, other taxpayers would pay less.

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 Legislature terminated this tax preference, the distribution of liability for the payment of state taxes would shift slightly as the private schools paid another $3.3 million in state property tax and the other taxpayers, who are paying $1.4 billion in state property taxes, paid $3.3 million less.

Property taxes are levy-based. Within certain restrictions, the state and local governments set the amount of taxes to be collected. If selected property is exempted from or added to the tax base, ordinarily the same amount of taxes will still be collected as the taxes are shifted to or from other taxpayers. Other taxpayers pay more as property is exempted and pay less as property is added

[11] Average annual wages per employee are 20 percent higher in the public elementary and secondary schools than in the private schools.

to the tax base. The total amount of property taxes collected by government remains the same, unless the taxing district is at its maximum levy rate.

Other States

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

All 50 states and the District of Columbia exempt nonprofit schools from property taxes. In some states, the exemption is for property and buildings owned or used by schools, while in other states it is for property and buildings used for educational purposes. In Washington, it is both – the property must be owned or used by a nonprofit school for educational purposes. Many of the states, including Washington, require that the schools meet certain state standards or have academic programs similar to public schools. Some states have a broad definition of "educational purposes." Seven states appear to exempt property owned by both nonprofit and for-profit schools – the exemption hinges on the use of the property and not the corporate form if its ownership. These states include: Arkansas, Delaware, Florida, Indiana, Minnesota, New Mexico, and South Dakota.[12]

Recommendation

The Legislature should continue the property tax exemption for private, nonprofit schools.

Legislation Required: None.

Fiscal Impact: None.

[12] In South Dakota, if the educational institution is operated for profit, the exemption applies only to that portion of the property used exclusively for student housing, student and administrative parking, and instructional or administrative purposes.

PRIVATE COLLEGES – SUMMARY

Current Law

State law exempts property owned or used by any nonprofit school or college for educational purposes or cultural or art education programs from state and local property taxes. The exemption pertains to both private K-12 schools and to private colleges and universities. This chapter reviews private colleges and universities. Another chapter in this volume reviews private K-12 schools.

The exempt property must not exceed 400 acres. In addition, the buildings and grounds must be designed for the educational, athletic, or social programs of the institution, the housing of students, religious faculty, and chief administrator, and athletic buildings. Other college facilities are exempt if the need for them exists only because of the presence of the college. The property must be principally designed to further the educational, athletic, or social functions of the college.

The property tax exemption for a nonprofit college is nullified if the property is used by an individual or organization that is not entitled to a property tax exemption, unless one of the following exceptions applies:

1. The property is used by students, alumni, faculty, staff, or other persons in a manner consistent with the educational, social, or athletic programs of the college;
2. The college may contract for food services for students, faculty, and staff, the operation of a bookstore on campus, and related maintenance, operational, or administrative services; or
3. The college may allow uses for monetary gain or to promote business activities for not more than seven days in a calendar year for each portion of the property. Sports or educational camp uses conducted by faculty members do not count against the seven days.

Any rent or donations received by the college for use of the property must be reasonable and not exceed maintenance and operation expenses. An inadvertent use of the property in a manner inconsistent with college purposes will not nullify the exemption, if the inadvertent use is not part of a pattern of use.

Another section of law (RCW 84.36.805) requires that the college be available to all regardless of race, color, national origin, or ancestry and that the college be licensed or certified if required by law or regulation. By rule (WAC 458-16-270), the Department of Revenue defines "schools and colleges" as including nonprofit institutions that meet the following criteria:

- They have a definable curriculum and measurable outcomes for a specific group of students;
- They have a qualified or certified faculty;

- They have facilities and equipment that are designed for the primary purpose of the education program; they have an attendance policy and requirement;
- They have a schedule or course of study that supports the instructional curriculum; and
- They are accredited, recognized, or approved by an external agency that certifies educational institutions and the transferability of courses.

See Appendix 3 for the current law statute RCW 84.36.050(1).

Findings and Recommendations

This review evaluated the legal history, public policy objectives, economic and revenue impacts, and other states' tax preferences of Washington's property tax exemption for private nonprofit colleges. The audit determined the following:

Legal History and Public Policy Objectives

- Private colleges did not receive a property tax exemption when the new state Legislature passed its first laws in 1890 and 1891. The state Constitution provided several exemptions, based on public ownership. Other exemptions were left to the discretion of the Legislature. The state Supreme Court limited the ability of the Legislature to grant property tax exemptions to only "quasi-public" property such as charitable institutions, (privately-owned) public libraries, and cemeteries.
- The Legislature enacted the exemption for private colleges in 1903. The Legislature included the restrictions that the property had to be used solely for education purposes and that the property had to be owned by a college that was supported in whole or part by gifts, endowments, or charity. The amount of property could not exceed ten acres. The income from endowments had to equal or exceed revenues from tuition.
- Over the years, the Legislature has adopted many amendments to the exemption. The acreage limitation increased to 400 acres. The Legislature removed the restriction that income from endowments must equal or exceed tuition revenue. Allowable campus purposes now include buildings and grounds designed for classrooms, dormitories, housing for faculty and other employees, dining halls, parking lots, students unions and recreational buildings, athletic buildings, and other college facilities. The Legislature inserted the term "nonprofit" in 1973 and deleted the requirement that a college be supported in whole or part by gifts, endowments, or charity.
- The Legislature last visited the property tax exemption for colleges in 2006. The exempted property no longer has to be used exclusively for campus purposes. However, with several exceptions, the property tax exemption is nullified if someone not otherwise entitled to a property tax exemption uses the property.
- The public policy objective in providing a property tax exemption to private nonprofit schools is to provide a subsidy to these schools. This objective is being met.

Beneficiaries

- In 2006, at least 20 colleges and universities received an exemption, along with two vocational institutes, 26 seminaries, 19 job-training programs, and four cultural or art education programs.

Revenue and Economic Impacts

- The estimated value of exempt real and personal property of private nonprofit colleges and universities in 2007 is $3.3 billion. The annual tax savings to the colleges and universities is $32 million. These savings are, are mostly shifted onto other taxpayers through higher levy rates.
- In future years, the expected tax savings to the colleges and universities is estimated to range from $36 to $38 million per year. Again, these savings are mostly shifted to other taxpayers.
- The economic impact of the property tax exemption for private nonprofit colleges is the extent to which the exemption promotes higher education in the state that otherwise would not occur. How much additional educational activity takes place in Washington because of the property tax exemption is not known. In general, the economic impact of colleges and universities is of two types:
  - The "tourism" impact of recruiting students from other states who pay tuition and purchase room and board and other items in Washington. For Washington's private nonprofit colleges, JLARC has estimated this to be $390 million per year.
  - The investment in human capital of students who remain in Washington after obtaining a degree. For every 1 percent increase in workers with a Bachelor's degree in a state there is an associated $800 increase in the state's median per capita income. On average, someone with a Bachelor's degree has lifetime earnings over 67 percent more than someone with a high school diploma. Washington's private nonprofit colleges award nearly 7,000 Bachelor's degrees per year, or 24 percent of the state's total.

Other States

- All 50 states and the District of Columbia exempt nonprofit colleges from property taxes. The states differ on whether the exemption is granted because of the owner of the property versus the use of the property. In some states the exemption is for property and buildings owned or used by colleges, while in other states the exemption is for property used for educational purposes. In Washington, it is both – the property must be owned or used by a nonprofit college for educational purposes. At least seven states appear to exempt colleges of all types, both nonprofit and for-profit colleges.

Recommendation

The Legislature should continue the property tax exemption for private, nonprofit schools.

Legislation Required: None.

Fiscal Impact: None.

PRIVATE COLLEGES – REPORT DETAIL

Statutory History

When Washington became a territory in 1854, the territorial Legislature granted a property tax exemption to the real and personal property belonging to any religious society, or to any benevolent, charitable, literary, or scientific institution, to all real and personal property belonging to the territory or any county thereof, and to all school houses and school lands. The measure did not specifically mention private schools and it is not clear whether they would have been considered benevolent or charitable institutions.

The territorial Legislature rewrote the general property tax exemption periodically over the years. In 1886, it added an intent section for the property tax exemptions and specifically included institutions of learning, presumably including private schools. The exemption included a restriction on the amount of land that could be exempted:

> *Whereas religion, morality and knowledge being necessary for good government and happiness of mankind, there is further exempted all buildings or institutions of learning, … including the lands upon which such buildings are situated, not to exceed two acres, if within a city or town, and not exceeding eighty acres if not within a city or town.*[13]

Property tax exemptions were not without controversy in the late 1800s and the turn of the century. Typical of the arguments for and against were those used at the Washington State Constitutional Convention in 1889.[14] For example, those opposed to exempting churches from property tax charged that such an exemption would be a show of favoritism and would work an injustice to the taxpayer who would have to supply the deficit created. Those favoring exemption urged that churches were maintained purely for community benefit, and a tax levied upon them would be like taxing a public institution. Constitutional convention attendees discussed exemptions for churches, places of burial, institutions of public charity, public libraries, and personal property (up to a specified dollar amount). In the end, they left it to the Legislature to determine.

The new State Constitution of 1889 provided that all property was to be taxed, with exceptions. The Constitution exempted property of the United States, the state and local governments, including school districts, and such other property the Legislature selected. Public schools and colleges had an exemption provided in the Constitution. Private schools and colleges did not receive a property tax exemption when the Legislature passed its first laws in 1890.

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[13] 1886 Laws of Washington Territory, p. 47 §1.

[14] See "The Journal of the Washington State Constitutional Convention, 1889, with analytical Index by Q. S. Smith," edited by B. P. Rosenow, 1999.

Schools and colleges did not make the list in the second effort to modify exemptions in 1891. A state representative did make a motion on the House floor in 1891 to expand the exemption for state colleges to include all colleges. The amendment failed.

An 1897 Washington Supreme Court ruling helped shape the Legislature's creation of property tax exemptions. The Court ruled that the property exempted by the Legislature needed to be of a "quasi-public" nature.[15] The Court found a set of 1897 exemptions to be unconstitutional. The court provided examples of quasi-public property such as charitable institutions, public libraries, cemeteries, and similar classes of property where the use of the property is not strictly private. Instead the public has an interest in the property and its maintenance, and the property does not truly enter into competition with private property. Also, the use of the property benefits the state from a financial standpoint in that services are performed for which the state would otherwise be called upon to discharge.

The Legislature enacted the exemption for private schools and colleges in 1903.[16] The exemption applied to the real and personal property owned by any school or college that was supported in whole or part by gifts, endowments, or charity. The income from the gifts, endowments, or charity had to be devoted to the purposes of the institution. The school or college had to be open to all persons upon equal terms. The property had to be used solely for educational purposes and could not exceed ten acres. Any real estate owned by the institution that was leased for the purpose of deriving income was not exempt. Finally, the annual income from endowments had to equal or exceed revenues received from tuition. During passage in the Senate, one senator explained his vote by stating:

> *I doubt the act being constitutional; but, not being absolutely certain that the same is unconstitutional, and believing the bill to be meritorious, I vote aye.*[17]

Later, the House added the amendments that restricted the exemption to ten acres, provided that leased land was not exempt, and required income from endowments to exceed revenues from tuition.

The next amendments occurred in 1925. Property used (but not necessarily owned) by a school or college could also be exempt. The acreage limitation increased to 40 acres for colleges. Before the exemption could be granted, the institution had to file an annual report with the county assessor listing all the property, the purpose for which it was used, revenue derived from the property, the number of students attending the institution, and the total revenues, by source, of the institution and how they were spent.

In 1931 and 1932, the King County assessor disallowed the property tax exemption for the Lakeside Day School, noting endowment income did not exceed tuition.[18] In deciding against the school, the state Supreme Court also took the opportunity to comment "That the [exemption

[15] "Chamberlin v. Daniel," 17 Wash. 111 (1897); and "Buchanan v. Bauer," 17 Wash. 688 (1897).

[16] Chapter 183, Session Laws, 1903.

[17] "Journal of the Washington State Senate," 1903, page 305.

[18] "Lakeside Country Day School v. King County," 179 Wash. 588 (1934).

statute] as a whole is poorly drafted and inconsistent in its provisions, is apparent enough at a glance…" In 1933, the Legislature removed the requirement that the annual income from endowments needed to equal or exceed all income from tuitions. The Legislature also increased the acreage limitation for all schools and colleges to 40 acres and expanded the use of the property to include dormitories and community residences for teachers or employees.

The next set of major amendments came in 1955. The Legislature increased the 40 acre limitation to 100 acres. The property had to be used exclusively for college or campus purposes, and the Legislature removed the allowance for dormitories and community residences for teachers or employees.

The Legislature in 1970 expanded the acreage limitation to 400 acres. Legislation in 1971 defined college or campus purposes to include buildings and grounds designed for classrooms, dormitories, housing of faculty and other employees, dining halls, parking lots, student unions and recreational buildings, athletic buildings, and all other school or college facilities, the need for which would be nonexistent but for the presence of the school or college and which are designed to further the educational functions of the institution.

The Legislature rewrote the property tax exemption code in 1973. A number of inconsistencies had developed among the various exemptions over the years, and not all types of exempt property were treated in a similar manner. But more likely, what prompted the Legislature to act then was a state Supreme Court ruling that denied a property tax exemption to a nonprofit church-run home for the aged.[19]

The 1973 changes to the exemption for schools and colleges inserted the word "nonprofit" before school or college; deleted the requirement that they be supported in whole or in part by gifts, endowments, or charity; and removed the requirement that the entire income of the institution from gifts, endowments, and charity be devoted to the purposes of the institution. The Legislature deleted the specific requirement that these institutions be open to all persons on equal terms. However, in a general section of law regarding several property tax exemptions, the Legislature provided that facilities and services must be available to all regardless of race, color, national origin, or ancestry. The organization or corporation must also be duly licensed or certified, where such licensing or certification is required.[20] The legislation revised the definition of what constituted college or campus purposes, and it eliminated the annual report to the county assessor.

In 1984, in a matter related to the Pilchuck Glass School, the Legislature expanded the concept of nonprofit school or college to include cultural and art education programs. Also, the Legislature removed the requirements that revenue derived from the property owned or used by the institution needed to be devoted exclusively to the support of the institution and established that property owned or controlled by the institution for the purpose of deriving revenue was not exempt from taxation.

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[19] "Yakima First Baptist Homes v. Gray," 82 Wn 2d 295 (1973).

[20] Certain postsecondary education degree-granting institutions are required by Chapter 28B.85 RCW and Chapter 28B.90 RCW to be certified by the Higher Education Coordinating Board.

The Legislature last visited the property tax exemption for schools and colleges in 2006. The Legislature provided that the exempted property no longer has to be used exclusively for college or campus purposes. However, the property tax exemption is nullified if the property is used by an individual or organization not entitled to a property tax exemption, unless one of the following exceptions applies:

1. The property is used by students, alumni, faculty, staff, or other persons in a manner consistent with the educational, social, or athletic programs of the school;
2. The school may contract for food services for students, faculty, and staff, the operation of a bookstore on campus, and related maintenance, operational, or administrative services; or
3. The school may allow uses for monetary gain or to promote business activities for not more than seven days in a calendar year for each portion of the property. Sports or educational camp uses conducted by faculty members do not count against the seven days.

Any rent or donations received by the school for use of the property must be reasonable and not exceed maintenance and operation expenses. An inadvertent use of the property in a manner inconsistent with school purposes will not nullify the exemption, if the inadvertent use is not part of a pattern of use.

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?

Two primary theories provide a rationale for a property tax exemption for nonprofit organizations: 1) the base-defining theory that holds that a charitable activity does not rise to the level of a taxable activity; and 2) the subsidy theory that holds that the state bestows an exemption because charities lessen the burdens of government. Given that private colleges did not receive a property tax exemption until well after a decade of statehood, it is clear that the Legislature did think that private colleges rose to a level of taxable activity. They were not charitable organizations that exclusively provided services to the poor. The subsidy theory is the more likely candidate for a public policy objective. The state wanted to encourage the activity of private colleges as they provided a positive benefit to society, and they lessened the burden on government.

Initially, the private college had to be supported in whole or part by gifts, endowments, or charity, and the income from endowments had to equal or exceed revenues from tuition. Today, these requirements have evolved to the requirement that the college be nonprofit.

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

Private nonprofit colleges, universities, seminaries, job training programs, and cultural or art educational programs exist in Washington and accept students that do earn degrees and certificates. The extent to which this property tax exemption contributes to this activity is not known. Nonetheless, students earned nearly 7,000 Bachelor's degrees at private nonprofit colleges and universities in 2006-07. This accounted for 24 percent of the total number of Bachelor's degrees earned in Washington colleges in that year. Any degrees and certificates earned at private nonprofit institutions rather than at Washington public institutions, or not earned at all, indicate some achievement of the public policy to subsidize private nonprofit institutions to avoid costs in the public sector.

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

It is unknown what the impact of the tax preference has been on the education programs of the private nonprofit postsecondary institutions. It is possible for private colleges to operate without the benefit of a property tax exemption. There are 49 private for-profit institutions in Washington that do pay property taxes and report to the U.S. Department of Education. Students at these institutions earned 4,395 certificates, 766 Associate's degrees, 746 Bachelor's degrees, and 280 post-Bachelor's degrees in 2006-07. Private for-profit institutions concentrate more on programs taking less than four years than do private nonprofit institutions. However, the number of Bachelor's and Master's degrees being awarded by for-profit institutions has been increasing in the past several years.

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 of subsidizing private nonprofit colleges to lessen the burden on the state is being fulfilled.

Beneficiaries

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

The beneficiaries of the property tax exemption to private nonprofit colleges include a number of postsecondary education institutions, such as four-year colleges and universities, religious seminaries, two-year vocational institutes, apprenticeship and job-training programs operated by unions, and cultural or art education programs. In 2006, there were at least 20 colleges and

universities receiving an exemption, two vocational institutes, 26 seminaries, 19 job-training programs, and four cultural or art education programs.[21]

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

No unintended benefits are apparent.

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 Department of Revenue estimates the real and personal property value of exempted private colleges in 2007 to be $3.3 billion.[22] The Department estimates the tax savings to the private schools to be $33.6 million in 2008. This is a combination of $6.7 million in state property tax savings and $26.9 million in local property tax savings. These savings to the taxpayer are not a loss of revenues to state and local governments as the taxes are mostly shifted onto other taxpayers through higher levy rates. There may be some local taxing districts at the maximum levy rate that have a loss of tax revenues due to the tax exemption.

Exhibit 2 – Property Tax Savings by Private Nonprofit Colleges ($ in millions)

CY	Value	State Property Tax Savings	Local Property Tax Savings	Total Property Tax Savings
2007	$3,310	$6.4	$25.9	$32.3
2008	$3,442	$6.7	$26.9	$33.6
2009	$3,580	$7.1	$28.7	$35.8
2010	$3,723	$7.3	$30.1	$37.4
2011	$3,872	$7.4	$31.0	$38.4

Source: Department of Revenue worksheets.

Property taxes are levy-based. Within certain restrictions, the state and local governments set the amount of taxes to be collected. If selected property is exempted from the tax base, ordinarily the

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[21] One nonprofit college, Mars Hill Graduate School, is not readily apparent on the Department's list of colleges receiving a property tax exemption. In addition, seminaries, job-training programs, and cultural and arts education programs are not separately identified as such in the Department's records but are grouped with either colleges or schools. The identification of these programs was made by the name of the organization and some organizations may have been missed.

[22] This estimate is understated as it values only the private colleges that participate in federal financial aid programs and report to the U.S. Department of Education. These colleges report land, building, and equipment values and this provided the base from which the value of real and personal property was made. It excludes religious seminaries, union-operated job-training programs, and cultural or art education programs. This estimate is used here to provide a scale to the magnitude of the exemption.

same amount of taxes will still be collected as the taxes are shifted to other taxpayers. The total amount of taxes collected by government remains the same, unless the taxing district is at its maximum levy rate.

The economic impact of the property tax exemption for private nonprofit colleges is the extent to which the exemption promotes students to attend these colleges, that otherwise would not attend, were it not for the exemption. How much additional educational activity takes place in Washington because of the property tax exemption is not known. In general, however, the economic impact of private nonprofit colleges is of two sorts. First, there is the impact of bringing new dollars into the Washington economy. This is accomplished by bringing into Washington nonresident students who would otherwise come to this state. These nonresident students spend money on tuition, room and board, as well as other items. This impact is the similar to the impact of tourism. The second impact results from the investment in human capital. To the extent that graduates remain in Washington, it provides a productivity boost to the state. There are increased lifetime earnings associated with a better educated workforce.

Several of the private nonprofit colleges have the majority of their entering class coming from outside of Washington. The overall average for out-of-state freshmen at all the private nonprofit schools that report to the Department of Education is 46 percent. Applying the share of out-of-state freshmen students to the overall enrollments at these colleges results in 16,000 nonresident students. The listed undergraduate tuition at these colleges ranges from $8,000 to $33,000 per year. Nearly $230 million per year in tuition income can be attributed to nonresident students in Washington's private nonprofit colleges. In addition these students need to purchase room and board and other items. Expenditures on room and board, books, transportation, entertainment, and other items come to approximately $160 million per year.

The important long-term role of the nonprofit colleges is the education of Washington residents and of students who will remain in Washington after graduation. Higher education provides considerable value to individuals and creates economies of educated individuals. Economies that have experienced substantial investment in either private or public institutions of higher learning have realized considerable growth and prosperity.[23] There is a high and increasing rate of return to earning a Bachelor's or graduate degree. College educated students see a substantial return for an Associate's degree or technical program certificate. Higher earnings are associated with higher tax revenues and lower social assistance costs.[24]

For every 1 percent increase in workers with a Bachelor's degree in a state there is an associated $800 increase in the state's median per capita income.[25] At any given age a person with an Associate's degree earns between 15 to 28 percent more than someone with only a high school diploma. Someone with a Bachelor's degree earns from 67 to 82 percent more. Between the ages of 45 to 54 the average earnings of someone with a Bachelor's degree working full-time is over

[23] "The Value of Higher Education," Kent Hill, et al, L. William Seidman Research Institute, Tempe, Arizona, October 2005.

[24] "Rate of Return to Education Investments: Economic and Social," Paul Sommers, Seattle University, June 2006.

[25] "The Social and External Benefits of Education," Theo Eicher, UW Economic Policy Research Center, 2006.

$74,000. This is $32,000 more than the average income of someone who only graduated from high school.

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 Legislature terminated the property tax exemption for private nonprofit colleges, the costs of operating these colleges would increase. These private nonprofit colleges and programs would need to either increase tuition or reduce costs by cutting wages or services. Higher tuition costs would be paid by wealthier in-state and out-of-state households. The overall impact on the economy would be mostly netted out. As the private nonprofit colleges paid more in property taxes, other taxpayers would pay less. The total amount of taxes collected by government would remain about the same. Since the colleges would be paying higher property taxes, and other businesses and households paying less, the overall impact on the economy would not be significant.

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 Legislature terminated this tax preference, the distribution of liability for the payment of state taxes would shift slightly as the private colleges paid another $7 million in state property tax and the other taxpayers, who are currently paying $1.4 billion in state property taxes, paid $7 million less. This is a result of total state property tax collections being fixed in a given year.

Other States

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

All 50 states and the District of Columbia exempt nonprofit colleges from property taxes. In some states, the exemption is for property and buildings owned or used by colleges, while in other states it is for property and building used for educational purposes. In Washington, it is both – the property must be owned or used by a nonprofit college for educational purposes. Many of the states, including Washington, require that the colleges meet certain accrediting standards. Some states have a broad definition of "educational purposes." Seven states appear to exempt property owned by for-profit schools – the exemption hinges on the use of the property

and not the corporate form if its ownership. These states include: Arkansas, Delaware, Florida, Indiana, Minnesota, New Mexico, and South Dakota.[26]

Recommendation

The Legislature should continue the property tax exemption for private, nonprofit schools.

Legislation Required: None.

Fiscal Impact: None.

[26] In South Dakota, if the educational institution is operated for profit, the exemption applies only to that portion of the property used exclusively for student housing, student and administrative parking, and instructional or administrative purposes.

INTANGIBLES – SUMMARY

Current Law

Current law exempts certain intangibles from property taxes. Exempt intangibles include financial assets like moneys, credits, mortgages, notes, certificates of deposit, and stocks and bonds. Other intangible assets exempt from property tax include trademarks, brand names, patents, copyrights, trade secrets, licenses, customer or patient lists, favorable financing agreements and contracts, and good business management and reputation.

Washington's current law also lists the features that are not exempt from property taxes as intangible personal property. These include physical attributes of real property such as zoning, location, view, geographical features, conditions of the neighborhood, and proximity to markets. Current law does not restrict assessors to any particular appraisal method and allows them to use generally accepted appraisal practices. See Appendix 3 for the current law statute, RCW 84.36.070.

Findings and Recommendations

This review has evaluated the legal history, public policy objectives, economic and revenue impacts, and other states' similar tax preferences of the property tax exemption for intangible personal property. The audit determined the following:

Legal History and Public Policy Objectives

- The state Constitution originally provided that "all property" not exempted by federal law or other provisions of the state Constitution was subject to taxation.
- However, in 1901 the Legislature reversed this practice by providing an exemption from taxation for accounts, notes, bonds, certificates of deposit, judgments, and all other state and local government bonds. This exemption was upheld by the Supreme Court.
- In 1930, Washington voters adopted an amendment to the state Constitution which provided that, for purposes of taxation property "shall mean and include everything, whether tangible or intangible, subject to ownership." The amendments to Washington's Constitution also prohibited the taxation of intangible property secured by real property.[27] Essentially, the amendment gave the Legislature greater ability to exempt property from taxation.
- In 1931, the Legislature excluded from property tax all monies, credits, mortgages, notes, accounts, certificates of deposit, stocks, and bonds.

[27] "Tax Exemptions 1982" by Washington Department of Revenue.

- No substantive changes or court challenges occurred again until the Legislature excluded from property taxation non-governmental personal service contracts and athletic or sports franchise agreements in 1974.
- By the mid-1990s, federal income tax law allowed companies to claim depreciation of intangible personal property, and two court cases allowed certain intangible personal property to be included in property value. This led to legislative changes in 1997 to expand the legal definition regarding which intangible personal property was exempt and to clarify the property features expressly not included as intangible personal property.

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

1. To avoid double taxation of financial assets; and
2. To facilitate administration of the property tax on intangible personal property.

Beneficiaries

- The total number of beneficiaries is unknown. The Department of Revenue and county assessors do not generally separate intangible personal property from other property when valuing a company.
- At the time of completion of this performance review, there did not appear to be any unintended beneficiaries of this tax preference. There have not been many major court challenges pertaining to intangible personal property since the tax preference was redefined in 1997.

Revenue and Economic Impacts

- The revenue impact of this tax preference is based on taking Washington's share of national estimates of the value of intangible property. The value of Washington's exempt intangible personal property is nearly $1 trillion. This is larger than all taxable property assessed in the state in 2007.
- JLARC estimates the property tax taxpayer savings from this exemption to be $11 billion in fiscal year 2008, increasing to $12.8 billion by fiscal year 2011.
- Given the size of this property tax exemption, if it were eliminated, there would be significant shifts occurring in the property tax system statewide.
- Over time, companies and individuals are tending to hold less real property and more intangible personal property assets.

Other States

- Washington is one of five states not imposing a tax on intangible personal property held by individuals either through the property tax, income tax or other form of tax.
- Washington is also one of three states not imposing similar taxes on intangible personal property held by businesses either.

Recommendation

The Legislature should continue the property tax exemption for intangible personal property.

Legislation Required:	None.
Fiscal Impact:	None.

Statutory History

The state Constitution originally provided that "all property" not exempted by federal law or other provisions of the state Constitution was subject to taxation. In the late 1800's, taxpayers were required to separately list, and pay taxes on, intangible personal property such as "moneys, notes, accounts, bonds or stock, shares of stock, of joint stock or other companies (when the property of such company is not assessed in the state), franchises, royalties and other personal property." Mortgages and all credits for the purchase of real estate, however, were excluded from the taxable personal property definition.[28]

1901

In 1901, however, the Legislature reversed this practice by providing that:

> *All **credits** including accounts, notes, bonds, certificates of deposit, judgments, choses in action and all other debts of state, county, municipal and taxing district bonds and warrants shall not be considered as property for the purpose of this act….*[29]

The Legislature expanded this concept in 1907 by adding mortgages, tax certificates, judgments, and money to the list of items to be excluded from the definition of taxable personal property. Subsequent Supreme Court cases challenged these statutes based on the constitutional requirement that "all property" is subject to taxation. These cases upheld as constitutional the exclusion of the credits but stated that "money" itself had intrinsic value and should not be excluded. The Washington Supreme Court, however, noted that taxing of the listed items could in fact lead to double taxation as the state would be taxing both the right to the property and the property itself.[30] No laws, however, prohibit double taxation.

1930s

In 1930, Washington voters amended the state Constitution to clarify for purposes of taxation that property "shall mean and include everything, whether tangible or intangible, subject to ownership." With the approval of the 14th Amendment, the state Constitution prohibited the taxation of intangibles secured by real property.[31] Taxation of property had to be uniform within a class of property. However, the Legislature could exempt classes of property from taxation.[32]

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[28] Laws of 1891, c. 140, Laws of 1893, c. 124, Laws of 1895 c.176, Laws of 1897, c. 71.

[29] Laws of 1901, Extraordinary Session, c.2 §1.

[30] State ex rel. Wolfe v. Parmenter, 50 Wash. 164 (1908).

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

[32] Laws of 1929, p. 499, §1, Amendment 14.

As a result, in 1931, the Legislature adopted this statutory exemption for intangible personal property with the following provision:

> *All monies and credits including mortgages, notes, accounts, certificates of deposit, tax certificates, judgments, state, county and municipal bonds and warrants and bonds and warrants of other taxing districts, bonds of the United States and of foreign countries or political subdivisions thereof and the bonds, stocks, or shares of private corporations shall be and hereby are exempt from ad-valorem taxation.*[33]

1974

No substantive changes or court challenges to this section occurred until 1974. At that time, the Legislature amended the law to exclude from property taxation non governmental personal service contracts, and athletic or sports franchises and agreements that do not pertain to interest in tangible personal or real property. Little legislative history exists relative to this change, but the fiscal note indicates that only King County would be affected and that the tax revenue would be prospective only as no such tax had yet been collected.

1980s

Burlington Northern (BN) challenged the Department of Revenue on their assessed value and uniform treatment in the late 1980s. One aspect of the case pertained to intangible personal property of the railroad. The Federal Court decision clarified that these intangible assets were taxable and should be inventoried and assessed. As a result, the Department of Revenue included intangible personal property book values in the audits used in the ratio study. County assessors began to specially request information on the personal property affidavits and include them in the assessment roll.[34]

1993

Changes to federal tax law in 1993 allowed taxpayers to claim depreciation for intangibles by requiring a separate listing of these items for federal income tax purposes.[35] Since businesses were also required to list their personal property to local county assessors each year, some businesses' lists of personal property began to include intangible personal property.

1995

An informal task force on intangible personal property comprised of business, county assessors and Department staff convened in 1995. The group came close to consensus on proposed legislation in December 1995, but did not reach agreement.

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[33] Laws of 1931, c.96, §1.

[34] "Property Tax Exemption of Intangible Assets," Report of the Department of Revenue December 2000.

[35] 26 USC § 197. Many of the items covered by the federal statute are similar to those contained in the state law.

1996

In a letter dated January 18, 1996, the Department of Revenue advised the county assessors not to separately list and value intangible personal property. The Department had concerns that the intangible personal property would not be identified and taxed uniformly by counties.

In the 1996 Legislative Session, SHB 2745 was introduced and passed the House but died in the Senate. This legislation proposed changes to the taxation of intangible personal property and was opposed by the county assessors. All of these proposed changes and discussions led to new intangibles legislation in 1997.

In 1996, two Board of Tax Appeal rulings were made regarding taxation of certain intangible personal property.[36]

1997

The discussions about the intangible legislative proposals was about whether the legislation would maintain the status quo or require government appraisers to subtract the value of intangibles from the appraisals of certain business properties.

The 1997 bill contained four points:

1. The Legislature added specific items to the list of intangible personal property exempt from taxation.[37]
2. The Legislature excluded attributes and characteristics of real property (such as zoning, location, view, etc.) from the definition of "intangible personal property."
3. The Legislature allowed the use of generally accepted appraisal practices in valuing real and personal property.
4. The Legislature required the Department of Revenue to provide a report by December 2000, regarding the effects of the legislation.[38]

The Legislature has not amended the law pertaining to the taxation of intangible personal property since 1997.

Other Relevant Background

In Washington State, county assessors have the statutory obligation to identify and assess all taxable property, both real and personal that is located in their county. One exception to this is

[36] Ki Joo Huh v. Noble, Docket No. 45437 (1996) (good will and covenant not to compete includable in purchase price used to determine assessment value); Quadrant Business Park v. Noble, Docket No. 46004 (1996)(business value of hotel includable in determining assessment value).

[37] The list includes trademarks, trade names, brand names, patents, copyrights, trade secrets, franchise agreements, licenses, permits, core deposits of financial institutions, noncompete agreements, customer lists, patient lists, favorable contracts, favorable financing agreements, reputation, exceptional management, prestige, good name, or integrity of a business. Computer software is exempt from property tax under a different statute. RCW 84.36.600.

[38] ESSB 5286.

the valuation of the inter-county utilities. These are referred to as state-assessed properties as these are assessed by the Department of Revenue. The development of an inventory of real and personal properties involves three processes:

- For real property: assessors identify every legal parcel of real property and physically inspect properties on a regular basis.
- For personal property: owners of taxable personal property are required to submit an listing form to the assessors each year which lists all personal property in their ownership.
- For state-assessed property: each company is required to compile and submit an annual report that includes an array of information ranging from asset listings to audited financial statements and stockholder reports.

The methods for determining assessed value of real and personal property are defined in statute and allow for three basic methodologies: sales, cost and income. Different industries are suited to various appraisal methods. Appraisers assess the quality of the data and analysis that is available at the time of appraisal. The amount of intangible personal property captured in a valuation of real property of certain businesses will depend on the appraisal method used and the assets of the businesses.

Three Basic Appraisal Methods

In the sales approach, the value of the property is based on recent sales prices of comparable properties. With the cost approach, the value is based on estimates of the cost of reconstructing the property with adjustments made for depreciation. In the income approach, the value is based upon the capitalized income that could be generated from the use of the property. The cost approach excludes intangible assets from the property value. Questions arise regarding intangible assets when assessors apply the income or the sales approach.

Complex commercial and industrial properties are typically a class of properties which are difficult to estimate because in order for the properties to have operational value, they require an integration of various real and personal property assets that can not stand alone. These complex commercial and industrial properties are typically located in larger Washington counties. Examples of these properties are hotels, resorts, and manufacturing facilities such as sawmills, refineries, and paper manufacturing. All three appraisal approaches to value may be appropriate for valuing these types of properties but the analysis can be complex. For state-assessed companies, the same issues are relevant in the valuation of complex properties.[39]

Under provisions in RCW 84.40.030 and WAC 458-07-030, the true and fair value of property must be based upon sales of the subject property or sales of comparable properties made within the past five years. In addition, consideration may be given to cost, cost less depreciation, and the capitalization of income that would be derived from prudent use of property. The assessor is afforded considerable discretion to determine the methodology employed to arrive at market

[39]"Property Tax Exemption of Intangible Assets," Report of the Washington Department of Revenue December 2000.

value.[40] State law and court rulings have stated that the value placed on the property by the county assessor is presumed to be correct, and can only be overcome by presentation of clear, cogent, and convincing evidence that the value is erroneous.[41]

Different Sources of Intangibles

All individuals and firms have two kinds of assets: those you can touch (tangible) and those you cannot (intangible). The Brookings Task Force on Intangibles defined intangibles as nonphysical factors that contribute to, or are used in, the production of goods or the provision of services, or that are expected to generate future productive benefits to the individuals or firms that control their use.[42] Intangible assets can be further divided into identifiable and unidentifiable intangibles.[43] Identifiable intangibles include financial assets and other non-financial assets such as patents, copyrights, trademarks, trade secrets, and research and development expenditures. Unidentifiable assets are those that cannot be easily quantifiable. Good will is an example of an unidentifiable intangible asset. It is defined by financial accountants as a residual, created when one firm buys another firm for more than the fair value of the identifiable assets. There are other unidentifiable assets like customer lists and human capital present in certain firms that could add value to the firm and be captured in good will. There is overlap between an individual's or firm's tangible and intangible assets.

There are three major sources of intangibles. The first source is financial intangible assets easily identifiable on financial statements. Another source of intangible personal property in Washington is the state-assessed utility properties appraised by the Department of Revenue. The third source of intangible personal property is the locally-assessed large industrial and commercial properties.

1) Financial Intangible Personal Property

All financial assets are intangible, although some may be securitized by physical assets. Cash and cash equivalents are not real property and do not need a valuation. Financial intangible personal property includes not only cash deposits but also time and saving deposit accounts, equities in corporate stocks, bonds, and mutual funds and government securities. The pie graph, Exhibit 3, depicts the value of financial intangible assets in the U.S. by type of owner in 2006. Besides households and nonprofit organizations, other corporate and non corporate businesses hold financial assets as well. Financial businesses owned 44 percent of the $132 trillion in U.S. intangible assets in 2006. Households and nonprofit organizations had the second largest share of all financial assets at 32 percent. Other nonfinancial businesses owned 11 percent of U.S. intangible financial assets in 2006.

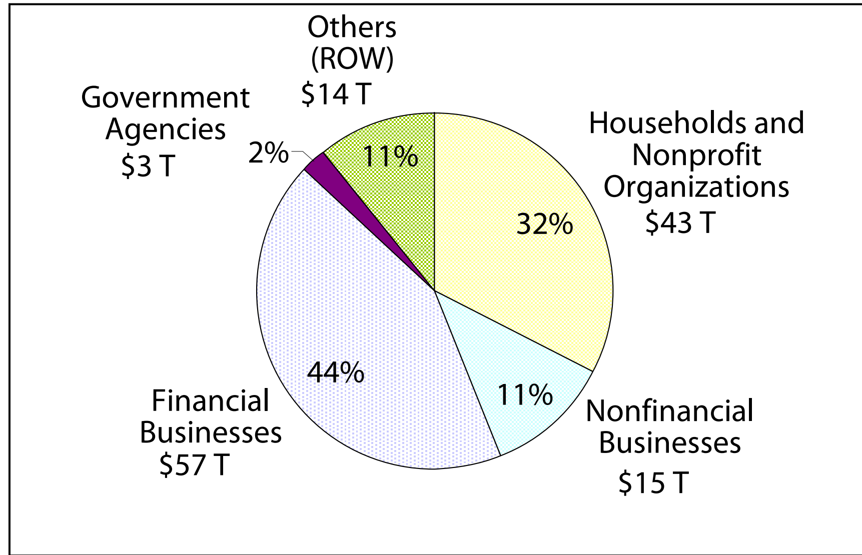
[40] Tacton v. Noble,. Docket No. 59921 (2005).

[41] Weyerhaeuser Co. v. Easter, 126 Wn. 2d 370, 890 P. 2d 1290 (1995).

[42] "Unseen Wealth Report of the Brookings Task Force on Intangibles" by Margaret Blair and Steven Wallman.

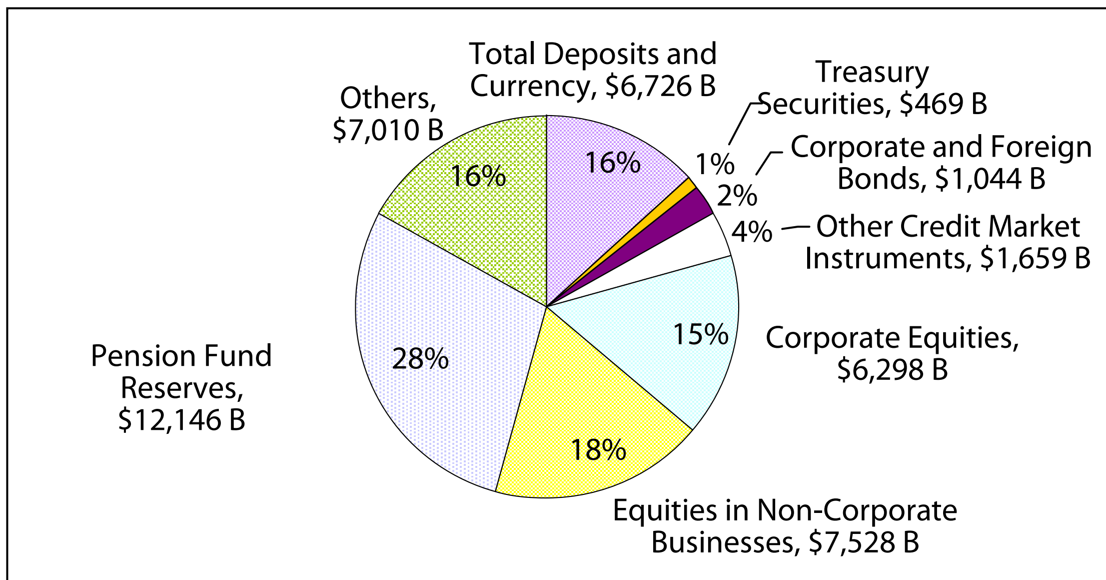
[43] "Intangible Assets Valuation and Economic Benefits" by Jeffrey A. Cohen.

Exhibit 3 – 2006 U.S. Financial Assets ($132 trillion) By Owner Type



Source: U.S. Federal Reserve data of the flow of funds.

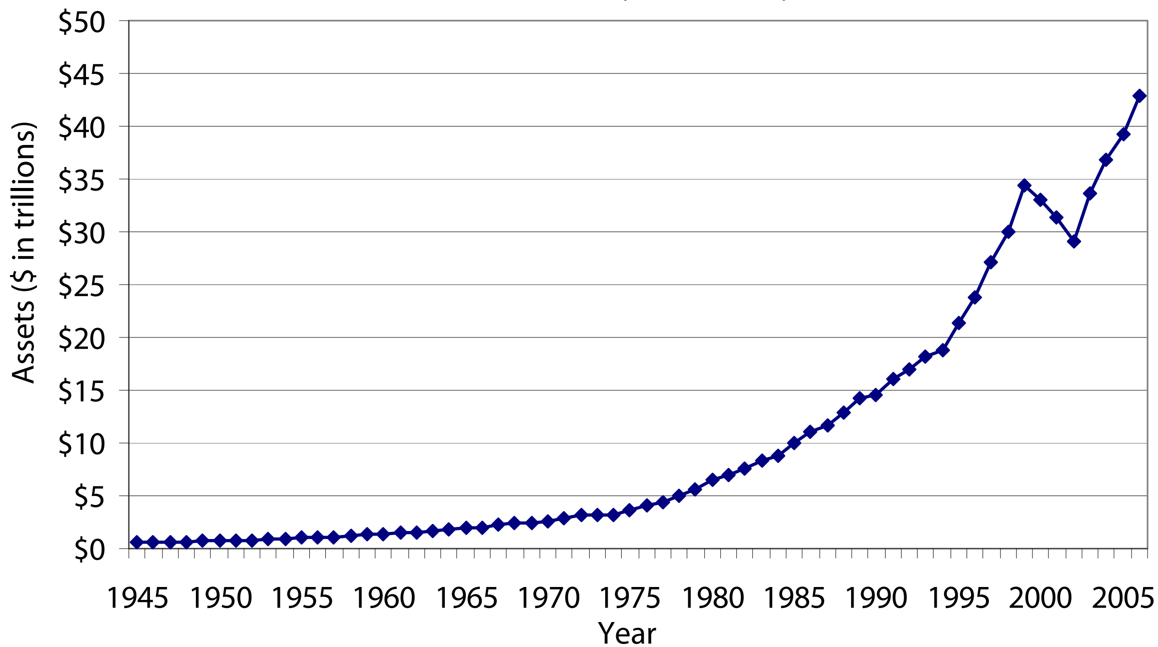
Exhibit 4 – Types of Financial Intangibles of U.S. Households and Nonprofits Institutions ($42.88 trillion) - 2006



Source: U.S. Federal Reserve data of the flow of funds.

To further examine the value of U.S. financial intangibles, the 2006 financial intangibles for households and nonprofits are detailed in Exhibits 4 and 5. Exhibit 4 provides a breakdown of households and nonprofit institutions' financial intangible personal property by type of financial asset. It reveals that pension fund reserves at $12.1 trillion made up the largest portion of U.S. households and nonprofits' intangible financial assets at 29 percent. Equities in non corporate (18 percent) and corporate businesses (15 percent) also made up large portions of U.S. households and nonprofits' intangible financial assets as well. The other category of intangible financial assets includes mutual fund shares, life insurance, and other miscellaneous assets. Exhibit 5 reveals that total U.S. households and nonprofits financial assets have grown to nearly $45 trillion by 2006.

Exhibit 5 – Total U.S. Households and Nonprofits Financial Assets Since 1945 ($ in trillions)



Source: U.S. Federal Reserve data of the flow of funds.

2) State-Assessed Companies – Intangible Personal Property

A second source of intangible personal property is from state-assessed companies. State assessed companies are companies required by law to have their property assessed by the Department of Revenue.[44] These companies include railroads, airlines, electric light and power, telegraph, telephone and cell phone, gas, pipeline, and logging railroad companies. These companies are state-assessed because their property value lies beyond a single county and even outside Washington, and a portion of that total company value must be apportioned to Washington. Most of the state-assessed companies have some other nonfinancial intangible personal property in addition to their current assets. The following exhibit outlines some examples of intangible personal property that certain state-assessed utility companies may own. These examples are

[44] 84.12.200.

based on discussions between JLARC and Department of Revenue staff regarding the intangible personal property which different utilities could potentially own.

Exhibit 6 – State-Assessed Companies – Examples of Possible Intangible Personal Property (Excluding Financial Intangible Assets and Computer Software)

State-Assessed Utility Group	Examples of Possible Intangible Personal Property
Airlines	International routes and slots; leasehold interests at airports, workforce, frequent flyer programs, trademark, and all intangibles identified by section 197 of IRS code
Electrics	Tradable pollution credits, pre-paid contracts with BPA and agreements to lock in prices and sales
Gas companies	Contracts of purchases of fuel supplies; gas sale agreements with purchasers
Private railcars	Favorable/unfavorable contracts suppliers and railroads
Railroads	Non-software high tech. systems, contracts and workforce
Wireless	FCC licenses, trade name
Telecommunications	Trade names and customer lists

Source: JLARC.

The Department of Revenue has been identifying and valuing certain intangible personal property that had not been exempted prior to the 1997 legislative changes. This annual report provides an estimate of the intangible personal property value of state-assessed utility companies but excludes those intangible personal property assets exempted prior to 1997, such as financial intangibles. In examining this data for the past five years, some interesting trends can be seen in Exhibit 7. In 2003, the value of intangible personal property of state-assessed utility companies was $782 million. In 2007, the total value of intangible personal property increased to

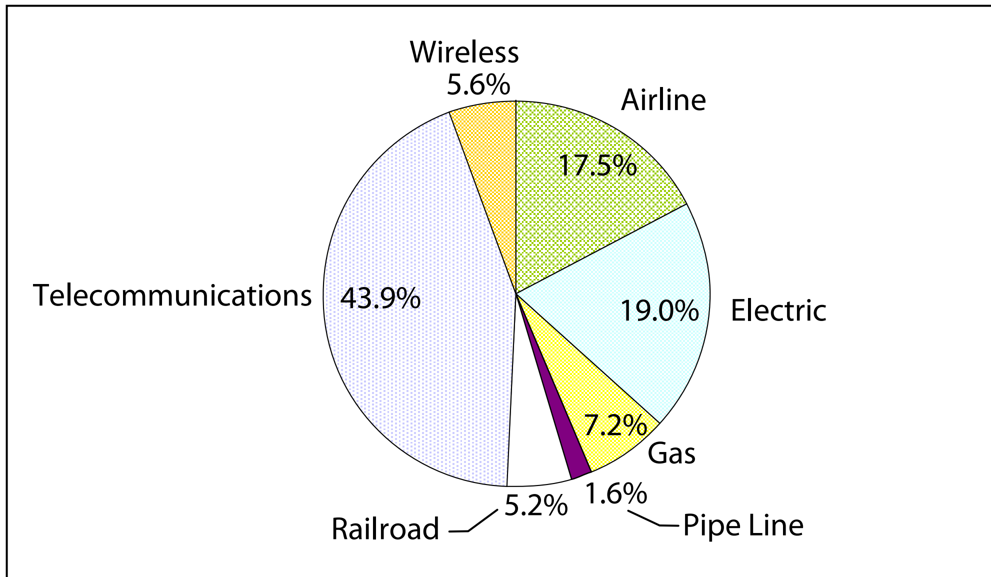
Exhibit 7 – Washington State-Assessed Intangible Personal Property Value By Utility Type: 2003 and 2007 Most Recent 5 Years

State-assessed Intangible Value		
	2007	**2003**
Airline	311,164,173	137,244,953
Electric	30,758,846	148,928,752
Gas	25,294,023	56,022,000
Pipe Line	1,373,206	12,241,000
Railroad	4,657,138	40,590,267
Telecommunications	447,100,860	343,250,623
Wireless	1,282,929,044	44,033,573
Total	**2,103,277,289**	**782,311,168**

Source: Washington Department of Revenue State-Assessed Utility data.

$2.1 billion. This corresponds to an annual growth rate of 33.7 percent in the value of intangible personal property. One explanation for the recent change in the value of intangible personal property is the recent sales of intangible personal property which provides the Department of Revenue with a realistic value of the intangible asset. Appraisers have had more comparable sales of intangible assets to use in valuing intangible personal property which has improved the accuracy of the estimates in recent years. In prior years' reports of intangible personal property, those intangibles may not have been included in the estimate reported by DOR. For example, in 2003, the intangible personal property value for wireless companies was 5.6 percent of all intangible assets but by 2007, the wireless intangible personal property represented 61 percent of all intangible assets. This increase in wireless intangible personal property value is primarily due to having more recent sales of wireless licenses and consolidations of wireless companies, providing the Department of Revenue with more accurate information to value these intangible personal property assets in recent years.

Exhibit 8 – 2003 State-Assessed Companies' Intangible Property Value As Percent of Total Intangibles ($782.3 million) – By Type of Utility



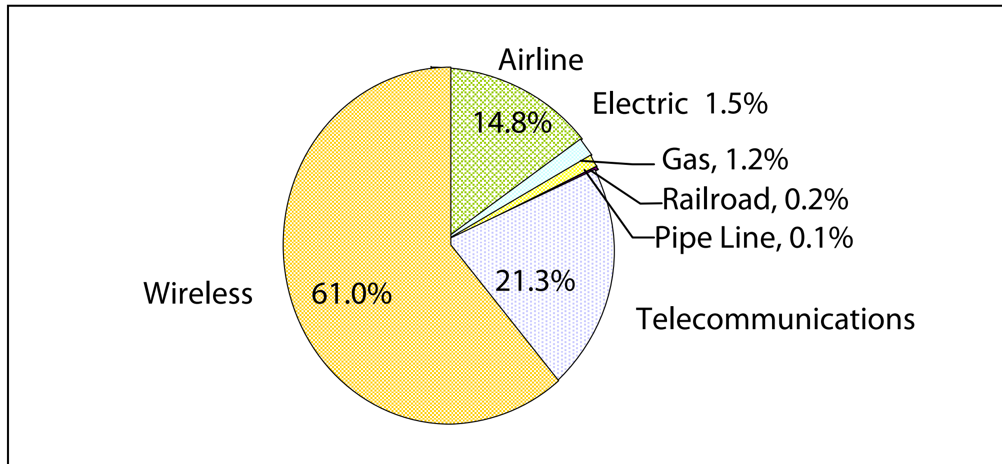
Source: Washington Department of Revenue annual state-assessed property tax reports.

As wireless companies' growth has expanded rapidly to more than $1.2 billion in value, wire line telephone companies have seen a much smaller increase in their business due to competing wireless and cable technologies. This has resulted in a much smaller annual growth rate of 6 percent in telecommunications' intangible personal property in the last five years. Airlines have seen a much higher annual growth rate in their intangible personal property over the past five years at 25 percent.

Electric, gas, railroads, and pipeline companies have all seen a decline in the overall value of their intangible personal property over the past five years. According to the Department of Revenue, electrics, gas, and pipelines generally report very low percentages of total property value as

intangible personal property. Railroads also do not report large amount of their property as intangible personal property and in recent years, there has been a decline in their property value which has lead to a decline in their intangible personal property as the value of the intangible personal property is a percentage of total property value.

Exhibit 9 – 2007 State-Assessed Companies' Intangible Property Value As Percent of Total Intangibles ($2.1 billion) – By Type of Utility



Source: Washington Department of Revenue annual state-assessed property tax reports.

There are some inherent problems with the data on the value of state-assessed utility companies. Generally, if the Department cannot determine an accurate value for a non-financial intangible personal property, the intangible personal property will not be reported in these DOR estimates. If there are accounting changes or mergers and acquisition documents that report the value of intangible assets in recent years, then the Department can include that value for the intangible in the overall estimate for that company. Prior years' estimates for intangible personal property will not include a value for that intangible personal property because the Department did not have any readily available data for estimating it. In some cases, comparing prior years' data with current year estimates is not comparing the same intangibles in both estimates. In addition, some values of intangible personal property are a set percentage of the total revenue/sales or net worth of the company. As the company becomes more profitable, then the value of intangible personal property assets increases. This growth may not always directly correspond to an increase in the value of intangible personal property assets.

3) Locally-Assessed Properties – Intangible Personal Property

A third source of intangible personal property is the locally-assessed companies. Besides the state-assessed utility companies, other large industrial and commercial properties with well known trade names, favorable contracts, noncompeting agreements, or other intangible personal property specified in statute may have intangible personal property value captured in the value of real property set by county assessors. For example, a locally-assessed sawmill owned by a large multi-state corporation could potentially have intangible personal property. The county assessors may employ appraisal techniques that exclude any intangible personal property when

determining the sawmill property value. Typically, county assessors do not identify and exclude intangible personal property from the value of large industrial and commercial properties. Therefore, it is nearly impossible for some county assessors to know the actual value of all intangible personal property in their county.

JLARC Survey of County Assessors

In order to assess the difficulty county assessors may have in implementing this property tax exemption, JLARC conducted a survey of the 39 county assessors. This 2008 JLARC survey was similar to a Department of Revenue survey conducted in 2000 which also addressed the impact of the intangible personal property exemption given the 1997 legislative changes.[45]

JLARC received by email and follow-up phone conversations responses from 24 counties in the state. The responding counties were the larger counties in Washington and represent more than 83 percent of the total locally-assessed value statewide.

Change in Property Assessment Processes and Reduction in Assessed Value Due to Intangible Personal Property Tax Exemption

Most counties surveyed by JLARC said they have not changed their assessment processes or methodologies since the 1997 legislative changes. In addition, most counties said they have not had any reduction in their annual locally-assessed personal property value for intangibles. Two counties said they had moved away from using the income appraisal method and they had initially experienced a reduction in certain businesses' property values due to the 1997 intangible personal property tax exemption being placed in law.[46]

Change in Property Value Due to Court/Board of Tax Appeals or Other Challenges

All, except two counties, said they have had no property value disputes based on intangible personal property. Benton County reported that after the 1997 legislative change pertaining to intangible personal property, they changed their appraisal method of U.S. Ecology and did not value a Hanford nuclear site 20-year lease agreement that the company owned. This resulted in a loss in property value of millions to the county.

The other exception was Pacific County which reported that they had a Board of Tax Appeal (BTA) case with Weyerhaeuser regarding the property value of a sawmill which could be based in part on intangible personal property.[47] According to the Department of Revenue, this appeal has since been settled.

Several county assessors expressed their overall concern about future court or BTA interpretations or expansions of the intangible personal property exemption.

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[45] "Property Tax Exemption for Intangible Assets," Washington State Department of Revenue, December 2000.

[46] Pierce and Benton counties no longer use the income approach.

[47] Weyerhaeuser Company v. Bruce Walker, Pacific County Assessor, BTA Docket No. 63874, April 16, 2007.

Long-term Impacts and Suggestions for Possible Changes

All county responses, except two, stated that they did not see any long-term impacts from the 1997 legislation pertaining to intangible personal property. The King County assessor expressed his overall concerns for the "influences of intangibles" to property values in the future. Columbia County was the only county stating that they saw long-term impacts from the 1997 legislation and provided some suggestions for possible changes to the property tax exemption. The Columbia County Assessor stated that the inclusion of intangible personal property values on the real estate excise tax affidavits can skew the sales data used in revaluing properties and result in inaccurate ratios of real market to assessed value in the ratio study conducted by the Department of Revenue. As a suggestion for legislative changes, the assessor stated that the values assigned to certain intangible personal property should be required to be disclosed at the time of sale of the business. This information should be kept separate from the real estate excise tax documentation.

No county identified any specific intangible personal property that was especially difficult to exclude from the valuation of real property.

Growth of Intangible Assets in New Economy

In the "Old Economy," the value of a company was mostly based on its physical assets (buildings, machines, and equipment).[48] In the "New Economy," whole firms have been created on the basis of certain intangible assets. Many traditional firms have incorporated more intangible assets into their business models and have started reporting them in increasing detail. A study by the Brookings Institution revealed that in 1982, 62 percent of companies' market value was tangible real property. Ten years later, 38 percent of companies' market value was tangible real property.[49]

Ebay, the biggest online auction company, is an example of a company made up of primarily intangible assets. According to eBay's balance sheet for 2003, property and equipment represented about 10 percent of total assets.[50] Goodwill and intangible assets made up about 34 percent of total assets. Customer lists made up the majority of the intangible assets. Most of the remainder of the assets was cash. There has also been growth in intangible personal property in firms like IBM with demonstrated increases in service revenue. Another reason for the growth in intangible property is that companies have started to license patents, copyrights, and trademarks that were developed as a secondary business. Some businesses may still earn money on licenses long after the physical company has ended.

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[48] "The Stock Market and Investment in the New Economy: Some Tangible Facts and Intangible Fictions" by Stephen Bond and Jason Cummins quote from Al Gore.

[49] "Intellectual Capital," by Stewart T. 1997.

[50] "Intangible Assets Valuation and Economic Benefits" by Jeffrey A. Cohen.

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?

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

Avoid Double Taxation

One of the public policy objectives of this intangible personal property tax exemption was originally to avoid double taxation of secured credits (financial assets) from taxation. The position taken by the state Supreme Court was that substantially all property can be taxed with the exception of credits – that to tax them is double taxation. This court position was summarized in a 1909 article as follows:

> *The position taken by the court that substantially all the property in the State can be taxed without the taxation of credits – that to tax them is double taxation. "Double taxation," it said, "should be avoided as far as possible, and in any event the constitution should not be so construed as to require it."* [51]

The double taxation argument for this exemption rests on the assumption that intangible financial assets are being taxed and included in the overall valuation of a company's real property. In recent years, the value of large companies' intangible assets is much greater than the value of their real property assessed through the property tax. Not all intangible personal property is currently being assessed a tax.

Ease of Administration

Another public policy objective for the exemption of certain intangible personal property is the difficulty in identifying, valuing, and administering a property tax on intangible property. The Legislature attempted to clarify which intangible personal property is exempt from other attributes which are not exempt to assist in administering the exemption.

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

This tax preference has achieved the objectives of avoiding double taxation. To a certain extent, the law has been clarified to ease the administration of the intangible personal property tax exemption.

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[51] Custis, Vanderveer. "Tax Reform in Washington: The Exemption of Intangibles", The Quarterly Journal of Economics, Vol. 23, No. 4 (Aug., 1909).

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

Continuation of this tax preference will achieve the objective of easing administration of the property tax but it is still a difficult tax preference to administer.

One result of continuing this tax preference is not only avoiding double taxation but also eliminating any taxation on intangible personal property like interest-bearing money market accounts, stocks, and bonds. In other income tax states, this property is taxed once earnings are realized in these accounts or when stocks are sold and capital gains are realized. Given Washington's tax structure that does not have a personal income or corporate income tax and the trend toward more intangible property being held by businesses, there is potentially a large amount of intangible personal property that is not being assessed any tax. It is unclear if the Legislature anticipated this growth in intangible personal property.

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

Given the fact that certain intangible personal property is not being taxed and an objective of the Legislature was to avoid double taxation, the Legislature could impose an intangibles tax on certain intangible personal property. The difficulty would be in structuring the tax so it would not viewed by the court as unconstitutional. It would be important to structure the tax similar to an excise tax and not an income or property tax to avoid having to meet the constitutional conditions of uniformity.

This property tax exemption has certain intangibles undefined in statute and this could lead to difficulty in administering this property tax exemption. If there are court decisions in the future defining some intangible personal property as exempt, then further clarification may be needed by the Legislature to better define this exemption.

Beneficiaries

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

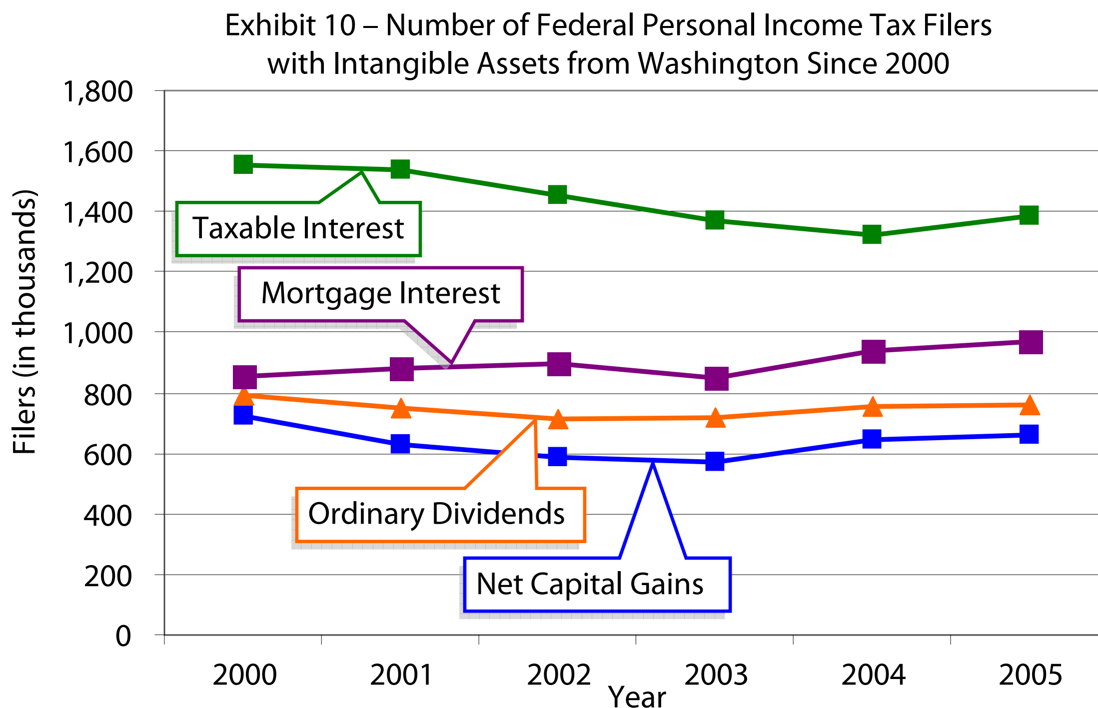
The overall number of beneficiaries annually is uncertain but we can identify a subset of all beneficiaries statewide. The three known groups of beneficiaries of this property tax exemption are owners of financial assets, state-assessed utility companies, and other locally-assessed large industrial and commercial properties.

1) Financial Assets

From the IRS data of federal personal income tax returns from Washington filers, we can determine the following number of beneficiaries that owned certain financial intangibles. In 2005, there were 2.9 million federal personal income tax returns filed in Washington State. Of all Washington federal personal income returns filed, the largest category of intangible personal property claimed on 1.39 million returns (47 percent of personal income tax returns) was taxable

interest. These taxpayers could have earned interest on checking or savings accounts and/or CDs. Over the past six years, the number of returns with taxable interest earnings has declined from its high point in 2000 of 1.55 million returns to 1.38 million returns in 2005. The second largest category of financial intangible personal property was mortgage interest with 972,435 individual households claiming the mortgage interest deduction in 2005. Even though the mortgage interest deduction can be claimed by households and businesses, the owners of mortgages are financial institutions and other lending agencies. The number of returns claiming the mortgage interest deduction has grown since 2000.

The third largest category of financial intangible personal property reported on the IRS individual income tax form was stock dividends at 759,150 returns or 26 percent of personal income tax returns. The number of federal personal income tax returns from Washington reporting capital gains on stocks was nearly as large as dividends at 662,595 Washington filers. Income from both stock dividends and capital gains has declined recently since their high point in 2000.



Source: Washington Department of Revenue analysis of federal personal income tax returns from Washington.

Businesses in Washington also have financial assets which are exempt from property tax. According to the Department of Revenue's registered businesses database, in fiscal year 2006, nearly 300,000 businesses had B&O tax liability prior to credits.[52] These firms would be beneficiaries of this tax preference.

[52] "2007 Tax Reference Manual" by Washington Department of Revenue.

State-Assessed Utility Companies

Another group of beneficiaries of the intangible personal property tax exemption is the state-assessed utility properties. These companies benefit from the intangible personal property tax exemption in different ways. JLARC assumed that 185 state-assessed utility companies have intangible personal property. Some 40 percent of these companies are airlines and 32 percent of the companies are telecommunications companies.

Exhibit 11 – State-Assessed Utility Companies in 2007
Assumed to have Intangible Personal Property

State-Assessed Utility Companies – 2007	Number of Companies	% of Total Companies
Airlines	75	40.5%
Electric and Power	14	7.6%
Gas	4	2.2%
Pipelines	7	3.8%
Railroads	10	5.4%
Telecommunications	59	31.9%
Wireless Telephone	16	8.6%
Estimated State-Assessed Utility Companies with Intangibles	**185**	**100%**

Source: JLARC based on DOR state-assessed companies' 2007 annual report.

3) Locally-Assessed Companies

The other group of beneficiaries of the intangible personal property tax exemption is the locally-assessed large commercial and industrial properties that county assessors appraise. The value and number of companies throughout the state that are locally-assessed and also have intangible personal property is unknown.

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

At the time of this review, only one major court challenge had been identified since the 1997 legislative changes which might have an impact on the administration of the intangible personal property tax exemption. From these findings, there does not appear to be any unintended beneficiaries of this tax exemption.

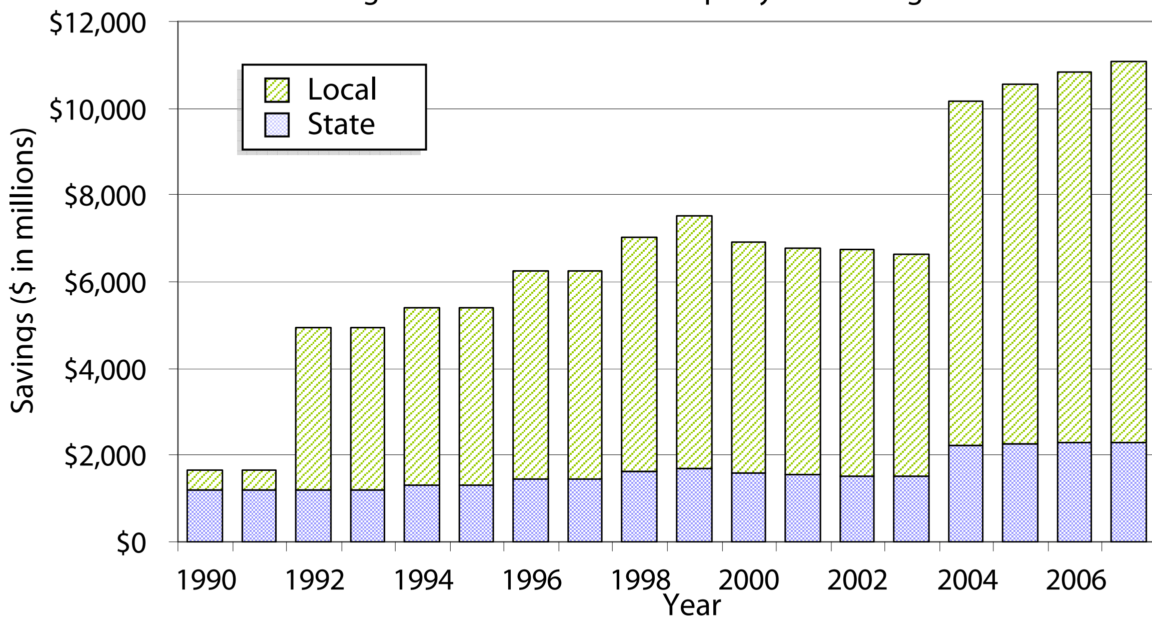
Revenue and Economic Impacts

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 estimated revenue impact of the intangibles property tax exemption is based on similar procedures by the Department of Revenue presented in Tax Exemption Reports. One

component of this intangible personal property tax forecast is the forecast of Global Insights estimate of U.S. households' total financial assets. In the 2008 estimate, the Department of Revenue multiplied the estimate of U.S. households' total financial assets by an inflator factor of 2.2 times in order to adjust for not having other estimates for intangible assets captured in the household financial assets statistic. In 2008, in addition to the inflator factor, the Department used a nationwide estimate for U.S. corporate intangibles of $1 trillion in 2000. DOR added both household and corporate intangible estimates together and that is why there was such a large increase in the Washington intangible estimates reported in the 2008 Tax Exemption Report. Since the 2008 DOR estimate for U.S. intangible assets included a $1 trillion estimate for businesses intangibles, the blow-up factor needed to be adjusted in order to not double count the value of businesses' intangible personal property.

Exhibit 12 – Intangibles Local and State Property Tax Savings: 1990 – 2007



Source: Department of Revenue Tax Exemption Reports prior to 2008.

The JLARC estimates for intangible personal property used the same U.S. households' financial assets and businesses' intangible assets but it significantly lowered the blow-up factor for households and the overall estimate for intangible personal property for Washington. JLARC assumed the Washington portion of the U.S. totals to be roughly 2 percent. These intangible personal property tax estimates are more in line with previous DOR estimates of intangible personal property. Washington's total intangible personal property tax base is estimated at a little less than $1 trillion for both households' financial assets and businesses' financial and other intangible assets. The local and state taxpayer savings is estimated to be $10 billion in fiscal year 2007, increasing to $12.8 billion by fiscal year 2011.

Exhibit 13 – Taxpayer Savings Estimates for the Exemption of Intangible Personal Property

Calendar Year	State PT savings ($ millions)	Local PT savings ($ millions)	Total PT savings ($ millions)
2007	$2,046.8	$7,858.7	$9,905.5
2008	$2,205.1	$8,592.7	$10,797.8
2009	$2,345.8	$9,276.5	$11,622.3
2010	$2,424.9	$9,735.5	$12,160.4
2011	$2,513.8	$10,255.4	$12,769.2

Source: JLARC with Global Insight data and nationwide estimates for intangibles.

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 Legislature terminated this tax preference, there would be nearly $1 trillion per year of additional property value added to the property tax rolls. This is more than the entire statewide property tax base in 2007. Given the large size of this tax preference and the number of taxpayers impacted from this exemption, the negative effect of higher taxes would be spread out among many taxpayers with the larger businesses and wealthier individuals having to pay higher property taxes. Washington households spent more than $5.8 billion on financial assets from banks, credit unions, and other depository agencies. These households also spent more than $2.1 billion in trusts and other financial vehicles.

Exhibit 14 – 2006 Average Purchases of Financial Assets by Households

Household Category	Monetary authorities and depository credit agencies ($)	Funds – trusts and other financial vehicles ($)
Households less than $10K	$1,160.6	$90.3
Households $10-$15K	$1,283.3	$159.9
Households $15-$25K	$1,286.7	$160.4
Households $25-$35K	$1,914.5	$288.1
Households $35-$50K	$2,590.0	$649.7
Households $50-$75K	$2,642.6	$912.2
Households $75-$100K	$2,769.1	$1,598.3
Households $100-$150K	$3,363.3	$1,941.2
Households greater than $150K	$4,100.0	$2,366.5
Overall Average	**$2,334.7**	**$865.9**

Source: Washington IMPLAN dataset for 2006.

The households with income between $50,000 and $75,000 have the largest total expenditures on financial assets in 2006 at $2 billion. On average as households' income rises, their average expenditure on financial assets increases too. Therefore, on average the highest income group, households with income greater than $150,000, purchased the largest amount of financial assets.

If certain households had to pay higher property tax but others received lower property taxes, then there would be less spending in the economy by higher income households and more spending by lower income homeowners.

The larger businesses with intangible personal property would see higher property taxes, but small businesses would see no change or some benefit of lower property taxes because they would not be owners of large intangible non-financial assets but would have a smaller amount of financial assets to pay property tax on.

It is uncertain what impact eliminating this tax preference would have on the overall state economy. If higher income households moved their financial assets to other states with lower overall tax liability, then this could negatively impact the financial industry in Washington. There could be a decline in employment in that sector. If large businesses decided to decrease investment in Washington due to the higher property tax on intangible personal property, then this also could negatively impact employment and spending in Washington. On the other hand, smaller businesses could see Washington's overall lower property tax as a benefit of doing business in this state, and these types of jobs could be enhanced by eliminating this tax preference. The overall impact from eliminating this tax preference is uncertain.

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

Due to this tax preference being a property tax exemption, there would be shifting of tax liability onto owners of intangible financial assets as well as large companies with significant financial assets and known non-financial intangible personal property like trademarks, customer lists, favorable contracts, and others specified in statute. In addition, there would also be a reduction in property taxes for other individuals and businesses that do not own intangible assets. Due to the large number of individuals and businesses with financial intangible assets, eliminating this property tax exemption would affect the property tax liability of most individuals living in Washington. Eliminating this tax preference could create new incentives to shift intangible assets to other states with no property tax on financial assets and a lower income tax than the property tax Washington would be imposing on financial assets. Businesses would also have an incentive to hold their financial assets in other states with lower overall tax liability on intangible personal property. There would be many factors to consider before businesses decide to move their business operations to another state due to the elimination of a property tax exemption. Smaller businesses, with little or no intangible personal property beyond financial assets, would see lower property taxes from the elimination of this property tax exemption, so Washington would be a more attractive location to start or expand a business. Overall, with the elimination of this property tax exemption, there may be an increase in local government revenue due to some districts being able to levy more because they were at their maximum levy limit. The exact

amount of the increase in local government revenue will depend on where the additional tax liability was extended and the approximation of each taxing districts' to their maximum tax authority. With the exception of this local government increase, the elimination of this tax preference will result in shifting of the remaining tax burden from one group of taxpayers to another group.

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?

Nineteen states, including Washington, have a broad property tax exemption for intangible personal property specified in statute. This broad property tax exemption goes beyond exempting only intangible financial property. Another nine states specify an intangible personal property tax exemption for financial intangible property only. An additional 11 states exclude all intangible personal property by defining their property tax base as including only tangible property. Nine states have no mention of intangible personal property in their property tax statutes.

Seven states impose a tax on intangible assets.[53] For example, Tennessee has a tax on stocks of certain corporations and Ohio has a tax on dealers of intangible property.

States with personal or corporate income taxes levy a tax on financial assets once interest or capital gains are acquired.

Personal Income Tax

Forty-three states and the District of Columbia have personal income taxes. Most states (36) link their state law to the federal law provisions for federal income taxes. Thirty states link their state law to federal adjusted gross income as their tax base, and six states connect to the federal taxable income. Six states have their own state specific adjusted gross income base. Two other states–New Hampshire and Tennessee–assessed their personal income tax on just interest and dividend income.

Corporate Business Tax

Forty-five states and the District of Columbia impose a corporate income tax in which states refer to federal law by either referencing the IRC code or by having similar state provisions as federal law. Some 25 states and the District of Columbia link their state law to the definition of federal taxable income before net operating loss and special deductions, and 20 states link their state law to the definition of federal taxable income after net operating loss and special deductions. Two states, Tennessee and New Hampshire, only apply their corporate income tax to

[53] Alabama, Iowa, Kansas, Ohio, Pennsylvania, Tennessee, and Texas.

interest and dividend income of corporations only. Michigan and Texas each impose their own business tax.

Washington is one of five states that do not impose a tax on intangible personal property either through the property, income or other form of tax on intangible personal property held by individuals. Washington is one of three states that do not impose a tax on intangible personal property either through the property, income or other form of tax on intangible personal property held by corporate businesses.

Recommendation

The Legislature should continue the property tax exemption for intangible personal property.

Legislation Required: None.

Fiscal Impact: None.

COMMERCIAL VESSELS – SUMMARY

Current Law

A commercial vessel is any vessel that is engaged in trade or carries passengers for hire. A commercial vessel is required to have a valid marine document from the U.S. Coast Guard or the vessel is used exclusively for commercial fishing. Commercial vessels are subject to the state property tax. Commercially operated vessels exempted from the watercraft excise tax (Chapter 82.49 RCW) and excepted from watercraft registration requirements (Chapter 88.02 RCW) are subject to the state property tax. The assessed values of commercial vessels used in interstate or foreign commerce or used exclusively in fishing, tendering, harvesting, and/or processing seafood products on the high seas are apportioned for state property tax purposes. Apportionment identifies which percentage of the assessed value of the vessel is subject to tax and which is exempt. All commercial vessels are exempt from local property tax levies.[54]

Exhibit 15 – Property Taxation of Commercial Vessels

	State Levy	**Local Levies**
Commercial vessel *not* used in interstate/ foreign commerce or fishing on high seas	Taxed on full value	Exempt
Commercial vessel used in interstate/foreign commerce or fishing on high seas *in Washington for over 120 days*	Tax on apportioned value based on the number of days in the state	Exempt
Commercial vessel used in interstate/foreign commerce or fishing on high seas *in Washington for 120 days or less*	Exempt	Exempt

Source: RCW 84.40.036 and RCW 84.36.080.

The apportionment formula for vessels used in interstate or foreign commerce of fishing on the high seas requires that the vessel be in the state for more than 120 days. Vessels in the state for more than 120 days are apportioned to this state based on the total number of days that the vessel is within the state. Time spent undergoing repair, taking on or discharging cargo, passengers, or supplies, or serving as a tug for a vessel undergoing repair or taking on or discharging cargo, passengers, or supplies does not count as time within the state.

See Appendix 3 for the current law statute RCW 84.40.036 (apportionment of vessels) and RCW 84.36.080 (exemption from local levies).

[54]The performance reviews of tax preferences mandated by EHB 1069 (2006) are limited to state tax preferences, although local tax preferences have been discussed in other reviews when they have been closely linked to a state tax preference. This review focuses on the portion of the state property tax levy for which some commercial vessels are partially exempt.

Another chapter in this report is on “other ships and vessels,” which are non-commercial recreational watercraft exempt from all property taxes and subject to the watercraft excise tax.

Findings and Recommendations

This review evaluated the legal history, public policy objectives, economic and revenue impacts, and other states’ tax preferences of Washington’s apportionment formula for commercial vessels subject to the state property tax levy. The audit determined the following:

Legal History and Public Policy Objectives

- The long-standing rule provided by the U.S. Supreme Court in an 1855 decision regarding the taxation of a ship or vessel is that a ship or vessel could be taxed only at its legal location which is the home of its owner, and is not taxable by a state other than that in which the owner resides.
- This rule has given way to the rule of fair apportionment, through which the U.S. Supreme Court has ruled it is permissible for instrumentalities of commerce to be taxed, on a properly apportioned basis, by the non-home states through which they travel.
- The 14th Amendment to the state Constitution, adopted by the voters in 1930, allowed the Legislature to make distinctions in the classification of personal property for property tax purposes. The Legislature followed in 1931 by providing a local property tax exemption to all ships and vessels whose home ports are in the state and that are engaged in interstate commerce.
- The Legislature created a new vessel registration requirement and vessel excise tax for recreational watercraft in 1983. At this time, the Legislature exempted all commercial vessels and commercial fishing boats from local property tax levies; no longer did the vessels need to be engaged in interstate or foreign commerce or commerce between ports of the state and the high seas to be eligible for the local levy exemption.
- The Legislature provided for the apportionment of vessels engaged in interstate commerce or in fishing the high seas in 1986. The apportionment is based on the length of stay in Washington if the stay exceeds 120 days. If the length of stay is under 120 days, the vessel is not assessed for state property tax purposes.
- The public policy objective was to bring the taxation of vessels engaged in interstate or foreign commerce into line with more recent U.S. Supreme Court rulings allowing for the fair apportionment of vessels.
- The public policy objective is being met. However, Washington’s minimum threshold of 120 days within the state before a vessel is assessed exceeds that of the few other states that apportion vessels for property tax purposes.

Beneficiaries

- The Department of Revenue assesses nearly 2,500 commercial vessels. All of these vessels are exempt from local property taxes. Many of these vessels that engage in interstate or foreign commerce or commerce between the ports of Washington and the high seas are apportioned, based on its length of stay in Washington, for state property tax purposes. This came to 780 vessels in 2006. Of these vessels, 453 had its assessed value reduced to zero because their stay in Washington was less than 120 days.

Revenue and Economic Impacts

- Owners of apportioned vessels saved $900,000 in state property taxes in 2007.
- State property tax savings in 2011 are expected to be about be $900,000 per year through 2011.
- Industries that utilize commercial vessels employed about 6,800 workers in 2006 and paid average yearly wages of $65,000. This amount exceeds the statewide average wage for all industries of $43,000 per year.

Other States

- Two other states have statutory provisions for apportionment of vessels: Maine and South Carolina. Maine has a threshold of 75 days, and South Carolina 30 days. Alaska does not have state statutes on taxing vessels, but local governments are permitted to impose a fairly apportioned property tax on seagoing vessels.
- At least 28 states exempt all commercial vessels or commercial fishing boats from property tax, including 12 states that exempt all or most tangible personal property from property taxes. These states comprise both coastal and inland states.

Recommendation

The Legislature should continue the apportionment of commercial vessels for property tax purposes.

Legislation Required: None.

Fiscal Impact: None.

COMMERCIAL VESSELS – REPORT DETAIL

Statutory History

Since 1891, state law has provided that all vessels of every class that are required to be registered or licensed, are to be assessed and taxes paid only in the county where the owner resides. All other boats and small craft not required to be registered are to be assessed in the county where they are kept. This law is still on the books today.[55]

The longstanding general rule regarding the taxation of a ship or vessel, based on an 1855 U.S. Supreme Court decision, is that a ship or vessel could be taxed only at its legal "situs," which is its home port and the domicile of its owner, and is not taxable by a state other than that in which the owner resides.[56] However, when a vessel is kept and used wholly within the limits of another state, it acquires a situs in such state for the purpose of taxation, even though engaged in interstate commerce.[57] "Situs" is a legal term meaning the location of a property for taxation purposes. If the owner (which could be a person or corporation) of a vessel resided (or was incorporated) in Washington, the vessel could be taxed in Washington unless the vessel was always entirely within some other state. If the owner of a vessel lived (or was incorporated) outside of Washington, the vessel could not be taxed here unless the vessel was always in Washington.

In 1901, the Legislature attempted to exempt ships and vessels used exclusively in interstate or foreign commerce from the property tax. The Legislature deemed such vessels not to be property within this state. The state Constitution required that all property in the state, not exempt under the laws of the United States or under the state Constitution, be taxed. The state Supreme Court found this exemption to be unconstitutional because the clause "all property in the state … shall be taxed" meant all property subject to taxation by the state shall be taxed, regardless of whether or not the property could be said to be technically within, or have actual situs within the state.[58]

The 14th Amendment to the state Constitution, adopted by the voters in 1930, allowed the Legislature to make distinctions in the classification of personal property for property tax purposes. The original text of the state Constitution required that all property, both real and personal property, in the state be taxed in proportion to its value. While the Legislature could exempt some property from taxation, this was restricted by the state Supreme Court to "quasi-

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[55] See RCW 84.44.050.

[56] "Hays v. Pacific Mail S. S. Co.," 58 U.S. 596 (1855). The "home port doctrine" enunciated in Hays was based on the doctrine that "movables follow the person" and resulted in personal property being taxable in full at the domicile of the owner. See "Japan Line, Ltd. v. County of Los Angeles," 441 U.S. 434 (1979).

[57] The general rule as enunciated in Hays is referred to in "Arthur Earnest Guiness v. King County," 32 Wn. 2d 503 (1949).

[58] "Pacific Cold Storage v. Pierce County," 85 Wash. 626 (1915).

public" property.[59] The 14th Amendment required that all taxes upon the same class of property were to be uniform and that all real estate was to constitute one class. This allowed different types of personal property to be classified separately.

In the following legislative session in 1931, the Legislature provided that all ships and vessels whose home ports of registry are in the state of Washington and engaged in interstate commerce, foreign commerce, and/or commerce between ports of the state and the high seas were exempt from taxes, except for taxes levied for any state purpose. At that time the only tax that would have been applicable to ships and vessels was the property tax.

Competition existed among the West Coast states for the registration of vessels. The 1931 change brought Washington's taxation of commercial vessels into line with California and Oregon. California voters in 1913 adopted a constitutional amendment that exempted vessels of more than 50 tons and registered in California from taxation, except for state purposes. Oregon voters in 1915 adopted a similar constitutional amendment. In addition, the Oregon Legislature, in 1925, reduced the state tax on vessels to one-fiftieth of the state tax on real estate.

The State Tax Commission understood this exemption from local property taxes to apply only to vessels that had their actual situs in Washington, or if it has no actual situs anywhere, its owner must reside in Washington, its home port of registry must be in the state, and it must be engaged in interstate or foreign commerce or commerce between ports of the state and the high seas.[60] Vessels with actual situs outside the state would not be taxable here. Vessels with a home port outside the state but with actual situs here would not be affected by the exemption (as they did not engage in interstate or foreign commerce) and would be fully taxable.

The Legislature created a new vessel registration requirement and vessel excise tax for recreational watercraft in 1983. The legislation exempted recreational watercraft from all property taxes. All ships and vessels exempt from the recreational vessel registration and vessel excise tax continued to be subject to the state property tax and exempted from local property taxes. The vessels exempt from the recreational vessel registration and vessel excise tax included vessels used exclusively for commercial fishing and vessels primarily engaged in commerce which are required to have a marine document as a vessel of the United States. No longer did the vessels need to be engaged in interstate or foreign commerce or commerce between ports of the state and the high seas in order to be exempt from local property taxes.

The Legislature switched the responsibility of valuing commercial vessels to the Department of Revenue from county assessors in 1984.

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[59] "Chamberlin v. Daniel," 17 Wash. 111 (1897); and "Buchanan v. Bauer," 17 Wash. 688 (1897). The state Supreme Court ruled that the property exempted by the Legislature needed to be of a "quasi-public" nature. The Court found unconstitutional exemptions provided for ships in actual construction, fruit trees for four years after being transplanted into an orchard, improvements in land up to $500, and increasing the personal property exemption to $500.

[60] "Annotated Code of Property Tax Laws of the State of Washington," Tax Commission of the State of Washington, 1939.

Apportionment of vessels became an issue in Washington in 1986. The "home port doctrine" as described above had fallen into disuse by the U.S. Supreme Court, and the Court now looked to the "rule of fair apportionment."[61] If the state tax is applied to an activity with a substantial nexus with the taxing state, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the state, the Court would find the taxation method constitutional.

Prior to 1986, vessels with out-of-state owners and not permanently moored in Washington were exempt from all Washington property taxes. Vessels owned by persons living or incorporated in Washington and engaged in interstate or foreign commerce were subject to the state property tax and exempt from local property taxes. For 1986 and thereafter, the Department of Revenue attempted to change the rules administratively so that ships and vessels engaged exclusively in foreign commerce were exempt from property tax if the length of stay in Washington was reasonable. Vessels engaged exclusively in interstate commerce or in fishing the high seas were to be subject to the state property tax if the length of stay in Washington exceeded 60 days. The tax was to be apportioned based on the number of days the vessel was within Washington. Vessels in the state exclusively for repair were not subject to the property tax.

The Legislature pre-empted the Department's rule with legislation in 1986. The legislation provided that vessels engaged in interstate or foreign commerce or fishing on the high seas are exempt from all property taxes if the length of stay in Washington is less than 120 days. If the length of stay exceeds 120 days, the state property tax is apportioned based on the total number of days within Washington. Days during which a vessel is engaged in undergoing repair, taking on cargo or passengers, or serving as a tug for a vessel undergoing repair or taking on cargo or passengers are not considered as part of the length of stay.

The collection of property taxes on commercial vessels became the responsibility of the Department of Revenue in 1993. Previously this had been the responsibility of county treasurers.

The next change came in 1998. Prior to then, steamships owned by steamship companies, along with other property owned by the companies, were valued by the Department of Revenue as centrally assessed property. Commercial vessels were assessed by the Department under a different statute. In both cases only the state property tax was paid on the value of the vessels. In 1998 the Legislature eliminated the separate valuation of steamships and treated them like all other commercial vessels.

[61] "Japan Line Ltd. v. County of Los Angeles," 441 U.S. 434 (1979); "Ott v. Mississippi Valley Barge Line Co.," 336 U.S. 169 (1949).

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 history presented in this chapter has included discussion of the local property tax exemption. However, these reviews conducted under EHB 1069 (2006) are concerned with state tax preferences. Thus, the item under review is the state property tax apportionment formula applied to vessels engaged in interstate or foreign commerce or engaged exclusively in fishing or seafood processing on the high seas or waters under the jurisdiction of other states.

The public policy objective of the apportionment of vessels appears to be to bring Washington's taxation of vessels into line with U.S. Supreme Court rulings allowing for "fair apportionment." The Court had stated that no impermissible burden on interstate commerce would be found if a state tax is applied to an activity with substantial nexus with the taxing state, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the state. Vessels used in interstate or foreign commerce could be subject to tax, even if the owner resided in another state, if the tax is "fairly apportioned."

In the mid-1980s, the Department of Revenue attempted to impose by rule an apportionment formula to vessels that were within the state for more than 60 days. The Legislature pre-empted this rule and set the number of days at 120. The Legislature provided no statement of purpose as to the distinction between 60 days and 120 days. Testimony presented by industry representatives at legislative committee hearings claimed that California, Oregon, and Alaska did not levy such a tax; that ships were mobile and could take their business elsewhere; and the result would be that the state would lose B&O and sales tax revenues and jobs in repair yards. The public policy objective of distinguishing between 60 and 120 days may have been to encourage interstate and foreign commerce and fishing on the high seas.

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

Some taxation of ships and vessels engaged in interstate or foreign commerce is allowed under U.S. Supreme Court decisions, even if the vessel does not have situs in the state. Taxation of vessels is allowed if the tax is fairly apportioned. The Court did not provide a definition as to what constitutes a fair apportionment. The tax preference has achieved the objective of conforming Washington law to U.S. Supreme court decisions.

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

Continuing the apportionment of commercial vessels is required to maintain the public policy of apportioning commercial vessels as allowed by the U.S. Supreme Court. However, Washington appears to be only one of four states that apportion vessels for property tax purposes.

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 overall public policy objective of apportioning commercial vessels is being fulfilled. The threshold could be adjusted by the Legislature and "fair apportionment" might still be maintained. The impacts of such a change are not known.

Beneficiaries

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

In 2006, nearly 2,500 commercial vessels were subject to the state property tax levy. All of these vessels benefited from the exemption from local property tax levies.

Exhibit 16 – Commercial Boats Subject to Property Tax

Year	Charter Boats	Fishing Boats	Other Vessels	Total
1998	709	1,986	848	3,543
1999	711	1,728	1,172	3,611
2000	676	1,558	1,190	3,424
2001	664	1,441	993	3,098
2002	703	1,359	982	3,044
2003	632	1,236	991	2,859
2004	627	1,113	968	2,708
2005	606	1,029	964	2,599
2006	593	934	971	2,498

Source: Department of Revenue "Property Tax Statistics."

Many of these vessels also benefitted from having their value apportioned for state property tax purposes. In 2006, 780 vessels had its assessed value reduced from market value due to apportionment. Of these vessels, 453 had its value reduced to zero due to being in Washington for less than 120 days.

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

The intent of the 1986 apportionment legislation is to exempt from the state property tax vessels engaged in interstate or foreign commerce, fishing and seafood processing on the high seas if the length of stay within the state is less than 120 days. Days during which a vessel is undergoing repair are not considered as days within the state.

The number of commercial fishing vessels subject to the state property tax has declined by over one-half since 1998 – from 1,986 vessels to 934 vessels in 2006, for a drop of 1,052 vessels. This is either because the actual number of commercial vessels in Washington has declined or because

more vessels are avoiding Washington's property tax by staying in the state for less than 120 days.

It is likely that the drop in the number of commercial fishing boats is principally due to the state of the commercial fishing industry in Washington. The number of commercial fishing licenses issued between 1998 and 2006 has declined by 1,255 licenses. Most of these have been in the salmon fisheries with a decline of 1,096 licenses. Vessels may hold more than one license, e.g., a single vessel may have a commercial crab fishing license, a bottom fish license, and a salmon license. The drop in the number of commercial fishing boats corresponds with the drop in the number of commercial fishing licenses.

Exhibit 17 – Commercial Fishing Licenses Issued in Washington

License Type	1998	2006	Change
Salmon*	1,797	701	(1,096)
Other Food Fish*	603	452	(151)
Shellfish	825	824	(1)
Baitfish	74	67	(7)
Total	3,299	2,044	(1,255)

Source: Department of Fish and Wildlife.
*Excludes charter and fishing guide licenses.

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?

All commercial vessels in Washington in 2006 had a market value of $901 million. This is a decline of over 30 percent from the 1998 value of $1.3 billion. The taxable apportioned value in 2006 was $455 million. Overall, the Department has assessed vessels at 51 percent of their market value. The Department assessed charter boats at 96 percent of their market value; fishing boats at 37 percent; and other vessels at 47 percent.

Exhibit 18 – Valuation of Commercial Vessels Subject to Property Tax ($ in millions)

Year	Actual Value	Apportioned Value
1998	$1,299	$233
1999	$1,208	$618
2000	$1,236	$717
2001	$939	$401
2002	$949	$437
2003	$880	$434
2004	$837	$346
2005	$885	$382
2006	$901	$455

Source: Department of Revenue "Property Tax Statistics."

Overall, commercial vessel owners saved $8.2 million in property taxes in 2007. Of this amount, $7.3 million came from being totally exempt from local property tax levies, and $900,000 was due to being taxed on the apportioned share of the vessels value for state property tax purposes. For the most part, these are tax savings to the taxpayer and are not always tax losses to local governments and the state. The savings to the vessels owners result in higher property taxes for other taxpayers. Some local governments are at their maximum levy rate and would lose revenue due to a property tax exemption.

Exhibit 19 – Property Tax Savings by Commercial Vessels (dollars in millions)

Calendar Year	Actual Value (exempt Local Levies)	UnTaxed Value (exempt State Levy)	State Property Tax Savings	Local Property Tax Savings	Total Property Tax Savings
2007	$935	$448	$0.9	$7.3	$8.2
2008	$970	$449	$0.9	$7.6	$8.5
2009	$1,006	$448	$0.9	$8.1	$9.0
2010	$1,044	$447	$0.9	$8.5	$9.4
2011	$1,083	$444	$0.9	$8.7	$9.6

Source: Department of Revenue worksheet for 2008 Tax Exemptions report.

Washington industries that are likely to utilize commercial vessels, such as water transportation of freight and passengers, tugboats, and commercial fishing, employed nearly 6,800 persons in 2006 and paid wages of $440 million.[62] Wages averaged $65,000. This compares to a statewide average wage in all industries of $43,000 in 2006. Average wages ranged from a high of $100,000 in the fishing industry and $81,000 in deep sea freight transportation to lows of $34,000 in charter boats, $47,000 in shellfish harvesting, and $48,000 in cruise ships.

Exhibit 20 – Washington Employment and Wages in Water-Related Industries that Utilize Vessels, 2006

Industry	Employment	Total Wages (in millions)	Average Wages
Water Transportation	3,360	$200.0	$59,524
Deep Sea Freight	210	$17.1	$81,326
Deep Sea Passenger	1,443	$69.0	$47,847
Coastal Freight	1,244	$86.2	$69,255
Inland Water Freight	335	$22.2	$66,201
All Other Water Transp.	128	$5.6	$43,723
Navigational Services/ Tugboats	1,003	$65.0	$64,808
Sightseeing/Charter Boats	439	$15.1	$34,330
Finfish Fishing	1,260	$126.6	$100,461
Shellfish Fishing	712	$33.5	$47,062
Total	**6,774**	**$440.2**	**$64,984**

Source: Department of Employment Security.

[62] This is an undercount of the total number of persons earning a living in these industries because sole proprietors, common in the fishing and charter boat industries, are not included.

These industries utilize vessels that are both assessed at full value and vessels that are apportioned. Deep sea freight and passenger vessels, tugboats that travel to Alaska, and fishing boats that fish the high seas or off Alaskan waters likely are apportioned. Vessels that are used only in inland waters, charter boats, and in shellfish harvesting are not as likely to be apportioned. Some of the higher wages are in vessels that are apportioned, while some of the lower wages are in vessels that are not apportioned.

In addition to the direct employment in the industries utilizing vessels, there is additional employment in other industries that support these industries and their employees. Using employment multipliers from the 1997 Washington Input-Output Study, there are an estimated 8,100 additional jobs in the shipbuilding and repair, seafood processing, insurance, and professional services industries, among others.

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

The owners of apportioned vessels are saving about $900,000 per year in state property taxes. It is not known how much these owners may be paying in property taxes in other states. This amount is 0.2 percent of all the wages paid in the industries that utilize commercial vessels. It is unlikely that a termination of apportionment for vessels would have much effect, if any, on total employment or the economy.

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

The owners of apportioned vessels are saving about $900,000 per year in state property taxes. The state property tax levy raises $1.5 billion dollars per year. If the apportionment of vessels were terminated or lowered, the state levy would remain the same as there are levy limitations on total collections. There would be a shift in tax from other taxpayers to owners of commercial vessels. If the full value of all vessels were added to the property tax rolls, other taxpayers would face slightly lower levy rates – about one-tenth of a penny per $1,000 of assessed value. This equates to a savings of about 10 cents per $100,000 of assessed valuation.

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?

With regards to apportionment, at least two states have statutory provisions: Maine apportions and taxes vessels that are within the state for at least 75 days, and South Carolina apportions and taxes vessels that are within the state for a minimum of 30 days. Alaska does not have statutes or

rules that clarify the taxable situs of moveable or transient property, but Alaska does permit local governments to impose a fairly apportioned property tax on seagoing vessels. The Alaska Supreme Court has rejected the home port doctrine and found that it is constitutional for a borough to apportion taxes on vessels based on the number of months the vessels were within the borough's jurisdiction.

Some 28 states appear to exempt all commercial vessels or commercial fishing boats from property tax. These states include both coastal and inland states. Some of these states impose an alternative fee or tax. Twelve of these states exempt all or most tangible personal property from property taxes. This exemption applies not only to vessels but other forms of business and household property.

Oregon assesses watercraft in the county in which the vessel is customarily moored or if there is no customary place of moorage, then in the county in which the owner resides, or if neither situs applies, then in the county in which the owner maintains a place of business. Ships and vessels whose home ports are in Oregon and that ply the high seas or between the high seas and inland ports are assessed at 4 percent of fair market value. Other ships and vessels whose home ports are in Oregon are assessed at 40 percent of fair market value.

California has a constitutional provision that vessels of more than 50 tons burden engaged in the transportation of freight or passengers are exempt from property taxation. By statute this exemption applies to local taxes, not to taxes for state purposes. Commercial fishing boats and charter boats are assessed at 4 percent of full cash value.

Recommendation

The Legislature should continue the apportionment of commercial vessels for property tax purposes.

Legislation Required: None.

Fiscal Impact: None.

OTHER SHIPS AND VESSELS – SUMMARY

Current Law

State law exempts all ships and vessels, except commercial vessels and vessels under construction, from state and local property taxes. For the most part, this exemption pertains to pleasure or recreational boats.

Under other sections of law, most boats longer than 16 feet or powered by a motor larger than ten horsepower must be titled and registered to be able to operate legally on the waters of the state (Chapter 88.02 RCW). An exception to this requirement includes vessels engaged in commerce.[63] State law imposes a vessel excise tax equal to 0.5 percent of fair market value on most vessels that have to register (Chapter 82.49 RCW). An exemption from the vessel excise tax includes commercial fishing boats. See Appendix 3 for the current law statute RCW 84.36.090.

Exhibit 21 – Recreational Vessel Registration and Excise Tax

			Registration Required?	Excise Tax Required?
Motorized	Less than 16 ft.		Yes*	No
	More than 16 ft.		Yes	Yes
Sailboats	Less than 16 ft.	Motor	Yes	No
		No Motor	No	No
	More than 16 ft.	Motor	Yes	Yes
		No Motor	Yes	Yes
Human Powered	Any length		No	No

Source: Department of Licensing.

*No, if 10 horsepower or less when used only on non-federally regulated waters.

Commercial fishing boats and vessels primarily used in commerce are subject to the state property tax levy. These vessels are covered in another chapter in this report as they are exempt from local property taxes and some are partially exempt from the state property tax.

Findings and Recommendations

This review evaluated the legal history, public policy objectives, economic and revenue impacts, and other states, similar tax preferences of Washington's property tax exemption for pleasure boats. The audit determined the following:

[63] "Engaged in commerce" generally means the carrying of freight or passengers for hire.

Legal History and Public Policy Objectives

- The Legislature first exempted noncommercial vessels from 80 percent of local property taxes in 1931. This occurred after the voters adopted the 14th Amendment to the state Constitution in 1930 that allowed for the classification of different types of personal property.
- Many county assessors did not attempt to locate and assess boats because the boats were difficult to find and the assessing process cost counties more than they would receive in taxes. In 1980, only about 18 percent of the state's pleasure boat value was being assessed for tax purposes.
- The Legislature imposed the vessel registration and vessel excise tax in 1983. At the same time, the Legislature exempted noncommercial vessels from all property taxes.
- The initial public policy objective for exempting noncommercial vessels from 80 percent of local property tax levies in 1931 is moot. Since then the Legislature, as a public policy objective, defined the base of the property tax to exclude noncommercial boats. In lieu of the property tax, the Legislature made noncommercial boats subject to vessel registration and a vessel excise tax. The Legislature replaced a failed tax with one it thought might be successful. This objective has been achieved.
- Tax equity among different types personal transportation equipment was another public policy objective in 1983, with boats treated similarly to other large items of personal property such as motor vehicles, campers and trailers, and aircraft. However, this equitable treatment has changed; while motor vehicles, campers, and trailers are still exempt from property taxes, they are no longer subject to excise taxes. Aircraft remain subject to the aircraft excise tax. Noncommercial vessels are not treated similarly to some other large items of personal property.

Beneficiaries

- In 2008, some 239,036 owners of registered vessels benefit from this property tax exemption on their recreational watercraft.

Revenue and Economic Impacts

- Owners of recreational boats saved $32.8 million in state and local property taxes in 2007, while they paid $19.7 million in vessel registration fees and vessel excise taxes. The net savings to boat owners was $13.0 million.
- Net savings in future years is expected to remain in the $12 to $16 million range.
- What recreational boat owners save in state and local property taxes is shifted onto other property taxpayers.
- The effect on employment and the economy is minimal.

Other States

- Thirty-three other states exempt or do not impose a property tax on noncommercial vessels.

Recommendation

The property tax exemption for other ships and vessels should be continued.

Legislation Required: None.

Fiscal Impact: None.

OTHER SHIPS AND VESSELS – REPORT DETAIL

Statutory History

In 1931, the Legislature exempted from 80 percent of all local levies all ships and vessels under 200 tons whose home ports were in the state. These vessels were subject to the state property tax levy and 20 percent of local levies. At the same time, the Legislature exempted from all local levies all ships and vessels whose home ports were in the state and that were engaged in interstate commerce, foreign commerce, and/or commerce between ports of the state and the high seas.

The enactment of this personal property tax exemption followed the adoption in 1930 of the 14th Amendment to the state Constitution which allowed for distinctions in the classification of personal property. Prior to this time all property in the state, both real and personal property, was to be taxed in proportion to its value. While some property could be exempted, the exemptions were very limited.

The Legislature made a clarification in 1945 to exempt all ships not engaged in commerce from 80 percent of local property tax levies.

As with other forms of noncommercial personal property such as household goods, taxing pleasure boats was difficult. Boat owners generally did not voluntarily list their boats with county assessors, and since these boats were exempt from 80 percent of local levies, it was not in the interest of local assessors to seek them out. The 1966 Tax Advisory Council proposed a state excise tax on all ships, vessels, and boats in place of the existing general property tax.[64] The Council recognized that in practice many assessors did not attempt to locate and assess boats because they were difficult to find and the assessing process cost the county more than it would receive in taxes. The Council felt that a state excise tax would be far more equitable than the existing statutes. It also noted that similar large items of personal property, such as automobiles, house trailers, camping trailers, and aircraft, were subject to state excise taxes. The Council recommended a 2 percent state excise tax.

A 1980 report of the Department of Revenue indicated that only 18 percent of the state's pleasure boat value was being assessed for tax purposes.[65] A 1981 DOR survey of county assessors reported that one-third of the assessors made no effort to locate and list boats. Assessors cited the lack of cost-effectiveness of assessment as a primary rationale for non-enforcement.

In 1983, the Legislature imposed the vessel registration and excise tax. At the time the Legislature established this new tax, it also exempted noncommercial vessels from all property taxes. At the start of the 1983 Session, in an effort to solve a revenue shortfall for the ending

[64] "Proposals for Changes in Washington's Tax Structure, Report of the Tax Advisory Council of the State of Washington," 1966.

[65] Reported in "Tax Exemptions 1982," Washington State Department of Revenue, 1982.

1981-83 Biennium, the Legislature imposed a new vessel excise tax of 1.0 percent, effective March 1, 1983. This was timed to begin revenue collections prior to the close of the biennium on June 30, 1983. Later in 1983, to meet the expenses of the 1983-85 Biennium, the Legislature passed another omnibus tax bill that included decreasing the vessel excise tax from 1.0 percent to 0.5 percent and adding an annual vessel registration fee of $6.

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 initial public purpose in 1931 for exempting noncommercial boats from 80 percent of local property tax levies is now moot as the Legislature made significant changes in 1983.

In 1983, the Legislature completely exempted noncommercial boats from all property taxes for the public policy purpose of replacing a failed tax with a tax that potentially could collect increased revenues. The Legislature defined the base of the property tax to exclude noncommercial boats and, in lieu of the property tax, made noncommercial boats subject to vessel registration and a vessel excise tax. The property tax exemption for noncommercial boats also avoids the potential for the double taxation of those boat owners. The double taxation of noncommercial boats was not a major consideration in 1983 as most boat owners did not pay property taxes.

Another argument for the change was equity among different types of personal transportation equipment. The 1983 legislation treated boats similarly to other large items of personal property such as motor vehicles, travel trailers and campers, and aircraft.[66] These items were exempt from the property tax and subject to their own excise tax.

The partial taxation of pleasure boats through the state levy and 20 percent of local levies had not been working. Owners of pleasure boats were not voluntarily paying property taxes, and county assessors had little incentive to find them.

In lieu of the property tax, the Legislature in 1983 created a new vessel registration requirement and a vessel excise tax. The complete property tax exemption for pleasure boats recognized that the partial property tax was not working and that a new tax needed to be substituted for a failed tax. The 1966 Tax Advisory Council pointed out the difficulties with the property tax on boats. The 1982 report by the Department of Revenue documented the failings of the partial property tax on boats and the tax treatment of large items of personal property.

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[66] The aircraft excise tax applies mainly to small planes used for personal or business purposes; interstate commercial aircraft are exempted.

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 of defining the property tax base to exclude pleasure boats and make them subject to vessel registration and a vessel excise tax has been achieved. The partial property tax on pleasure boats was not working, and the vessel registration and excise tax appear to be working. In 1980, only 18 percent of the state's pleasure boat value was being assessed for tax purposes. Today 80 to 90 percent of the state's vessels that are supposed to register are, in fact, registered.

Since the repeal of the motor vehicle excise tax in 1998, the public policy objective of equity in the taxation of large items of personal property is no longer being met. Motor vehicles, travel trailers, campers, and aircraft are all exempt from property taxes, as are noncommercial vessels. However, motor vehicles, travel trailers, and campers are no longer subject to the state motor vehicle excise tax or the travel trailer/camper excise tax. Small planes are still subject to annual excise tax. Some items are exempt from all taxes (other than registration fees) while other items, such as noncommercial vessels, are subject to an excise tax.

Exhibit 22 – Taxation of Large Items of Personal Property

	1983		Today	
	Property Tax	**Excise Tax**	**Property Tax**	**Excise Tax**
Noncommercial Vessels	Exempt	Yes	Exempt	Yes
Motor Vehicles	Exempt	Yes	Exempt	No
Travel Trailers and Campers	Exempt	Yes	Exempt	No
Small Aircraft	Exempt	Yes	Exempt	Yes

Source: JLARC.

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

Continuing the property tax exemption for noncommercial vessels along with the vessel registration and excise tax contributes to the public policy objective of replacing a failed tax with one that works.

Continuing the property tax exemption for noncommercial vessels contributes to the objective of equity in tax treatment of large items of personal property since these other items are also not subject to the property tax. (However, the objective of equity in the overall taxation of large items of personal property is not being met because motor vehicles, travel trailers, and campers are not subject to an excise tax while vessels are subject to excise tax.)

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 of replacing a failed tax with one that works is being fulfilled.

The public policy of equity in tax treatment of large items of personal property is not being fulfilled. However, modifying the property tax exemption for pleasure boats will not help achieve any tax equity.

Beneficiaries

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

As of February 2008, there are 239,036 owners of registered vessels in this state.[67] They own 272,866 vessels. State law exempts all of these vessels, except about 900 commercial fishing boats, from the property tax.[68] All of these vessels are subject to vessel registration, with 174,297 also subject to the vessel excise tax.

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

No unintended beneficiaries are apparent.

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?

Based on vessel excise tax collections, the estimated value of pleasure boats in Washington in 2007 was $3.3 billion. These are only the boats subject to the vessel excise tax and do not include the 98,569 boats that are required to register but that do not pay excise tax. This also excludes human powered craft (rowboats, canoes, and kayaks) and boats under 16 feet in length. The property tax savings for boats subject to the vessel excise tax was $33 million in 2007 – of which $26 million was in local property tax savings and $7 million in state property tax savings. The history of the property tax on pleasure boats is that most boat owners did not list their boats with county assessors, and county assessors did not put much effort into finding and listing pleasure boats. Therefore, even if pleasure boats were subject to the property tax, it is unlikely that much of the property tax would be paid. It is also unlikely that if the boats had been listed that the state or local governments would see additional revenues. With a levy-based property tax system, increased property tax rolls lead to lower levy rates, and tax collections remain the same.

[67] Source: Department of Licensing, as of February 5, 2008.

[68] The property tax exemption for commercial fishing boats is addressed in a separate chapter in this report.

Exhibit 23 – Forecast of Local and State Property Tax Savings for Pleasure Boats ($ in millions)

Fiscal Year	Estimated Value of Pleasure Boats	State Property Tax Savings	Local Property Tax Savings	Total Property Tax Savings
2007	$3,276	$6.7	$26.1	$32.8
2008	$3,571	$6.6	$26.4	$33.0
2009	$3,829	$7.0	$28.2	$35.2
2010	$4,082	$7.6	$31.0	$38.6
2011	$4,352	$8.0	$33.1	$41.1

Source: Department of Revenue worksheets for the 2008 Tax Exemption Report.

Motorized pleasure boats must be registered if they operate on state waters. County sheriffs do enforce this requirement. However, the Department of Revenue estimates that 10 to 20 percent of big-boat owners in Washington do not pay the required excise tax. In 2007, vessel owners paid $3.3 million in registration fees and $16.4 million in vessel excise taxes for a total of nearly $20 million.

Exhibit 24 – Forecast of Vessel Registration and Vessel Excise Tax Revenues ($ in millions)

Fiscal Year	Vessel Registration Fees	Vessel Excise Tax	Total Registration Fees and Excise Taxes
2007	$3.3	$16.4	$19.7
2008	$3.5	$17.9	$21.4
2009	$3.5	$19.1	$22.6
2010	$3.5	$20.4	$23.9
2011	$3.5	$21.8	$25.3

Source: Department of Licensing revenue forecast, November 2007.

Overall, boat owners saved a net of $13 million in 2007 when considering both the vessel excise tax and the property tax exemption. While they paid nearly $20 million in vessel registration fees and vessel excise taxes, they were exempted from $33 million in property taxes (most of which likely would not have been paid). The state government therefore gained nearly $20 million in registration fees and taxes. While the state property tax on boats could have raised an additional $6.7 million, this amount was not lost to the state as other taxpayers paid this amount through slightly higher tax rates. However, the same is not always true for local government. Local governments at their maximum levy rate would lose revenue due to a property tax exemption. Property taxes are levy-based. Within certain restrictions, the state and local governments set the amount of taxes to be collected. If selected property is exempted from the tax base, ordinarily the levy rate will increase and the same amount of taxes will still be collected, with the remaining taxpayers paying a slightly higher amount.

Exhibit 25 – Forecast of Net Taxpayer Savings, Assuming Property Taxes Were Paid ($ in millions)

Fiscal Year	Net taxpayer savings
2007	$13.0
2008	$11.6
2009	$12.6
2010	$14.7
2011	$15.8

Source: JLARC calculation from the above Department of Revenue and Department of Licensing 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 the property tax exemption on pleasure boats were terminated, there are two general alternative scenarios regarding the vessel registration and vessel excise tax: 1) that vessel registration be continued, or both vessel registration and the excise tax be continued, or 2) that vessel registration, along with the vessel excise tax be discontinued.

1) If the vessel registration were continued, with or without the excise tax, it would become easier for county assessors to identify and list pleasure boats on the property tax rolls. Boat owners may pay an additional $33 million in state and local property taxes. On average, this would amount to about $188 per boat that is currently paying vessel excise tax, or roughly a 200 percent increase in taxes on boats. Someone owning a boat valued at $10,000 and paying an annual excise tax of $50 would see an additional property tax of about $102. Someone owning a boat with a value of $500,000 and paying an annual excise tax of $2,500 would see an additional property tax of about $5,100.

   The effect on employment and the economy would be minimal. As boat owners paid an additional $33 million in property taxes, other property owners would pay $33 million less. The amount of property taxes collected in total would remain the same.

2) If vessel registration were discontinued, experience shows that finding and listing boats becomes problematic. The issue before 1983 was that boat owners did not voluntarily list their boats, and county assessors had little incentive to go out and find them. Without state registration, enforcement becomes difficult. Without registration, boat owners may save the $20 million currently paid in registration and excise fees and not pay the $33 million owed in state and local property taxes.

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 property tax exemption for pleasure boats were terminated, the change in the distribution of liability for the payment of state taxes would be minimal. The estimated increase in state property taxes on pleasure boats would be about $7 million per year. The reduction in the state property tax levy would be about 0.85 cents per $1,000 of assessed valuation or a savings of 85 cents per $100,000 of assessed valuation. In total the state property tax levy is expected to raise about $1.5 billion per year with a levy rate about $2.00 per $1,000 of assessed valuation.

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?

Thirty-three states and the District of Columbia, in addition to Washington, either:

- Exempt noncommercial watercraft from the state property tax;
- Tax only business personal property and do not tax individual/household personal property;
- Do not tax any personal property; or
- Do not have a state property tax.

Seventeen states subject recreational watercraft to the personal property tax. It is not known how successful this effort is.

Recommendation

The property tax exemption for other ships and vessels should be continued.

Legislation Required:	None.
Fiscal Impact:	None.

EXPORTED AND IMPORTED FUEL – SUMMARY

Current Law

Motor vehicle fuel taxes are laid out in two separate chapters of state law. Chapter 82.36 RCW pertains to motor vehicle fuel, which is basically gasoline, and Chapter 82.38 RCW pertains to special fuel, which is made up of all combustible gasses and liquids other than gasoline that can propel a motor vehicle (primarily diesel).[69]

Several sections in the motor vehicle fuel tax code exempt exported and imported fuel from the motor vehicle fuel and special fuel taxes. To receive an exemption, one must be a licensed motor vehicle fuel supplier, special fuel supplier, motor vehicle fuel exporter, special fuel exporter, motor vehicle fuel importer, or a special fuel importer. Licensed suppliers can both import and export fuel. The sections of law providing for the exemptions include:

- RCW 82.36.020 – Imposes the motor vehicle fuel tax when motor vehicle fuel is removed from a terminal or refinery rack, unless the removal is to a licensed exporter for direct delivery to a destination outside of the state; also imposes the tax when motor vehicle fuel enters into this state when the entry is by bulk transfer and the importer is not a licensee.
- RCW 82.36.230 – Exempts from the motor vehicle fuel tax, motor vehicle fuel imported into the state in interstate or foreign commerce when the fuel is intended to be sold while in interstate or foreign commerce; also exempts the tax motor vehicle fuel exported from this state by a licensee.
- RCW 82.38.030 – Imposes the special fuel tax when special fuel is removed from a terminal or refinery rack, unless the removal is to a licensed exporter for direct delivery to a destination outside of the state; also imposes the tax when special fuel enters into this state when the entry is by bulk transfer and the importer is not a licensee.
- RCW 82.38.080 – Exempts from the special fuel tax special fuel, which, if under contract of sale, is shipped to a point outside this state by a supplier.

While state law exempts imported fuel from taxation when it is first brought into this state by a licensed supplier or importer, this fuel is taxed at some later point unless it is sold to a party that has an exemption in its own right or the fuel is later exported.

In addition, two sections of law deal with refunds of fuel tax for exported fuel: RCW 82.36.300 (motor vehicle fuel/gasoline) and RCW 82.38.180 (special fuel/diesel). In both cases, a person who has exported fuel outside of Washington, on which the fuel tax has been paid, is entitled to a refund of the fuel taxes. JLARC reviewed this tax preference in 2007. See Appendix 3 for the text of RCW 82.36.230 and RCW 82.38.030.

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[69] This chapter uses motor vehicle fuel and gasoline interchangeably. It also uses special fuel and diesel interchangeably as well. The chapter also refers to the motor vehicle fuel tax and the special fuel tax as fuel taxes.

Findings and Recommendations

This review evaluated the legal history, public policy objectives, economic and revenue impacts, and other states' similar tax preferences of the fuel tax exemption for exported and imported fuel. The audit determined the following:

Legal History and Public Policy Objectives

- The Legislature established the motor vehicle fuel tax in 1921 on the sale of liquid fuel for use in internal combustion engines. In 1923, the tax became a tax on the fuel used to operate motor vehicles upon the public highways. The statute did not impose the tax on liquid fuel sold for export.
- When rewriting the motor vehicle fuel tax in 1933, the Legislature (a) continued the exemption for exported fuel, (b) specifically exempted fuel imported into the state in interstate or foreign commerce, and (c) provided refunds for taxes previously paid on exported fuel.
- The voters passed the 18th Amendment to the state Constitution in 1944, dedicating motor vehicle fuel tax receipts to highway purposes.
- There are two possible public policy objectives for granting exemptions from fuel taxes on exported and imported fuel:
    - To promote equity – under the "benefits received" principle of tax equity, fuel used in motor vehicles on Washington's public highways is subject to motor vehicle fuel taxes, and fuel used otherwise is exempt; and
    - To comply with the interstate commerce clause of the U.S. Constitution.
- The exemptions meet the public policy objective of promoting equity. Motor vehicle fuel used in vehicles on Washington's public highways is subject to tax while fuel that is exported from Washington is exempt. To tax exported fuel in any amount would violate this objective.
- The interstate commerce clause of the U.S. Constitution limits the state taxation of goods shipped among the states. The Legislature's original exemption of all exported fuel from the fuel tax in 1921 would have met the criteria in place at the time for the U.S. Constitution's interstate commerce clause. Since then, however, the U.S. Supreme Court has created a four-part test to determine when and to what extent exported goods may be taxed by a state. Because the four-part test is less absolute, it is possible that the complete exemption of exported fuel from the motor vehicle fuel tax is broader than is necessary to still comply with the interstate commerce clause.

Beneficiaries

- There are 162 companies with one or more licenses that allow them to export or import motor vehicle fuel or special fuel.

Revenue and Economic Impacts

- In 2007, licensees exported some 3.6 billion gallons of fuel from Washington. The tax on this amount of fuel would have been $1.2 billion, if the fuel had been subject to the full amount of fuel tax. The U.S. Constitution prohibits taxing exported fuel at a state's full tax rate. At a minimum, a credit would need to be provided for fuel taxes paid in the recipient state. It is not known what the tax savings would have been if the fuel had been taxed at a level permissible by the U.S. Constitution.
- In future years, the tax savings is expected to increase to $1.35 billion per year as the fuel tax has increased to 37.5 cents per gallon.
- Washington is a net exporter of motor vehicle and special fuel. Washington is home to five major refineries that employed 1,900 people in 2006 and paid $197 million in wages for an average annual wage of $106,000. Average wages in the petroleum refinery industry were 82 percent higher than the statewide average manufacturing wage in 2006 of $58,000 and 146 percent higher than the average wage for all industries of $43,000.

Other States

- All states grant complete fuel tax exemptions on export sales. Tennessee does impose a tax on petroleum products that are exported from that state. Texas requires suppliers to collect either the Texas fuel tax or the destination state's fuel on fuel exported from the state. A Florida court found that the imposition of the Florida fuel tax on fuel sold in Florida, picked up by a common carrier in Florida, and exported to Georgia for sale in Georgia, did not violate the commerce clause of the U.S. Constitution.
- The U.S. Constitution requires that imports cannot be taxed while they remain in interstate or foreign commerce.

Recommendation

The motor vehicle fuel tax and special fuel tax exemption for exported and imported fuel should be continued.

Legislation Required: None.

Fiscal Impact: None.

EXPORTED AND IMPORTED FUEL – REPORT DETAIL

Statutory History

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

"Distributor" meant any person who produced, refined, or manufactured liquid fuel in the state for use and sale in the state, or who imported and sold liquid fuel into this state. The Legislature specifically did not impose the tax on liquid fuel sold for exportation from the state to any other state, territory, or nation.

In 1923, the Legislature raised the tax to two cents per gallon and drew the tax base more narrowly. The tax applied to sales of liquid fuel to everyone who used liquid fuel for the purpose of operating motor vehicles upon the public highways. Exported fuel remained exempt from taxation. Tax receipts were still credited to the Motor Vehicle Fund. The Legislature also provided several refunds for non-highway use of fuel. The 1923 changes clarified that, if fuel was used in vehicles operated upon the public highways, that fuel was subject to the fuel tax, and the tax receipts were dedicated to the Motor Vehicle Fund. If the fuel was used for some other purpose, the consumer could apply for a tax refund if the tax had previously been paid.

In 1933, the Legislature rewrote the motor vehicle fuel tax statutes. Every distributor still paid the tax on each gallon of motor vehicle fuel sold, distributed, or used by it in the state. "Distributor" still meant everyone who refined, produced, or manufactured motor vehicle fuel and sold or distributed it in the state as well as every person who imported any motor vehicle fuel into the state and sold or used it in the state. In addition to the tax not applying to motor vehicle fuel exported from this state, the Legislature specified that the tax did not apply to motor vehicle fuel imported into the state in interstate or foreign commerce and intended to be sold while in interstate or foreign commerce. Any person who exported fuel and who had previously paid tax on the fuel could seek a refund of those taxes.

In 1944, the voters passed the 18th Amendment to the state Constitution. This constitutional provision states that "… all excise taxes collected … on the sale, distribution or use of motor vehicle fuel … shall be … placed in a special fund to be used exclusively for highway purposes." The 18th Amendment constitutionally dedicated motor vehicle fuel tax receipts to highway purposes and prevented the Legislature from using the tax receipts for other purposes.

In 1998, the Legislature changed the point of taxation from when the distributor sold the fuel to when the fuel was removed from a refinery or terminal rack. The provisions regarding the exemption from the tax of fuel imported into the state in interstate or foreign commerce and intended to be sold while in interstate or foreign commerce and the exemption for fuel exported from the state remained.

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?

There are several possible public policy objectives that provide a justification for the tax exemption for exported fuel. The most obvious are 1) to promote tax equity and/or 2) to comply with the U.S. Constitution.

1) Equity: From the beginning of the fuel tax in 1921, together with the 1923 and ensuing exemptions/refunds and the 18th Amendment to the state Constitution, it appears that:

- Fuel used in motor vehicles on public highways is to be taxed by the motor vehicle or special fuel taxes;
- Fuel not used on public highways is not to be taxed by the motor vehicle or special fuel taxes; and
- Fuel tax revenues are dedicated for highway purposes.

The public finance literature discusses two notions of tax equity.[70] One is the "ability to pay" principle, and the other is the "benefits received" principle. The ability to pay principle requires that burdens on taxpayers be related to their ability to pay. The benefits received principle states that the burden on taxpayers should be related to the benefits they receive. The gas tax is a prime example of equity under the benefits received principle. The gas tax is considered equitable because the people who pay the tax (drivers) are the same taxpayers who receive the benefits.

The Washington Supreme Court recognized the "just and reasonable policy" of the motor vehicle fuel tax in a 1939 decision:

> *That the burden of special taxes created and imposed to raise funds for the construction and upkeep of the costly and highly specialized highways suitable for motor vehicle traffic ought to be borne by those who use the highways for that traffic.*[71]

Exported fuel is not used on Washington's highways. Fuel imported into the state and continuing on in interstate or foreign commerce, is not being used on Washington's highways. Equitable treatment of exported and imported fuel, based on the benefits received principle, requires that this fuel not be subject to any motor vehicle fuel taxes because it is not used on Washington's highways.

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[70] For example, see "Public Finance and the American Economy, Second Edition," Neil Bruce, Addison-Wesley Longman, Inc., 2001 or "Understanding the Tax Reform Debate: Background, Criteria, & Questions," U.S. Government Accountability Office, September 2005.

[71] "Mason-Walsh-Atkinson-Kier Company v. Otto Case," 2 Wn. 2d 33 (1939).

2) U.S. Constitution: Providing tax exemptions on fuel imported into the state in interstate or foreign commerce and intended to be sold while in interstate or foreign commerce and on fuel exported from the state may be seen as an attempt to comply with the U.S. Constitution. The commerce clause of the U.S. Constitution is generally read as prohibiting states from taxing exports and imports from other states and nations. In 1921, this reasoning would have been well-founded.

However, if the original decision of not imposing any motor vehicle fuel tax on fuel exported from the state was based upon the belief that such a tax would violate the commerce clause of the U.S. Constitution, that belief is no longer well-founded. Interpretation of the federal commerce clause has been a subject of much debate and litigation before the U.S. Supreme Court over the years. State taxes can currently be tested under the four-prong approach established in the 1977 U.S. Supreme Court decision *Complete Auto Transit*.[72] The four prongs include:

1. Is the tax applied to an activity with substantial nexus with the taxing state?
2. Is the tax fairly apportioned?
3. Does the tax discriminate against interstate commerce?
4. Is the tax fairly related to the service provided by the state?

Although the constitutionality of a tax on exported fuel would depend on the tax's exact structure, the U.S. Supreme Court has ruled that such a tax is no longer per se restricted by the federal constitution.

A state tax must not discriminate against interstate commerce and must avoid double taxation of a good. It is possible that the exemption for exported fuel is currently written more broadly than it needs to be to comply with the U.S. Constitution. The exemption might be narrowed and still be permissible under the commerce clause if a credit were allowed for fuel taxes paid in other states. For example, the fuel tax in Washington is 37.5 cents per gallon and the fuel tax in Oregon is 27 cents per gallon. It might be possible for Washington to tax fuel exported to Oregon at a rate of 10.5 cents per gallon – 37.5 cents per gallon less a credit of 27 cents per gallon for taxes paid in Oregon.

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

There are two possible public policy objectives for granting fuel tax refunds paid on fuel that is exported and imported:

1) Equity: The public policy objective of equity is being met as fuel that is exported from the state and not used on Washington's highways is not subject to tax. Equity is also being met by not taxing imported fuel that is still in interstate or foreign commerce and is not used on Washington highways.

[72] "Complete Auto Transit v. Brady," 430 U.S. 274 (1977).

2) Comply with the U.S. Constitution: As discussed above, there is a question about whether the exemption for exported fuel needs to be for the full amount of Washington taxes or just the amount of taxes paid in the destination state. It may be possible to provide less than a full exemption on exported fuel and still comply with the U.S. Constitution. Under the interstate commerce clause it is not possible to tax imported fuel while the fuel is still in interstate or foreign commerce.

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

(1) Equity: Continuation of this tax preference contributes to the public policy objective of equity. A public policy objective of equity requires collecting fuel tax only on fuel used on the public highways and not collecting fuel tax on fuel not used on the public highways. It is necessary to continue to exempt exported and imported fuel from the fuel taxes to maintain this public policy objective.

(2) U.S. Constitution: Continuing the tax preference leaves no doubt the tax system complies with the U.S Constitution. However, it may be possible to provide less than a full exemption on exported fuel and still comply.

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 of tax equity, taxing only fuel used on Washington's highways, is being fulfilled. Any modification of the complete exemption for exported fuel would breach this principle. The public policy objective of compliance with the U.S. Constitution is also being fulfilled, even though the complete tax exemption may go beyond what is absolutely required.

Beneficiaries

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

There are 162 companies with one or more licenses that allow them to export or import motor vehicle fuel or special fuel. There are 73 companies with a supplier license that may export or import motor vehicle fuel, special fuel, or both. There are 45 companies that are exporters only of either motor vehicle fuel, special fuel, or both. There are 32 companies that are importers only of either motor vehicle fuel, special fuel, or both. The other 12 companies have some combination of both, export and import licenses.

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

There are no 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?

In fiscal year 2007, licensees exported some 3.6 billion gallons of motor vehicle fuel and special fuel from Washington. Motor vehicle fuel taxes on this amount of fuel would have come to $1.2 billion. If the exported amount of fuel remains relatively constant, the tax savings in future years will be about $1.35 billion per year. To the extent constitutionally permissible, a portion of these savings could possibly be taxed by the state government, but the amount permissible is difficult to identify.

Exhibit 26 – Exported Fuel (millions of gallons)

Fiscal Year	Motor Vehicle Fuel	Special Fuel	Total
2004	2,223	932	3,155
2005	2,459	905	3,364
2006	2,749	994	3,744
2007	2,606	1,008	3,614

Source: Department of Licensing.

Exhibit 27 – Fuel Tax Rate and Taxpayer Savings (dollars in millions)

Fiscal Year	Tax Rate Per Gallon	Taxpayer Savings
2007	34 cents	$1,229
2008	36 cents	$1,296
2009	37.5 cents	$1,350
2010	37.5 cents	$1,350
2011	37.5 cents	$1,350

Source: Historical data – DOL; forecast – JLARC.

Washington is a net exporter of fuel. The state is home to five major refineries. Petroleum refineries in Washington employ nearly 1,900 people and pay $197 million in wages.[73] Average wages are $106,000 per year. The employment is concentrated in Skagit county (nearly 800 workers with average wages of $98,000 in 2006) and Whatcom county (830 workers with average wages of $107,000 in 2006).[74]

[73] Washington State Employment Security Department, data for 2006.

[74] Washington State Employment Security Department, data for 2006.

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

The price of gasoline in Washington has increased dramatically in the past several years. The retail price of gasoline (all grades, including taxes) in Washington has gone from $1.68 per gallon in 2003 to $3.01 in 2006, an increase of $1.33 per gallon or 79 percent.[75] During this time, gross fuel consumption in Washington increased slightly from 3.356 billion gallons to 3.437 billion gallons (although consumption in 2007 was slightly lower than in 2006). Washington's refineries have also increased fuel exports. These increases tend to confirm studies showing that fuel use is "price inelastic." [76] Past studies have indicated that a gasoline price increase of 10 percent would reduce consumer demand by just 2 percent (a price elasticity of 0.2).[77] Being "price inelastic" means that a tax increase can be passed forward onto consumers without a proportionate loss in sales. Production of gasoline in this state likely would not decline significantly if the Legislature terminated this exemption from fuel taxes on exported fuel and allowed a credit for fuel taxes paid in other states.

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 Legislature partially terminated the tax exemption for exported fuel, the amendments would need to comply with the U.S. Constitution. The current full motor vehicle fuel tax rate of 37.5 cents per gallon could not be applied to the 3.6 billion gallons of exported fuel; the Legislature would need to devise some means of crediting fuel taxes in other states to avoid double taxation.

Also, Washington is a party to the International Fuel Tax Agreement (IFTA), a cooperative agreement among the states and Canadian provinces to simplify the reporting of fuel used by interstate motor licensees. Under this agreement, licensees report and pay motor vehicle fuel taxes to a home state for distribution to other states and provinces in which the licensee traveled and incurred motor vehicle fuel tax liability. There may be a need to review this agreement to determine whether there are any conflicts between it and the termination of the tax exemption

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[75] Source: Energy Information Administration.

[76] "Price elasticity of demand" measures the consumers' sensitivity to price changes and is the change in a product's demand compared to a change in its price. If a 10 percent increase in the price of a good leads to a 10 percent decrease in demand, the price elasticity of demand is one. A good with a price elasticity greater than one is price "elastic" – demand decreases faster than the price increases. A price "inelastic" good is one where the demand decreases at a slower rate than the price increase. Generally, goods that are essential to everyday living and have fewer substitutes are price inelastic.

[77] For example, see "Gasoline Price Changes: The Dynamic of supply, Demand, and Competition," Federal Trade Commission, 2005. Also, the Washington Department of Transportation uses a gasoline price elasticity of 0.2 as an assumption in its revenue forecasting model.

for exported fuel. However, Tennessee participates in the IFTA and imposes a tax on exported fuel.

In fiscal year 2007, about as much fuel was exported (3.6 billion gallons) as was consumed (3.4 billion gallons) in Washington. A tax on any share of the exported fuel would have a significant impact on revenues when compared to current collections. The additional tax revenues most likely would be new revenues to the state as the taxes would be passed forward to consumers in other states. Without more information on how this might be addressed, it is difficult to identify the fiscal impact of a change.

Other States

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

All states grant motor vehicle fuel tax exemptions or refunds to distributors on motor vehicle fuel exported from the state.[78] Tennessee imposes an export tax of one-twentieth of one cent on petroleum products which are stored in the state and are subsequently exported. In Texas, licensed suppliers are required to collect either the Texas tax or the destination state's tax on gasoline and diesel fuel exported from that state. Florida courts have found that the imposition of the Florida diesel fuel tax on fuel sold in Florida, picked up by a common carrier in Florida, and exported to Georgia for sale in Georgia, did not violate the commerce clause of the U.S. Constitution.[79]

The interstate commerce clause requires that imports of fuel into a state that remain in interstate or foreign commerce cannot be taxed until the fuel leaves interstate or foreign commerce.

Recommendation

The motor vehicle fuel tax and special fuel tax exemption for exported and imported fuel should be continued.

Legislation Required: None.

Fiscal Impact: None.

[78] "Highway Taxes and Fees," U.S. Department of Transportation, Federal Highway Administration, Office of Highway Policy Information, Highway Funding and Motor Fuels Division, June 2001.

[79] "TA Operating Corporation dba Truckstops of America v. State of Florida, Department of Revenue," Florida District Court of Appeal, No. 1D99-3480, 767 So. 2d 1270 (2000).

REAL ESTATE SALES/RENTAL/LEASING – SUMMARY

Current Law

Current law exempts from the business and occupation tax income from real estate sales and rental and leasing of real estate. This exemption applies to both individual and business owners of real estate. The statutory definition for "sale of property" means the transfer of the ownership of or possession of property and it also includes lease or rental and conditional sale contracts. Real estate property is limited to real property. This tax preference excludes income derived from commissions, fees or interest from selling property. See Appendix 3 for the current law statute, RCW 82.04.390 (the exemption itself) and RCW 82.04.040 (definitions for sale, lease or rental).

Findings and Recommendations

This review has evaluated the legal history, public policy objectives, economic and revenue impacts, and other states' similar tax preferences of the business and occupation tax exemption for sales, renting and leasing of real estate. This audit determined the following:

Legal History and Public Policy Objectives

- In 1933, there was an exemption from the temporary business activities tax for renting and leasing of real estate. In 1935, the Legislature enacted the business and occupation tax and also exempted income from renting, leasing and sales of real estate.
- In 1959, the Legislature eliminated the B&O tax exemption for businesses renting and leasing real estate and made the income subject to at a rate of 0.25 percent.
- In 1960, the state Supreme Court ruled that a business and occupation tax on rental income constituted a property tax and not an excise tax.[80] The court determined that a business and occupation tax on rental income was unconstitutional because the tax was not assessed uniformly across all real estate. In 1961, the Legislature made statutory changes to delete reference to the B&O tax on rental and leasing income to reflect the Washington Supreme Court's ruling.
- Since 1959, the provisions of this exemption in RCW 82.04.390 have not been changed.

The tax exemption has achieved the following three public policy objectives:

1. To define the business and occupation tax base as excluding gross income from the sales, rental, and leasing of property and to limit the exemption to just the income earned from the renting, leasing, and selling of real estate.
2. To avoid double taxing income earned from real estate sales since income from those sales is subject to a conveyance / real estate excise tax.

[80] Apartment Operators Association of Seattle v. Schumacher, 56 Wn.2d 46, 351 P.2d 124(1960).

3. To comply with the state Constitution regarding taxation of income earned from rental or leasing real estate.

Beneficiaries

- The nationwide multiple listing service reports 280,970 real estate sales in Washington in calendar year 2006. The sellers of residential, commercial, industrial, and other properties are the beneficiaries of this business and occupation tax exemption.
- Owners of rental properties and owners of other real property with leasing agreements are also beneficiaries of this exemption.

Revenue and Economic Impacts

- Over the past ten years, the value of this tax preference has increased because it is based on Washington's real estate values. In the past year, the real estate market has declined and thus the value of this tax preference has fallen.
- The total business and occupation taxpayer savings estimates are projected to be $277 million in fiscal year 2008, declining and then rising again by fiscal year 2011 to $332 million. This estimate comprises the taxpayer savings from exempting gross sales, rents and leases.
- In 2006, Washington's real estate industry produced $23 billion in services and spent $7.1 billion to perform those services.

Other States

- The District of Columbia and 36 states, including Washington, have a state real estate excise tax. Three states have a local real estate excise tax. Eleven states do not have any real estate excise tax.
- The District of Columbia and 43 other states have personal income taxes. Most states (36) link state law to the federal law provisions for federal income taxes.
- Washington, Nevada, and Wyoming do not impose a business tax on rental and leasing income or a capital gains tax on sales of real estate.

Recommendation

The Legislature should continue the business and occupation tax exemption for income derived from real estate sales, rental and leasing.

Legislation Required: None.

Fiscal Impact: None.

REAL ESTATE SALES/RENTAL/LEASING – REPORT DETAIL

Statutory History

Exhibit 28 – History of Real Estate B&O Tax Exemption, Definition of Sale and Tax Extended

Year	General Definition of Sale Subject to Tax	Real Estate B&O tax Exemption	B&O tax imposing a tax on rental and leasing
1933	The word "sale" includes the exchange of property as well as the sale thereof for money. Every closed transaction shall constitute a sale.	Exemption applies to income derived from the **lease and rental** of real estate.	N/A
1935	"Sale" means any transfer of the ownership of, title to, or possession of property for a valuable consideration and includes any activity classified as a "sale at retail" or "retail sale." Includes conditional sale contracts, leases with option to purchase, and any other contract under which possession of the property is given to the purchaser but title is retained as security for the payment of the purchase price.	Exemption applies to income derived from the **lease, rental and sale** of real estate.	N/A
1959	**Renting** or **leasing** are added to the general definition of "Sale."	Exemption is modified to not apply to **lease** and **rental** of real estate.	Added renting and leasing of real property to the list of businesses subject to tax
1961	Same as 1959.	Same as 1959.	Removed the tax

Source: JLARC.

1933

The Legislature faced a revenue shortfall as it convened in January 1933. The prior November, the voters had passed Initiative Measure No. 64, a 40-mill property tax limit bill. The initiative limited property tax levies for state purposes to a maximum of five mills on a 50 percent valuation.[81] This measure effectively reduced the income from state taxes by approximately 50

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

percent, beginning with the second year of the 1933-35 Biennium. Assessed valuations and levies were already reduced due principally to the depressed economic conditions of the time. The Legislature also adopted in 1933 the Showalter Bill, a measure increasing, by about two-thirds, the state's obligation to support local school districts. The voters passed another initiative in 1932, Initiative Measure No. 69, imposing a state income tax on all corporations and individuals.

In response, the Legislature adopted a temporary business activities tax in 1933. The tax was to be in place from August 1, 1933, to July 31, 1935. The tax was measured by the application of rates against "value of products," "gross proceeds of sales," or "gross income of the business." The rates varied depending on the type of business activity. The tax rates ranged from 0.5 percent to 3 percent. The business tax applied to a wide range of businesses including public service and utility companies, retailing, wholesaling, manufacturing, professional services, financial and amusement businesses.[82] The temporary business activities tax enacted in 1933, included provisions to exclude the income from leasing and renting of real estate.

1935

The Legislature, meeting in 1935, faced the problems of replacing the revenue previously received from property taxes levied for the state general fund, as well as the state's obligations under the Showalter Act to support common schools, and payment for relief and welfare work. To raise the required revenue, the Legislature enacted the Revenue Act of 1935. The new act supplanted the temporary 1933 act and continued in general effect the business taxes imposed by it. The permanent business and occupation tax included an exemption for not only the renting and leasing of real estate but also for the sale of real estate:

> *The provisions of this title shall not apply to …*
>
> *(j) Amounts derived from the lease, rental or sale of real estate: Provided, however, that nothing herein shall be construed to allow a deduction of amounts derived from engaging in any business wherein a mere license to use or enjoy real property is granted, or to allow a deduction of amounts received as commissions from the sale or rental of real estate.*

The 1935 Revenue Act also imposed a conveyance tax on real estate sales. The tax rate was $.50 for every $500 of property value.

1959 – B&O tax on income from renting and leasing real estate

The Legislature made a major change by eliminating the exemption for the lease or rental of real estate from RCW 82.04.390 and instead making those transactions subject to the B&O tax.[83] The Legislature assessed a rate of 0.25 percent and applied it to any business which had rental income of more than $300 per month. This new tax only applied to any individual or businesses renting

[82] "Business Tax Instructions," Tax Commission of State of Washington, April 1934.

[83] RCW 82.04.280.

property. The exemption was clarified that real estate fees, handling charges, discounts, interest or similar financial charges are not part of this business and occupation tax exemption.[84]

The Legislature changed the statutory definition of "sale" to allow the Legislature to tax rental and leasing income.[85] The Legislature added renting or leasing to the type of sales subject to tax.[86]

1960 – State Supreme Court Ruling

The state Supreme Court ruled in *Apartment Operators Association of Seattle v. Schumacher, 56 Wn.2d 46, 351 P.2d 124(1960)* that the Legislature's B&O tax on rental income was unconstitutional. The court concluded that a tax on rental income was a property tax, rather than an excise tax. Since it was a tax on property, it had to comply with the uniformity requirements of the 14th Amendment of the state Constitution. According to the Washington Constitution, all taxes must be uniform and real estate must constitute one class of property.

> *All taxes shall be uniform upon the same class of property within the territorial limits of the authority levying the tax and shall be levied and collected for public purposes only. The word 'property' as used herein shall mean and include everything, whether tangible or intangible, subject to ownership.* ***All real estate shall constitute one class.***

The court concluded that the property tax was already a tax on real estate and this new business and occupation tax upon rental properties was a second tax and was not be levied uniformly against all gross income of rental property nor was it levied against all real estate. The court ruling does not provide extensive legal analysis or weight given to prior court decisions which classified the business and occupation tax as an excise tax.

1961

The Legislature amended RCW 82.04.280 to delete the B&O tax on the renting or leasing of real estate.[87] However, the Legislature did not amend the actual B&O tax exemption in RCW 82.04.390 to reinsert the rental and lease provisions back into the exemption law.

2003

In 2003, the Legislature added a definition of lease and rental property which applied to transfers of personal property.[88] According to the legislative bill reports, this definitional change to lease and rental was part of a larger bill pertaining to the streamline sales tax project to conform certain definitions across states. Given that the 2003 supporting documentation pertaining to the 2003 changes and the fact that the administrative rule for this tax exemption has not been

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[84] S.B. 6; Laws of 1959, ex. s. ch. 5 §§4, 8.

[85] RCW 82.04.040.

[86] SB 6; Laws of 1959, ex.s. ch.3 §1.

[87] HB 6; Laws of 1961 §82.04.280.

[88] SB 5783, Laws of 2003, ch. 168 §103.

changed, JLARC assumes that this additional definition will not impact this B&O tax exemption for renting and leasing of real estate.

Other Relevant Information

Conveyance Tax

Washington law defining this B&O tax exemption has never required the gross sales of real estate to be subject to another tax in order to qualify for this B&O tax exemption. Nonetheless, since 1935, Washington has taxed the gross sales of real estate with the conveyance tax and then in 1951 with the real estate excise tax.

At the same time that the Legislature enacted the business and occupation tax and exempted the gross sales of real estate, it also enacted the conveyance tax in the Revenue Act of 1935. The excise tax was levied on transfers of real property when the value exceeds $100. The conveyance tax applied to sales of real estate but also to other instruments conveyed to another person by the owner. The tax rate originally was $.50 for each $500 of property value until 1983 when it was increased to $1.00 per $500 of property value. Tax receipts were distributed to the state General Fund.[89] The 1987 Legislature repealed the conveyance tax and raised the real estate excise tax by an equivalent amount, increasing the state real estate excise tax from 1.07 to 1.28 percent.

Real Estate Excise Tax

The Legislature authorized a local real estate excise tax (REET) as a county tax in 1951.This tax is based on the value of the real estate transferred and it is typically paid by the seller of the property even though the buyer may be liable for the tax if it is not paid. Initially the tax rate was up to 1 percent with all receipts dedicated to school districts within the county, except for 0.5 percent retained by the county to cover administration costs. The Legislature shifted the tax to the state in 1981, but the actual collection of the tax remained with county treasurers.

In 1982, the Legislature increased the state real estate excise tax to 1.07 percent and also authorized two local real estate taxes: 0.25 percent for capital purposes and 0.5 percent in lieu of the second 0.5 percent local sales tax. After repealing the conveyance tax in 1987, the Legislature established the state REET tax rate at 1.28 percent for exclusive use in funding K-12 education and public works assistance.[90] Local cities and counties are allowed up to 2.5 percent for other dedicated purposes.

In 1990, the Legislature authorized two local REET taxes: a 1 percent county tax for conservation areas and 0.25 percent city/county tax for capital projects specified in comprehensive local plans. In 1993, the Legislature expanded the tax base for the real estate excise tax to include the acquisition of a controlling interest in an entity that owns real property in Washington. This change was enacted to counter a growing practice of structuring transactions involving

[89] "An Introduction to Washington Taxes" by Charles Hodde, Director of the Department of Revenue, December 1977.

[90] 2007 Tax Reference Manual, Washington Department of Revenue.

commercial/industrial property to avoid the tax. The Legislature established a one percent local tax for affordable housing in 2002.

Washington Administrative Rules

The definition of 'sale' in RCW 82.04.040 includes not only transfers of the ownership of or title to or possession of property but also lease or rental, conditional sale contracts, and any contract under which possession of the property is given to the purchaser but the title remains with the seller as collateral for future payments. Due to this broad definition of sale and the Schumacher court ruling, this tax exemption has been extended to a variety of rental and lease payments received by sellers for real estate property. The administrative rule, WAC 458-20-118, provides additional clarification on the definition of lease or rental of real estate and the longer term renting and leasing contracts that qualify for this exemption:

> *A lease or rental of real property conveys an estate or interest in certain designated area of real property with an exclusive right in the lessee of continuous possession against the world, including the owner, and grants to the lessee the absolute right of control and occupancy during the term of the lease or rental agreement. An agreement will not be construed as a lease of real estate unless a relationship of "landlord and tenant" is created thereby. It is presumed that the sale of lodging by a hotel, motel, tourist court, etc. for a continuous period of thirty days or more is a rental of real estate. It is further presumed that all rentals of mini-storage facilities, apartments and leased departments constitute rentals of real estate. The rental of a boat moorage slip or an airplane hanger/tie down site is presumed to be a rental of real estate only if a specific space, slip or site is assigned and the rental is for a period of thirty days or longer.*

Also, current administrative rule distinguishes between renting /leasing and having a license to use real estate. If a business activity falls under the category of a license to use real estate, then the seller of the license must pay business and occupation tax on the gross receipts from those licenses. Some examples in the administrative rule of a license to use real estate are the following:

- Hotel/motel rooms for periods of less than 30 days;
- Cold storage lockers;
- Safety deposit boxes and private mail boxes;
- Hairdressers, barbers or other beauty consultants who lease space from other businesses; and
- Use of boat launch facilities for recreational purposes.

Court Cases

The courts have addressed whether particular taxes are excise or property taxes. In addition, the courts have evaluated what type of activity constitutes a "sale" under the present exemption.

These court decisions are critical to understanding this tax exemption because the state Supreme Court ruled that a B&O tax on rental income was unconstitutional. Court decisions after the 1960 Schumacher case have raised questions on the validity of that case.[91] Other court decisions have identified which business activities qualify and which do not qualify as renting and leasing of real estate and the B&O tax exemption.[92]

Court decisions surrounding the classification of a tax as an excise or property tax have been abundant and generally have analyzed the voluntary nature of being subject to the tax and how and why it is assessed on the businesses or individuals. Some general rules have emerged:

- Personal and corporate net income taxes have been classified as property taxes;
- Once a tax is considered a "property" tax, the Constitution requires the tax to meet the uniformity clause of the Washington Constitution with real estate being classified as a single class of property;
- In general, the court has classified retail sales, use, public utility, real estate excise and business and occupation taxes as excise taxes not subject to the constitutions uniformity clause; and
- The renting or leasing of real property such as apartments, office buildings and other real structures under the control of the tenant is exempt from the business and occupation tax based on a court decision.[93] The decision ruled that a business and occupation tax assessed on the income from the rental or lease of real estate constitutes an unconstitutional property tax. That 1960 court decision has been questioned by other subsequent court decisions.

Business and Occupation Tax

The business and occupation tax is based on gross receipts. Initially, the tax rates were 0.25 percent for all businesses except services, which were taxed at 0.5 percent. Over time, the Legislature has developed a number of specialized tax rates for particular types of businesses.[94] Under current law, for most companies, the business and occupation tax rates range from 0.13 percent for pari-mutuel wagering to 1.5 percent for service and other activities, hospitals and gambling contests of chance (less than $50,000 per year). The B&O tax rate for manufacturing and wholesaling activities is .484 percent and retailing activities is .471 percent. Otherwise, businesses not covered by another tax rate pay the B&O tax rate of 1.5 percent.[95] The B&O tax

[91]Shurguard Mini-Storage v. State of Washington; 40 Wn. App. 721; 700 P.2d 1176; 1985; Black v. State of Washington; 67 Wn. 2d 97; 406 P. 2d 761; 1965.

[92]Hoersch v. State of Washington, Board of Tax Appeals Dockets Nos. 26407, 26408 & 26409 November 19, 1984; Shurguard Mini-Storage v. State of Washington; 40 Wn. App. 721; 700 P.2d 1176; 1985; Lacey Nursing Center, Inc. v. Department of Revenue; 103 Wn. App. 169; 11 P.3d 839; 2000.

[93] Apartment Operators Association of Seattle, Inc. v. Schumacher; 56 Wn.2d 46; 351 P.2d 124; 1960.

[94] "Sixth Biennial Report of the Tax Commission of the State of Washington for the Period Ending September 30, 1936" by Washington State Tax Commission.

[95] Ibid.

does not permit deductions for the costs of doing business, such as payments for raw materials and wages of employees. Any exemptions and deductions from the B&O tax are specified separately in law.

Business and occupation tax collections have grown from $1.7 billion in 1997 to $2.6 billion by 2007. The business and occupation tax was reported by approximately 300,000 firms in fiscal year 2006.[96] These are the firms with business and occupation tax liability (prior to credits).

Exhibit 29 – History of the Business and Occupation Tax Collections: 1997 – 2007

Fiscal Year	Collections ($ millions)	% Change
1997	$1,722.8	4.9
1998	$1,853.8	7.6
1999	$1,827.5	-1.4
2000	$1,854.9	1.5
2001	$2,012.4	8.5
2002	$1,958.3	-2.7
2003	$1,923.4	-1.8
2004	$2,067.9	7.5
2005	$2,269.1	9.7
2006	$2,477.8	9.2
2007	$2,640.9	6.6

Source: Department of Revenue 2007 Tax Reference Manual and Office of Forecast Council February 2008 forecast report.

Public Policy Objectives

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

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

1) **Define tax base:** A public policy objective of this tax exemption is to define the business and occupation tax base as excluding income from the renting, leasing, and sales of real estate. Initially in 1935, the Legislature may not have considered the renting, leasing, purchasing, and selling of real property as constituting "engaging in business." The Legislature is likely to have viewed sales of primary residences as not "engaging in business" in the state. Since 1935, there has been growth in the number of individuals, businesses, trusts, and estates investing in real estate. The Legislature did not clearly state whether it intended to exempt business investment sales from the business and occupation tax in 1935.

[96] 2007 Tax Reference Manual by Washington Department of Revenue.

In 1959, the Legislature tried to impose a business and occupation tax on income from renting and leasing of real estate. This legislative change may have been the result of recognizing that there were Washington businesses earning income on renting and leasing property. The Washington Supreme Court ruled this business and occupation tax unconstitutional a year later. Since that time, the Legislature has not changed the B&O tax exemption statute pertaining to real estate sales of real estate.

A part of the tax base defining objective was to exclude real estate agents' commissions or financial institutions' fees from the B&O tax exemption.

2) **Avoid double taxation:** A second objective could have been to avoid double taxation of the real estate sales income since that income was also subject to a conveyance tax initially and in later years subject to the state and local real estate excise tax. The rental and leasing income of real estate portion of this exemption did not have an objective of avoiding double taxation.

These two public policy objectives of defining the tax base and avoiding double taxation were original objectives since enactment of the tax preference in 1933 and 1935. Since the 1960 Washington Supreme Court ruling and the Legislature's subsequent eliminating of a B&O tax on receipts from renting and leasing of real estate, the Legislature has had an objective of complying with the state Constitution.

3) **Comply with state Constitution:** Since 1961, a third objective was to have a tax exemption for gross receipts from renting and leasing of real estate to adhere to the Schumacher court ruling which ruled this type of tax unconstitutional.[97]

Is there any documentation on the purpose or intent of the tax preference?

The statute does not have a specific statement of intent as to why real estate sales, renting and leasing are exempt from the business and occupation tax. Given that real estate sales were originally assessed a conveyance tax at the time of sale of property, it may have been an objective of the Legislature to impose a single statewide tax on the sales of real estate. The law is not clear on this point because the statute does not link qualifying for this B&O tax exemption with paying another statewide tax based on this income. For instance, the B&O tax exemption for insurance premium income required insurance carriers to pay the gross insurance premiums tax.

The statute is also not clear if the Legislature meant to exempt real estate sales because they did not rise to the level of a taxable business activity. Since 1935, there has been growth in the number of individuals, businesses, trusts, and estates investing in real estate and receiving gains once those properties are sold. Since the creation of the real estate investment trusts in 1960, small investors can now pool their financial resources to create a trust primarily to buy, sell, lease or rent different types of real estate. It is not clear that the Legislature's original intent was meant to encompass this expansion in real estate transactions.

[97]Apartment Operators Association of Seattle, Inc. v. Schumacher; 56 Wn.2d 46; 351 P.2d 124; 1960.

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

Since this tax preference was enacted at the same time as the temporary business activities tax and the business and occupation tax in 1935, there is an objective that is being fulfilled of defining the B&O tax base as excluding sales, rental and leasing of real estate. The Washington Supreme Court later stated the B&O tax base must constitutionally exclude rental and leasing income from the B&O tax as well. The Legislature codified in law the outcome of this court ruling after it was issued so it has achieved the objective of complying with the state Constitution.

Income on gross sales of real estate is being taxed just once, by the real estate excise tax. This B&O tax preference has achieved the public policy objective of avoiding double taxation of income of real estate sales.

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

If continued, this business and occupation tax preference will fulfill the public policy objective of defining the tax base by excluding all gross sales and rental and leasing income from the B&O tax base. Defining of the tax base has limited the exemption to sales, renting and leasing income and excludes the fees and commissions earned on real estate sales.

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 of avoiding double taxation, complying with the state Constitution and defining the tax base as excluding real estate sales and rentals and leasing are being met.

Due to court decisions on the constitutionality of assessing taxes on real estate property, the ability of the Legislature to modify this tax exemption may be limited. The court's ruling on a tax could be different depending on whether the real estate property is rented/leased or sold.

If the Legislature wanted to modify its policy objectives and extend the B&O tax to real estate rental and lease payments, this action could be viewed by the court as a property tax.[98] In the Schumacher case, a business and occupation tax extended on rental and lease income was ruled by the court as an unconstitutional property tax.

If the Legislature wanted to clarify its policy objectives and extend the business and occupation tax on certain types of gross sales of real estate owned by businesses which represented real estate business investment opportunities, the court might view this extension of the business and occupation tax like an excise tax instead of a property tax. The court has already determined that a real estate excise tax could be imposed on the sale of real estate. In that case, the excise tax would not be subject to the uniformity provisions of the Constitution. Given the uncertainty in

[98] Apartment Operators Association of Seattle v. Schumacher, 56 Wn.2d 46, 351 P.2d 124(1960).

future court rulings, any modifications to this business and occupation tax exemption may be subject to legal challenges.

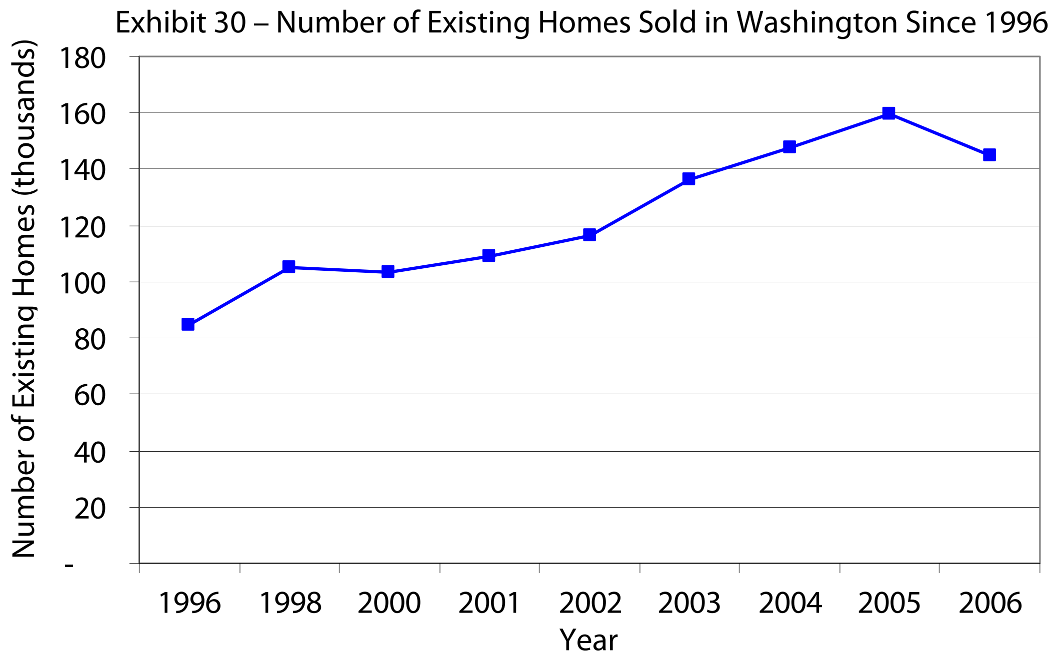
Beneficiaries

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

Real Estate Sales

Both sellers and buyers of real property are benefiting from not having to pay the B&O tax on the sale proceeds of real estate. The Department of Revenue stated that more than 365,000 real estate excise tax affidavits are filed each year.[99] In calendar year 2006, the nationwide multiple listing service reported 280,970 real estate sales in Washington. The real estate sales reported in the multiple listing service for the state of Washington do not include all real estate transactions. Businesses directly benefit from not having to report the sale of real property as income on their excise tax returns and homeowners benefit if the gross receipts from the sale of their residences, vacation homes or rental properties was sufficient to require the owners to file an excise tax return.

Exhibit 30 – Number of Existing Homes Sold in Washington Since 1996



Source: Washington State University – Center for Real Estate Research.

Since homeowners and businesses buying and selling real estate are some of the beneficiaries of this tax preference, it is important to examine the sales of real estate in Washington over time. Data from the Washington State University - Center for Real Estate Research reveals a growing trend during the late 1990s and through 2005 of growth in the number of existing homes sold. By 2005, the number of existing homes sold was more than 150,000 statewide. Then in 2006, the

[99] "2007 Tax Reference Manual," Department of Revenue January 2007.

number of existing homes sold started to decline and is expected to drop further once 2007 data is released. In 2006, 144,600 existing homes sold, and this represented 51 percent of all transfers subject to the real estate tax. The remaining sales were either new residential homes or other commercial/industry/ farm real estate sales.

People who make a business of buying homes, fixing them up, and reselling them at a profit are beneficiaries of this tax exemption because they do not have to pay the business and occupation tax on the gains from the sales of real estate investment property. Investors in equity real estate investment trusts also benefit from not having the B&O tax extended on sales of real estate. The same is true of developers who purchase property and make profits from appreciating real estate values. These businesses and individuals do not have to report the gains in sales of real estate with this B&O tax exemption in law. Once the real estate is sold, governments would collect the real estate excise taxes.

Rental and Leasing of Real Estate

Companies that rent or lease real estate are exempt from reporting the rental or lease income as business receipts subject to the B&O tax. This includes management companies of apartment complexes or office buildings. This also includes individuals who receive rental payments from vacation homes, rental properties, or other investment properties as well as owners of hotels and motels for payments received from long-term rental contracts of hotel/motel rooms. Owners of mini-storage facilities are also exempt from reporting rental payments as business receipts for B&O tax purposes.

Since Washington State does not have an income tax and the B&O tax is not extended on rental and leasing income or sales of real estate, JLARC did not have any data available to analyze this portion of the tax preference. At the federal level, individuals and businesses pay income taxes on rental income as well as on certain sales of real estate. In order to estimate the number of taxpayers benefiting from the portion of this tax preference for rental income, the Department of Revenue reviewed the 2005 federal tax return data for Washington residents and corporations. The Department reported 171,309 Washington taxpayers receiving rental income. This includes all Washington residents, sole proprietors, C corporations, and partnerships. It does not include rental income of S-corporations or out-of-state businesses with rental income in Washington. Of all the taxpayers, 90 percent of them are individual or sole proprietor income taxpayers. Eight percent of all taxpayers with rental income are partnerships, and two percent are C-corporations. Of the individual taxpayers with rental income, 65 percent of those taxpayers had total income of less than $90,000. Thirty-nine percent of the C-corporations with rental income had total income of $1 million or more. Ninety-two percent of the partnerships with rental income had losses or no income. These results indicate that the larger C-corporations are the ones with diversified portfolios which include rental income. Most partnerships, with rental income as one of their components of income, do not have positive profits. Most individuals with rental income are not the highest income taxpayers.

Exhibit 31 – 2005 Federal Tax Return Data for Washington Taxpayers
with Rental Income Reported

Number of Taxpayers				
Total Income Groups	**Individuals/ Sole Prop.**	**C-corps**	**Partnerships**	**Total**
Less than or Equal to 0	4,018	20	12,445	16,483
$1 - $49,999	52,000	570	537	53,107
$50,000 - $89,999	44,882	233	83	45,198
$90,000 - $199,999	40,294	378	114	40,786
$200,000 - $599,999	11,498	538	124	12,160
$600,000 - $999,999	1,052	262	47	1,361
$1,000,000 - $4,999,999	723	564	94	1,381
$5,000,000 +	39	734	60	833
Total	**154,506**	**3,299**	**13,504**	**171,309**
Rental Income ($ in millions)				
Total Income Groups	**Individuals / Sol Prop.**	**C-corps**	**Partnerships**	**Total**
Less than or Equal to 0	214	0.8	1,216	1,431
$1 - $49,999	775	7	45	826
$50,000 - $89,999	1,370	9	5	1,384
$90,000 - $199,999	972	19	15	1,006
$200,000 - $599,999	594	43	8	646
$600,000 - $999,999	66	17	1	85
$1,000,000 - $4,999,999	140	111	16	266
$5,000,000 +	9	2,366	38	2,413
Total	**4,139**	**2,573**	**1,344**	**8,056**
Rental Income (% of Total Rental Income)				
Total Income Groups	**Individuals / Sole Prop.**	**C-corps**	**Partnerships**	**Total**
Less than or Equal to 0	5%	0%	90%	18%
$1 - $49,999	19%	0%	3%	10%
$50,000 - $89,999	33%	0%	0%	17%
$90,000 - $199,999	23%	1%	1%	12%
$200,000 - $599,999	14%	2%	1%	8%
$600,000 - $999,999	2%	1%	0%	1%
$1,000,000 - $4,999,999	3%	4%	1%	3%
$5,000,000 +	0%	92%	3%	30%
Total	**100%**	**100%**	**100%**	**100%**

Source: Washington Department of Revenue analysis of federal tax returns.

In examining the amount of the rental income by type of ownership, 52 percent of all rental income is held by individual taxpayers, 31 percent by C-corporations and 17 percent by

partnerships. Of the C- corporations with rental income, large corporations with total income of more than $5 million hold more than 90 percent of all C-corporation's rental income. The opposite is true for partnerships which have 90 percent of all partnership rental income held by businesses with $0 income or losses. Nearly 60 percent of all rental income of individual taxpayers is held by taxpayers with total incomes of less than $90,000.

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

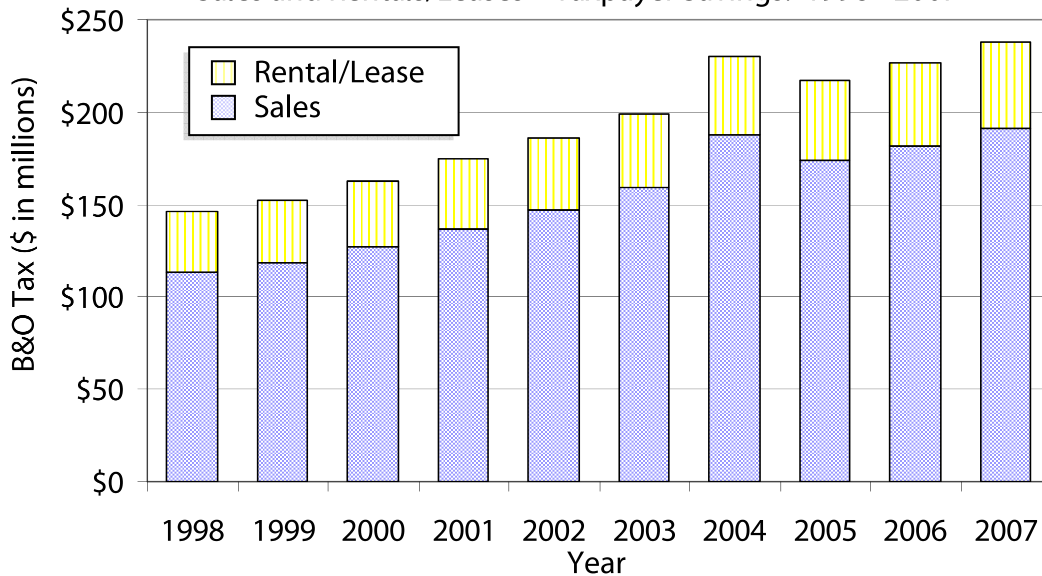
There are no unintended beneficiaries.

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?

In the past, the Department of Revenue's estimate of the B&O taxpayer savings from the sales of real estate and rental and lease income had been growing slowly throughout the 1990s until 2007. Up until the most recent 2008 Tax Exemption Report, the Department of Revenue's estimate for the B&O taxpayer savings for real estate sales had not exceeded $200 million annually. The rental and lease income that is also tax exempt under this tax preference is significantly smaller in size, less than $50 million per year. These past estimates have assumed a 1.5 percent B&O tax rate for rental and lease income and a 0.47 percent tax rate for gross sales of real estate. The Department of Revenue's forecast for the real estate sales B&O tax exemption is based on the total real estate excise tax collection divided by the state real estate excise tax rate of 1.28 percent. That became the real estate sales base for the taxpayer savings.

Exhibit 32 – Exemption from Business and Occupation Tax for Real Estate Sales and Rentals/Leases – Taxpayer Savings: 1998 - 2007



Source: Department of Revenue Tax Exemption Reports.

JLARC projections for this tax preference are presented in Exhibit 33 below. The rental and leasing tax base is based on the Department of Revenue's collection of federal tax return data for individuals, sole proprietors, partnerships, and C corporations that reported rental income in 2005. These data do not include rental income of S corporations. In 2005, total rental income equaled $8.1 billion. JLARC assumed the tax rate for rental and leasing revenue to be 0.25 percent since that was the rate that the Legislature originally enacted in 1959 on rental and leasing income. JLARC based the projections of the real estate sales taxpayer savings on the real estate excise tax collection forecast from the February 2008 Office of Forecast Council projections of real estate excise tax collections. JLARC assumed a business and occupation tax rate of 0.47 percent for the real estate sales tax exemption. The taxpayer savings estimates are equivalent to the loss in state government revenue if these tax exemptions are continued.

Exhibit 33 – Business and Occupation Taxpayer Savings from Sales, Rents, and Leases on Real Estate

Fiscal Year	Gross sales taxpayer savings ($ 000)	Gross rents taxpayer savings ($ 000)	Total B&O taxpayer savings ($ 000)
2006	$343,204	$20,027	$363,231
2007	$393,579	$20,881	$414,460
2008	$253,903	$18,082	$276,985
2009	$249,851	$18,624	$268,475
2010	$287,236	$19,183	$306,419
2011	$312,773	$19,759	$332,532

Source: JLARC projections.

Washington's real estate industry consists of individuals and businesses engaged in renting and leasing real estate to others; managing real estate for others; selling, buying, or renting real estate for others; and providing other real estate-related services such as appraisal services. Only the owners of real estate would be required to pay a new business and occupation tax. According to Washington Employment Security Department data, in the second quarter of 2007, Washington's real estate industry had a total of 36,586 employees with 6,051 firms. In 2006, the average number of firms, employment and total wages for the real estate industry are given in the following table, Exhibit 34. Some 5,945 businesses were in this sector, with 30 percent of all real estate businesses being lessors of residential buildings. There were 35,938 employees in the real estate industry, which represented a little more than one percent of all employees statewide. Real estate businesses paid their employees $1.28 billion in total wages for an average wage per employee of $35,853. The total wages paid by the real estate industry represents 1 percent of all wages paid to employees in Washington in 2006.

Exhibit 34 – Washington's Real Estate Industry Average Number of Firms, Employment and Total Wages for 2006

Real Estate Industry Categories	Average Number of firms	Average Number of employees	Total Wages ($ 000)
Lessors of Residential Buildings	1,811	10,905	$292,030.1
Lessors of Non-Residential Buildings	544	4,018	$187,106.9
Lessors of miniwarehouses and other real estate property	690	2,314	$70,660.5
Real Estate Agents and Brokers	1,553	7,045	$290,393.1
Property Managers	753	8,617	$294,608.5
Real Estate Appraisers and Other Activities related to Real Estate	594	3,039	$153,672.4
Total Real Estate Industry=	**5,945**	**35,938**	**$1,288,471.6**
% of totals statewide	3.1%	1.26%	1.05%

Source: Washington Employment Security Department 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 the Legislature eliminated this business and occupation tax preference for rental and leasing income, it is unclear whether the court would rule a business and occupation tax on rental income as unconstitutional. If the tax were upheld, owners of rental and leasing properties would be required to pay approximately $19 million more in taxes per year. If the Legislature eliminated this business and occupation tax preference on gross sales of real estate, again it is unclear if the court would uphold this new business and occupation tax, as there are no court decisions directly on this type of gross receipts of the B&O tax. If the court allowed this extension of the B&O tax, the owners of real estate would pay approximately $250 million more in state business taxes.

Some 5,945 businesses were in Washington's real estate industry in 2006, with 30 percent of all real estate businesses being lessors of residential buildings. The value of the services provided by the real estate industry in Washington was a $23.7 billion industry in 2006. The value added to the state economy was an additional $16.7 billion.[100]

[100] Value added is the value of the firm's output minus the value of the inputs that it purchases from other firms.

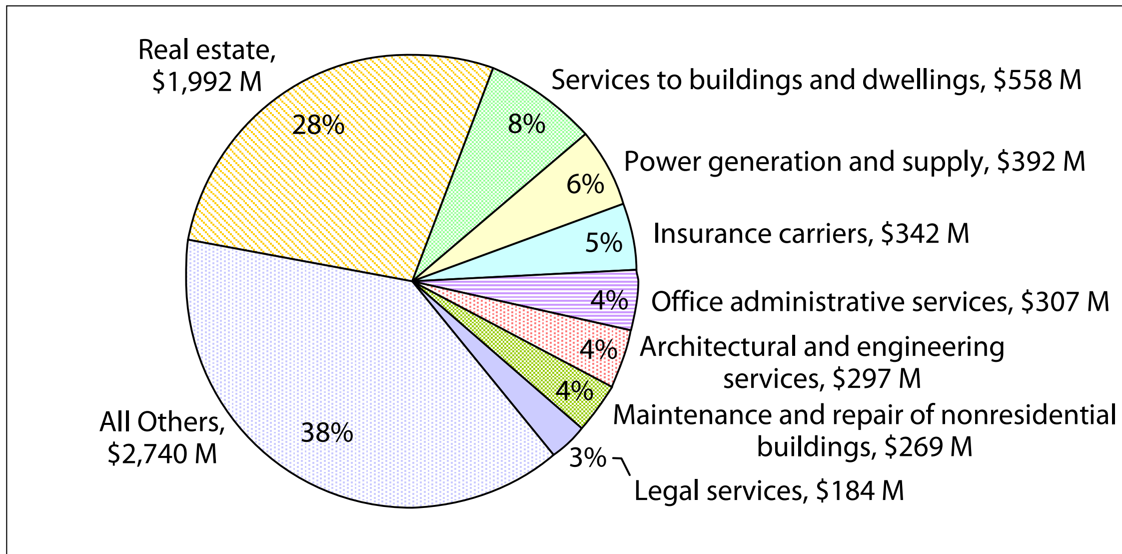
Exhibit 35 – Washington's Real Estate Industry Output and Value Added in 2006

	Industry Output		Value Added	
	($ millions)	% of Statewide Total	($ millions)	% of Statewide Total
Real Estate Sector	$23,745.5	4.4%	$16,664.3	5.7%

Source: 2006 Washington IMPLAN data.

The real estate industry represents roughly 4 percent of Washington's total industry output and nearly 6 percent of total value added in 2006. The real estate industry spent 10 percent of its value added on employee wages. The largest component of value added was $9 billion, or 59 percent of total value added of the real estate industry, for other property income. In order to provide real estate services, the industry's largest expenses were on other real estate related businesses, services to buildings and dwellings, power generation and supply, and insurance carriers.

Exhibit 36 – 2006 Expenditures ($7.1 billion) by the Washington Real Estate Industry



Source: 2006 Washington IMPLAN data.

If the Legislature eliminated this tax preference and owners of real estate lost $277 million in taxpayer savings in fiscal year 2008, the additional tax might be reflected in higher real estate sales prices, rents and lease charges. The total tax loss from this tax preference is small compared to Washington's total General Fund state cash receipts of $29.4 billion in the 2007-09 biennium. There would be minimal statewide economic impacts from eliminating this tax preference. All Washington Statewide changes to prices, quantity produced, or employment would be less than 0.5 percent from the initial base year.[101]

[101] These economic impact results were based on a computable general equilibrium model for Washington State based on IMPLAN data for 2006.

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 state business and occupation tax, there would be no change in the distribution of tax liability of state 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?

Most states within the U.S. have personal income taxes, and each state decides the point at which they will link their state law to federal law. The federal income tax law assesses a tax on rental income by both individuals and businesses and certain sales of real estate.

Rental Income

On the federal income tax return, individuals and corporations must report rental or lease income from real estate such as renting rooms or apartments. For individuals or sole proprietors, the taxpayer reports the rental income and expenses while filing personal income tax returns. Typical expenses allowed as a deduction on rental real estate and royalty income are advertising, travel, cleaning and maintenance, insurance, legal and other professional fees, management fees, mortgage interest, repairs, utilities and taxes.

Sales of Real Estate

Federal law excludes from personal income tax the income earned from the sale of a primary residence for up to $250,000 for single filers and $500,000 on a joint return.[102] In order to qualify for the exemption, the taxpayer must meet an ownership test and use test, and the taxpayer could not have excluded gain on the sale of another home in the last two years. These requirements target the tax exemption only to taxpayers selling their own primary residence and limit the amount of gain that can be claimed. The federal law requires the taxpayer to own the home for at least two years prior to selling it and to live in the home as a primary residence for at least two out of the last five years.

Personal Income Tax

Regarding rental and leasing income and sales of real estate, the federal income tax does not provide a complete exemption for rental or leasing income or for sales of all types of real estate. Rental and leasing income is included in a taxpayer's total income, and deductions are allowed for various costs associated with rental properties.

[102] "Selling Your Home," Internal Revenue Service Publication 17 (2007).

The federal income tax provides a sizable exemption for income from sales of primary residences. The federal law requires any gain in the sale of a primary residence above $250,000 or $500,000 to be reported as income subject to the capital gains tax. In addition, any gain on other business or investment property must be included as income subject to the capital gains tax. The federal income tax exemption is targeted at typical homeowners.

The District of Columbia and 43 states have personal income taxes. Most states (36) conform their state law to the federal law provisions for federal income taxes. Thirty states link their state law to federal adjusted gross income as their tax base and six states conform to federal taxable income. Six states have their own state specific adjusted gross income base. Two other states, New Hampshire and Tennessee, assess their personal income tax on just interest and dividend income and exclude the income earned on the sale of homes and rental and leasing income. There are seven states that do not impose a personal income tax like Washington.[103] These states do not impose any additional income tax on rental or leasing income or gains from the sale of properties.

Corporate Business Tax

Various types of corporations are all required to file federal income tax returns. These corporations report their gross rental income and capital gains income from the sale of real estate for their business. Federal law allows deductions for expenses associated with renting, leasing and selling real estate. Forty-four states impose a corporate income tax in which states conform to federal law by either referencing the Internal Revenue Code (IRC) code or by having similar state provisions as federal law. Some 26 states link state law to the definition of federal taxable income before net operating loss and special deductions and 20 states link to the definition of federal taxable income after net operating loss and special deductions. Two states, Tennessee and New Hampshire, only apply their corporate income tax to interest and dividend income of corporations only.

Michigan and Texas each impose their own business tax neither of which includes a specific provision to exempt rental and leasing income. Nevada and Wyoming do not impose a corporate income tax or any other statewide business tax on corporations. In conclusion, Washington, Nevada, and Wyoming are the only three states that do not impose a business tax on rental and leasing income or a capital gains tax on sales of real estate.

Real Estate Excise Tax

The District of Columbia and 36 states, including Washington have a state real estate excise tax. Three states have a local real estate excise tax. Eleven states do not have any real estate excise tax.

[103] States without a personal income tax: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming.

Recommendation

The Legislature should continue the business and occupation tax exemption for income derived from real estate sales, rental and leasing.

Legislation Required: None.

Fiscal Impact: None.

CREDIT LOSSES – SUMMARY

Current Law

State law provides a business and occupation tax deduction for credit losses and bad debts acquired by businesses. This tax preference is targeted at businesses that utilize the accrual accounting method. Washington's law refers to the federal Internal Revenue Code (26 U.S.C. Sec. 166), as of January 1, 2003, for the definition of "bad debt" as the basis for determining the amount of the deduction. See Appendix 3 for the current law statute, RCW 82.04.4284.

Findings and Recommendations

This review has evaluated the legal history, public policy objectives, economic and revenue impacts, and other states' similar tax preferences of the business and occupation tax deduction for credit losses or bad debt incurred by businesses. The audit determined the following:

Legal History and Public Policy Objectives

- The temporary business activities tax enacted in 1933 allowed taxpayers with an accrual accounting system to deduct the amount of unpaid debts.
- The Legislature enacted the business and occupation tax deduction for credit losses in 1935. The Legislature targeted this tax preference at taxpayers using accrual accounting systems. The taxpayers with accrual accounting could claim a bad debt deduction.
- In 2004, the Legislature amended the statute to link Washington's deduction to the federal Internal Revenue Code definition of "bad debt." Businesses using accrual accounting continue to benefit from this tax preference.

This tax deduction has achieved three public policy objectives:

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

Beneficiaries

- In 2007, 7,630 taxpayers claimed this deduction on their business and occupation tax. These taxpayers represent roughly 2.5 percent of the more than 307,000 business and occupation tax filers in calendar year 2007.
- There is no indication of this tax preference providing unintended benefits to businesses other than those intended.

Revenue and Economic Impacts

- Since 2004, the DOR has estimated the business and occupation taxpayer savings for credit losses at a little more than $5 million per year.
- In 2007, business and occupation taxpayers claimed $870 million in credit losses. JLARC projects the annual taxpayer savings from the credit losses deduction at approximately $10 million per year over the next two biennia.
- The economic impact from eliminating this tax preference would be minimal since such a small portion of the business and occupation taxpayers use this deduction, and the amount is minimal compared to the size of the state economy.

Other States

- All states that impose a corporate income tax refer to the federal law definition of bad debts in IRC § 166, with only a few states having minor deviations from the federal definition.

Recommendation

The Legislature should continue this business and occupation tax deduction for credit losses incurred by businesses.

Legislation Required: None.

Fiscal Impact: None.

CREDIT LOSSES – REPORT DETAIL

Statutory History

The Legislature faced a revenue shortfall as it convened in January 1933. The prior November, the voters had passed Initiative Measure No. 64, a 40-mill property tax limit bill. The initiative limited property tax levies for state purposes to a maximum of five mills on a 50 percent valuation.[104] This measure effectively reduced the income from state taxes by approximately 50 percent, beginning with the second year of the 1933-35 Biennium. Assessed valuations and levies were already reduced due principally to the depressed economic conditions of the time. The Legislature also adopted in 1933 the Showalter Bill, a measure increasing, by about two-thirds, the state's obligation to support local school districts. The voters passed another initiative in 1932, Initiative Measure No. 69, imposing a state income tax on all corporations and individuals.

In response, the 1933 Legislature adopted a temporary two-year business activities tax. The tax was measured by the application of rates against "value of products," "gross proceeds of sales," or "gross income of the business." The rates varied depending on the type of business activity. In the business activities tax, several exemptions and deductions were allowed. One of those deductions was for taxpayers with an accrual accounting system that had bad debts.[105]

The Legislature, meeting in 1935, faced the problems of replacing the revenue previously received from property taxes levied for the state general fund, as well as the state's obligations under the Showalter Act to support common schools, and payment for relief and welfare work. To raise the required revenue, the Legislature enacted the Revenue Act of 1935. The new act supplanted the temporary 1933 act and continued in general effect the business taxes imposed by it. The 1935 act also added several new consumer taxes, including a 2 percent retail sales tax and a complementary use tax.

The tax base for the business and occupation tax is gross receipts of businesses' activities. Initially the business and occupation tax rates were either a quarter of one percent or one half of one percent.[106] The 1935 legislation provided fourteen deductions and exemptions from the tax including the credit losses tax preference under review.[107]

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

[105] "Business Tax Instructions Revised Rules and General Instructions," by Tax Commission of State of Washington April, 1934.

[106] "Sixth Biennial Report for the Tax Commission of the State of Washington for the Period Ending September 30, 1936."

[107] Tax preference exemptions: Bimonthly gross income less than $1,000;Public utility business taxable under the public utility tax; Insurance companies; Farming – except retailing of products; Licensed boxing and wrestling; Licensed horse racing; Employees; Hospitals; Lease, rental or sale of real estate; Packing fresh horticultural products for growers; Sales of commodities to the federal government and sales interstate and foreign commerce; Credit losses; State and federal tax to sellers of motor vehicle fuel; Cash discounts taken by customers.

In 1935, the Legislature put this tax business and occupation tax deduction in place to benefit businesses using accrual accounting. A minor change in 1980 added a sentence clarifying that the deduction was for the amount of credit losses actually sustained by taxpayers using the accrual method.

In 2004, the Legislature linked the bad debt deduction to qualifying for the definition of "bad debt" in the federal Internal Revenue Code (IRC).[108] The 2004 legislation adopts recommended language from the streamline sales tax agreement by linking the definition for this tax preference to the definition of "bad debt" in the federal Internal Revenue Code.[109] Currently, this tax preference is explicitly dependent on a business having bad debts that meet the federal IRC definition in place on January 1, 2003. The 2004 legislation made the same link for the credit loss provisions of the public utility tax and E-911 tax. Other 2004 legislation specified that the use tax also be linked to the federal law definition for bad debt. If businesses later receive revenue for bad debt accounts previously charged off as a deduction for bad debt, then in subsequent periods, the businesses must report this income in gross sales on the business excise tax return.

Other Relevant Information

Business and Occupation Tax

The business and occupation tax is generally a state tax but cities are authorized to impose their own B&O tax. Over time, the Legislature has developed a number of specialized tax rates for particular types of businesses. [110] Current law provides ten different business and occupation tax rates applying to various business activities. The tax rates for most companies range from 0.13 percent from pari-mutuel wagering to 1.5 percent for service and other activities, hospitals and gambling contests of chance (less than $50,000 per year). The B&O tax rate for manufacturing and wholesaling activities is .484 percent and retailing activities is .471 percent. Otherwise, businesses not covered by another tax rate pay the B&O tax rate of 1.5 percent.[111] The B&O tax does not permit deductions for the costs of doing business, such as payments for raw materials and wages of employees. Any exemptions and deductions from the B&O tax are specified separately in law.

Business and occupation tax collections have grown from $1.7 billion in 1997 to $2.6 billion by 2007.[112] The business and occupation tax was reported by approximately 300,000 firms in fiscal year 2006.[113] These are the firms with business and occupation tax liability (prior to credits).

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[108] Puget Sound National Bank v. the Department of Revenue 123 Wn. 2nd 284 (1994).

[109] Legislative documentation on SB 6515 (2004).

[110] "Sixth Biennial Report for the Tax Commission of the State of Washington for the Period Ending September 30, 1936."

[111] Ibid.

[112] Department of Revenue 2007 Tax Reference Manual and Office of Forecast Council February 2008 forecast report.

[113] 2007 Tax Reference Manual by Washington Department of Revenue.

Exhibit 37 – History of the Business and Occupation Tax Collections: 1997 – 2007

Fiscal Year	Collections ($ millions)	% Change
1997	$1,722.8	4.9
1998	$1,853.8	7.6
1999	$1,827.5	-1.4
2000	$1,854.9	1.5
2001	$2,012.4	8.5
2002	$1,958.3	-2.7
2003	$1,923.4	-1.8
2004	$2,067.9	7.5
2005	$2,269.1	9.7
2006	$2,477.8	9.2
2007	$2,640.9	6.6

Source: Department of Revenue 2007 Tax Reference Manual and Office of Forecast Council February 2008 forecast report.

Cash Basis vs. Accrual Basis

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

In 1935, the state Tax Commission's rules relating to the Revenue Act of 1935 specified that the amount of business credit losses that businesses can deduct is the amount actually sustained and reported in income in a previous year. The current administrative rule WAC 458-20-196 outlines current law requirements for "bad debt" to meet the federal law definition.

Federal Law Definition for Bad Debt

When a business has accounts it cannot collect payment on, it has bad debt. Washington State statute uses the IRC definition for bad debt stated in 26 USC Sec.166. A business can claim bad debt only if it has first included it in business gross income. Bad debt can consist of both business and nonbusiness bad debt. Generally, bad debt of a business comes from operating a trade or business, and this debt can be deducted from federal business taxes.[114]

[114] IRS Publication 535 Business Expenses.

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

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

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

State statute links the definition of bad debt to the specific IRC as of January 1, 2003. If there are changes at the federal level in the definition of bad debt, then Washington will not incorporate those changes in this deduction. Businesses that employ accrual accounting practices can deduct the amount uncollectible in debt from the public utility tax in the current year. In subsequent years, businesses are supposed to add back any amount already deducted as credit losses on their excise tax returns.

Credit Losses of Other Excise Taxes

In addition to the credit loss provisions provided in the business and occupation tax, the public utility tax also has a deduction for credit losses. The tax deduction provided for credit losses from the public utility tax also links to the federal definition of bad debt. JLARC's 2008 expedited report include a review of the credit loss deduction on public utility taxes. The emergency 911 tax and use tax also have similar bad debt deductibility provisions.

RCW 82.08.037 and RCW 82.12.037 provide credits and refunds for retail sales and use taxes previously paid on debts that are uncollectible. The statute again links the bad debt deduction to the definition of bad debt in the Internal Revenue Code. The Streamlined Sales and Use Tax Project (SSTP), a multi-state effort to simplify state sales and use tax structures, has advocated for states to adopt uniform definitions and administrative provisions of the Streamlined Sales and Use Tax Agreement (SSTA). In response to adopting the SSTA, Washington adopted bad debt provisions for the retail sales and use tax and E-911 tax provisions that conform to the federal law definition for bad debt.

Public Policy Objectives

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

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

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

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

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

3) **Equal tax treatment of credit losses among excise taxes:** Another objective of this tax deduction was to provide all excise taxes (business and occupation, retail sales and use, public utilities and E-911 tax) with the same type of deduction. Both business and occupation and public utility taxes have the credit losses deduction reported on the excise tax return. The Legislature enacted both of these bad debt deductions in 1935 at the time of the establishment of these statewide taxes. The retail sales tax has provisions for a credit and refund for bad debt, enacted in 1982.[115] All credit loss provisions link to bad debt as defined in federal law under IRC § 166 as of January 1, 2003.

Is there any documentation on the purpose or intent of the tax preference?

The law clearly allows businesses to deduct their bad debts from the measure of the business and occupation tax. The statute does not have a specific statement of intent as to why credit losses are allowed to be deducted from gross income on both the public utility tax and the business and occupation tax.

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

Since 1935, businesses claiming bad debts on their business and occupation tax returns have not been subject to the business and occupation tax on that income. Therefore, this tax preference has met its objective of defining the business and occupation tax base.

For 73 years, with this tax preference in law, business taxpayers have received similar tax treatment regardless of their accounting method. This business and occupation tax preference has achieved the objective of providing similar tax treatment for bad debt income for all businesses.

Businesses receive similar tax treatment for credit losses in both the business and occupation tax and the public utility tax. This tax preference has achieved the objective of providing equal treatment among excise taxes.

[115] RCW 82.08.037.

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

This business and occupation tax preference continues to fulfill the public policy objectives of defining the tax base, providing equal tax treatment among businesses, and providing equal tax treatment among excise 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 objectives of this tax preference are being fulfilled.

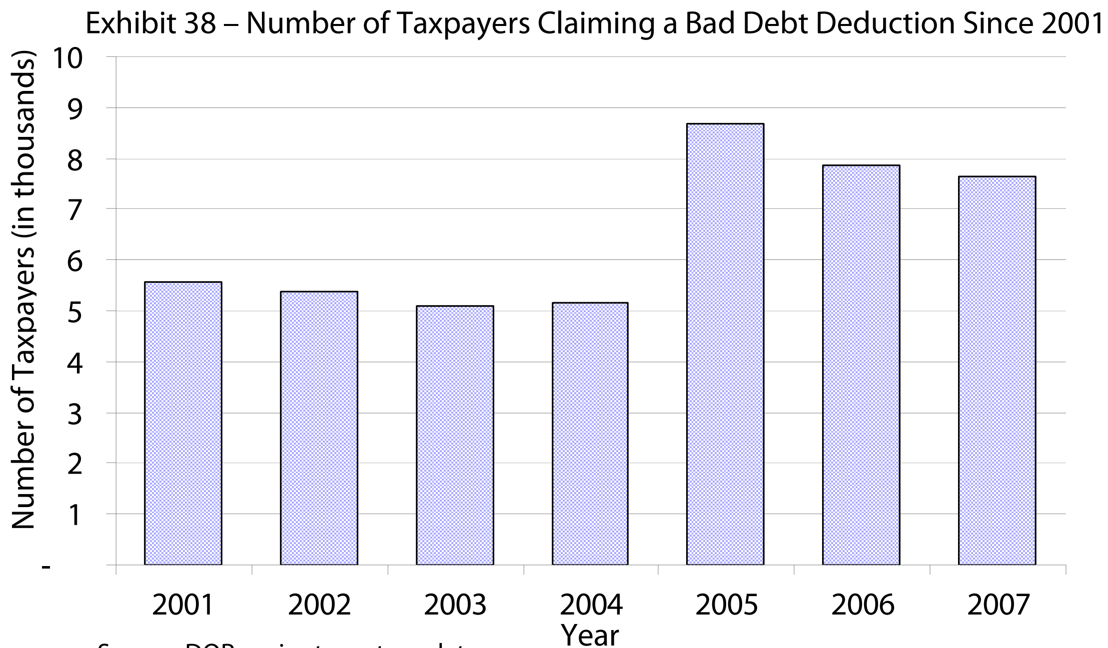
Beneficiaries

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

Statistics on the number of beneficiaries for this tax preference comes from the state excise tax returns as there is a specific line for the bad debt deduction on the excise tax return form. Since 2001, on average 6,481 taxpayers per year claim this deduction on their business and occupation tax. The number of taxpayers claiming this tax deduction can change from year to year as it depends on the companies in the state utilizing an accrual accounting system and with accounts that are uncollectible.

Taxpayers from a variety of industry sectors claim this bad debt deduction. In 2007, the top three business activities in terms of the number of businesses claiming the bad debt deduction were retailing, service and other activities, and wholesaling.

Exhibit 38 – Number of Taxpayers Claiming a Bad Debt Deduction Since 2001



Source: DOR excise tax return data.

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

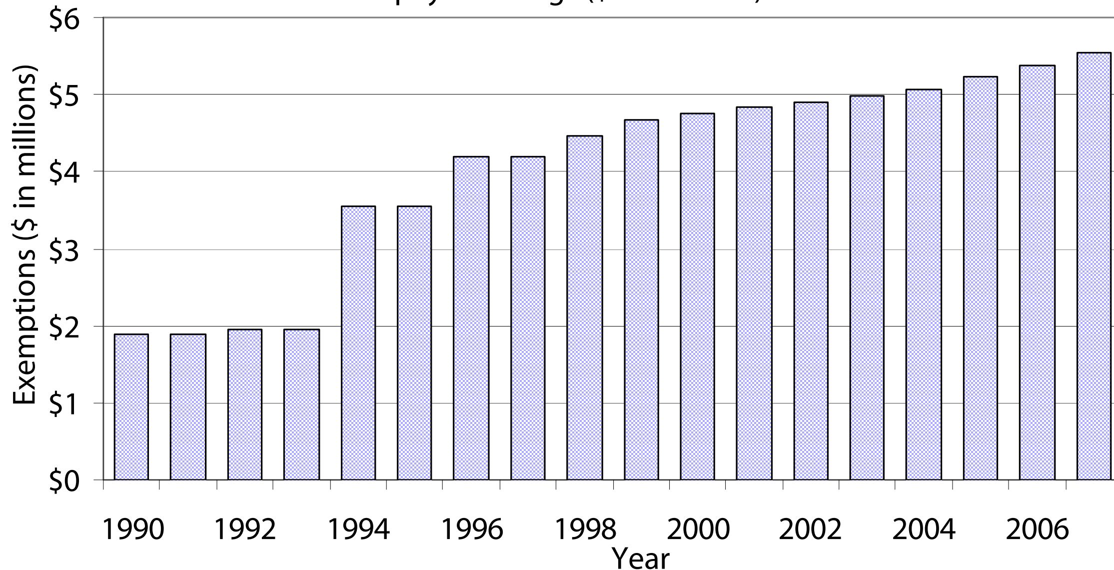
During the course of this tax preference review, there were no unintended beneficiaries of this tax preference identified.

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 Department of Revenue's estimate for the business and occupation tax deduction has been growing steadily since the early 1990s. The Department of Revenue based its 2008 estimate on projecting the 2004 Tax Exemption Report estimate of approximately $5 million per year.

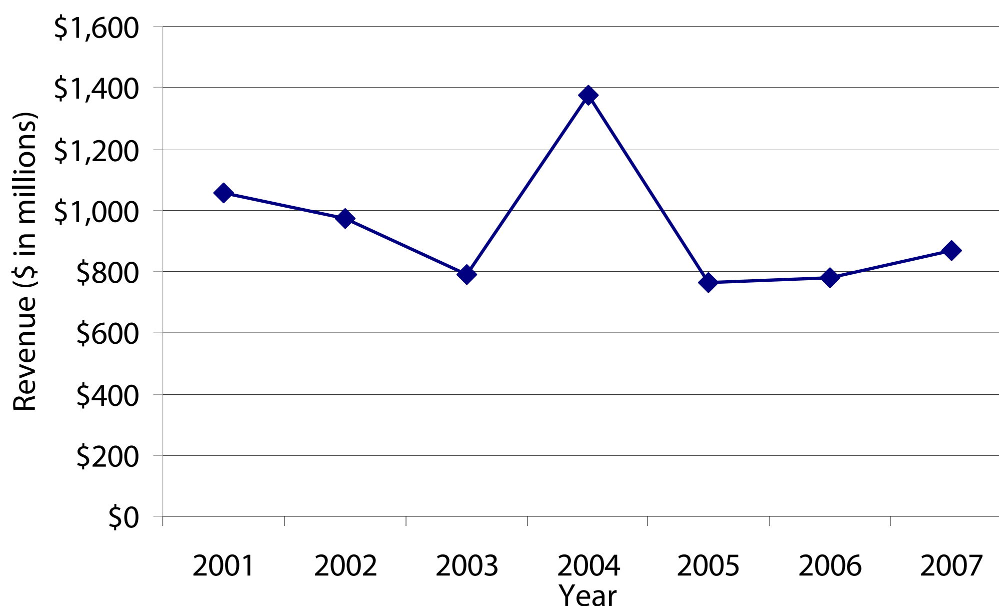
Exhibit 39 – Exemption from Business and Occupation Tax for Credit Losses – Taxpayer Savings ($ in millions): 1990-2006



Source: DOR Tax Exemption Reports.

JLARC estimated the future impact of this tax preference by examining recent excise tax returns with reported credit losses as a deduction on their business and occupation tax. From 2000 until 2007, income from credit losses has fluctuated, with an overall slight downward trend. Income from credit losses has fallen from approximately $1.1 billion in 2000 to $779 million in 2006. In 2007, there is a slight increase in credit losses claimed. Income from credit losses has ranged from 1 to 2.5 percent of these business taxpayers' total gross income from all activities subject to the business and occupation tax.

Exhibit 40 – Amount of Bad Debt Revenue Claimed Since 2001 ($ in millions)



Source: DOR excise tax returns.

Based on JLARC's analysis, the projections for this tax preference are approximately $10 million per year beginning in fiscal year 2008 and the projection remains fairly steady over the next two biennia. JLARC assumed the average tax rate of 1.2 percent which was the average tax rate of the deduction amount claimed by business and occupation taxpayers in 2006.

Exhibit 41 – B&O Taxpayer Savings from the Credit Losses Income Deduction

Year	Credit Losses Income Deduction Amount ($ millions)	B&O Tax Taxpayer Savings ($ millions)
2006	$779.0	$9.3
2007	$824.4	$9.8
2008	$840.9	$10.0
2009	$857.7	$10.2
2010	$866.3	$10.3
2011	$874.9	$10.4

Source: JLARC based on DOR excise tax returns.

The taxpayer savings estimates are equivalent to the loss in state government revenue if this B&O tax preference is continued.

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

The income deducted for credit losses is providing taxpayer savings of approximately $10 million each year in lower B&O taxes. If the Legislature terminated this tax preference, $10 million per

year is the amount of additional taxes these taxpayers would be required to pay. The elimination of this tax preference could encourage some taxpayers to change their accounting systems, if possible, to a cash basis so they would not be required to include uncollectible revenue in their reporting of gross sales. This would result in a similar tax reduction for these taxpayers. Therefore, it is unrealistic to assume that if the Legislature terminated this tax preference, the government would actually collect an additional $10 million in state business and occupation tax.

This tax preference is used by some business taxpayers more than others. As the exhibit below indicates, public and nonprofit hospitals have the highest average bad debt deduction amount of $7.6 million per hospital in 2006. This deduction amount represents that average taxpayer savings for each hospital of $114,734 for 2006. The services and other activities industry had the next highest average deduction amount of $129,910, with a taxpayer savings of $1,949 per business. All non-hospital taxpayers had an average bad debt income deduction of $61,320 and taxpayer savings of $657. For the majority of business taxpayers, this bad debt tax preference is not very large compared to their overall business profits.

Exhibit 42 – Average Deduction and Taxpayer Savings for B&O Taxpayers Claiming Bad Debts By Type of Industry - 2006

Industry	Average Deduction Amt ($)	Average Taxpayer Savings ($)
Public or Nonprofit Hospitals	$7,648,930	$114,734
Non-Hospital Taxpayers		
Services & Other Activities	$129,910	$1,949
Wholesaling	$65,210	$316
Public Road Construction	$49,580	$240
Average for non-hospital taxpayers	**$61,320**	**$657**

Source: DOR excise tax return information.

If the Legislature eliminated this tax preference and businesses with bad debt lost up to $9 million in annual taxpayer savings, there would be nearly no change on price, quantity produced, or employment statewide from this policy change alone. Since the total tax loss from this tax preference is small compared to Washington's total General Fund state cash receipts of $29.4 billion in the 2007-09 Biennium, there would be minimal negative economic impact from eliminating this tax preference. All Washington statewide changes to prices, production or employment would be less than 0.1 percent from the initial base year.[116]

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 a deduction from the state business and occupation tax, there would be no change in the distribution of tax liability of state taxes.

[116] These economic impact results were based on a computable general equilibrium model for Washington State based on IMPLAN data for 2006.

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?

According to the JLARC survey, allowing credit losses to be deducted from gross income is a common tax preference in most states. Forty-seven states adopt the federal law definition of bad debt in IRC § 166. Six states had minor deviations in their state law from the federal bad debt provisions. JLARC surveyed states with a corporate income tax.

Recommendation

The Legislature should continue this business and occupation tax deduction for credit losses incurred by businesses.

Legislation Required: None.

Fiscal Impact: None.

AGRICULTURAL PRODUCERS – SUMMARY

Current Law

State law provides a business and occupation tax exemption for wholesale income earned by agricultural producers. This tax preference applies to farmers who sell their product at wholesale and to farmers who grow agricultural products owned by others. This exemption also applies to farmers who raise poultry and sell poultry products and eggs. The poultry farmer exemption does not require the producer to own or lease the land upon which the production takes place. This exemption does not apply to taxpayers who sell their agricultural products at retail. See Appendix 3 for the current law statutes, RCW 82.04.330 and 82.04.410.

Findings and Recommendations

This review has evaluated the legal history, public policy objectives, economic and revenue impacts, and other states' similar tax preferences of the business and occupation tax exemption for wholesale agricultural producers. The audit determined the following:

Legal History and Public Policy Objectives

- In 1933, the Legislature enacted a business activities tax of one tenth of one percent on income earned by agricultural producers.
- The Governor vetoed this provision because he thought farmers did not make enough money to justify assessing a business tax.
- Therefore, with the establishment of the business and occupation tax in 1935, there was a broad tax exemption for agricultural producers.
- Over time, the Legislature has expanded this tax preference to allow additional agricultural producers to qualify for this exemption and it has clarified which agricultural producers do not qualify for this tax preference.

This tax exemption has achieved the following two public policy objectives:

1. To define the business and occupation tax base as excluding wholesale agricultural income but including the retail sales of agricultural commodities or processed food by farmers.
2. To subsidize farmers originally in the difficult financial times of the 1930s.

With regard to the second objective, it is unclear whether the Legislature intended to continue to subsidize farmers once their income levels improved.

Beneficiaries

- This tax preference applies to approximately 35,000 producers of agricultural commodities. Beneficiaries include farmers of the following commodities: oilseed, grains, other crops, vegetables, melons, fruits and nuts, and animals.[117]
- It is unclear if there are any unintended beneficiaries of this tax exemption. If the Legislature assumed that agricultural producers would not earn sufficient income to justify taxing them as stated in the Governor's veto message in 1933, then there are unintended beneficiaries of this tax preference because there are agricultural producers with a range of income every year.

Revenue and Economic Impacts

- In recent years, the value of this business and occupation tax exemption has been growing due to the rise in agricultural commodity prices. This tax preference is forecast to have business taxpayer savings between $29 and $33 million over the next two biennia.
- In 2006, the total value of all farm production was $6.87 billion.

Other States

- Washington, Nevada, and Wyoming are the only three states that do not impose a business tax on corporate agricultural farms.
- Seven states, including Washington, do not impose a personal income tax and exempt non-corporate farmers from reporting and paying an income or business tax.

Since the 1930s, farming business activities have been consolidated and more profitable farms have emerged in Washington which leads to the following recommendation.

Recommendation

Given the fact that incomes have increased significantly for some farms since the period of financial hardships when this tax exemption was enacted, the Legislature should consider establishing an income threshold in order to qualify for the business and occupation tax exemption for agricultural producers.

Legislation Required: Yes.

Fiscal Impact: Depends on proposal.

[117] Beneficiaries include all farmers who sell agricultural products as defined in RCW 82.04.213(1).

Statutory History

The Legislature faced a revenue crisis as it convened in January 1933. The prior November, the voters had passed Initiative Measure No. 64, a 40-mill property tax limit bill. The initiative limited property tax levies for state purposes to a maximum of five mills on a 50 percent valuation.[118] This measure effectively reduced the income from state taxes by approximately 50 percent, beginning with the second year of the 1933-35 Biennium. Assessed valuations and levies were already reduced due principally to the depressed economic conditions of the time. The Legislature also adopted in 1933 the Showalter Bill, a measure increasing, by about two-thirds, the state's obligation to support local school districts. The voters passed another initiative in 1932, Initiative Measure No. 69, imposing a state income tax on all corporations and individuals.

In response to the state's revenue predicament, the 1933 Legislature adopted a temporary two-year business activities tax. The tax was measured by the application of rates against "value of products," "gross proceeds of sales," or "gross income of the business." The rates varied depending on the type of business activity. The legislation imposed a lower rate on people engaging in the business of growing or raising for sale, profit or use, any commodity, product or crop.[119] The amount of the business activities tax assessed on farmers by the 1933 Legislature was the product of the sales of the crop produced, grown or raised for sale multiplied by 0.1 of one percent. The law stipulated that the tax be based on the entire value of the crop grown or produced for sale, regardless of the place of sale or where the crops would be delivered. The Governor vetoed that portion of the 1933 tax.[120] In the Governor's veto message, he essentially said he thought the money collected would be minimal compared to the burden of paying the tax:

> *The revenue producing possibilities of said item would appear to be small and the nuisance occasioned thereby to the producer and the expense to the administrative would undoubtedly be great and all out of proportion to benefits to accrue to the public.*[121]

In the 1934 Special Session, the Legislature exempted farmers from the temporary business activities tax.

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

[119] "Business Tax Instructions Revised Rules and General Instructions," by Tax Commission of State of Washington April, 1934.

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

[121] Governor's Messages on Bills Vetoed, March 21, 1933.

The Legislature, meeting in 1935, faced the problems of replacing the revenue previously received from property taxes levied for the state general fund, as well as the state's obligations under the Showalter Act to support common schools, and payment for relief and welfare work. To raise the required revenue, the Legislature enacted the Revenue Act of 1935. The new act supplanted the temporary 1933 act and continued in general effect the business taxes imposed by it. The 1935 act also added several new consumer taxes, including a 2 percent retail sales tax and a complementary use tax. The 1935 legislation included fourteen deductions and exemptions including the agricultural producers' tax preferences: [122]

> *In computing tax there may be deducted from the gross operating revenue the following items:*
>
> *(d) Any person in respect to the business of growing or cultivating for sale any agricultural or horticultural products or crops or breeding ;or raising any fowl, animals or livestock for sale or for milk, eggs, wool, fur or other substance obtained therefrom, or in respect to the sale of such products at wholesale by the grower or producer thereof. This exemption does not apply to any person selling such products at retail; nor to any person purchasing and feeding or fattening livestock; nor to any person growing, raising or cultivating trees, shrubs, bushes, plants, bulbs, flowers, and the like, either as forest, greenhouse or nursery products; nor to any association of persons whatever, whether mutual, co-operative or otherwise, engaging in any business activity with respect to which tax liability is imposed under the provisions of this title;*

In 1943, the Legislature created a new section which separated this B&O tax exemption for farmers raising poultry to sale eggs and poultry products. The Legislature also clarified that the exemption did not apply to the sale of any animal or substance connected with the business of operating a stock yard or a slaughter or packing house.

In subsequent years (1965, 1985, and 1987), the Legislature expanded this law to include other types of agricultural commodities and specified which activities were not exempt. In 1988, the Legislature modified this tax exemption to exclude persons who participate in the USDA conservation reserve program.

In 1993, the Legislature modified the law to delete all the specific language on the types of agricultural commodities that could qualify for this tax preference. This language was replaced with a general statement that a "farmer that sells any agricultural product" at wholesale qualifies for the tax exemption. [123] The modifications in 1993 also eliminated many restrictions on which

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[122] Bimonthly gross income less than $1,000;Public utility business taxable under the public utility tax; Insurance companies; Farming – except retailing of products; Licensed boxing and wrestling; Licensed horse racing; Employees; Hospitals; Lease, rental or sale of real estate; Packing fresh horticultural products for growers; Sales of commodities to the federal government and sales interstate and foreign commerce; Credit losses; State and federal tax to sellers of motor vehicle fuel; Cash discounts taken by customers.

[123] See RCW 82.04.213 for definitions of agricultural product and farmer.

operations do not qualify for the exemption. The 1993 legislation left one restriction that the tax exemption does not apply to any person selling products at retail. In 2001, the Legislature allowed farmers who grow and raise agricultural products such as custom feed operations to qualify for the tax exemption. In 2008, the Legislature extended the B&O tax exemption to the wholesale sale of honey bee products by an eligible owner of bee colonies.

Relevant Background

Washington Agriculture in 1930s

Even though the economic depression hurt all individuals and businesses in the 1930s, the depression hit the agricultural industry especially hard. In 1934, the average farm per capita income was $166, about one-third lower than that of the nonfarm sector. The price parity ratio, which is the ratio of prices received by farmers relative to prices paid by farmers, had fallen from 89 in 1929 to 55 in 1932.[124] Prices for agricultural commodities had fallen very low, and input prices for agricultural production had not declined significantly with the Great Depression.

According to the Oral History by Charles Hodde, as a lobbyist for the Grange he pushed to get an amendment for farmers to the business tax so if the tax computed was less than five dollars then they did not have to file a report. Later this portion of the business activities tax was vetoed by the Governor.

> *Well, there weren't very many farmers at that time that were making enough to have a five dollar tax, the rate set for agriculture in the bill was ten cents, that is ten cents on a hundred, whereas twenty-five cents on a hundred was the general rate for most businesses recognizing that most farmers got exempt on five thousand dollars worth of income whereas the other guy, the way it was set up, was exempt only on two thousand dollars.*[125]

Due to the wide concern over abandoned farms in the U.S. in 1940, a special US Commerce study inventoried U.S. farms that were either abandoned or left idle.[126] This study found that, in Washington State between 1930 and 1938, 1,332 farms were abandoned and 64,319 acres of farmland were not in production.

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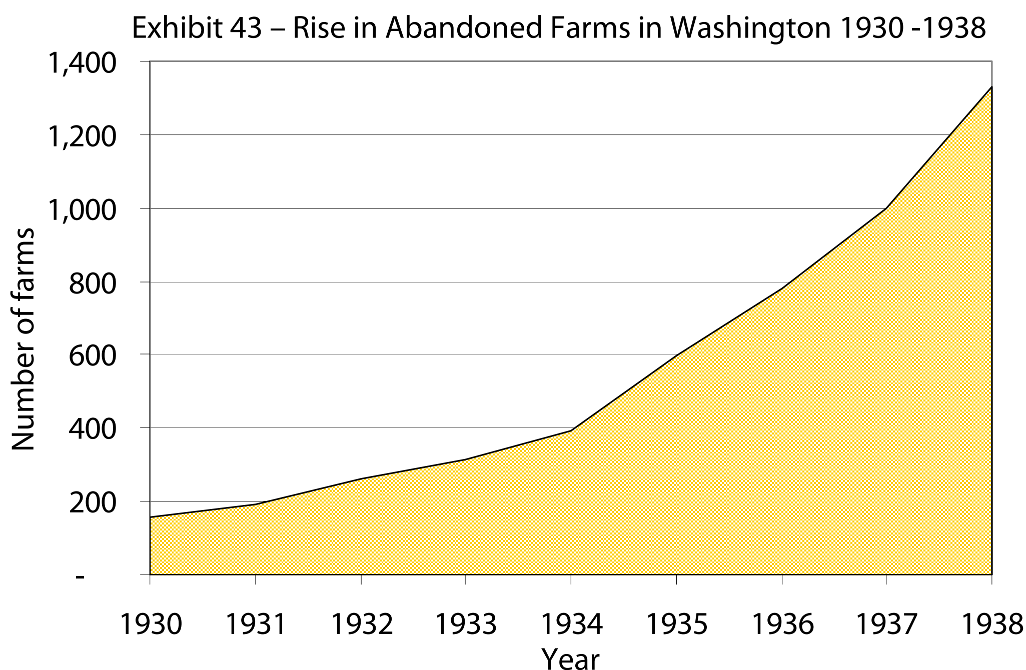
[124] 1982 Tax Exemptions Report, Washington State Department of Revenue.

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

[126] 16th Census of US: 1940 Agriculture - Abandoned or Idle Farms Number and acreage, with classification of those reporting acreage by cause of non operation and by year of abandonment.

Exhibit 43 – Rise in Abandoned Farms in Washington 1930 -1938



Source: 16th Census of US: 1940 Special Study on Abandoned or idle farms.

This study also asked farmers why they were nonoperational. It should be noted that the reported causes of farm abandonment may not represent the fundamental reasons but just represent the opinions of the respondents. For Washington farms, the number one reason for farm abandonment was financial, economic or legal reasons which represented 25 percent of all abandoned farms in Washington. The second most common reason was for conditions or other physical factors of the farm. This explanation represented 24 percent of all abandoned farms. The third most common reason for leaving a farm abandoned was for the physical condition or death of the operator at 18 percent.

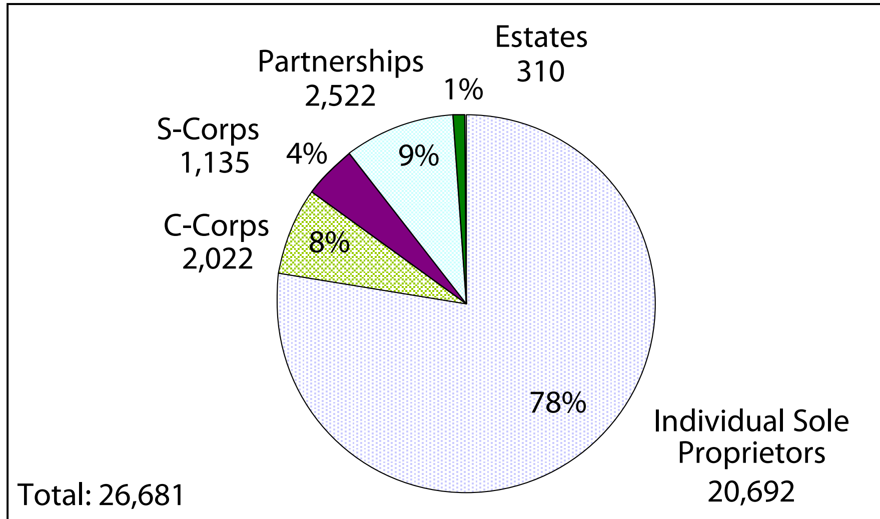
The number of farms in Washington has declined since the 1930s, but the average size of farms has increased. In 1930, Washington's average farm size was 191 acres and it had increased 123 percent to 426 acres per farm by 2002.[127] Farm income has increased since the 1930s, but it is still unpredictable as it depends heavily on commodity output and input prices. In recent years, the output price for certain agricultural commodities produced in Washington like wheat has significantly increased.

Federal tax data for Washington Agricultural Firms

Since the financial hardships of the 1930s, incomes for Washington agriculture have risen for various types of farm ownerships and commodity farms. In order to examine this trend, JLARC requested an analysis of 2005 federal personal and corporate income tax return data from the Department of Revenue. In this analysis, federal tax returns were examined by ownership, income categories and type of commodity produced. In order to examine the financial

[127] "1982 Tax Exemption Report" by Washington Department of Revenue and 2002 Census of Agriculture – Washington State.

Exhibit 44 – Taxpayers with Farm Income by Type of Taxpayer

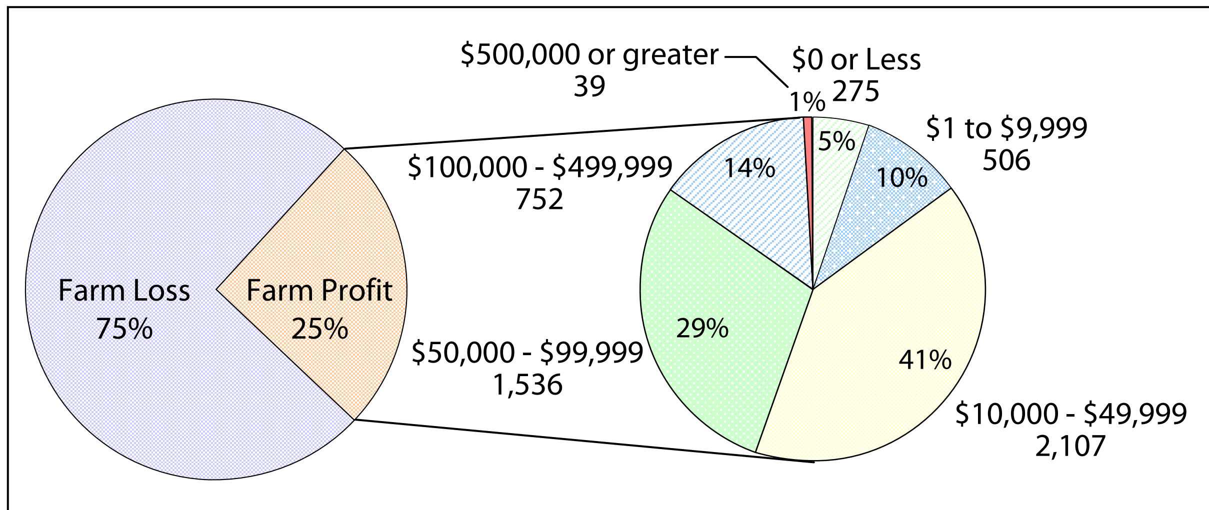


Source: 2005 Federal tax return data compiled by DOR.

conditions of Washington's farms over time, historical USDA data for Washington was examined by economic class.

The Department of Revenue reviewed 26,681Washington taxpayers who either reported farm income or were classified in an agricultural production industry sector for 2005. Of the 26,681Washington taxpayers filing federal tax returns, 78 percent of all farms were organized as sole proprietors, 9 percent were partnerships, 8 percent were large C-corporations and 4 percent was S-corporations. There were 310 estates which identified farm income as one of their components of income.

Exhibit 45 – Number of Non-Corporate Washington Farms by Farm Profits and Losses and Size of Total Income

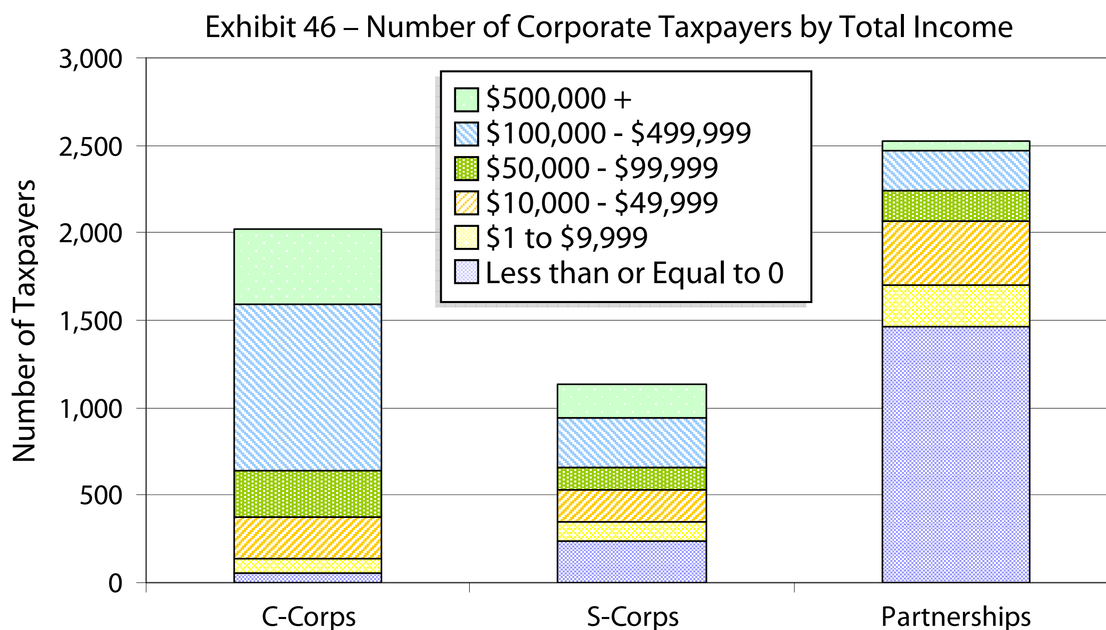


Source: DOR analysis of 2005 federal tax return data.

Farmers who have their businesses structured as sole proprietors pay the personal income tax on farm profits. Of these 20,692 farms organized as non-corporate farms, 5,215 farms or 25 percent of the individual farms had net farm profits. The majority of Washington farms with positive farm profits had income of less than $50,000 at 56 percent of farms with profits. Eighty-five percent of all non-corporate farms with net farm profits have federal total income of $100,000 or less. Non-corporate farms with positive net farm profits and income in excess of $100,000 totaled 791.

Of the reviewed federal tax returns for corporate businesses, 2,522 were farm partnerships, 2,022 were large C-corporations and 1,135 farms were S-corporations. The breakdown of corporate business farms by income category revealed that for partnerships, the largest group of farms, 58 percent, reported no income or losses. S-corporations had 21 percent of all corporations reporting $0 income or losses. Washington's C-corporations only had three percent of all companies experiencing no income or losses. Forty-seven percent of the large C corp. farms, 953, reported between $100,000 and $500,000 in total income. Twenty-four percent of all S-corporations and 9 percent of the partnerships also had income between $100,000 and $500,000 in total income. Of the taxpayers in the highest income category with total income greater than $500,000, there were 426 C-corporations, (21 percent), 195 S-corporations, (17 percent), and 48 partnerships, (2 percent).

Exhibit 46 – Number of Corporate Taxpayers by Total Income



Source: 2005 Federal tax return data compiled by DOR.

The farm partnerships in Washington, with positive business income, had $168 million in total income and $88 million in net business income after deductions. The S-corporations, with positive business income, had $849.8 million in total income and $53.6 million in net business income after deductions. The C-corporations in the farming producing industry sectors with positive income had $553 million in total income and $43.9 million in net income after deductions. These corporate taxpayers paid $18.7 million in federal corporate income tax. For C-corporate farm taxpayers, they paid an average of $9,248 per business.

Exhibit 47 – Washington Farms by Type of Ownership and Agricultural Production

All Washington Farms (number of taxpayers)					
Industry	**Non-corporate**	**S-Corps**	**C-Corps**	**Partnerships**	**Total**
Oilseed & Grains	2,566	229	1,196	888	4,879
Veg. & Melon	1,055	138	151	156	1,500
Fruit and Tree Nut	2,606	341	258	678	3,883
Other Crops	2,714	142	224	270	3,350
Animal Production	10,910	285	193	530	11,918
Others	841	0	0	0	841
Total Tax returns	**20,692**	**1,135**	**2,022**	**2,522**	**26,371**
Washington Farms with Income Greater than $500,000 (% of Total)					
Oilseed & Grains	1%	7%	8%	1%	3%
Veg. & Melon	0%	30%	44%	5%	8%
Fruit and Tree Nut	1%	21%	38%	3%	6%
Other Crops	1%	14%	43%	0%	4%
Animal Production	1%	16%	33%	3%	2%
Total Tax returns	**1%**	**17%**	**21%**	**2%**	**3%**

Source: 2005 Federal tax return data compiled by DOR.

In examining the 2005 federal income tax returns by different types of agricultural commodities, JLARC staff found that the taxpayers in the highest income category were a larger part of all vegetable and melon and fruit tree and nut farming than any other agricultural sectors. Thirty percent of the vegetable and melon S-corporations and 44 percent of the vegetable and melon C-corporations had profitable farms with income in excess of $500,000. Fruit and tree nut corporate farms had 21 percent of the S-corporations and 38 percent of the C-corporations with incomes in excess of $500,000. Forty-three percent of the other crops C-corporations had incomes in excess of $500,000.[128] This exhibit also reveals that most non-corporate farms did not have income which exceeded $500,000. Oilseed and grain farms were typically non-corporate farms. Overall, oilseed and grain farmers had a much lower portion of all farms which had income exceeding $500,000.

In examining the historical trends of income of Washington farms, JLARC analyzed USDA-National Agricultural Statistics Service data for Washington State from 1998 until 2006. The analysis finds the total number of Washington farms has declined slightly but most of that is due to a decline in the lowest income farms, (those producing income of $1,000 - $9,999). The number of medium sized farms (income from $10,000 - $99,999) has remained nearly the same since 1990. The number of larger sized farms (income greater than $100,000) has also remained constant. The number of Washington farms in the highest income group of $500,000 or more in total income has remained fairly constant over the past 10 years. In 2006, out of roughly 35,000

[128] Other crops includes commodities such as hay, sugar beets, hay and grass seeds or a combination of crops or fruits and tree nuts.

farms, almost 18,700 farms (more than 50 percent) had gross income ranged from $1,000 - $9,999. There were 3,100 farms, nine percent of all farms, which had income in excess of $100,000 and less than $250,000. There were an additional 1,900 farms, (5 percent of total farms) with income above $250,000 but less than $500,000. There were 2,200 farms (6 percent of all farms) with the highest gross income category, more than $500,000. Overall, the USDA data reveals that in 2006, there were 7,200 farms, 21 percent of all farms, with gross income in excess of $100,000. The USDA data shows a greater number of large farms than the federal income tax return information. This could be due to the fact that the USDA data includes larger corporate farms which are not headquartered in Washington State.

Small Business Tax Credit

Since the enactment of the B&O tax, there has been a small business tax credit in order to be exempt certain small businesses. To qualify, the Legislature provided a minimum gross income filing threshold. Currently, if a businesses' gross income is under $12,000 per year, then they are not required to even register with the Department of Revenue and they are exempt from the B&O tax. In 1994, the Legislature replaced the business and occupation tax minimum gross income threshold with a small business tax credit.[129] Reasons for the tax policy change were to assist new start-up businesses and phase out the B&O tax credit if taxpayers exceed the maximum income limit. The B&O tax credit is reduced by the amount of tax liability that exceeds the maximum small business credit amount for higher income businesses. In 1997, the Legislature passed HB 1261, a bill requiring the Department of Revenue to create a tax table for small business taxpayers so it would be easier for these businesses to calculate the small business tax credit.

Public Policy Objectives

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

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

1) **Define Tax Base:** Tax base defining theory states that at the time Legislatures are developing a tax, they will define the elements that will be subject to the tax and the elements excluded. Since the Legislature enacted this tax preference in 1935 at the same time as the business and occupation tax, one public policy objective of this tax preference was to define the tax base for the business and occupation tax. Another justification for the tax base defining theory is that at the time of enactment of the tax preference, the activity of the exempt organizations did not rise to the level of taxable activity. To the extent that income derived from farmers and contractors working for farmers did not amount to significant gross business income in the early 1930s, the Legislature had not intended farmers' income to be a large part of the business and occupation tax base.

[129] RCW 82.04.4451.

An element of this business and occupation tax exemption is to target farmers who are selling their agricultural commodities at wholesale. Retail sales activities by farmers are subject to the business and occupation tax. For example, consider a working farm that produces apples and then process the apples to make apple butter and jam. If the farm then sells the apples or processed apple products like apple butter and jelly at a country store at the farm, income from those sales to the public are considered retail sales and are subject to the business and occupation tax. Otherwise, if the farm sells the apples at wholesale to another business which produces the jam, the farm does not pay any B&O tax on the sale of the apples.

2) **Subsidize Low Income Farmers:** A second public policy objective could have been to benefit agricultural farmers at a time when farming was in financial trouble during the Great Depression. This is consistent with the subsidy theory of exemptions, when the state grants exemptions because the exempted organization lessens the burden on government or provides a public benefit. Originally, an objective in this business and occupation tax exemption could have been to lower the costs to farmers by providing them with reduced tax liability so they could continue to produce food for local and worldwide consumption. The price of food could be kept down from the tax subsidy so individuals experiencing tough financial times in the Depression could still afford to purchase these food necessities.

Is there any documentation on the purpose or intent of the tax preference?

Statutory language is clear that agricultural producers who sell at wholesale are exempt from the business and occupation tax. The statute does not have a specific statement of intent as to why agricultural producers are allowed this exemption, as opposed to meeting the minimum income requirements applicable to all other businesses under the small business tax credit. The original legislation in 1933 and the subsequent Governor's veto message suggest a belief that in the early 1930s farming activities were not producing positive net farm profits.

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

Since 1933, businesses selling agricultural commodities at wholesale have not been subject to the business and occupation tax on that income. Therefore, this tax preference has met its objective of defining the business and occupation tax base. This tax preference is targeted at wholesale sales for the tax exemption from the B&O tax. Each year, there is some B&O tax paid by a number of agricultural producers who also sell their farm products at retail to customers, or when they process their farm commodities and sell their processed food at retail. These activities on a farm are subject to the business and occupation tax. This tax exemption has achieved its original objective of targeting just wholesale activities.

This tax preference achieved the objective of subsidizing farmers who suffered economic hardships in the 1930s. It is understandable that in the 1930s farmers were suffering hard financial times. It is unclear from the statute if the Legislature thought agricultural producers

would always have low gross farm receipts. Based on the most recent federal income tax information for farms doing business in Washington, some farms have positive net farm profits, and they are paying federal income taxes.

Since Washington's tax preference is a complete exemption from the business and occupation tax for wholesale agricultural producers, this tax preference has been subsidizing all wholesale farmers regardless of the size of their farm income. It is not clear from the legislative intent if that was one of the original objectives of this tax exemption.

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

If continued, this business and occupation tax preference will keep on fulfilling the public policy objectives of defining the tax base and targeting the tax exemption to just wholesale sales of agricultural producers. If this B&O tax preference is continued, then this tax preference will continue to subsidy farmers regardless of their income. It is unclear whether this was the legislative intent when this tax exemption was enacted.

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

It is unclear if the Legislature anticipated agricultural producers would be earning the current level of positive income and if it intended this tax preference to be extended to income earning farms as well as farms that do not generate any income. Farmers in states with personal income taxes do not pay any income tax if they have no net farm income or losses. If farmers have positive net farm profits, those taxpayers pay tax on that income.

The Legislature could eliminate this business and occupation tax exemption for agricultural producers and allow producers that qualify for the small business tax credit to receive tax exempt status like other types of businesses with minimal income. Another modification to this tax preference could be to require agricultural producers to meet specified income or profit levels in order to qualify for the tax exemption. These modifications would target this tax preference to low income farmers and eliminate this tax preference for high income farms.

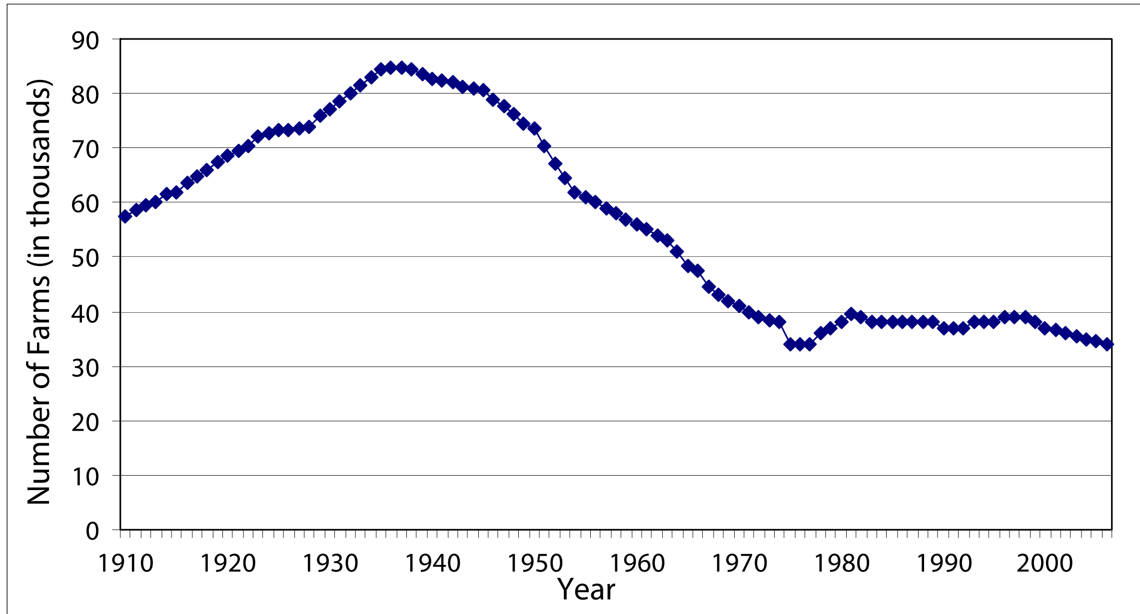
Beneficiaries

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

The beneficiaries of this tax preference have been between 36,000 agricultural producers in 2002 to 34,000 producers in 2006. However, only about 10,000-12,000 of these would have taxable income in excess of the small business tax credit (according to the DOR 2004 and 2008 Tax Exemption Study).

At the time of enactment of this tax preference in 1935, there were 84,400 farms in Washington.[130] This was the third highest number of farms in the Washington's history since 1910. In 2006, more than 34,000 farms were in Washington. The number of acres of land in farms in Washington has declined since 1950 from 18,000 acres to 15,100 acres in 2006. This is a decline of 16 percent in the number of farmland acres in the state since 1950.

Exhibit 48 – Number of Farms in Washington 1920 – 2006



Source: USDA data for Washington State.

In examining the county level data, Yakima has the largest number of farms at 3,730 and the highest percent of all farms statewide at 10 percent. Spokane County has the second highest number of farms at 2,225 and Grant County has third largest number of farms at 1,801. The county with the largest average farm size is Ferry County at 3,862 acres. Lincoln has the second highest average farm size at 1,651 acres and Garfield has the third highest at 1,578 acres.

[130] USDA/National Agricultural Statistics Service database - Washington State.

Exhibit 49 – WA Farms and Average Size of Farms by County

County	Number of farms	% of total	Avg. Size of farm
Adams	717	2%	1,488
Asotin	180	1%	1,558
Benton	1,313	4%	463
Chelan	1,193	3%	94
Clallam	455	1%	49
Clark	1,596	4%	44
Columbia	255	1%	1,156
Cowlitz	532	1%	74
Douglas	947	3%	928
Ferry	207	1%	3,862
Franklin	943	3%	705
Garfield	198	1%	1,578
Grant	1,801	5%	596
Grays Harbor	510	1%	105
Island	348	1%	43
Jefferson	207	1%	59
King	1,548	4%	27
Kitsap	587	2%	27
Kittitas	931	3%	248
Klickitat	702	2%	864
Lewis	1,402	4%	93
Lincoln	747	2%	1,651
Mason	320	1%	68
Okanogan	1,486	4%	835
Pacific	341	1%	152
Pend Oreille	263	1%	233
Pierce	1,474	4%	39
San Juan	225	1%	76
Skagit	872	2%	131
Skamania	99	0%	58
Snohomish	1,574	4%	44
Spokane	2,225	6%	289
Stevens	1,269	4%	416
Thurston	1,155	3%	64
Wahkiakum	125	0%	99
Walla Walla	890	2%	787
Whatcom	1,485	4%	100
Whitman	1,087	3%	1,222
Yakima	3,730	10%	450
Total	**35,939**		**426**

Source: 2002 US Census of Ag. Data.

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

All farmers regardless of their income level are exempt from paying the business and occupation tax. If the Legislature originally intended all farmers to be exempt from this business tax, regardless of their farming income, then there are no unintended beneficiaries of this tax preference. If the Legislature did not anticipate the positive income wholesale agricultural producers would have from farming, then there could be unintended beneficiaries of this tax exemption. The specific intent for this tax preference is not clear in the statute.

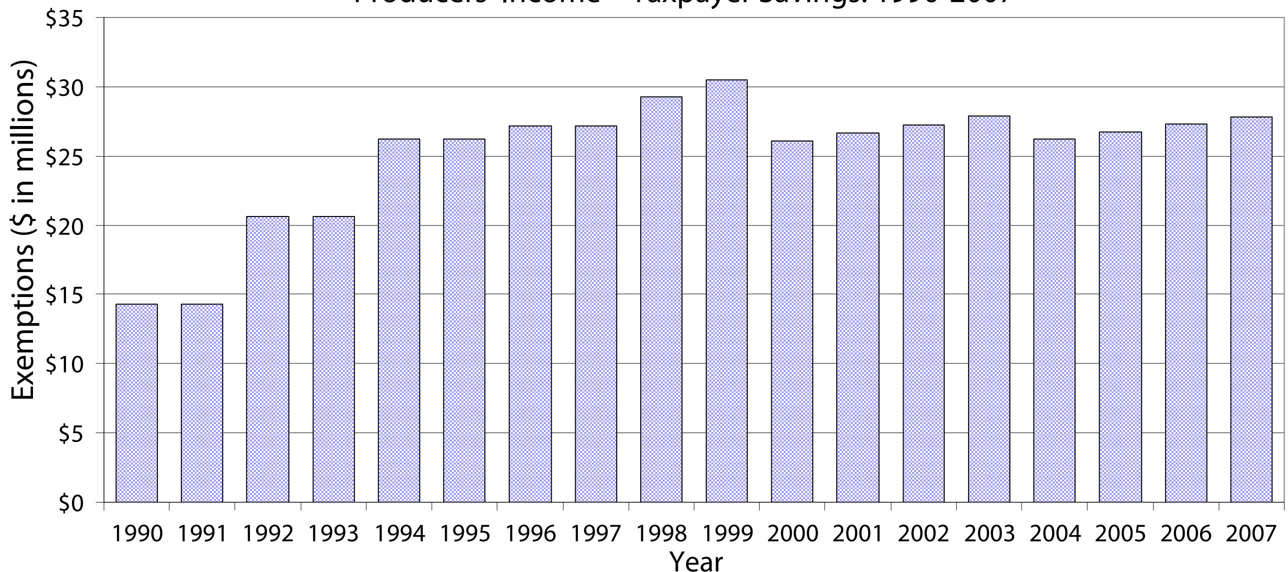
Revenue and Economic Impacts

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 taxpayer savings from the agricultural producers' business and occupation tax exemption grew throughout the 1990s. The taxpayer savings for this exemption has been between $25 million and $30 million from 1994 through 2007. The reason why this tax preference has been growing is because it is based on the value of agricultural production in Washington, which has been growing in recent years due to high commodity prices.

This tax preference is forecasted to have taxpayer savings between $29 and $33 million over the next two biennia. JLARC estimates are based on the latest USDA 2006 Washington Ag. Statistics on the value of agricultural production. In addition, the estimates assume an annual growth rate of 3 percent and that agricultural producers would pay a 0.484 B&O tax rate.

Exhibit 50 – Exemption from Business and Occupation Tax for Ag. Producers' Income – Taxpayer Savings: 1990-2007



Source: Department of Revenue Tax Exemption Reports.

Exhibit 51 – Forecast of State B&O Tax Savings for Agricultural Producers

Fiscal Year	Exempt Value ($ billions)	B&O Tax Savings ($millions)
2006	$5.94	$28.8
2007	$6.12	$29.6
2008	$6.31	$30.5
2009	$6.50	$31.4
2010	$6.69	$32.4
2011	$6.89	$33.4

Source: Department of Revenue based on USDA agricultural production data.

The taxpayer savings estimates are equivalent to the loss in state government revenue if this tax preference is continued.

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 Legislature terminated this tax exemption, Washington's agricultural producers would have to pay more than $30 million in business and occupation tax on their income generated from farming annually. Some farmers would qualify for the small business tax credit and have insufficient income to be liable for the business and occupation tax.

In the past decade, agriculture in Washington has been a $5.5 to $6 billion industry. In 2006, the total value of all farm production was $6.87 billion. The additional value the agriculture industry brings to the state economy is the difference between the total market value of the output sold and the total cost of the agricultural inputs purchased to create the output. The following exhibit summarizes the USDA data for the most recent year, 2006. This exhibit indicates that the gross value added is 46 percent of the value of the final agricultural output. The net value added, which is gross value minus capital consumption, was 39 percent of the value of the final agricultural output. The total cost of labor, employee compensation, was 18.9 percent of total value of final output. As a measure of the cost of labor to the farm operator, this employee compensation statistic can be considered the annual wage bill for agricultural labor in the state.

Exhibit 52 – 2006 Composition of Washington's Total Value of Final Agricultural Output

	Dollar Value ($000)	Percent of Total Output (%)
Value of Final Agricultural Output	6,872,632	
Components of Agricultural Output		
Total Intermediate Consumption Outlays	3,649,029	53.1
Gross Value Added	3,177,565	46.2
Net Value Added	2,689,603	39.1
Employee Compensation – Total Hired Labor	1,300,775	18.9
Net Farm Income	897,726	13.1

Source: USDA-NASS, 2007 Washington Agricultural Statistics.

If the Legislature eliminated this tax preference and agricultural producers lost $30 million in annual taxpayer savings, there would be nearly no change on price, quantity produced, or employment statewide from this policy change alone. Since the total tax loss from this tax preference is small compared to Washington's total General Fund state cash receipts of $29.4 billion in the 2007-09 Biennium, there would be minimal negative economic impact from eliminating this tax preference. All Washington statewide changes to prices, quantity produced, or household income would be less than 0.1 percent from the initial base year.[131]

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 state business and occupation tax, there would be no change in the distribution of tax liability of state 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?

The federal income tax does not provide agricultural producers with tax exempt status but requires farmers to report their gross and net farm income and file personal income or corporate tax returns depending on the type of ownership of the farm. If a farmer is a sole proprietor or partnership, then the net farm income is reported on the personal income tax return. Net farm income can be positive or negative depending on a variety of factors including the output price of the commodity produced, input prices for producing the commodity and other expenses deducted from income.

[131] These economic impact results were based on a computable general equilibrium model for Washington State based on IMPLAN data for 2006.

Personal Income Tax

The District of Columbia and 43 states have personal income taxes. Most states (36) connect their state law to the federal law provisions for federal income taxes. Thirty states conform their state law to federal adjusted gross income as their tax base and six states connect to the federal taxable income. Six states have defined their own state specific adjusted gross income base. Two other states, New Hampshire and Tennessee, assess their personal income tax on just interest and dividend income. Seven states do not impose a personal income tax including Washington.[132] These states do not impose any additional income or business tax on the earnings of non-corporate businesses including agricultural producers like sole proprietor farmers.

Some 41 states, which have state personal income taxes, require farmers to report that they had negative or low net farm income in order to not pay income taxes to the state government. Two states require agricultural producers to report their interest and dividend income for state income tax purposes. Seven states do not have a personal income tax and exempt non-corporate farmers from reporting and paying an income or business tax.

Corporate Business Tax

Forty-five states and the District of Columbia impose a corporate income tax in which states refer to federal law by either referencing the IRC code or by having similar state provisions as federal law. Some 25 states and the District of Columbia conform their state law to the definition of federal taxable income before net operating loss and special deductions, and 20 states link their state law to the definition of federal taxable income after net operating loss and special deductions. Two states, Tennessee and New Hampshire, extend their corporate income tax to interest and dividend income of corporations only and they do not appear to exempt corporate farms from their corporate income tax. None of these states have a blanket exemption for agricultural producers but rather entities' tax liability is determined in a similar manner as used under federal law.

Corporate farms are also required to file the federal corporate income tax return. These corporate farms report their farm wholesale receipts in the gross receipts for their business. If their deductible expenses exceed the value of the commodity produced and sold, then they are not subject to state and federal income taxes. The corporate income tax states require corporate farm businesses to report their gross business receipts and claim deductions for their business expenses. The result is that farming businesses with positive taxable income after net operating losses are taken into account are assessed a corporate tax. The amount of corporate tax actually paid depends on not only the corporate taxable income but also on any credits the corporation qualifies for.

Michigan and Texas each impose their own business tax, neither of which includes specific provision to exempt agricultural producers. Nevada and Wyoming do not impose a corporate income tax or any other statewide business tax on corporations. In conclusion, Washington,

[132] States without a personal income tax: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming.

Nevada, and Wyoming are the only three states that do not impose a business tax on corporate agricultural farms.

Recommendation

Given the fact that incomes have increased significantly for some farms since the period of financial hardships when this tax exemption was enacted, the Legislature should consider establishing an income threshold in order to qualify for the business and occupation tax exemption for agricultural producers.

Legislation Required: Yes.

Fiscal Impact: Depends on proposal.

INSURANCE PREMIUMS – SUMMARY

Current Law

Current law exempts from the business and occupation tax the gross income from premiums, fees, assessments, dues, or other charges for insurance that are assessed a statewide gross premiums tax. This tax preference is targeted at insurance carriers. The exempt income is restricted to income from premiums, fees, assessments, dues, or other charges directly attributable to the insurance premiums. The law also specifies certain types of businesses that do not qualify for the exemption such as agents or brokers representing insurance companies or bonding companies. This business and occupation tax exemption affects the retaliatory tax that is imposed on Washington insurers in other states and on foreign insurance carriers operating in Washington.[133] See Appendix 3 for the current law statute, RCW 82.04.320.

Findings and Recommendations

This review has evaluated the legal history, public policy objectives, economic and revenue impacts, and other states' similar tax preferences of the business and occupation tax exemption for income from insurance premiums that are also subject to the insurance premiums tax. The audit determined the following:

Legal History and Public Policy Objectives

- The Legislature enacted Washington's insurance premiums tax in 1891.
- When the Legislature adopted the business activities tax in 1933, it included provisions to exempt insurance companies from paying the new tax.
- In the Revenue Act of 1935, the Legislature included provisions to exempt income from insurance premiums subject to a gross premiums tax from the payment of the new business and occupation tax. In later years, the Legislature clarified which companies did not qualify for this tax exemption. The basic premise of this business and occupation tax exemption has not changed since 1935.

This tax exemption has achieved two public policy objectives:

1. To define the business and occupation tax base and limit this business and occupation tax exemption to only income derived directly from insurance premiums provided by insurance companies; and
2. To avoid double taxing income from insurance premiums that was already subject to the gross insurance premiums tax.

[133] RCW 48.14.040; The retaliatory tax is the amount of additional tax that can be assessed by Washington State on foreign or alien insurers if other states charge higher tax rates on Washington-based insurance companies.

Beneficiaries

- In March 2008, Washington's Office of the Insurance Commissioner identified 1,729 insurance companies which paid the insurance premiums tax.
- There is no indication of this tax preference providing unintended benefits to companies other than those intended.

Revenue and Economic Impacts

- The business and occupation taxpayer savings is $370 million in fiscal year 2008. This exemption is expected to grow to $428 million by fiscal year 2011.
- In 2006, Washington's insurance carriers produced $7.5 billion in services and spent $4.3 billion to perform those services.

Other States

- All 50 states impose an insurance premiums tax. In addition, nine states make income earned from insurance premiums part of their corporate income tax base. Most states, except for Wisconsin, provide a tax credit against the insurance premiums tax or the retaliatory tax, or an option to choose which of the two taxes to pay. Even though Wisconsin has income from insurance premiums subject to both the corporate income and insurance premiums tax, the insurance premiums tax only applies to unauthorized insurers.

Recommendation

The Legislature should continue the business and occupation tax exemption for income derived from insurance premiums.

Legislation Required: None.

Fiscal Impact: None.

INSURANCE PREMIUMS – REPORT DETAIL

Statutory History

The Legislature enacted Washington's insurance premiums tax in 1891. The initial tax rate of 2 percent remains unchanged. In 1911, the Legislature adopted a retaliatory provision.[134] The retaliatory tax specifies that foreign or alien insurers can be charged higher tax rates compared to tax rates charged on Washington insurance companies if other states and countries charge higher tax rates on Washington-based insurance companies doing business in those other states. This is known as a retaliatory tax.

The Legislature faced a revenue shortfall as it convened in January 1933. The prior November, the voters had passed Initiative Measure No. 64, a 40-mill property tax limit bill. The initiative limited property tax levies for state purposes to a maximum of five mills on a 50 percent valuation.[135] This measure effectively reduced the income from state taxes by approximately 50 percent, beginning with the second year of the 1933-35 Biennium. Assessed valuations and levies were already reduced due principally to the depressed economic conditions of the time. The Legislature also adopted in 1933 the Showalter Bill, a measure increasing, by about two-thirds, the state's obligation to support local school districts. The voters passed another initiative in 1932, Initiative Measure No. 69, imposing a state income tax on all corporations and individuals.

In response, the Legislature adopted a temporary business activities tax in 1933. The tax was to be in place from August 1, 1933, to July 31, 1935. The tax was measured by the application of rates against "value of products," "gross proceeds of sales," or "gross income of the business." The rates varied depending on the type of business activity. The 1933 temporary business activities tax imposed taxes upon the privilege of engaging in business activities. In 1933, insurance companies paying the gross premium tax were one of the exemptions allowed from the business activities tax.[136]

The revenue crisis continued into 1935. The state Supreme Court found the graduated net personal and corporate income tax adopted by the voters in 1932 to be unconstitutional.[137] At the general election in 1934, voters again passed the 40-mill limit.[138] This 1934 initiative further reduced the state levy from five mills to two mills, exclusively for the institutions of higher education. The Legislature, meeting in 1935, faced the problems of replacing the revenue previously received from property taxes levied for the state general fund, as well as the state's

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[134] RCW 48.14.040.

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

[136] "Fifth Biennial Report of the Tax Commission of the State of Washington for the Period Ending September 30, 1934," November 1934.

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

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

obligations under the Showalter Act to support common schools, and payment for relief and welfare work. To raise the required revenue, the Legislature enacted the Revenue Act of 1935. The new act supplanted the temporary 1933 act and continued in general effect the business taxes imposed by it. The 1935 act also added several new consumer taxes, including a two percent retail sales tax and a complementary use tax.

The Revenue Act of 1935 consisted of twelve titles, with the business and occupation tax (Title II) as a tax upon persons for the privilege of conducting business in the State of Washington. Initially, there were ten exemptions from the tax, including taxpayers in the insurance business with insurance premiums subject to a gross premiums tax.[139] The statute enacted in 1935 stated that the exempt income must come from businesses subject to the gross premiums tax:

> *The provisions of this title shall not apply to …*
>
> *(c) Any person in respect to insurance business upon which a tax based on gross premiums is paid to the State of Washington: Provided, however that the provisions of this subsection shall not exempt any person engaging in the business of representing any insurance company, whether as general or local agent or acting as broker for such companies;*

In 1939, the Legislature clarified that this B&O tax exemption does not apply to bonding companies' gross income derived from the completion of contracts. Additional changes to the law were made in 1959 specifying that individuals representing insurance companies or brokers for insurance companies were not exempt from the business and occupation tax. The Legislature has not made additional changes to this tax preference since 1959.

The insurance premiums tax is paid in lieu of the business and occupation tax and all other taxes, except real and personal property taxes and excise taxes applied thereon (RCW 48.14.080).[140] However, insurance companies pay B&O tax on income derived from other non-insurance related business activities.

Other Relevant Information

Insurance Premiums Tax

The insurance premiums tax began in 1891 and is paid on net premiums collected or received by authorized insurers, health maintenance organizations, and health care service contractors. In addition, ocean marine and foreign trade insurers are subject to the tax on their net underwriting

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[139] Business and Occupation tax exemptions in 1935 included the following: minimum income threshold; person whose business activities were subject to the public utility tax; person in the insurance business which had their gross premiums subject to another tax; agricultural producers; person who was conducting boxing and wrestling matches; person in the business of conducting horse race meets; person who was an employee; fraternal benefit societies and fraternal fire insurance associations; person in the business of operating a hospital and amounts derived from the lease, rental or sale of real estate. Reported in "Rules and Regulations Relating to the Revenue Act of 1935" by Tax Commission of the State of Washington April 1, 1936.

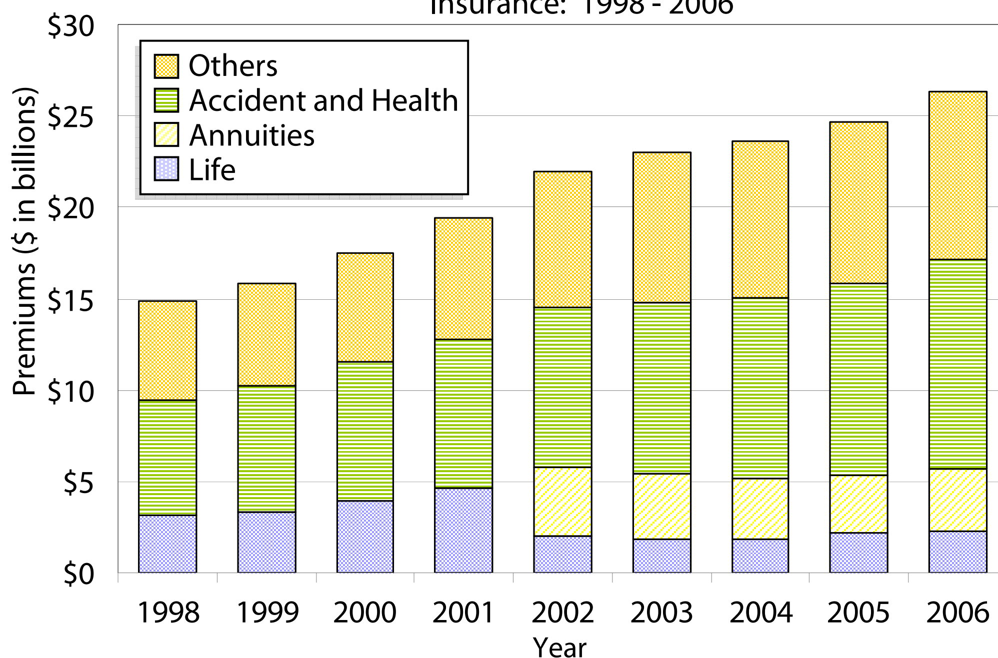
[140] 2007 Tax Reference Manual by Washington Department of Revenue.

profit. The tax rate is 2 percent on all taxable premiums and a special lower rate of 0.95 percent on ocean marine and foreign trade.[141] According to the Washington Insurance Report in 1935, there were 201 stock fire and marine insurance companies, 38 mutual and inter-insurance fire companies, and 162 life and miscellaneous companies authorized to transact business in Washington. The number of insurance companies doing business in Washington has increased significantly over the last 73 years. In 2008, there were 839 property insurance companies, 460 life insurance companies, 77 risk retention insurance companies, 25 health care service contractors, five health maintenance organizations, and four multiple employer welfare associations.

Revenue from the insurance premiums tax is distributed to several dedicated accounts in addition to the state General Fund. Insurance premium taxes paid on fire insurance premiums are distributed to three separate accounts besides the state general fund. Legislation in 1993 shifted health care companies (health maintenance organizations and health care service contractors) from the B&O tax to the insurance premiums tax. The revenue from the insurance premiums tax paid by health care companies goes to the Health Services Account.

The value of Washington's gross insurance premiums has been rising steadily since 1998, from a little under $15 billion to a little more than $25 billion in 2006. Since 2002, annuities have been separately reported from life insurance premiums. Health and accident insurance has been growing the fastest of all types of premiums over the past nine years.

Exhibit 53 – Value of Gross Insurance Premiums Written by Type of Insurance: 1998 - 2006



Source: Insurance Commissioner's Annual Report various years.

[141] 2007 Tax Reference Manual by Washington Department of Revenue.

The insurance premiums tax base is gross insurance premiums written less exemptions and deductions from this tax.[142] Insurance premiums tax collections have grown from $260.9 million in 2000 to $378.8 million in 2006.

Exhibit 54 – Insurance Premiums Tax Collections Since 2000

Fiscal Year	Collections ($ millions)	% Change
1997	$211.9	4.6
1998	$227.3	7.3
1999	$239.0	5.1
2000	$260.9	9.2
2001	$279.8	7.2
2002	$291.3	4.1
2003	$316.7	8.7
2004	$345.6	9.1
2005	$357.4	3.4
2006	$378.8	6.0

Source: 2007 DOR Tax Reference Manual.

Business and Occupation Tax

The business and occupation tax is based on gross receipts. Initially the tax rates were 0.25 percent for all businesses except services, which were taxed at 0.5 percent. Over time, the Legislature has developed a number of specialized tax rates for particular types of businesses.[143] Under current law, for most companies, the business and occupation tax rates range from 0.13 percent for pari-mutuel wagering to 1.5 percent for service and other activities, hospitals and gambling contests of chance (less than $50,000 per year). The B&O tax rate for manufacturing and wholesaling activities is .484 percent and retailing activities is .471 percent. Otherwise, businesses not covered by another tax rate pay the B&O tax rate of 1.5 percent.[144] The B&O tax does not permit deductions for the costs of doing business, such as payments for raw materials and wages of employees. Any exemptions and deductions from the B&O tax are specified separately in law.

[142]According to the 2007 Tax Reference Manual, the insurance premiums tax has 13 exemptions, deductions and credits.

[143] "Sixth Biennial Report of the Tax Commission of the State of Washington for the Period Ending September 30, 1936."

[144] Ibid.

Business and occupation tax collections have grown from $1.7 billion in 1997 to $2.6 billion by 2007. The business and occupation tax was reported by approximately 300,000 firms in fiscal year 2006.[145] These are the firms with business and occupation tax liability (prior to credits).

Exhibit 55 – History of the Business and Occupation Tax Collections: 1997 – 2007

Fiscal Year	Collections ($ millions)	% Change
1997	$1,722.8	4.9
1998	$1,853.8	7.6
1999	$1,827.5	-1.4
2000	$1,854.9	1.5
2001	$2,012.4	8.5
2002	$1,958.3	-2.7
2003	$1,923.4	-1.8
2004	$2,067.9	7.5
2005	$2,269.1	9.7
2006	$2,477.8	9.2
2007	$2,640.9	6.6

Source: 2007 DOR Tax Reference Manual and Office of Forecast Council February 2008 forecast report.

Public Policy Objectives

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

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

1) **Define Tax Base:** Since this tax preference was enacted in 1933 with the temporary business activities tax and then again when the business and occupation tax was enacted, one public policy objective of this tax preference was to define the tax base for the B&O tax. Tax base defining theory states that at the time Legislatures are developing a tax, they will define the elements that will be subject to the tax and the elements excluded.

   An element of defining the tax base for this tax preference is to restrict the business and occupation tax exemption to just the income from insurance premiums, directly attributable to insurance services. All other income earned by insurance companies is subject to the business and occupation tax.

2) **Avoid Double Taxation:** A second public policy objective could have been to avoid double taxation of income from insurance premiums since that income was already being taxed under the insurance premiums tax. Paying the insurance premiums tax was in lieu of

[145] 2007 Tax Reference Manual by Washington Department of Revenue.

paying the business and occupation tax especially since the insurance premiums tax had been in place for 44 years when this tax exemption was enacted.

Is there any documentation on the purpose or intent of the tax preference?

Statute clearly states that insurance companies with income subject to the insurance premiums tax shall have that income exempt from the business and occupation tax. The statute does not have a specific statement of intent as to why insurance companies are exempt from the business and occupation tax. However insurance companies had already been paying a gross receipts insurance tax for 44 years prior to the enactment of the business and occupation tax, and it is common for a Legislature to impose a single statewide tax on certain income and exempt it from a general income tax to avoid taxing the same income twice.

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

Since 1935, businesses have excluded insurance premiums receipts on their business and occupation tax returns. Therefore, this tax preference has met its objective of defining the business and occupation tax base. Insurance carriers have paid business and occupation taxes on income earned on non-insurance premium business activities. Therefore, the objective of targeting this exemption to income derived from insurance premiums has been achieved.

Insurance carriers have been assessed a single statewide tax on insurance premiums since 1891 in Washington. This tax preference has achieved the objective of avoiding double taxation of insurance premiums income for 73 years.

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

If continued, this business and occupation tax preference will continue fulfilling the public policy objectives of defining the tax base, avoiding double taxation, and targeting the tax exemption to specific insurance 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?

The public policy objectives of this tax preference are being fulfilled.

Beneficiaries

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

Insurance companies are the beneficiaries. In 2008, there were 839 property insurance companies, 460 life insurance companies, 77 risk retention insurance companies, 25 health care service contractors, five health maintenance organizations, and four multiple employer welfare associations. All these insurance companies paid the insurance premiums tax and thus are beneficiaries of this business and occupation tax exemption.

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

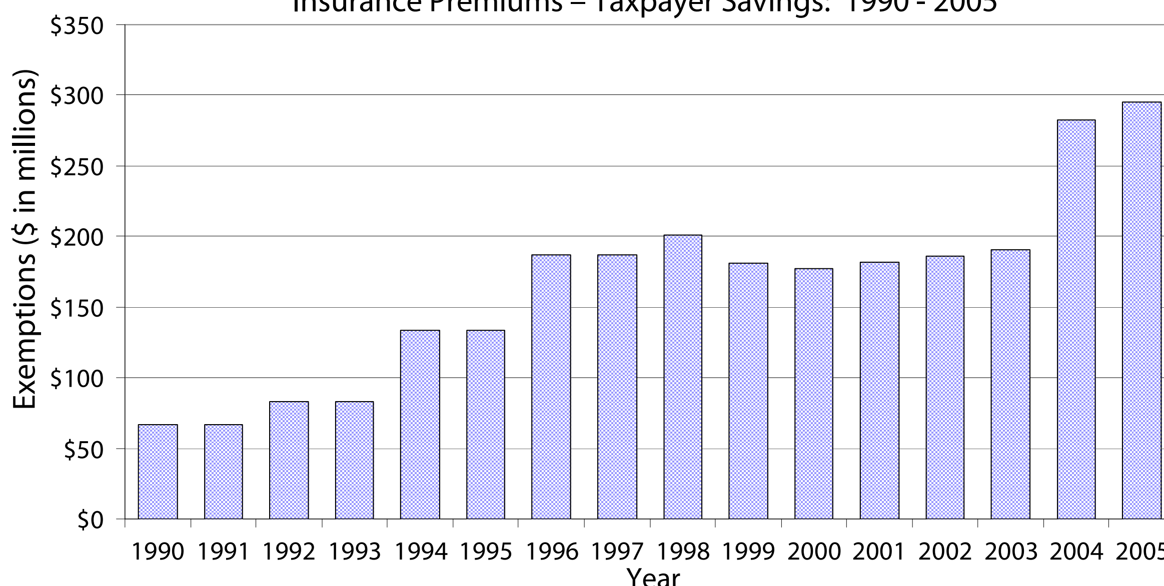
During the course of this tax preference review, there were no unintended beneficiaries of this tax preference identified.

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?

Up until 2004, the Department of Revenue estimated the taxpayer savings of this B&O tax exemption at less than $200 million per year. JLARC and the Department of Revenue calculated the past and future projections of the value of this tax preference based on the insurance companies' financial reports submitted to the Office of the Insurance Commissioner, with the latest year being 2006. There are several exemptions from the premiums tax (fraternals, ocean

Exhibit 56 – Exemption from Business and Occupation Tax for Insurance Premiums – Taxpayer Savings: 1990 - 2005



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

marine insurers, and title insurers). These exemptions were excluded from the total premiums written in arriving at the revenue estimates for the taxpayer savings.

JLARC assumed an annual growth rate of 5 percent in the direct premiums written that would be subject to the B&O tax if this exemption was not law. This analysis also assumed a B&O tax rate of 1.5 percent for insurance companies. JLARC calculated the future taxpayer savings of this B&O tax exemption to be $370 million in 2008, growing to $428.3 million by 2011.

Exhibit 57 – Forecast of State B&O Tax Savings for Insurance Companies

Fiscal Year	Exempt Value ($ billions)	B&O Tax Savings ($ millions)
2006	$22.37	$335.6
2007	$23.49	$352.4
2008	$24.67	$370.0
2009	$25.90	$388.5
2010	$27.19	$407.9
2011	$28.56	$428.3

Source: JLARC estimates based on Office of Insurance Commissioner's annual reports.

Given the fact that this tax preference is a business and occupation tax exemption, the taxpayer savings estimates are equivalent to the loss in state revenue.

According to the Washington Employment Security Department data, the insurance carrier sector of the economy has 21,884 employees and an average wage of $66,386 in 2006. Insurance carriers make up less than 1 percent of statewide employment. The average wage is above the statewide average in 2006.

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 Legislature eliminated this business and occupation tax preference and gross income from insurance premiums was subject to an additional tax, taxpayers would pay $370 million or more in state business taxes. Washington's insurance industry consists of direct insurance carriers of different types of insurance as well as insurance agents and brokerages. Only the direct insurance carriers would be required to pay a new business and occupation tax. Exhibit 58 shows the average number of firms, employment and total wages for direct insurance carriers for 2006. The total number of firms was 292 businesses, with 43 percent of all insurance carriers being property and casualty insurers. There were 21,884 employees of insurance carriers in Washington, which represented less than one percent of all employees statewide. Insurance carriers paid their employees $1.45 billion in total wages for an average wage per employee of $66,386. The total

wages paid by insurance carriers represents 1.19 percent of all wages paid to employees in Washington in 2006.

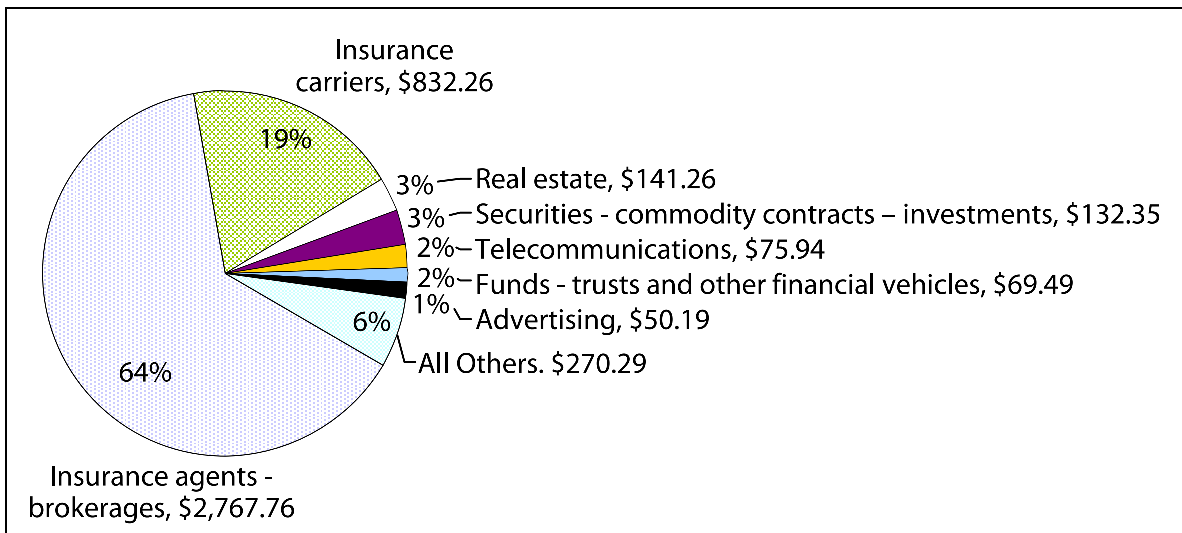
Exhibit 58 – Washington's Average Number of Firms, Employment and Total Wages for 2006

Type of Insurance Carrier	Average Number of firms	Average Number of employees	Total Wages ($ 000)
Life Insurance	48	3,371	$209,819.4
Health and Medical	25	5,296	$304,532.2
Property and Casualty	126	9,126	$693,411.3
Title	67	3,657	$218,228.6
Other Insurance	16	249	$13,143.6
Reinsurance	10	185	$13,663.3
Total Insurance Carriers=	**292**	**21,884**	**$1,452,798.4**
% of totals statewide	0.15%	0.77%	1.19%

Source: Washington Employment Security Department Data.

The insurance carrier industry represents roughly 1 percent of Washington's total industry output and value added in 2006. The insurance carrier industry spent more than 60 percent of their value added on employee wages.[146] In order to provide insurance services, the carriers' largest expenses were on insurance agencies – brokerages who could sell the carriers' insurance policies.

Exhibit 59 – 2006 Expenditures ($4.3 billion) by Washington's Insurance Carrier Industry



Source: 2006 Washington IMPLAN data.

[146] Value added is the value of the firm of industry's output minus the value of inputs that it purchases from other firms.

The revenue impact of eliminating this B&O tax exemption would mean higher B&O taxes on all insurance carriers in Washington. Also, the retaliatory tax would be reduced for foreign alien companies doing business in Washington. For Washington based insurance companies, an increase in taxes here would mean higher retaliatory taxes in other states in which they issue insurance. For the insurance industry, if the Legislature eliminated this tax preference, the industry could pass on the additional cost of the higher B&O taxes through higher insurance rates.

Since the total tax loss from this tax preference is small statewide compared to Washington's total General Fund state cash receipts of $29.4 billion in the 2007-09 Biennium, there would be minimal statewide economic impact from eliminating this tax preference. All Washington statewide changes to quantity produced, or employment would be less than 0.5 percent from the initial base year.[147]

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 state business and occupation tax, there would be no change in the distribution of tax liability of state 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?

All 50 states impose an insurance premiums tax. In addition, nine states make income earned from insurance premiums part of their corporate income tax base. Most states, except for Wisconsin, provide a tax credit against their insurance premiums or the retaliatory tax or an option to choose which of the two taxes to pay. Even though Wisconsin has income from insurance premiums subject to both the corporate income and insurance premiums tax, the insurance premiums tax only applies to unauthorized insurers. These provisions in other states allow income from insurance premiums to be taxed only once, avoiding double taxation. This is the same objective seen in Washington with this tax exemption.

Recommendation

The Legislature should continue the business and occupation tax exemption for income derived from insurance premiums.

Legislation Required:	None.
Fiscal Impact:	None.

[147] These economic impact results were based on a computable general equilibrium model for Washington State based on IMPLAN data for 2006.

PUBLIC UTILITIES – SUMMARY

Current Law

Under current law, gross income taxed under the public utility tax is exempt from the business and occupation tax. Other income earned on business activities not subject to the public utility tax are taxed under the appropriate business and occupation tax rate. See Appendix 3 for the current law statutes, RCW 82.04.310.

Findings and Recommendations

This review has evaluated the legal history, public policy objectives, economic and revenue impacts, and compared other states' similar tax preferences to Washington's business and occupation tax exemption for utility income subject to the public utility tax. The audit determined the following:

Legal History and Public Policy Objectives

- The Legislature enacted the temporary business activities tax in 1933 which included a tax on the gross income of utility and transportation businesses.
- Two years later, the Legislature enacted the business and occupation tax with an exemption for utility income which is subject to the public utility tax in the Revenue Act of 1935. The 1935 Act created a separate business and occupation tax and a public utility tax. In addition, the Legislature exempted the utility income subject to the public utility tax from the business and occupation tax.
- This B&O tax preference has remained nearly the same since 1935.

The tax exemption has achieved the following two public policy objectives:

1. To define the business and occupation tax base and limit the exemption to utility income of companies; and
2. To avoid double taxing utility income, that has already been subject to the statewide public utility tax.

Beneficiaries

- Over the years, the beneficiaries of this tax preference have been public service and utility companies in the following areas: private and municipal utilities, transportation providers, communication, sewerage collection, and distribution of water and energy.
- In 2006, more than 5,000 taxpayers filed excise tax returns with public utility income.
- There is no indication of this tax preference providing unintended benefits to companies not subject to the public utility tax.

Revenue and Economic Impacts

- According to Department of Revenue estimates, the taxpayer savings has been approximately $40 million annually.
- The future projection for this tax preference ranges from approximately $50 million in fiscal year 2008 to $58 million in fiscal year 2011.
- In 2006, the value added by the utilities sector was nearly $2 billion and the transportation sectors subject to the public utility tax had $5.6 billion. These two sectors combined value added represented 2.6 percent of all value added in Washington's economy.

Other States

- Most states within the U.S. only tax utility income once. One exception is Indiana, which makes utility income subject to the income tax as well as a utilities receipts tax.

Recommendation

The Legislature should continue the business and occupation tax preference for public utility income.

Legislation Required: None.

Fiscal Impact: None.

Statutory History

The Legislature faced a revenue shortfall as it convened in January 1933. The prior November, the voters had passed Initiative Measure No. 64, a 40-mill property tax limit bill. The initiative limited property tax levies for state purposes to a maximum of five mills on a 50 percent valuation.[148] This measure effectively reduced the income from state taxes by approximately 50 percent, beginning with the second year of the 1933-35 Biennium. Assessed valuations and levies were already reduced due principally to the depressed economic conditions of the time. The Legislature also adopted in 1933 the Showalter Bill, a measure increasing, by about two-thirds, the state's obligation to support local school districts. The voters passed another initiative in 1932, Initiative Measure No. 69, imposing a state income tax on all corporations and individuals.

In response, the Legislature adopted a temporary business activities tax in 1933. The tax was to be in place from August 1, 1933 to July 31, 1935. The tax was measured by the application of rates against "value of products," "gross proceeds of sales," or "gross income of the business." The rates varied depending on the type of business activity. The tax rates ranged from 0.5 percent to 3 percent. The business tax applied to a wide range of businesses including public service and utility companies, retailing, wholesaling, manufacturing, professional services, financial and amusement businesses.[149]

The Legislature, meeting in 1935, faced the problems of replacing the revenue previously received from property taxes levied for the state general fund, as well as the state's obligations under the Showalter Act to support common schools, and payment for relief and welfare work. To raise the required revenue, the Legislature enacted the Revenue Act of 1935. The new act supplanted the temporary 1933 act and continued in general effect the business taxes imposed by it. The 1935 act also added several new consumer taxes, including a two percent retail sales tax and a complementary use tax.

The Revenue Act of 1935 consisted of 12 titles, with the business and occupation tax (Title II) clearly separated from the public utility tax (Title V). Initially, there were ten exemptions from the business and occupation tax including business activities already subject to the public utilities tax.[150] With this tax preference, the Legislature created provisions so businesses would not have

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

[149] "Business Tax Instructions," Tax Commission of State of Washington, April 1934.

[150] Business and Occupation tax exemptions in 1935 included the following: minimum income threshold; person whose business activities were subject to the public utility tax; person in the insurance business which had their gross premiums subject to another tax; agricultural producers; person who was conducting boxing and wrestling matches; person in the business of conducting horse race meets; person who was an employee; fraternal benefit societies and fraternal fire insurance associations; person in the business of operating a hospital and amounts derived from the lease, rental or sale of real estate. Reported in "Rules and Regulations Relating to the Revenue Act of 1935" by Tax Commission of the State of Washington April 1, 1936.

the same income subject to both taxes. The original language provided the business and occupation tax exemption for gross income that was subject to the public utilities tax (title V) of the 1935 legislation:

> *The provisions of this title shall not apply to ….*
>
> *(b) Any person in respect to a business activity with respect to which tax liability is specially imposed under provisions of title V of this act;*

The Legislature made minor reference changes to the B&O tax exemption in 1959. A clarifying change to RCW 82.04.310 (1) made in 1989 stated that the B&O tax exemption applied to sales of commodities that were allowed a public utility tax deduction, such as irrigation water, bad debt, cash discounts and others in RCW 82.16.050. Besides these minor changes, this section of law has remained the same since its enactment in 1935.

Business and Occupation Tax

The business and occupation tax is based on gross receipts. Initially in 1935, the tax rates were .25 percent for all businesses except services which were taxed at .5 percent. Over time, the Legislature developed a number of specialized tax rates for particular types of businesses.[151] Under current law, for most companies, the business and occupation tax rates range from 0.13 percent for pari-mutuel wagering to 1.5 percent for service and other activities, hospitals and gambling contests of chance of less than $50,000 per year. The B&O tax rate for manufacturing and wholesaling activities is .484 percent and retailing activities is .471 percent. Otherwise, businesses not covered by another tax rate pay the B&O tax rate of 1.5 percent.[152] The B&O tax does not permit deductions for the costs of doing business, such as payments for raw materials and wages of employees. Any exemptions and deductions from the B&O tax are specified separately in law.

This business and occupation tax exemption for income taxed under the public utility tax is restricted to only income subject to the public utility tax. Public service and utility companies with income earned from business activities not subject to the public utility tax are required to pay the appropriate business and occupation tax rate on that income.

Business and occupation tax collections have grown from $1.85 billion in 1998 to $2.6 billion by 2007. The business and occupation tax was reported by approximately 300,000 firms in fiscal year 2006.[153] These are the firms with business and occupation tax liability (prior to credits).

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[151] "Sixth Biennial Report of the Tax Commission of the State of Washington for the Period Ending September 30, 1936."

[152] Ibid.

[153] 2007 Tax Reference Manual by Washington Department of Revenue.

Exhibit 60 – History of the Business and Occupation Tax Collections: 1998 – 2007

Fiscal Year	Collections ($ millions)	% Change
1998	$1,853.8	7.6
1999	$1,827.5	-1.4
2000	$1,854.9	1.5
2001	$2,012.4	8.5
2002	$1,958.3	-2.7
2003	$1,923.4	-1.8
2004	$2,067.9	7.5
2005	$2,269.1	9.7
2006	$2,477.8	9.2
2007	$2,640.9	6.6

Source: Department of Revenue 2007 Tax Reference Manual and Office of Forecast Council February 2008 forecast report.

Public Utility Tax

The tax base for the public utility tax is gross income from the operation of public and privately-owned utilities and public service companies. Companies provide services in the main areas of transportation and the supply of energy and water. In 1935, there were eight exemptions outlined in the public utility tax.[154] The 1935 legislation imposed four public utility tax rates:

- 3% of gross operating revenue
  - Railroads, water light and power, telephone and telegraph
- 2% of gross operating revenue
  - Gas distribution
- 1.5% of gross operating revenue
  - Highway transportation and all other public service businesses
- 0.5% of gross operating revenue
  - Urban or interurban transportation, vessels under 65 feet in length operating upon Washington waters

[154] Eight public utility tax exemptions in 1935: Minimum monthly threshold of gross operating revenue; Irrigation water; Sales of commodities to other persons for resale purposes; Payment to other persons taxable under public utility tax for service rendered jointly; Taxes received by municipal utilities; Sales and service to federal government and in interstate and foreign commerce; Credit losses; Cash discounts taken by customers; reported in "6th Biennial Report of the Tax Commission of the State of Washington," September, 30 1936.

Currently, there are five public utility tax rates which apply to specific utilities. The public utility tax rates are higher than most business and occupation tax rates on businesses. Companies in the business of distributing water pay the highest rate of 5.029 percent and urban transportation and watercraft vessels under 65 feet pay the lowest rate of .642 percent.

Exhibit 61 – History of the Public Utility Tax Collections: 1998 - 2007

Fiscal Year	Collections ($ millions)	% Change
1998	$211.8	4.2
1999	$221.4	4.5
2000	$246.4	11.3
2001	$267.6	8.6
2002	$274.6	2.6
2003	$269.8	-1.7
2004	$292.8	8.5
2005	$303.8	3.7
2006	$339.9	11.9
2007	$352.9	3.8

Source: Department of Revenue 2007 Tax Reference Manual and Office of Forecast Council February 2008 forecast report.

The public utility tax applies only on sales to consumers. The tax is a state tax only. In recent years, the public utility tax collections have grown from $211.8 million in 1998 to $352.9 million in 2007. The public utility tax is reported by about 5,000 firms annually. Approximately 110 electric companies account for more than 50 percent of the tax liability.

Public Policy Objectives

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

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

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

   Since the Legislature enacted this tax preference in 1935 at the same time as the public utility and business and occupation taxes, one public policy objective of this tax preference was to define the tax base for the business and occupation tax as excluding utility income subject to the public utility tax.

Even though income subject to the public utility tax is exempt from the B&O tax, other business income from non-utility activities is subject to the business and occupation tax.

2) **Avoid Double Taxation:** Having this business and occupation tax preference in place avoids utility income being taxed twice: once under the public utility tax and again under the business and occupation tax.

Is there any documentation on the purpose or intent of the tax preference?

Statute clearly states that utility income subject to the public utility tax is exempt from the business and occupation tax. The statute does not have a specific statement of intent as to why utility income is exempt from the B&O tax. However, allowing gross utility income to be subject to just one statewide tax is common in defining most tax bases in states in order to avoid double taxation.

Washington law is also clear that public utility income should be subject to a single statewide tax and that a public policy objective is to avoid double taxation. The statute has always stated that income from other non-utility related business activities is subject to the business and occupation tax.

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

Since 1935, businesses that pay the public utility tax on utility income have not been subject to the business and occupation tax on that income. Therefore, this tax preference has met its objective of defining the business and occupation tax base. Businesses have been paying the business and occupation tax on non-utility income earned through other business activities. In calendar year 2006, 2,450 taxpayers (35 percent of all public utility taxpayers) paid $70 million in business and occupation tax. This is evidence that the tax preference has been narrowly defined to exempt only utility income from the business and occupation tax. Therefore, this tax preference has achieved the objective of subjecting non-utility income to the business and occupation tax.

For 73 years, public utility taxpayers have been subject to a single tax, the public utility tax, on their utility income. The public policy objective of eliminating double taxation of utility income has been achieved.

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

If continued, this business and occupation tax preference will continue to fulfill the public policy objectives of defining the tax base, avoiding double taxation, and taxing non-utility income.

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 of this tax preference are being fulfilled.

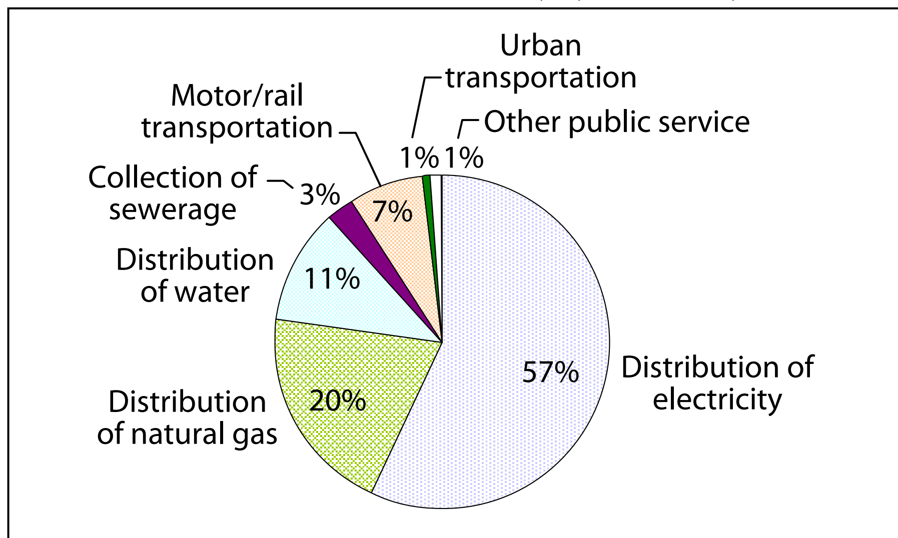
Beneficiaries

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

The beneficiaries of this business and occupation tax exemption are the public service and utility businesses that are subject to the public utility tax on gross receipts. These companies include the following areas: private and municipal utilities, transportation providers, sewerage collection, and distribution of water and energy and other public services.

The number of taxpayers filing excise tax returns with public utility income has grown from 6,169 in 2000 to 7,037 in 2006. These were the primary beneficiaries of this tax preference. In 2006, taxpayers that reported public utility income paid $341 million in utility taxes.

Exhibit 62 – Fiscal Year 2006 Public Utility Tax Collections ($339 million) Breakdown by Type of Utility



Source: Washington Department of Revenue excise tax return database.

Exhibit 63 – Public Utility Tax Payers Distribution by Gross Income - CY 2006

Gross Income Category	Number of Taxpayers	% of Total Taxpayers	Total Tax Paid ($000)	% of Total Tax Paid
> $200 million	11	0.2%	211,694.8	62%
<= $200 million but > $100 million	9	0.1%	17,044.8	5%
<= $100 million but > $50 million	15	0.2%	21,194.3	6%
<= $50 million but > $30 million	19	0.3%	16,657.9	5%
<= $30 million but > $10 million	87	1.2%	26,014.9	8%
<= $10 million but > $1 million	769	10.9%	36,067.1	11%
<= $1 million	6,127	87.1%	12,786.9	4%
Total	**7,037**	**100%**	**341,460.7**	**100%**

Source: DOR excise tax return database.

As exhibit 63 above indicates, 11 companies paying the public utility tax reported more than $200 million in gross income. These large utility companies paid 62 percent of all public utility tax in calendar year 2006 and are the biggest beneficiaries of this business and occupation tax exemption. These large public utility taxpayers, with gross income in excess of $200 million, are primarily electric utility companies.

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

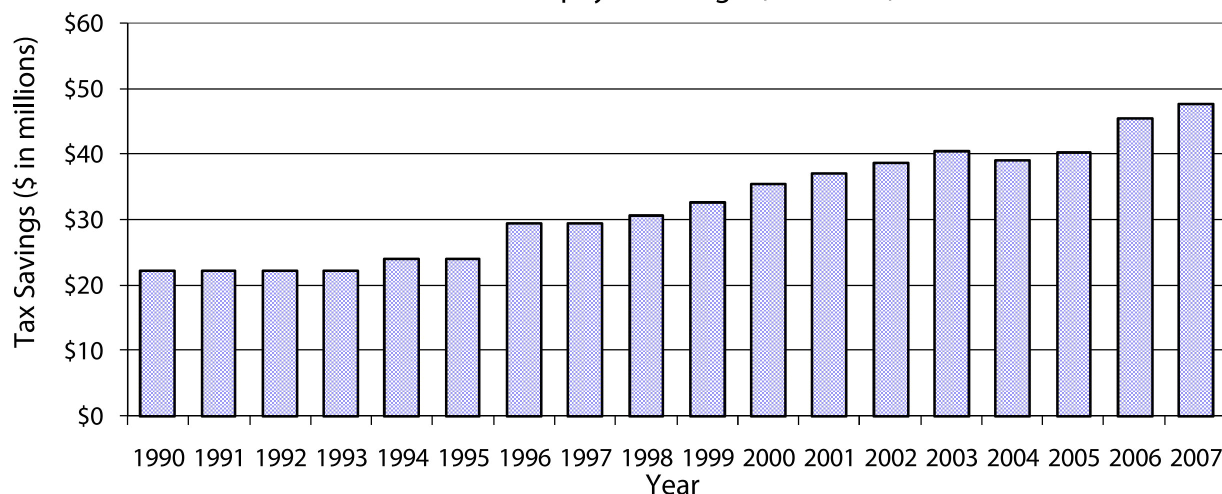
During the course of this tax preference review, there were no unintended beneficiaries of this tax preference identified.

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 Department of Revenue estimated that the utility tax exemption has been growing steadily since the early 1990s. The estimates for the value of this public utility tax exemption have grown from a little more than $20 million in 1990 to $45 million in 2006.

Exhibit 64 – Exemption from Business and Occupation Tax for Public Utilities Income Taxpayer Savings: ($millions) 1990 – 2007



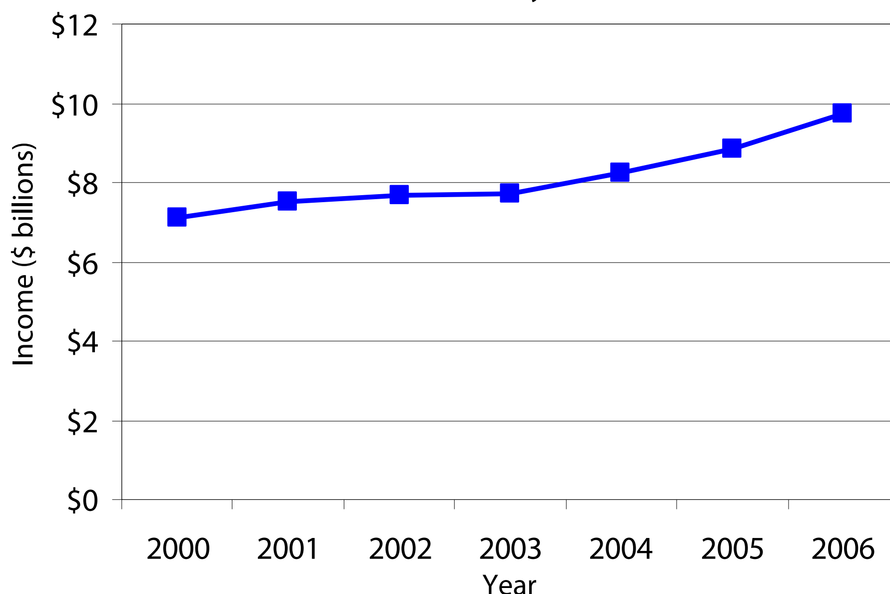
Source: Department of Revenue past Tax Exemption reports and recent excise tax return data.

The Department of Revenue's tax base for this business and occupation tax exemption is taxable utility income of those businesses subject to the public utility tax, as reported in the excise tax return information.[155] Therefore, the chance of duplicating any utility income in multiple tax preferences is minimized.

Taxable utility income has been growing moderately since 2000. Taxable utility income has grown from $7.1 billion in 2000 to $9.7 billion in 2006. The average annual growth rate over this time period was 5 percent.

[155] This assumption of taxable income, and not gross income, takes into account the fact that other estimates for various deductions from the public utility tax are already incorporated in other public utility tax preferences.

Exhibit 65 – Taxable Utility Income Since 2000



Source: Department of Revenue excise tax return database.

JLARC assumed a tax rate of 0.484 percent for this tax exemption. This is a common B&O tax rate and also the tax rate for manufacturing which could apply to large electrical utility companies. The JLARC estimate ranges from approximately $50 million in fiscal year 2008 to $58 million in fiscal year 2011. The taxpayer savings estimate is equivalent to the loss in state and local government revenue from continuing this B&O tax exemption.

Exhibit 66 – B&O Taxpayer Savings from the Utility Income Exemption

Year	Utility Income Deduction Amount ($ millions)	B&O Tax Taxpayer Savings ($ millions)
2006	$9,404	$45.5
2007	$9,874	$47.8
2008	$10,344	$50.1
2009	$10,861	$52.6
2010	$11,404	$55.2
2011	$11,975	$58.0

Source: JLARC based on DOR excise tax returns.

According to the Washington Employment Security Department data for the second quarter of 2007, the utilities industry had 225 firms. In 2006, this sector paid $317 million in total wages. There has been a decline in the number of firms over the past five years, but the average number of employees per firm increased. In 2002, the utilities industry had 242 firms with 4,461 average employees and total wages of $264 million.

The transportation industries had 2,546 firms in second quarter of 2007. The total employee wages were $1.5 billion in 2006. The number of firms has fallen by the past five years, but the average number of employees per firm has grown as well as wages since 2002.

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 Legislature eliminated this business and occupation tax preference and gross income earned by public utility taxpayers was subject to an additional tax, these taxpayers would pay more than $50 million annually in state business taxes. This would include all businesses subject to the public utility tax, including not only large utility companies but also transportation companies. Besides the taxpayers that would directly be impacted from this policy change, other industries would also be indirectly impacted because these businesses would be purchasing less in the state economy from having a higher business and occupation tax to pay.

Exhibit 67 – Businesses Subject to the Public Utility Tax
Production and Percent of Total Value – 2006

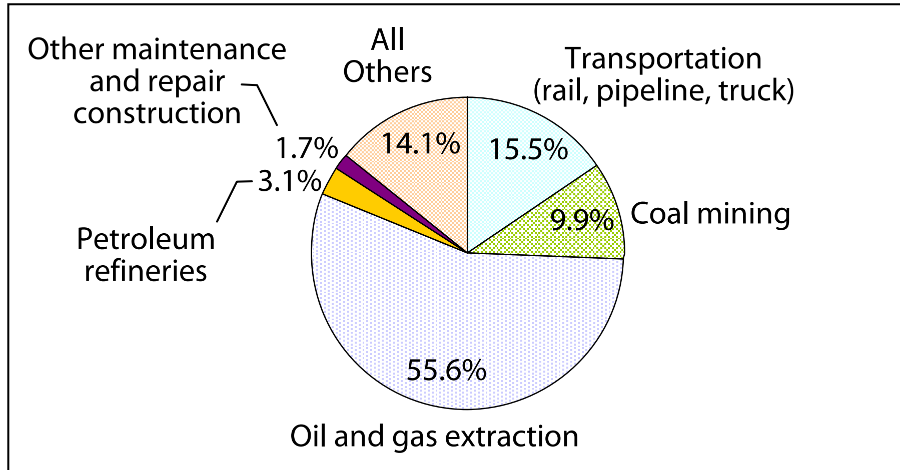
Industry Sector	2006 Commodity Production ($ millions)	Percent of Total Commodity Value
Power generation and supply	$10,834.1	44.8%
Water sewage and other systems	$1,560.2	6.5%
Natural gas distribution	$1,494.2	6.2%
Truck transportation	$4,624.5	19.1%
Scenic and sightseeing transportation	$2,117.4	8.8%
Rail transportation	$1,257.7	5.2%
Transit and ground transportation	$1,136.6	4.7%
Couriers and Messengers	$1,028.8	4.3%
Pipeline transportation	$106.8	.4%
Total =	$24,160.3	100%

Source: Washington IMPLAN 2006.

The $24.16 billion in total production in 2006 for these businesses subject to the public utility tax represents 4.4 percent of total statewide commodity production ($552.9 billion). The utility industries (natural gas distribution, power generation and supply, water-sewerage systems) spend 86 percent of their expenditures on five primary areas. Over half of their expenditures, 55.6 percent, were on oil and gas extraction at $613.9 million. The second largest expenditure category was the transportation sectors such as pipeline and rail transportation at $171.6 million (15.5 percent). Coal mining was the third largest expenditure sector at $109.6 million (9.9

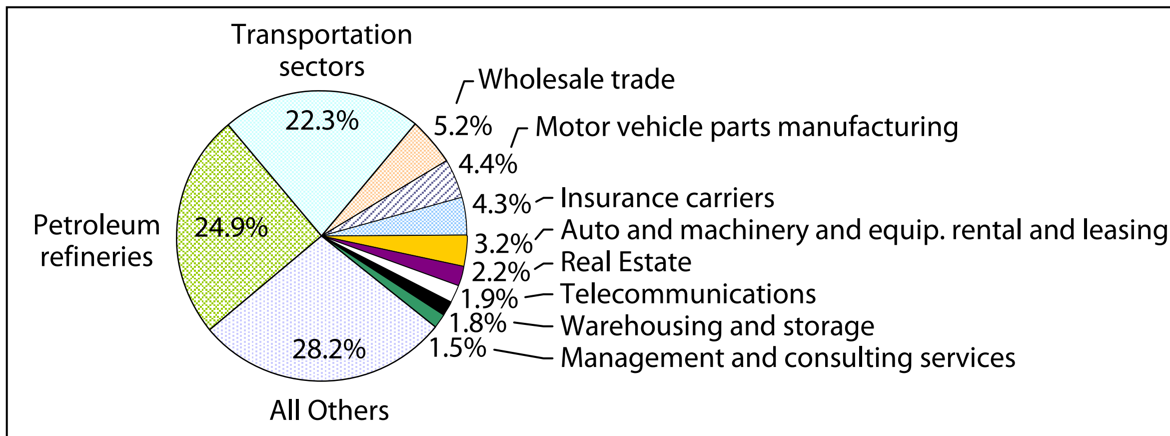
percent). The fourth and fifth largest sectors were the petroleum refineries, (3.1 percent) and other maintenance and repair construction (1.7 percent). These five industry sectors would be impacted from public utility companies having to pay higher business taxes in Washington if this tax preference was eliminated.

Exhibit 68 – 2006 Washington Utilities' Expenditures ($1.1 billion) by Type



Source: Washington IMPLAN 2006.

Exhibit 69 – 2006 Washington Transportation Expenditures ($3.9 billion) by Type



Source: Washington IMPLAN 2006.

Washington's transportation (rail, pipeline, truck, transit and ground passenger, courier and messenger services) sectors' expenditures in 2006 totaled $3.9 billion. The top five expenditure sectors comprised 71.2 percent of all expenditures, and they were in the following areas: petroleum refineries, transportation services, wholesale trade, motor vehicle parts manufacturing and insurance industries. The other remaining categories of expenditures comprised 38 percent of the total. The remaining industries affected by the transportation sectors were quite varied including industry sectors such as tire manufacturing and professional services like management, consulting, and accounting services. These industry sectors would be impacted from certain

transportation companies having to pay higher business taxes in Washington if this tax preference was eliminated.

The value added and employment in the utility and transportation sectors in 2006 represented a small portion of total value added and employment in Washington.[156] The exhibit below indicates that the total value added for the utilities sectors was $1.9 billion and the transportation sectors had $5.6 billion in value added. Their combined value added represented less than 3 percent of all value added in the state in 2006.

The 2006 IMPLAN dataset for Washington employment is based on Washington's share of national employment estimates produced by the U.S. Bureau of Economic Analysis. The number of employees in the utilities sectors was small (5,297), or 0.14 percent of total employees statewide. More than half of these employees were in the power generation and supply industries. In the transportation sectors, there were 81,059 employees, of which 42 percent of all employees (33,913 employees) were in the truck transportation industry. The second largest sector in terms of employees was scenic and sightseeing transportation at 19,580 employees (24 percent of all transportation sector employees), and the third largest sector was couriers and messengers at 13,632 employees (17 percent of all transportation sector employees).

Exhibit 70 – Utilities and Transportation Sectors Paying the Public Utility Tax in 2006: Value Added and Employment

	Value Added		Employment	
	($ millions)	% of Statewide Total	Employees	% of Statewide Total
Utilities	$1,987.8	0.68%	5,297	0.14%
Transportation	$5,650.6	1.9%	81,059	2.1%
Total	**$7,638.4**	**2.6%**	**86,356**	**2.3%**

Source: Washington IMPLAN dataset – 2006.

If the Legislature eliminated this tax preference and utility and transportation companies had to pay $50 million in additional B&O taxes, these companies might pass on the higher tax by charging higher utility and transportation rates on their consumers.

The total tax loss from this tax preference is small compared to Washington's total General Fund state cash receipts of $29.4 billion in the 2007-09 Biennium. There would be minimal economic impact statewide from eliminating this tax preference. All Washington statewide changes to prices, quantity produced or employment would be less than 0.1 percent from the initial base year.[157]

[156] Value Added is the total sales of firms less purchases of inputs from other firms. This remaining value added income can be used for payment of employees' wages and profits to owners.

[157] These economic impact results were based on a computable general equilibrium model for Washington State based on IMPLAN data for 2006.

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 state business and occupation tax, there would be no change in the distribution of tax liability of state 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?

Only one state, Indiana, has a utilities receipts tax in addition to utility income being subject to an income tax. All other states have utility income subject to one statewide tax. In summary, 21 states, including Washington, have a public utility tax, and the other states have an income or franchise tax. JLARC's 50-state survey revealed that having a business and occupation tax exemption for utility income subject to the public utility tax is consistent with most other states that have chosen to tax utility income.

Recommendation

The Legislature should continue the business and occupation tax preference for public utility income.

Legislation Required: None.

Fiscal Impact: None.

TAX RATE FOR URBAN TRANSPORTATION AND VESSELS - SUMMARY

Current Law

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

The public utility tax has several tax rate categories ranging from 0.642 percent to 5.029 percent. This report focuses on the special tax rates for two types of transportation services – urban transportation and vessels under 65 feet in length. The "standard" public utility tax rate for most transportation services is 1.926 percent. This is the rate paid by motor transportation (which the motor vehicle transportation of persons and property for hire, other than "urban transportation"), railroads, airplane transportation of property, tugboats, and water transportation businesses conducting business in vessels 65 feet or more in length. Current law provides a lower tax rate of 0.642 percent to two categories of transportation services:

- Urban transportation businesses; and
- Vessels under 65 feet in length, except tugboats, operating upon the waters within the state.

"Urban transportation business" means the business of operating any vehicle for hire in the conveyance of persons or property operating entirely (a) within the corporate limits of any city or town or within five miles of the corporate limits, or (b) within and between cities and towns whose corporate limits are not more than five miles apart or within five miles of the corporate limits of either.

See Appendix 3 for the current law statute RCW 82.16.020(1)(d) and (e) which provides the special tax rates and RCW 82.16.010 which provides the definition of "urban transportation business" and "motor transportation business."

Findings and Recommendations

This review evaluated the legal history, public policy objectives, economic and revenue impacts, and other states' tax preferences of the public utility tax preferential rates for urban transportation businesses and for vessels under 65 feet in length. The audit determined the following:

Legal History and Public Policy Objectives

- The Legislature, faced with a revenue shortfall in 1933, adopted a temporary business activities tax. The general tax rate for transportation service companies was 1.5 percent. The Legislature provided a lower rate of 0.5 percent to electric interurban railways, street railways, and all passenger automotive transportation systems operating entirely within a city or contiguous cities.
- The Legislature adopted a permanent public utility tax in 1935. Highway transportation and other public service businesses subject to state regulation such as airplane transportation, water transportation, and ferries had a tax rate of 1.5 percent. Urban or interurban transportation and vessels under 65 feet in length had a lower tax rate of 0.5 percent. Urban transportation included street cars, electric interurban railways, and the business of conveying passengers for hire within cities, contiguous cities, or within three miles of such cities. This latter category meant primarily busses and taxicabs.
- Street cars and interurban railways had significant financial difficulties in the 1930s. The Seattle Electric Railway Company, purchased by the City of Seattle in 1919, had been losing money when it was purchased and continued to lose money in the 1930s. With improved city streets and new highways, competition developed from busses and motor vehicles. The street cars and interurban railways were gone by the end of the 1930s.
- Water transportation companies also had financial difficulties. As a whole these companies were losing money from 1931 through 1935 and service to the public was suffering.
- In 1949, the Legislature, while removing the terms "street railways" and "electric interurban railways" from the definition of "urban transportation," expanded on the definition by providing that the term meant the conveyance of persons or property for hire within the city limits or five miles of the limits or within and between cities whose limits are not more than five miles apart.
- The current tax rate for urban transportation and vessels under 65 feet in length is 0.642 percent. The current tax rate for other forms of transportation services, such as motor transportation, railroads, airlines transporting freight, tugboats, and water transportation in vessels 65 feet or longer is 1.926 percent.
- The initial public policy objective in 1933 and 1935 of providing a lower tax rate to urban transportation may have been in recognition of the financial difficulties of the street cars and interurban railways at that time. Since 1935, street cars and interurban railways have disappeared (until recently with the appearance of Sound Transit and new streetcars in Seattle and Tacoma). The public policy objective of expanding the definition of urban transportation in 1949 is unclear.
- The initial public policy in 1935 of providing a lower tax rate to water transportation being conducted in vessels under 65 feet length may have been due to the overall financial difficulties of water transportation companies at that time. Since then, water

transportation has become less important as a private industry, and the state has purchased the ferry system.

Beneficiaries

- The beneficiaries of the lower public utility tax rate for urban transportation and vessels under 65 feet in length are 2,015 taxpayers. These taxpayers are mostly in the businesses of freight hauling, busses, taxicabs, limousine services, commuter transit systems, parcel delivery services, and local messenger services. There are 17 water transportation companies that operate vessels under 65 feet in length.

Revenue Impacts

- The tax savings to these companies paying a public utility tax rate of 0.642 percent rather than the general transportation tax rate of 1.926 percent was $6.2 million in fiscal year 2007.
- By 2011, the tax savings is expected to increase to $9.0 million.
- The economic impact of the tax rate is difficult to discern because companies in the same industrial sector can pay at different rates depending on where the transportation activity takes place, and in the case of water transportation, the size of the vessel.

Recommendation

The Legislature should review the policy of taxing transportation related business activity at different public utility tax rates based on where a transportation service takes place or the size of a vessel in which the service is conducted.

Legislation Required: Yes, if changes are desired.

Fiscal Impact: Variable, depending on the extent of changes.

TAX RATE FOR URBAN TRANSPORTATION AND VESSELS – REPORT DETAIL

Statutory History

1933

The Legislature faced a revenue shortfall is as it convened in January 1933. The prior November, the voters had passed Initiative Measure No. 64, a 40-mill property tax limit bill. The initiative limited property tax levies for state purposes to a maximum of five mills on a 50 percent valuation.[158] This measure effectively reduced the income from state taxes by approximately 50 percent, beginning with the second year of the 1933-35 Biennium. Assessed valuations and levies were already reduced due principally to the depressed economic conditions of the time. The Legislature also adopted in 1933 the Showalter Bill, a measure increasing, by about two-thirds, the state's obligation to support local school districts. The voters passed another initiative in 1932, Initiative Measure No. 69, imposing a state income tax on all corporations and individuals.

In response to the state's revenue predicament, the Legislature adopted a temporary business activities tax in 1933. It was to be in place from August 1, 1933 to July 31, 1935. The tax rates on public service and utility activities ranged from 0.5 percent to 3 percent. Utilities, such as light and power companies, water companies, and telephone and telegraph companies, were taxed at 3 percent. Steam railways, passenger and freight highway transportation companies, and other public service companies such as aeroplane transportation companies, toll-bridge companies, ferry operators, and water transportation companies had a tax rate of 1.5 percent. Electric interurban railways, street railways, and all automotive transportation systems operating entirely within the limits of any city or town or contiguous cities or town had a lower tax rate of 0.5 percent.

Generally, public service and utility companies were subject to state regulation of rates or state supervision or control. They were required to serve all who demanded the service rendered, the "right to refuse to serve being dependent solely upon limitations of capacity and obnoxious character of the person or property involved."[159] The Department of Public Works[160] exercised regulatory authority over telephone and telegraph companies, light and power companies, water and irrigation companies, gas companies, docks, warehouses, ferries and other water freight and passenger transportation companies, railroads, street railways, auto passenger and freight transportation companies, and all trucks engaged in transporting property outside city limits for compensation. The 1933 Legislature extended the jurisdiction of the Department to cover what

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

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

[160] A forerunner agency to the present Utilities and Transportation Commission.

was estimated to be approximately 20,000 motor trucks operating in the state outside of city limits as certified carriers, contract haulers, for hire carriers, or private carriers. Ten electric railroads filed reports with the Department in 1933. Tugboats were not regulated by the Department of Public Works and were taxed under other statutes.

1935

The revenue shortfall continued into 1935. The state Supreme Court found the graduated net personal and corporate income tax adopted by the voters in 1932 to be unconstitutional.[161] At the general election in 1934, voters again passed the 40-mill limit.[162] This 1934 initiative further reduced the state levy from five mills to two mills, exclusively for the institutions of higher education. The Legislature, meeting in 1935, faced the problems of replacing the revenue previously received from property taxes levied for the state general fund, as well as the state's obligations under the Showalter Act to support common schools and payment for relief and welfare work. To raise the required revenue, the Legislature enacted the Revenue Act of 1935. The new act supplanted the temporary 1933 act and continued in general effect the business taxes imposed by it. The Legislature called the portion of the tax dealing with public services and utilities the "public utility tax." The tax base for the public utility tax is gross income from the operation of public and privately-owned utilities and public service companies. Utility and public service companies provide services in the areas of energy, water, communications, and transportation. The original legislation included four public utility tax rates:

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

The Legislature provided urban or interurban transportation businesses a tax rate that was one-third that of most other transportation businesses. The term "urban or interurban transportation business" meant 1) the business of operating any railroad for public use in the conveyance of

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

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

people or property for hire, being mainly on, along, above, or below any street within one city or town; 2) the business of operating any electric interurban railroad for public use in the conveyance of persons or property for hire primarily between cities or towns; or 3) the business of operating any motor propelled vehicle for public use in the conveyance of persons (but not property), operating within the limits of any city or town or within the limits of contiguous cities or towns. The term included busses and taxicabs operating entirely within the limits of any city or town, or in contiguous cities or towns or within three miles of such limits.

The Legislature also provided vessels under 65 feet in length a tax rate that was one-third the rate of other vessels and most other transportation businesses. "Vessels under 65 feet in length" meant every person engaging in the business of operating upon the waters of the state any vessels under 65 feet in length that were are common carriers regulated by the Department of Public Service.[163]

Highway transportation companies operating outside of city limits were regulated by the Department of Public Service and paid the public utility tax at 1.5 percent. Highway transportation companies were taxable under the business and occupation tax at a rate of 0.5 percent upon income from hauling or transporting property (but not persons) wholly within the limits of a city or town.

The business of operating tugs, towboats, scows, barges, or lighters that were not common carriers and were not regulated by the Department of Public Service were taxable under the business and occupation tax at a tax rate of 0.5 percent.

The Temporary Business Activities Tax of 1933 and the Revenue Act of 1935 imposed new taxes on businesses. In setting the tax rates for the public utility tax, the Legislature may have given consideration to the type of utility or public services business, the regulation of the industry, the ability of the businesses to pass the tax on to their customers, and the economic health of the industry. There is evidence that the urban and interurban transportation business was undergoing dramatic changes with electric railways and street cars going out of business and that waterborne commerce faced serious financial difficulties.

Financial Status of Urban and Water Transportation in the 1930s

Urban Transportation Systems

Streetcars, street railways, trolleys, cable cars, and electric interurban railways were all early forms of urban transportation systems. Horse-drawn streetcars, street railways, cable cars, and electric streetcars all appeared in Northwest cities in the 1880s. Fares were a nickel.

An interurban streetcar system between Tacoma and Steilacoom began in 1890 soon followed by an interurban railroad between Seattle and Renton. Interurban rail service between Seattle and Tacoma began in 1902; between Seattle and Everett in 1910.

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[163] The Department of Public Service is the successor agency to the Department of Public Works and a predecessor to the Utilities and Transportation Commission.

Electric interurban railways played a major part in defining early transportation routes. Early roads were primitive, and most shippers and commuters in the Puget Sound region relied on water transportation and the "Mosquito Fleet" steamers for mobility.[164]

A national cartel, the Stone and Webster Management Company, acquired many urban utilities and transportation systems across the country. They began taking control of Northwest utilities and street railways at the turn of the century. They formed the Seattle Electric Railway Company to run street railways in Seattle, and the Puget Sound Traction, Light & Power Company, a forerunner to today's Puget Sound Energy, to develop interurban railways from Seattle to Tacoma and from Seattle to Everett.

The Seattle Electric Railway Company lost money (due to mandated nickel fares) and was sold to the City of Seattle in 1919. By 1936, the Municipal Street Railway had run up a $4 million deficit and still owed half of the principal on the 1919 bonds sold to purchase the street railways. Seattle eventually went to "trackless trolleys" and motor busses.[165]

Federal anti-trust rulings dissolved the Stone and Webster cartel in 1934, and the Puget Sound Power & Light Company was reorganized under local control.

In the end, electric street and interurban lines were a technological steppingstone between steam railroads and the earliest motor vehicles.[166] From the late 1930s to the early 1940s, the interurban railways and streetcars were eliminated by competition from private automobiles, busses, and trucks. The condition of city streets improved, and new highways were built. In the early 1930s, there were unmistakable indications that the days of street car transportation were numbered. Busses were replacing street cars on existing routes, and bus service had taken the place of street railways on new extensions.

The Seattle-Tacoma interurban ended service in 1928 with the completion of Highway 99 between the two cities. The other interurban railways around Tacoma going to Steilacoom and American Lake were gone by the mid-1930s. In Spokane the conversion to busses started about 1932 and was completed in 1936. The Seattle-Renton interurban folded in 1937. The Seattle-Everett interurban ended service in 1939. Seattle ripped up its streetcar lines in 1941.[167]

Financial Status of Water Transportation Businesses

The Department of Public Service reported in 1936 on the poor condition of waterborne commerce in the state. Transportation services performed by steamboat companies on Puget Sound had become a major problem. Complaints were lodged with the Department concerning the lack of service, unsatisfactory service, interruptions in schedules, and discontinuance of schedules. The situation respecting ferries had become so acute that demand was growing for

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[164] "Interurban Rail Transit in King County and the Puget Sound Region," Walt Crowley, September 2000 (found at www.historylink.org/essays).

[165] "Street Railways in Seattle," Walt Crowley, October 2000 (found at www.historylink.org/essays).

[166] "The Electric Railway Era in Northwest Washington 1890-1930," D. E. Turbeville, Center for Pacific Northwest Studies, Western Washington University, 1978.

[167] With the steel to be used in the war effort.

state ownership and operations. Not all ferry routes on Puget Sound were self-supporting. The matter of ferry service presented a social as well as an economic problem. The islands in the Puget Sound and the Olympic Peninsula desired increased ferry service at less cost for development. Freight service on Puget Sound had also been a perplexing problem.

Overall, the water transportation companies regulated by the Department of Public Works had reported losing money for a number of years. The companies as a group had operating expenses exceeding operating revenues every year from 1931 through 1935. Revenues had peaked in 1929 at almost $3.4 million. By 1935 revenues had fallen by over $900,000 to slightly more than $2.4 million. Expenses did not decline as fast.

The state eventually took over the ferry system in 1951.

Additional Statutory History

1937

In 1937, the Legislature removed the term "interurban" from the tax category calling it just "urban transportation business." The term "urban transportation business" was defined to include any electric interurban railroad operated primarily for the purpose of transporting passengers when the distance between the terminals did not exceed 50 miles.

1943

In 1943, the Legislature expanded the definition of "urban transportation business" to include the business of operating any vehicle for hire in the conveyance of not only persons, but also property. The operation needed to be within the limits of any city or town or contiguous cities or towns or within five miles of the corporate limits of either (up from three miles). The definition included the business of operating passenger vehicles of every type and also the business of operating cartage, pick-up, or delivery services, including in such services the collection and distribution of property arriving from or destined to a point within or without the state.

1949

The Legislature adopted the current definition of "urban transportation business" in 1949 at the request of the State Tax Commission. References to railroads operating on streets within a city and to electric interurban railroads were dropped. The new definition included the business of operating vehicles for hire in the conveyance of persons or property (a) within the corporate limits of a city or town, or within five miles of the limits, or (b) within and between cities and towns whose corporate limits are not more than five miles apart. The definition still included the businesses of operating passenger vehicles of every type and also the business of operating cartage, pick-up, or delivery services, including such services as the collection and distribution of property arriving from or destined to a point within or without the state.

1965

The Legislature brought tugboats under the public utility tax at the motor transportation and other public service business tax rate of 1.5 percent. Previously they paid the B&O tax at a rate of 1 percent. Tugboats were specifically excluded from the special rate for vessels under 65 feet in length of 0.5 percent.

Current Tax Rates

Over the years, the Legislature has increased the public utility tax rates. Currently, the tax rate for motor transportation and other public service businesses is 1.926 percent. The tax rate for urban transportation and vessels under 65 feet in length is now 0.642 percent.

Other Information

Urban and Motor Transportation

"Urban transportation" means the conveyance of persons or property for hire (a) within the corporate limits of any city or town, or within five miles of such corporate limits, or (b) within and between cities and towns whose corporate limits are not more than five miles apart, or within five miles of such corporate limits. "Motor transportation" means the conveyance of persons or property for hire, except urban transportation.

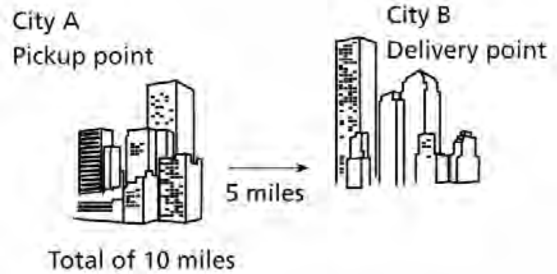
To determine if transportation of persons or property is urban or motor transportation, the taxpayer must look at the pickup and delivery points to determine the correct classification. For example, a delivery from Tumwater to Olympia is urban transportation as the cities have a common border. A delivery from Tumwater to Lacey (which borders on Olympia) can be either (a) urban transportation if the delivery point in Lacey is within five miles of the Olympia city limits, or (b) motor transportation if the delivery point in Lacey is outside five miles of the Olympia city limits.

A single business may conduct more than one activity. For example, a package delivery service may conduct both urban transportation and motor transportation on the same route, depending on the pickup and delivery points. A taxicab may conduct urban transportation on one trip and motor transportation on another. A water transportation company may own several vessels, some less than 65 feet in length and some over. For tax purposes, these business activities need to be separated.

Examples: Urban Transportation

Example 1

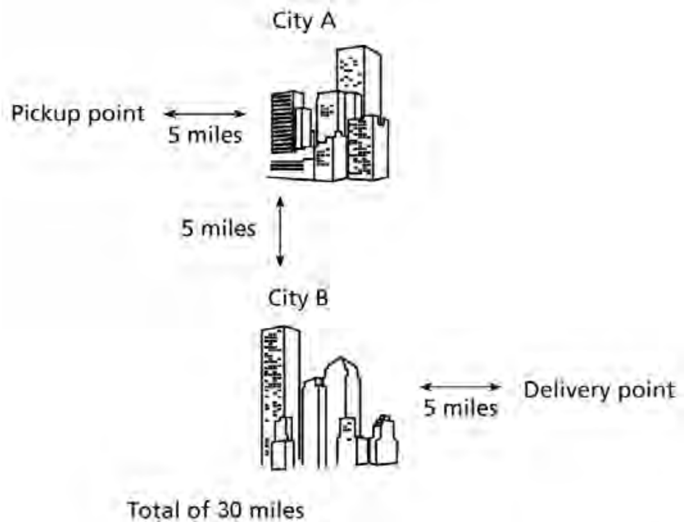
Speedy Trucking is hired to transport property from a location in City A to a location in City B. The total mileage between the pickup point and the delivery point is ten miles. City B is within five miles of the corporate limits of City A.



The urban transportation tax applies because the corporate limits of City A and City B are within five miles of each other.

Example 2

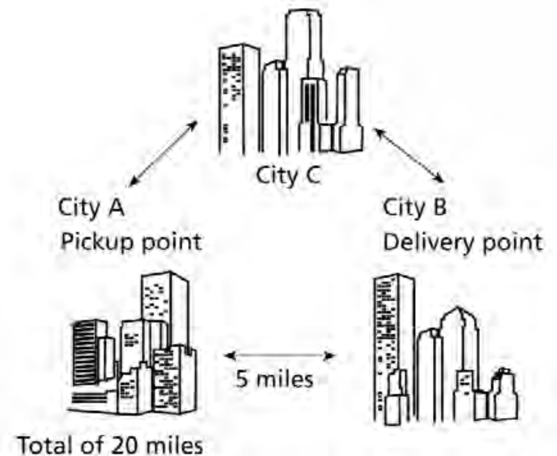
Speedy Trucking is hired to transport goods from a point five miles outside of City A, to a point five miles outside of City B. The total mileage between the pickup point and delivery point is thirty miles. City B is within five miles of the corporate limits of City A.



The urban transportation tax applies because the corporate limits of City A and City B are within five miles of each other, and the pickup and delivery points are within five miles of the city limits of City A and City B.

Example 3

Speedy Taxi is hired to transport Mr. Jones from City A to City B. The total mileage between the pickup point and delivery point is twenty miles. However, Speedy' route will also take Mr. Jones through City C. City B is within five miles of the corporate limits of City A, as the crow flies.

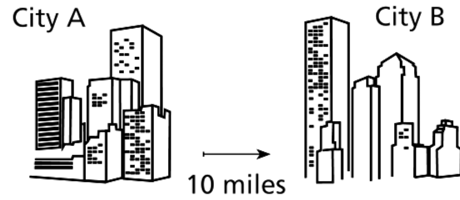


The urban transportation tax applies because the corporate limits of City A and City B are within five miles of each other.

Examples: Motor Transportation

Example 4

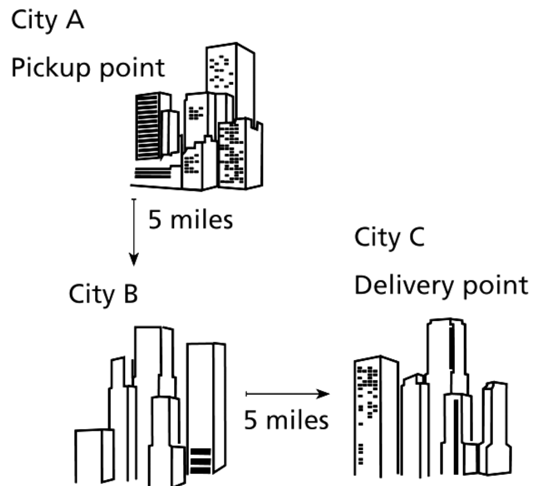
Speedy Trucking is hired to transport goods from City A to City B. The total mileage between the pickup point and delivery point is 15 miles. There is ten miles between the corporate limits of City A and City B.



The motor transportation tax applies because the corporate limits of City A and City B are more than five miles apart.

Example 5

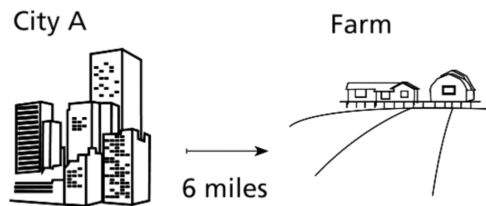
Speedy Trucking is hired to collect office furniture in City A and then deliver it to City C. The total mileage from the pickup point to the delivery point is twenty miles. The carrier will use a direct route from City A, through City B, and deliver the goods in City C. City B's corporate limits are within five miles of both City A and C.



The motor transportation tax applies because the corporate limits of City A and City C are more than five miles apart.

Example 6

Speedy Trucking is hired to transport goods from City A to a farm six miles outside of City A.



The motor transportation tax applies because the destination is not within five miles of the corporate limits of City A.

Source: "Washington State Tax Guide – Trucking," Department of Revenue.

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?

When the Legislature enacted the temporary business activities tax in 1933 and the Revenue Act in 1935, it was imposing new taxes. As these were new taxes, the Legislature could set the tax base and tax rates. The legislature created a new public utility tax on public service and public utility activities. Generally public service and utility companies were subject to state regulation of rates or state supervision or control.

The Legislature selected several rate categories for the new public utility tax. A rate of 1.5 percent (currently 1.926 percent) was provided to highway transportation companies and other public service companies such as airplane transportation, water transportation (operating vessels over 65 feet in length), and public warehouse businesses. The state regulated all trucks engaged in transporting property outside city limits for compensation as well as the other public service companies.

The Legislature provided a lower rate of 0.5 (currently 0.642 percent) to urban transportation and to vessels under 65 feet in length. This may have been in recognition of the financial difficulties of both the urban transportation systems such as street cars and interurban railways and the water transportation companies. For urban transportation, the Legislature provided a similar rate to the competition of the street cars and interurban railways – the busses and taxicabs.

During the time when these preferential tax rates were imposed, they achieved the public policy objective of assisting several transportations service sectors faced with financial hardships. Given the fact that modes of urban and water transportation have changed over the years, the evidence for whether this tax preference continues to achieve their initial purposes is unclear.

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

The street cars and interurban railways have disappeared.[168] The Legislature expanded the definition of urban transportation in the 1940s to include the business of operating any vehicle for hire in the conveyance of not only persons, but also property, and the operating area from within city limits to areas within five miles of the corporate limits or within and between cities whose corporate limits are not more than five miles apart. The public policy of the expanded definition is unclear.

The distinction between operating vessels less than and more than 65 feet in length remains in statute even though watercraft transportation is no longer as significant as it had been before the improvements in the state highway system and the state takeover of the ferry system.

[168] Street cars have recently reappeared in Tacoma and Seattle.

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

The initial objective of providing lower tax rates to transportation companies in financial difficulty – street cars, interurban railways, and water transportation – is no longer relevant. Today, the purpose for a distinction between urban transportation being within five miles of a city or town or between cities and towns with five miles of each other and motor transportation operating more than five miles from a city or town is unclear.

Similarly, the purpose today for imposing different tax rates based on a vessels length is unclear.

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

Modification of the tax preference would be dependent on what, if any, clarification was made by the Legislature about this tax preference's policy objective.

Beneficiaries

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

Public service firms in the business of conducting urban transportation of freight or passengers or water transportation operating with vessels less than 65 feet in length are the beneficiaries of the reduced public utility tax rate of 0.642 percent. Public service firms in businesses such as motor transportation, rail transportation, air freight transportation, or water transportation in vessels over 65 feet in length, or water transportation support activities (i.e., tugboats) are taxed at 1.926 percent of their gross income. A firm can conduct business in several activities and can pay taxes at different rates on the gross income earned in each activity. A firm can make deliveries of freight and passengers within the corporate limits of a city (urban transportation) and also make deliveries outside of five miles of a city (motor transportation) and pay two different rates. Similarly, a firm can operate several vessels, some under 65 feet in length and some over, paying different rates depending on the size of the vessel.

Exhibit 71 – Number of Taxpayers by Tax Rate, FY 2007

Primary Business Description	Pay Only 0.642% Tax Rate	Pay Both 0.642% and 1.926% Tax Rates	Total Paying 0.642%	Pay Only 1.926% Tax Rate
Truck Transportation	399	340	**739**	2,806
Ground Passenger Transportation and Transit	474	69	**543**	121
Water Transportation	15	2	**17**	16
Couriers and Messengers	198	61	**259**	212
Other Transportation	21	20	**41**	168
All Other Industries	261	155	**416**	1,158
Total	**1,368**	**647**	**2,015**	**4,481**

Source: Department of Revenue excise tax returns.

In fiscal year 2007, 1,368 taxpayers conducted all of their business activity either as urban transportation or vessels under 65 feet in length. Another 647 taxpayers conducted some business activity at the 0.642 percent rate and other business activity at the 1.926 percent rate. The total number of beneficiaries of the lower tax rate for urban transportation and vessels under 65 feet in length is 2,015 taxpayers.

Of the 2,015 taxpayers benefitting from the lower tax rate, 739 were in the freight hauling business. Taxicabs, limousine services, busses, and commuter transit systems comprised 543 taxpayers. Parcel delivery services and local messenger services numbered 259 taxpayers. The number of water transportation firms that operated vessels less than 65 feet in length came to 17.

Another 4,481 taxpayers reported business activity only at the 1.926 percent rate. This rate includes motor transportation, railroads, and other public services.

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

For businesses that provide multiple services – both urban and motor transportation or water transportation in vessels under and over 65 feet in length – good records need to be maintained to distinguish the type of service and the applicable tax rate. Auditing such firms can sometimes be difficult since the pick-up or destination point of a package or passenger and that point's relation to the city limits determines the tax rate of the transaction. However, absent conducting detailed audits of each business that provides multiple activities, JLARC has no evidence that there are unintended beneficiaries of this tax 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?

If the businesses that conducted urban transportation or water transportation in vessels under 65 feet in length were to pay taxes at the general transportation rate of 1.926 percent rather than the lower rate of 0.642 percent, the additional revenues to the state would have been $6.2 million in 2007. Of this amount, $200,000 would have been from water transportation companies and the remainder from the urban transportation of hauling of freight and passengers and the delivering of packages.

Exhibit 72 – Tax Savings from Preferential Tax Rate for Urban Transportation and Water Transportation in Vessels Under 65 Feet in Length ($ in millions)

Fiscal Year	Taxable Income	Tax At 0.642%	Tax At 1.926%	Tax Savings
2007	$478	$3.0	$9.2	$6.2
2008	$528	$3.4	$10.2	$6.8
2009	$581	$3.7	$11.2	$7.4
2010	$639	$4.1	$12.3	$8.2
2011	$703	$4.5	$13.5	$9.0

Source: FY 2007 from Department of Revenue; forecast JLARC analysis.

The economic impact of the tax preference for urban transportation and vessels under 65 feet in length is difficult to determine. Companies in the truck transportation, ground passenger transportation, couriers, and messenger sectors can provide multiple services. Some may only do urban transportation while others may only do motor transportation, and still others do both. Companies in other sectors, such as agriculture or construction, can also engage in urban transportation, motor transportation, or both. The gross income of all firms conducting urban transportation totaled $640 million in fiscal year 2007.[169] The gross income of all firms conducting motor transportation, railroads, or other public services totaled $4.6 billion in fiscal year 2007.

[169] "Gross income" is distinct from "taxable income" and is before allowable deductions are taken, such as income earned from interstate activities.

Exhibit 73 – Gross Income of Firms Conducting Urban and Motor Transportation, FY 2007
($ in millions)

Primary Business Description	**Urban Transportation**	**Motor Transportation, Railroads, or Other Public Service Businesses**
Truck Transportation	$206	$3,032
Ground Passenger Transportation and Transit	$195	$134
Couriers and Messengers	$99	$168
Other Transportation	$27	$578
All Other Industries	$113	$681
Total	**$640**	**$4,593**

Source: Department of Revenue.

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

The businesses most affected by a change in tax rates for urban transportation would be intra-city trucking firms, busses, taxicabs, limousine services, parcel delivery firms, and messenger services.

Given the relatively small size of the tax preference, terminating the tax preference would not have any significant impact on employment in the statewide economy.

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 tax preference for urban transportation and vessels under 65 feet in length would result in increased public utility taxes of $6 million to $9 million per year. This is about 2 percent of total public utility tax revenues that are forecasted to be $350 million to $430 million per year. All General Fund taxes are expected to generate from $14 billion to $16 billion per year over the next several years.

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 individual states have a wide variation in tax systems. In most states the primary tax on business is a net income tax. In these states there is no distinction between urban and motor transportation, as all businesses within a net income category or ownership category (corporation, partnership or sole proprietor) pay the same tax rate. Washington's primary taxes

on businesses are the business and occupation tax and the public utilities tax. These are gross receipts taxes similar to a vendor paid sales tax.

Washington appears to be the only state that distinguishes between urban transportation and motor transportation. Rhode Island has a gross receipts tax on common carriers, street railways, and railroads. Four states – Arizona, Hawaii, Idaho, and Oklahoma – subject transportation services to the sales tax. Oklahoma exempts the transportation of passengers within a city from the sales tax, except when it is done by taxi. Two states distinguish between freight and passenger transportation services. Ohio and Wyoming tax passenger transportation services and exempt freight transportation. Three states – Iowa, New Jersey, and South Dakota – tax limousine services. Charter and sightseeing services are subject to the sales tax in Georgia and West Virginia. Twenty-seven states (including Washington and the District of Columbia) do not have a sales tax on transportation services.

Recommendation

The Legislature should review the policy of taxing transportation related business activity at different public utility tax rates based on where a transportation service takes place or the size of a vessel in which the service is conducted.

Legislation Required:	Yes, if changes are desired.
Fiscal Impact:	Variable, depending on the extent of changes.

ITEMS USED IN INTERSTATE COMMERCE – SUMMARY

Current Law

The statute under review in this performance audit is a retail sales tax exemption specific to air, rail, and water transportation companies. Current law exempts the sale of items of tangible personal property, such as fuel or food (but not airplanes, trains, or vessels), to air, rail, or water private or common carriers to be used in interstate or foreign commerce from the retail sales tax. Any actual use of these items in this state is subject to the use tax. See Appendix 3 for the current law statute RCW 82.08.0261.

The retail sale of transportation equipment (i.e., airplanes, trains, and vessels) for use in conducting interstate or foreign commerce is exempt from the retail sales tax under another statute (RCW 82.08.0262) not under JLARC review at this time.[170]

Findings and Recommendations

This review evaluated the legal history, public policy objectives, economic and revenue impacts, and other states' similar tax preferences of the retail sales tax exemption for items used in interstate commerce. The audit determined the following:

Legal History and Public Policy Objectives

- The Legislature imposed the retail sales tax and the use tax in 1935. The retail sales tax generally applies to the retail sale of tangible personal property and certain services. The use tax is a companion tax to the retail sales tax and applies to taxable items used within the state, if the retail sales tax has not been paid.
- Under the initial 1935 rules of the State Tax Commission, the retail sales tax applied to the sales of coal and other tangible personal property sold to steamships, if the property was not resold by the steamship. Sales of foodstuffs for use in furnishing meals to

[170] In addition, there are several other sections of law that have similar exemptions, and these will be reviewed separately by JLARC in the future. These include:
RCW 82.12.0254 – The use tax does not apply to the use of any airplane, locomotive, railroad car, or watercraft used primarily in conducting interstate or foreign commerce or used in commercial deep sea fishing operations;
RCW 82.08.0263 – The retail sales tax does not apply to sales of motor vehicles and trailers to be used for the purpose of transporting persons or property for hire in interstate or foreign commerce;
RCW 82.08.0264 – The retail sales tax does not apply to sales of motor vehicles, trailers, or campers to nonresidents of this state for use outside of this state; and
RCW 82.04.433 – The business and occupation tax does not apply to receipts from the sale of fuel for consumption outside of the waters of the U.S. by vessels engaged in foreign commerce.

passengers and crew, and sales of tangible property for resale on board the vessel were considered sales for resale and were not subject to the retail sales tax. However the sales of meals and other tangible personal property by the steamship were subject to the retail sales tax when the sales occurred within the state.

- Under several decisions made by the U.S. Supreme Court with regards to the interstate commerce clause of the U.S. Constitution:
  - A state could impose a sales tax on the in-state sale of gasoline used in conducting interstate commerce, even if the use of the fuel occurred outside of the state; and
  - A state could not impose a use tax on the use of gasoline purchased outside of the state and used as fuel in a vessel engaged in interstate commerce.
- In 1947, the State Tax Commission proposed and apparently implemented a new policy regarding the collection of retail sales taxes on fuel sold to ocean-going vessels. The policy consisted of:
  - The purchaser of fuel is required to furnish the seller with an estimate of the portion of each sale of fuel oil that will be consumed in Washington;
  - The retail sales tax is to be collected on that portion of the sale; and
  - The balance of the fuel oil sold may be handled as an export and no retail sales tax will be payable.
- The new 1947 policy on the treatment of sales of fuel oil to ocean-going vessels conflicts with the Tax Commission rule at the time, that the sales of fuel to vessels operating in interstate and foreign commerce, if the fuel was not resold, is a sale at retail and the retail sales tax must be paid.
- In 1949, the Legislature passed Tax Commission request legislation that exempted from the retail sales tax the sale of tangible personal property to carriers by air, rail, or water engaged in interstate or foreign commerce. The use tax applied to any property actually used in Washington. This legislation essentially put into statute the 1947 policy of the Tax Commission – use tax on items consumed in Washington and no retail sales tax on items consumed outside-of-the-state.
- The nature of this 1949 exemption is clear. It provides a retail sales tax exemption on the sale of fuel and other tangible personal property to airlines, railroads, and vessels engaged in interstate or foreign commerce. However, the public policy purpose is not clear. The 1947 policy of the State Tax Commission is uncharacteristic of the Commission as the policy change does not appear to be mandated by the courts, the Legislature, or federal law.
- Since the public policy purpose of the tax exemption is not known, it is not possible to determine whether the public policy objective is being met.

Beneficiaries

- The beneficiaries of the retail sales tax exemption are airlines, railroads, and vessels engaged in interstate or foreign commerce. This could be as many as 115 air transportation companies, 67 water transportation companies, and two rail transportation companies benefiting from the exemption. There are 66 air, water, and rail transportation companies that directly paid use tax to the Department in 2007.

Revenue and Economic Impacts

- Expenditures on jet fuel in Washington came to $1.5 billion in 2006. State and local retail sales tax on the estimated amount of fuel consumed outside of Washington would have been $100 million. In addition, sales of fuel to the other modes of transportation and sales of food and other items could account for anther $10 million in taxpayer savings.
- The price of jet fuel is forecasted to increase by 18 percent per year in the next several years. The fiscal impact could exceed $200 million by 2011.
- The air, water, and rail transportation industries employed over 14,000 workers in 2006 and paid average wages of $58,000 per year.

Other States

- Other states vary in the taxation of fuel, food, and other items purchased in the state by airlines, railroads, and vessels. Some states exempt all the items to all three modes of transportation; a couple of states tax all the items. Many states are selective in exempting some items while taxing others and differentiate between airlines, railroads, and vessels.

Recommendation

The Legislature should clarify the public policy purpose for the retail sales tax exemption for sales of tangible personal property to air, rail, and water private or common carriers to be used in interstate or foreign commerce.

Legislation Required: None.

Fiscal Impact: None.

ITEMS USED IN INTERSTATE COMMERCE – REPORT DETAIL

Statutory History

The Legislature imposed the retail sales tax and the use tax in 1935. In general, the retail sales tax applies to the retail sale of tangible personal property and certain services. The use tax, or compensating tax as the Legislature called it in 1935, is a companion tax to the retail sales tax and applies to taxable items used within the state, if the retail sales tax has not been paid here or in some other state.

There were few exemptions to the retail sales tax when it was first adopted. Among others, the exemptions included:

- Sales that the state was prohibited from taxing under the Washington Constitution or the U.S. Constitution or laws;
- Sales of motor vehicle fuel taxable under the motor vehicle fuel tax; and
- Sales of fresh sweet milk, raw unprocessed fruits and vegetables, butter, eggs, cheese, canned milk and unsweetened bread in loaf form (including rolls and buns), sold for consumption off the premises.

The original use tax also had a few exemptions. One exemption was for the rolling stock or floating equipment used by a common carrier, if used within Washington in conducting interstate or foreign commerce.[171]

Under the 1935 rules and regulations of the State Tax Commission, the retail sales tax applied to sales to steamships and other vessels of coal, equipment, fuel oil, furniture, ice, lubricants, machinery, supplies, and other tangible personal property that is not resold.[172] These were sales at retail and were subject to the retail sales tax.[173] Sales of foodstuffs for use in furnishing meals to passengers or members of the crew, and sales of tangible personal property for resale on board the vessel were sales for resale and were not subject to the retail sales tax. However, the sales of meals and other tangible personal property by the steamship were subject to the retail sales tax when the sales occurred within the state.

The retail sales tax did not apply to any sale the state was prohibited from taxing under the U.S. Constitution. The U.S. Constitution has two clauses of relevance:

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[171] This exemption first appeared in the regulations adopted by the State Tax Commission. The Legislature adopted this exemption in 1937.

[172] The State Tax Commission was the state agency charged with administering the 1935 Revenue Act. It preceded the Department of Revenue.

[173] Rule 175, "Rules and Regulations Relating to The Revenue Act of 1935," Tax Commission of the State of Washington, April 1, 1936.

- The interstate commerce clause which leaves to Congress the power to regulate commerce with foreign nations and among the states;[174] and
- The import/export clause which prohibits states from laying any imposts or duties on imports or exports, except what may be absolutely necessary for executing its inspection laws.[175]

The retail sales tax did not apply to foreign imports and foreign exports. With regards to interstate commerce, the retail sales tax generally did apply to sales at retail when delivery of the item occurred in Washington, whether or not the item was within the state when the sale took place. The retail sales tax did not apply to sales at retail when the seller delivered the goods to the purchaser at a point outside the state.[176]

The U.S. Supreme Court, in a number of rulings pertaining to the interstate commerce clause, outlined the parameters of state taxation related to interstate commerce. A state retail sales tax could be imposed on the sale of fuel used to conduct interstate commerce, when the sale took place within the state. A state use tax could not be applied to fuel purchased outside the state and used within the state to conduct interstate commerce. Some of the decisions relating to the matter at hand include:

- A state may impose a (sales) tax on the in-state sale of gasoline used in conducting interstate commerce;[177]
- A state may not impose a (use) tax upon the use of gasoline purchased outside of the state for use as fuel upon a ferry engaged in interstate commerce;[178]
- A state may impose a (use) tax on gasoline that has been imported and stored by an air-transport company and is drawn from the tanks to fill the airplanes that use it in interstate commerce if the "use" to which the tax is applied is the withdrawal of the gasoline from the tanks and the placing of it in the fuel tanks of the planes, before its use in interstate transportation begins;[179]
- A state may tax property used to carry on interstate commerce (either a property tax or a sales tax);[180] and
- A state may impose a (use) tax or a property tax on goods imported in interstate commerce that have become part of the common mass of property within the state of

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[174] Article 1, Section 8, Clause 3, U.S. Constitution.

[175] Article 1, Section 10, Clause 2, U.S. Constitution.

[176] Thus large items of transportation equipment, such as airplanes, could be delivered to customers in Montana or Oregon, which did not have sales taxes, and avoid Washington sales tax.

[177] "Eastern Air Transport v. South Carolina Tax Commission," 285 U.S. 147 (1932).

[178] "Helson v. Kentucky," 279 U.S. 245 (1929).

[179] "Edelman v. Boeing Air Transport," 289 U.S. 249 (1933).

[180] "New Jersey Bell Telephone Company v. State of New Jersey," 280 U.S. 338 (1930).

destination as this is not a tax on interstate commerce, but on the privilege of use after commerce is at an end.[181]

The State Tax Commission instituted a new policy in 1947 with regards to the sale of fuel oil to ocean-going vessels. The new policy did not conform to the Commission's rules in place at that time. Nor was the policy required by any state or federal court decision. The policy consisted of:

- A purchaser of fuel oil is required to furnish the seller with an estimate of the portion of each sale of fuel oil that will be consumed in Washington;
- The retail sales tax is to be collected on that portion of the sale and the business and occupation applies to these receipts; and
- The balance of the fuel oil may be handled as an export and no retail sales tax nor business and occupation will be payable.

Purchasers of fuel needed to pay retail sales tax only on the portion of fuel consumed within Washington.

At the time of the new policy on fuel oil, the Tax Commission was in court defending the collection of retail sales tax on vessels sold to firms in foreign countries. An initial decision rendered by the Thurston County Superior Court on one of the cases held that retail sales tax was due on the sale of a vessel to a foreign corporation.[182]

In 1948, the Washington State Supreme Court reversed the Thurston County Superior Court decision. The Supreme Court ruled that the sale of a steamship, located within the state, by a local vendor to a foreign purchaser for subsequent foreign registry and movement to a foreign destination is, under the circumstances, a sale of property for export within the purview of the export-import clause of the U.S. Constitution and, as such, is not subject to the state sales tax.[183] The state Supreme Court voided the state retail sales tax upon the sale of merchandise that is exported.

The 1949, Legislature passed State Tax Commission request legislation, which among a number of things, exempted from the retail sales tax sales of all property, other than carrier property itself, to carriers by air, rail, or water engaged in interstate or foreign commerce. The use tax applied to any property that is actually used in this state. Passage of this legislation effectively codified the Commission's 1947 policy of taxing items consumed in Washington and exempting items consumed outside-of-the-state. While the 1947 policy change pertained only to fuel oil purchased by ocean-going vessels, the 1949 legislation included all tangible personal property purchased by air, rail, and water carriers engaged in interstate or foreign commerce.

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[181] "Henneford v. Silas Mason Co.," 300 U.S. 577 (1937).

[182] Stated in the summary to "Manila Steamship Company v. State of Washington," 31 Wn2d 952 (1948).

[183] The Court rendered four decisions on the same day. They included: "Alaska Steamship Company v. State of Washington," 31 Wn2d 328 (1948); "Alaska Steamship Company v. State of Washington," 31 Wn2d 946 (1948); "Alaska Steamship Company v. State of Washington," 31 Wn2d 949 (1947) [*sic*]; "Manila Steamship Company v. State of Washington," 31 Wn2d 952 (1948).

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?

In 1949, the Legislature exempted from the retail sales tax the sale of tangible personal property, other than airplanes, trains, and vessels, for use by the purchaser in the business of operating as a carrier by air, rail, or water in interstate or foreign commerce, except that the use of the property in this state is subject to the use tax. The State Tax Commission requested this statutory change. The requested legislation essentially codified the policy instituted by the Tax Commission in 1947 to exempt from the sales tax, fuel oil used outside Washington by ocean-going vessels.

The 1947 policy is uncharacteristic of the Commission. The Commission had a long history of defending Washington's tax laws before the State and U.S. Supreme Courts. While the Tax Commission eventually lost the cases with regards to taxing the sale of vessels to foreign corporations, when the sale and delivery took place in Washington, these cases did not extend to the sale of tangible personal property used to conduct foreign or interstate commerce. The U.S. Supreme Court had explicitly ruled that a state could impose a sales tax on gasoline that was used to conduct interstate commerce.

In 1949, revenues would not match expenditures in the upcoming biennium without substantial new taxes or cuts in spending. In the end the Legislature did neither and passed an unbalanced budget.[184] It is unclear why the Tax Commission initiated a policy and the Legislature adopted a tax exemption that does not appear to be constitutionally mandated, especially when faced with a revenue problem.

If the Legislature had adopted the exemption for items used in interstate commerce on its own, without the prompting of the State Tax Commission, it might be surmised that the public policy objective of the exemption was to encourage interstate and foreign commerce. However, there are no records to indicate that the Tax Commission had this objective in mind when they revised the policy in 1947 and requested the statutory changes in 1949.

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 not clear.

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

The public policy objective is not clear.

[184] "History of the Washington Legislature, 1854-1963," Don Brazier, 2000.

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 not clear.

Beneficiaries

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

The beneficiaries of the retail sales tax exemption for items used in interstate or foreign commerce are the air, rail, and water private and common carriers that purchase tangible personal property in Washington and consume these items outside of the state.

Exhibit 74 – Private Sector Employers by Industry Sector, 2006

Industry Sector	Number of Employers
Air Transportation	115
Water Transportation	67
Rail Transportation	2

Source: Department of Employment Security.

The Department of Employment Security reported that there were 115 air transportation establishments, 67 water transportation establishments, and two private-sector rail transportation establishments operating in Washington in 2006. It is not known how many of the establishments were conducting interstate or foreign commerce.

To receive a retail sales tax exemption, purchasers of tangible personal property need to provide the seller a certificate declaring that the items being purchased are for use in connection with the business of operating as a carrier by air, rail, or water in interstate or foreign commerce. The use tax then applies to the use of goods to the extent that the good is consumed in Washington.[185] The purchaser remits the use tax directly to the Department.

In 2007, 66 businesses in the air, water, and rail transportation sectors paid $19 million in state use tax.[186] It is not possible from the tax returns to determine whether these firms paid use tax on items purchased tax-exempt in Washington and then consumed in Washington while conducting interstate commerce (e.g., fuel and food), or whether the use tax was on items purchased tax-exempt in other states and then used in Washington while not conducting interstate commerce (e.g., office furnishings).

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[185] Department of Revenue rules provide that the use tax does not apply to the use of durable goods, such as furnishings and equipment, intended for use while operating partly within and outside of the state. The use tax applies to other types of tangible personal property, such as consumable goods.

[186] The majority of the use tax paid by the transportation carriers is likely to be on the retail sales of tax-exempt goods purchased in Washington and consumed in Washington. Some of the use tax may have been on goods purchased outside of Washington and used in Washington in the course of non-interstate or foreign commerce business (e.g., office furnishings).

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

No unintended beneficiaries are apparent.

Revenue and Economic Impacts

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

Exhibit 75 – Washington Purchases by Transportation Companies, 2004 ($ in millions)

Purchases of:	Air Transportation	Rail Transportation	Water Transportation	Total Transportation
Petroleum	$376	$31	$51	$458
Food Services	$120	$1	$10	$131
Transportation Equipment	$54	$41	$113	$209
Other Tangible Property	$21	$3	$12	$37
Other Services	$642	$185	$725	$1,552
Total Purchases	$1,214	$261	$912	$2,387

Source: IMPLAN data for 2004.

The IMPLAN dataset for Washington estimates that transportation companies purchased $2.4 billion of goods and services in Washington in 2004. Of this amount, $458 million was for petroleum products, $131 million for food services, and $37 million for other tangible property. In addition there were $209 million of transportation equipment and $1.6 billion in services. This analysis indicates the single greatest item of tax exempt sales is fuel to the airline industry, followed by food service sales to the airline industry. Another major item, sales of transportation equipment, is exempt from the retail sales tax under another statute.

Another data source estimates that the expenditures on jet fuel in Washington are a significantly higher amount than the amount estimated by IMPLAN. The Energy Information Administration of the U.S. Department of Energy estimates that $1 billion of jet fuel was sold in Washington in 2004. This increased to $1.5 billion in 2006.

Exhibit 76 – Expenditures on Jet Fuel, Washington State ($ in millions)

Year	Jet Fuel Expenditures
2003	$644
2004	$1,022
2005	$1,342
2006	$1,577

Source: U.S. Department of Energy, Energy Information Administration, State Energy Data System.

If 80 percent of the jet fuel purchased in Washington is consumed outside the state, the state and local sales tax on the fuel currently exempted would have totaled over $100 million in 2006.[187] The growth in jet fuel expenditures is mostly attributable to increases in fuel prices. Purchases of fuel (in terms of gallons) reached a peak in 2000 and have been about 25 percent below this peak since. However, the price of jet fuel increased 30 percent per year from 2002 to 2006. Jet fuel prices are forecasted to increase by 18 percent per year over the next three years. Annual taxpayer savings could grow to $229 million by 2011.

Exhibit 77 – Estimated Tax Savings by Exempting Jet Fuel Used in Interstate Commerce ($ in millions)

Year	State and Local Tax Savings
2006	$100
2007	$118
2008	$139
2009	$164
2010	$194
2011	$229

Source: JLARC analysis of U.S. Department of Energy data.

Total taxpayer savings is in excess of the amount saved on jet fuel purchases. Sales of other fuel, food, and other tangible personal property consumed outside the state could account for another $10 million in sales tax savings.[188] Total taxpayer savings on purchases of all tangible personal property is roughly estimated to be $110 million in 2006. This amount includes both state and local taxes.

[187]Using national statistics for 2006, 81 percent of airline passenger miles are beyond 250 miles of the point of enplanement. 80 percent is used as a rough estimate of airline fuel being used outside of Washington. Use tax is owed on fuel purchased in Washington and used in Washington.

[188] Based on the assumption that 50 percent of the Washington purchases by air, rail, and water transportation companies of food services and other tangible property are consumed outside the state.

The air, water, and rail transportation industries employed over 14,000 workers in 2006 and paid over $800 million in wages. Average wages in these industries were nearly $58,000 per year. In addition to the 14,000 directly employed in these transportation industries, there are another 18,000 workers in other industries that provide goods and services to the transportation industry. As discussed above, these goods and services include fuel, transportation equipment, food services, and other services such finance and insurance. In addition, the transportation industries facilitate trade between Washington and other states and countries. They provide the link between Washington manufacturers and producers and customers around the world. The transportation industry also contributes to the welfare of the state by bringing to Washington goods produced elsewhere.

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 Legislature terminated the retail sales tax exemption for items used in interstate commerce, the purchasers of these items, primarily fuel and food by the airline industry, and to some extent the water transportation industry, would need to either pay additional taxes or avoid paying the taxes by making purchases elsewhere. Washington's retail sales tax could be avoided by purchasing items elsewhere. Items purchased out-of-state and used in the conduct of interstate or foreign commerce are not subject to Washington's retail sales or use taxes.

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 from eliminating this retail sales tax exemption.

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?

Other states vary in the taxation/exemption of fuel, food, and other items purchased in the state by airlines, railroads, and vessels. Some states tax, and other states exempt from taxation, purchases of tangible goods by the airlines, railroads, and vessels. Some states tax sales to one mode of transportation while exempting other modes; some states exempt the purchase of one type of commodity while taxing another type.

With respect to sales of fuel, JLARC found information on 36 states. At least 20 states, including Washington, do not tax the sales of fuel to airlines or vessels. This includes two states that exempt sales of fuel to airlines for international flights only. Twenty-one states do not tax the

sale of fuel to vessels. Seventeen states do not tax the sale of fuel to railroads. These totals include four states that do not have a retail sales tax. Ten states explicitly tax sales of fuel to airlines (including two states that tax domestic flights only), four states tax sales to railroads, and three states tax sales to vessels.

With respect to food, JLARC found information on 24 states, including the District of Columbia. At least 15 states (including D.C.) do not tax the sale of food to airlines (or their passengers) while seven states apparently tax food sales to airlines or airline passengers. Ten states exempt from tax the sale of food to vessels while at least five states do tax such sales. Eight states exempt railroads from tax on food purchases while five states tax such sales. The states that do not tax food sales include four states that do not have a sales tax.

Recommendation

The Legislature should clarify the public policy purpose for the retail sales tax exemption for sales of tangible personal property to air, rail, and water private or common carriers to be used in interstate or foreign commerce.

Legislation Required: None.

Fiscal Impact: None.

ELECTRIC GENERATING EQUIPMENT; RENEWABLE RESOURCES – SUMMARY

Current Law

Current law exempts sales of machinery and equipment used directly in generating at least 200 watts of electricity using renewable energy of fuel cells, wind, sun, or landfill gas from retail sales and use taxes. These exemptions also apply to charges made for labor and services to install the machinery and equipment. These retail sales and use tax exemptions have an expiration date of June 30, 2009. See Appendix 3 for the current law statutes, RCW 82.08.02567 and 82.12.02567.

Findings and Recommendations

This review has evaluated the legal history, public policy objectives, economic and revenue impacts, and other states' similar tax preferences of Washington's retail sales and use tax exemptions for sales of machinery and equipment used to generate electricity from alternate energy sources. The audit determined the following:

Legal History and Public Policy Objectives

- The Legislature enacted these tax preferences in 1996, targeting at exempting sales of machinery and equipment used in generating electricity using wind or sun as the principal source of power.
- The Legislature expanded the types of qualifying alternative energy sources in 1998 to include landfill gas. In 2001 and 2004, the Legislature added fuel cells as qualifying alternative renewable energy sources of electricity.
- These tax preferences originally required that the machinery and equipment be capable of generating at least 200 kilowatts of electricity. In 2001, the Legislature decreased the required energy wattage of the machinery and equipment from 200 kilowatts (200,000 watts) to 200 watts.
- In 1996, the Legislature required purchasers to submit a duplicate certificate of the exempt sale or an annual report of exempt purchases to the Department of Revenue. In 1999, the Legislature deleted this reporting requirement.

There are three public policy objectives for these tax exemptions:

1. Encouraging the manufacturing of electricity from alternative renewable energy sources and expanding the renewable energy industry's employment and production in Washington.

2. Reducing air pollution and greenhouse gas effect by producing more electricity from renewable energy sources.
3. Encourage purchases of renewable energy equipment. Originally, these tax preferences targeted larger scale machinery and equipment that could generate large quantities of electricity from solar and wind sources. By 2001, the Legislature modified that objective to include smaller-scale electricity generating equipment used by homeowners. The Legislature sought to encourage purchases of smaller scale renewable equipment, such as residential solar panels through these tax preferences.

- Due to the expansion of wind farms, there has been an increase in renewable energy production and employment in Washington, so that objective has been achieved. In addition, the increase in wind energy production has reduced Washington's utilization of other forms of energy, reducing pollution and greenhouse gas emissions.
- Due to the lack of data available for these tax preferences, it is uncertain how effective this tax preference has been in encouraging additional production and employment in all areas of the alternative energy industry in Washington. In addition, data did not exist to analyze the effectiveness of these tax preferences in stimulating new purchases of renewable energy equipment that would not have otherwise been made without the tax exemption. It is uncertain whether the third objective of encouraging purchases of smaller renewable energy equipment has been achieved.

Beneficiaries

- There are eight wind farms statewide that have qualified for the retail sales and use tax exemptions. Two other wind farms are scheduled to begin operation in 2008.
- Since 2005, 581 individuals, businesses, and local government entities have been approved for an investment cost recovery incentive for each kilowatt-hour from a customer-generated electricity renewable energy system. These taxpayers are known beneficiaries of these retail sales and use tax exemptions but do not encompass all beneficiaries each year.
- The number of purchases of machinery and equipment used to generate electricity from fuel cells for Washington was unavailable.
- There may be unintended beneficiaries from these tax exemptions, but JLARC could not evaluate this without additional information being reported by the impacted businesses and individuals.

Revenue and Economic Impacts

- The annual retail sales and use taxpayer savings from these tax preferences was estimated to be approximately $27 million in fiscal year 2008.

- The anticipated economic impact from the alternative energy industry in Washington is difficult to evaluate because Washington has not studied the size of this renewable energy industry in the state.

Other States

- Three other states besides Washington have sales and use tax exemptions for purchases of alternative energy sources: fuel cells, solar, wind, and landfill gas or biomass energy generating equipment.
- Sixteen states, including Washington, have retail sales tax exemptions, and New Mexico has a use tax exemption for one or more alternative energy generating sources.

Recommendations

1) Continue the retail sales and use tax preferences and reexamine these alternative energy tax preferences at a later date to determine their effectiveness in encouraging growth in this industry in Washington.

2) The Legislature should implement reporting requirements and criteria on which to evaluate the tax exemptions and reevaluate the wattage threshold limit to ensure there are not unintended beneficiaries.

Legislation Required: Yes.

Fiscal Impact: See taxpayer savings estimates for 2010 and 2011.

ELECTRIC GENERATING EQUIPMENT; RENEWABLE RESOURCES – REPORT DETAIL

Statutory History

The Legislature enacted the retail sales and use tax exemptions for electrical generating equipment from renewable energy sources in 1996. The original exemptions targeted machinery and equipment used in generating electricity by renewable sources of wind or sun as the principal source of power.[189] The tax preferences originally had an expiration date of June 30, 2005. The Legislature originally required renewable energy machinery and equipment to be capable of generating at least 200 kilowatts of electricity (larger wind or sun generating facilities). In 1996, the Legislature also required the purchaser of this equipment to provide the Department of Revenue with a duplicate certificate of exempt sale or file an annual report of purchases.

The Legislature made changes to these tax exemptions in 1998, 1999, and 2001. In 1998, the Legislature added landfill gas to the list of alternative energy sources' machinery and equipment that qualify for these tax preferences. In 1999, the Legislature eliminated the reporting requirements of a duplicate certificate of exempt sales or annual report to the Department of Revenue. The Department of Revenue requested this change, claiming the reporting requirement was not operational and was obsolete. The Department stated they would see the exemption certificate once they performed their audits. According to conversations with legislative staff, this reporting change was consistent with eliminating similar reporting requirements in other tax preferences, such as the manufacturing retail sales tax exemption in 1998.[190] This change was brought before the Legislature because businesses complained about the burden in reporting and after the businesses had already provided the Department with three years of data.

In 2001, the Legislature decreased the required energy wattage of the machinery and equipment for these tax preferences from 200 kilowatts (200,000 watts) to 200 watts.[191] The 2001 changes also added fuel cells to the list of energy sources that could qualify for the retail sales tax preference and extended the expiration date for both tax preferences to June 30, 2009.

In 2004, the Legislature added fuel cells to the use tax exemption, making it consistent with the retail sales tax exemption for fuel cells changed in 2001.[192] In addition, the retail sales tax exemption was clarified to include certain items used to generate electricity from fuel cells under the definition of eligible machinery and equipment.

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[189] Renewable energy sources qualifying for these tax exemptions: wind, solar and landfill (added in 1998) and fuel cells (added in 2001).

[190] SB 6348 (1998).

[191] HB 1859 (2001).

[192] SB 6490 (2004).

In 2005, the Legislature created tax incentives for manufacturers of renewable electrical generating machinery and equipment; and provided an investment cost recovery incentive to individuals, businesses, and local government entities as well as a public utility tax credit for utility companies that provide incentive payments.[193] To qualify for these new tax preferences, purchasers of solar and wind renewable energy systems must be approved by the Department of Revenue. In addition, a purchaser of an installed renewable energy system must report to the utility company annually the number of kilowatt-hours of electricity the purchaser's system generated. This annual report is used by the utility company to pay the taxpayer for the electricity generated from his or her system, not to exceed $2,000 per applicant. Then, the total amount of all incentive payments made is the basis for the utilities' tax credit. In order to receive the renewable energy systems' manufacturing preferential business and occupation tax rate of 0.2904 percent, each business must annually report to the Department of Revenue. This report must include information on the employment, wages, and employer-provided health and retirement benefits per job at the manufacturing site.

Since these tax preferences were enacted, the Legislature has considered various bill proposals to expand the list of renewable energy sources, in particular to biomass electrical generating equipment.

Other Relevant Background

Definitions of terms: Bioenergy, Biomass, Renewable Energy and Watt

Bioenergy is useful, renewable energy produced from organic matter. Biomass is any organic matter that is available on a renewable or recurring basis, including agricultural crops and trees, wood and wood residues, and other residue materials. Renewable energy is generated from sources that do not rely on fossil fuel or large-scale hydropower, including solar, wind, biomass, geothermal, fuel cell, and small scale hydro.

A watt (W) is one joule of energy per second. Watts multiplied by a period of time equals energy. If a 100-watt light bulb is turned on for one hour, then the amount of energy used is 100 watts of power. A kilowatt (kW) is equal to one thousand watts. A megawatt (MW) is equal to one million watts. A kilowatt-hour is the amount of energy derived from one kilowatt running for one hour. The kilowatt-hour is commonly used for measuring electric energy. Many electric utility companies use the kilowatt-hour for billing. A variety of alternative energy machines and equipment qualify for this tax exemption because the minimum wattage requirement is 200 watts. For example, there are small 200-watt wind turbine generators that can be used to power boats, RVs, and batteries. Stationary bicycles can generate 200 watts to charge batteries that can be used to power lights or small appliances.

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[193] SSB 5101 and SSB 5111 (2005).

Retail Sales and Use Taxes

The retail sales tax applies to goods, construction including labor, repair of tangible personal property, certain lodging activities, telephone services and participatory recreational activities. Some personal and professional services are also subject to the retail sales tax. The Legislature enacted this tax in the Revenue Act of 1935. The current retail sales state tax rate is 6.5 percent, and local retail sales tax rates range from 0.5 to 2.5 percent depending on the jurisdiction.

Use tax is imposed on items and certain services used in the state and the Legislature also enacted this tax in the Revenue Act of 1935. If at the time of purchase of taxable property, retail sales tax is not collected, then the purchaser is responsible for paying the use tax once the property is used in Washington. This includes purchases made from out-of-state sellers, purchases made from sellers who are not required to collect Washington's sales tax, items produced for use by the producers, and gifts and prizes. The use tax is measured by the value of the item at the time of the first use within Washington. The use tax rates are the same as rates for the retail sales tax.[194] This retail sales and use tax exemption under review if for all machinery and equipment used in generating electricity from alternative energy sources of wind, solar, landfill and fuel cells.

Washington Energy Production and Consumption

Energy use in homes, businesses, industry, and transportation grew at an average rate of 1.6 percent between 1985 and 2000 in Washington, peaking in 1999 at 1.4 quadrillion BTU.[195] Electricity consumption declined sharply in 2001 and 2002 due to the shortage in electricity on the west coast. Electricity use in the last several years appears to be returning to pre-shortage growth trends.

Washington historically has had some of the lowest electricity prices in the nation. In 1999, Washington had the lowest electricity price for residential consumers in the U.S. and the second lowest commercial and industrial state ranking in the U.S. This situation changed as a result of electricity price increases from 2000 to 2002. In the past three years, Washington's electricity prices have leveled off and declined for industrial consumers. In 2005, Washington's electricity price ranked 4th lowest in the U.S. for residential consumers, 6th lowest for industrial consumers, and 11th lowest for commercial consumers.

Washington is part of an interconnected, regional power system, and utility companies purchase electricity generated from a variety of sources throughout the region.[196] Electricity is either generated within the state or it is generated outside the state and is sold to consumers in the state. Electricity generated within Washington is not necessarily consumed here due to the interconnected nature of the electricity system.

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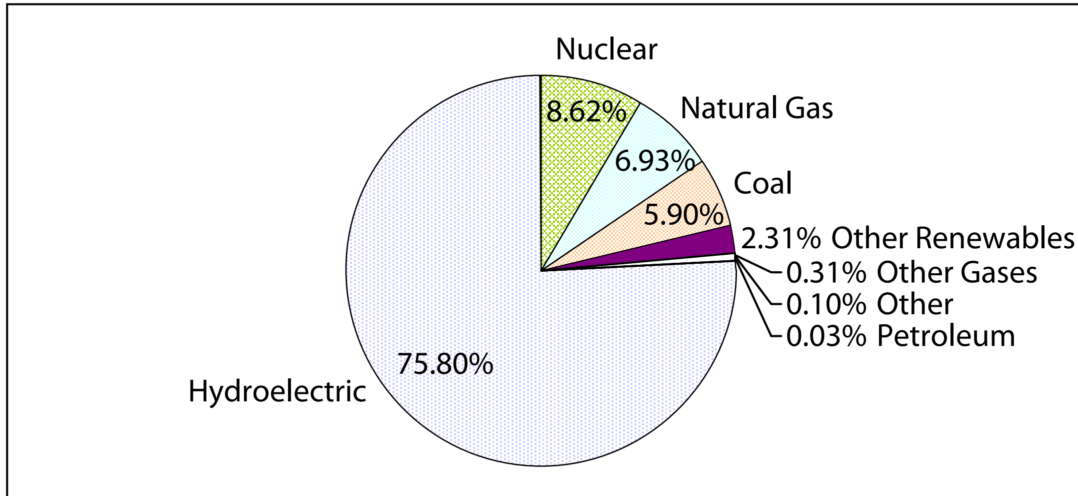
[194] "2007 Tax Reference Manual – Information on State and Local Taxes in Washington State," Department of Revenue.

[195] 2007 Biennial Energy Report – Issues and Analysis for the Washington State Legislature and Governor, Washington State Department of Community, Trade and Economic Development – Energy Policy Division, January 2007 p. 1.

[196] Ibid., p.7.

On an annual basis, Washington is a net exporter of electricity, but in the winter we import electricity. As shown in the exhibit, Washington's primary source of electricity is hydroelectric, (76 percent) of total electrical generating capacity of 108,203,155 MWhours in 2006. Nuclear is the second largest source of electrical power at 8.6 percent. Natural gas is the third largest source of power at 7 percent. Other renewable energy sources, like wind, only represented 2 percent of Washington's electricity generation capacity in 2006.

Exhibit 78 – Electricity Generated in Washington by Primary Sources (108,203,155 MWh) - 2006



Source: US Energy Information Administration – Washington.

According to the Energy Information Administration in 2006, Washington had the highest state ranking in the U.S. in total renewable net generation. This ranking includes hydroelectric power as well as wind, solar, biomass, waste/landfill, geothermal, and others. Washington is ranked number one in hydroelectric power generation in the U.S.

The fuel mix for electricity sold to Washington consumers reported to the Washington Community Trade and Economic Development Department has seen a growth in the alternative fuels consumed in Washington. In 2006 from the fuel mix reports, CTED reported that the largest portion of electricity consumed in Washington was from hydroelectric. Electricity generated from coal, nuclear and natural gas are the next largest sources of energy and the remaining two percent of electricity is from wind and other renewable energy sources. The renewable energy resource which has grown the fastest since 2001 has been wind energy.[197] In 2006 and 2007, almost three-quarters of the new capacity of electricity was wind generation.[198] The Northwest Power and Conservation Council estimated that in the next 20 years, the Pacific Northwest electricity industry will need to add nearly 7,000 MW of power resources.

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[197] 2007 Biennial Energy Report – Issues and Analysis for the Washington State Legislature and Governor, Washington State Department of Community, Trade and Economic Development – Energy Policy Division, January 2007 p. 9.

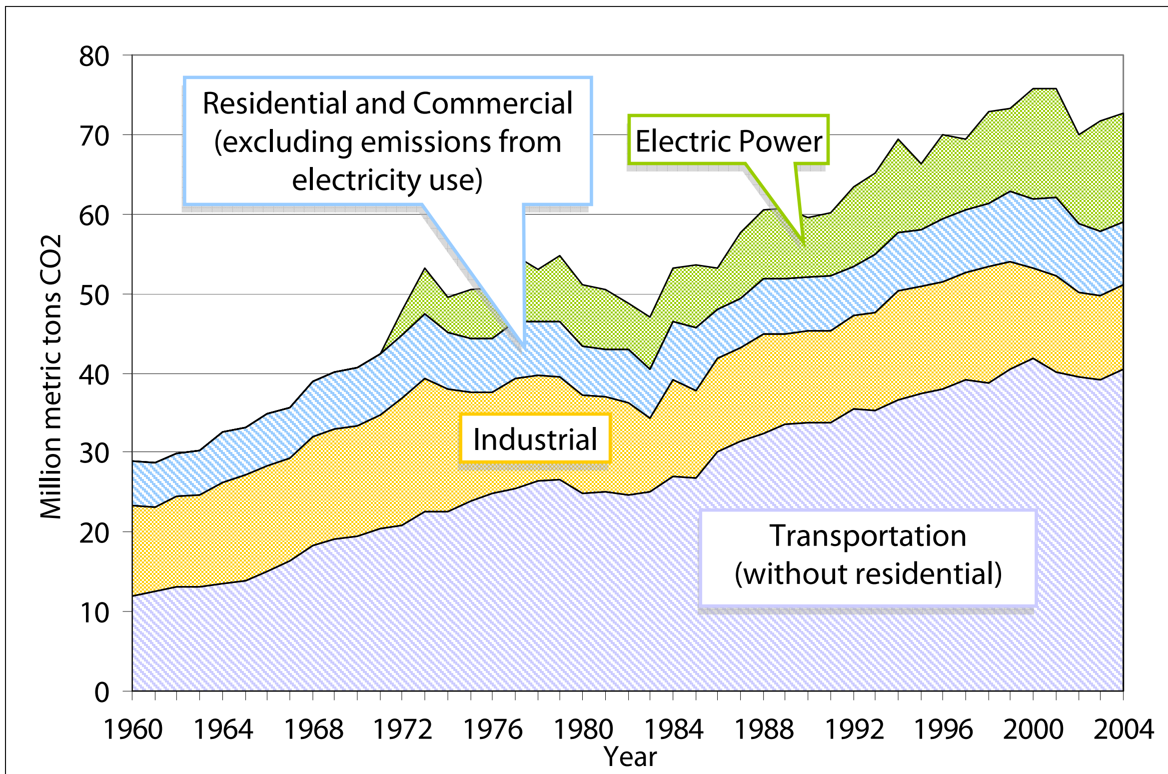
[198] Northwest Power and Conservation Council database.

Washington's renewable energy industry has an opportunity to supply a large portion of this power.

Greenhouse Gas Emissions

One effect that production of electrical energy has on the environment can be measured by the amount of greenhouse gas emissions associated with electric power. The majority of greenhouse gas (GHG) emissions and almost half of total emissions are from the transportation sector. As the GHG figure reveals, since 1960, changes in CO2 emissions for Washington have increased significantly. In addition, emissions generated from electrical power have been steadily increasing since the early 1970s.

Exhibit 79 – Cumulative Energy-related CO2 Emissions by Sector for Washington Since 1960



Source: "2007 Biennial Energy Report" by the Energy Policy Division of Washington State Department of Community Trade and Economic Development, January 2007.

Wind Energy

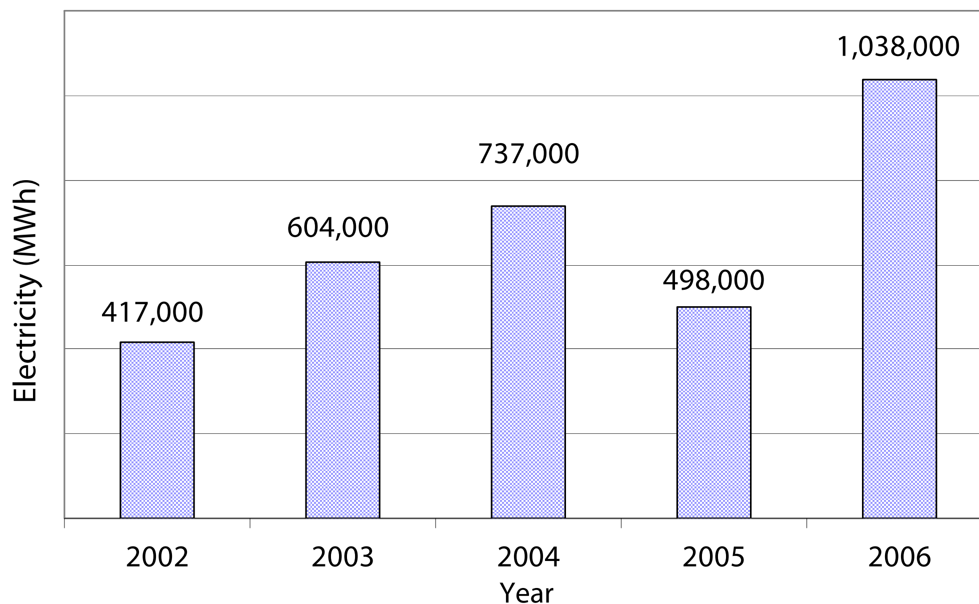
The value of wind power lies in its ability to displace fossil fuel consumption, limit exposure to volatile fossil fuel prices, and control of greenhouse gas emissions.[199] Wind energy is not

[199] 2007 Biennial Energy Report – Issues and Analysis for the Washington State Legislature and Governor, Washington State Department of Community, Trade and Economic Development – Energy Policy Division, January 2007.

sufficient to meet energy peak loads so it is used in conjunction with other sources of energy. Wind energy is naturally a variable resource since the amount of energy that can be produced is a function of the wind. The costs of using wind energy depend on several factors including the size of the wind power relative to other power sources, geographic diversity of wind sites, amount of flexibility available to the power system, and access to markets and storage areas.

The Pacific Northwest has potential wind energy generating sites available. Many factors are driving the wind energy industry's growth including volatile natural gas prices, and renewable energy and climate policy developments at the federal, state, and local levels.[200] Since 2002, electricity generated from wind has grown from 417,000 MW hours to more than a million MW hours in 2006. This reveals the state's significant growth in electricity generated from wind.

Exhibit 80 – Electricity Generated from Wind (MWh) in Washington Since 2002



Source: Power Plant Report, US Energy Information Administration, Form EIA-906, October 2007.

Another driver of the increase in wind energy in Washington is the passage of Initiative 937. This initiative mandated that 15 percent of all electricity be from renewable energy by 2020. Western governors have called for 30,000 MWh of clean, diversified energy in Western states by 2015. In addition at the federal level, the Wind Production Tax credit has also been extended.

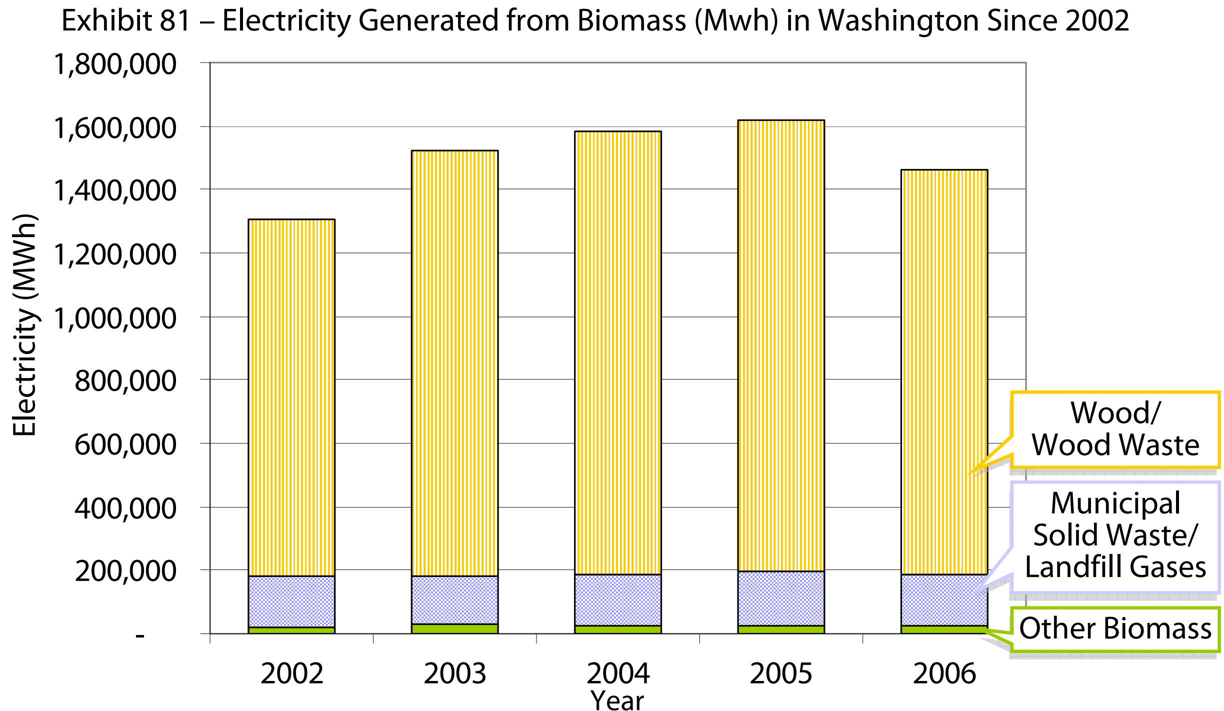
Biomass Energy

There are many different types of biomass resources currently being used and potentially available to produce bioenergy. This includes primary crops and residues harvested/collected directly from the land to secondary sources such as sawmill residuals and residuals in landfills.

[200] "The Northwest Wind Integration Action Plan," by Northwest Power and Conservation Council in March 2007.

Biomass resources also include the gases that result from the breakdown of animal manures or organic materials in landfills.

Exhibit 81 – Electricity Generated from Biomass (Mwh) in Washington Since 2002



Source: "Power Plant Report," by US Energy Information Administration October 2007.

According to data maintained by the U.S. Energy Information Administration, Washington has seen a slight growth in the electricity generated from various forms of biomass over the past five years. Wood/Wood Waste biomass is the largest biomass source of renewable electric energy. According to the Northwest Power Planning Council database, as of April 2008, Washington has 28 biomass-fueled electricity generating plants in the state. Half of the companies using wood waste fuel to generate electricity are lumber and paper mills in the state. There have been several unsuccessful attempts to add biomass renewable resources to the list of energy sources generating electricity that qualify for these tax preferences.[201]

Solar Energy

Solar energy is renewable energy from the sun in the form of radiated heat and light. Solar electric technology converts sunlight directly into electricity. Photovoltaics is technology that converts light directly into electricity. Due to the growing need for solar energy, the manufacture of solar cells and solar photovoltaic array has expanded in recent years.

The advantage of solar power is the assurance that even though there may be cloudy or stormy days, the sun will provide more energy again in the future. Use of solar energy can decrease the need for electricity and lower monthly electrical costs. In addition, solar power reduces global

[201] HB 3256 (2008); HB 3116 (2008); HB 2477 (2004); HB1703 (2003); ESSB 5541 (2001) .

warming and American's dependence on foreign oil. The disadvantage of solar energy is the upfront cost. Brand new solar energy packages can cost at least $20,000 for 2.5 kilowatt systems. The average cost per watt for a residential solar system in Washington is $8 per watt.[202] Policymakers have targeted new incentives at helping purchasers of these systems with incentives to lower their initial cost by eliminating the retail sales or use tax and providing an annual payment of up to $2,000 for the electricity that is generated from these systems.

Under Washington law, all public and private utilities, including cooperatives, must offer net metering. Net metering measures the difference between the electricity you buy from your utility and the electricity you produce using your own generating equipment. Each business or homeowner's electric meter must keep track of this difference.

In the United States, annual production of solar photovoltaics (PV) modules reached 150 megawatts in 2005. The PV industry has grown at a rate of greater than 40 percent per year from 2000 through 2005.[203] The total cost of PV systems currently ranges from $6 to $9 per peak watt. Component costs include the PV modules at about $3 to $4 per peak watt with another $3 to $5 per peak watt for inverter, installation, and balance of the system. The PV module cost has dropped significantly since 1980 when the cost was $10 per peak watt.

Fuel Cells

Fuel cells are a renewable energy source that reduce emissions of greenhouse gas carbon dioxide. A fuel cell is a mini power plant that produces electricity without combustion and pollution. Instead, chemical energy is converted directly into electrical energy and heat when hydrogen fuel is combined with oxygen from the air.[204] Hydrogen can be produced from water using renewable solar, wind, hydro, or geothermal energy. Hydrogen also can be extracted from any material that contains hydrocarbons, including gasoline, natural gas, landfill gas, methanol, ethanol, methane, and coal-based gas. Fuel cells are more efficient than conventional energy sources because they convert the chemical energy of the fuel directly into electricity without going through the combustion step. Thus fuel cells are cleaner than any carbon fuel even when using the carbon fuel as its hydrogen source.

Each fuel cell provides a small amount of voltage. Therefore, individual fuel cells are arranged in "stacks" to generate a useful level of voltage. Fuel cells have many applications and have been used in spacecraft, remote weather stations, large parks, rural locations and military applications. Automakers have made significant progress in developing fuel cell vehicles. Some test fuel cell vehicles are operating on the roads but they will not be ready for the mass market until 2010. Airbus has successfully tested a fuel cell system for the first time on a civil aircraft, powering the back-up hydraulic and electric power systems.[205]

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[202] Conversation with Mike Nelson of the WSU Cooperative Extension Energy Program.

[203] "Tackling Climate Change in the U.S. Potenital Carbon Emissions Reductions from Energy Efficiency and Renewable Energy by 2030," American Solar Energy Society Charles Kutscher, Editor, January 2007.

[204] "Fuel Cell Fact Sheet" by Environmental and Energy Study Institute February 2000.

[205] "Fuel Cell Technology Update March 2008," published in the Earthtoys – The Renewable Energy EMagazine.

Washington's Renewable Energy Policy

In 2006, The Legislature required investor-owned and consumer-owned electric utilities with more than 25,000 customers to develop integrated resource plans (IRP) by September 1, 2008.[206] IRPs must include, among other elements, a comparative evaluation of renewable and nonrenewable generating technologies. In addition, the plan must explain why renewable resources or conservation and efficiency resources were not selected. The Legislature also appropriated $17 million to the Department of Agriculture for the Energy Freedom Loan Program. This program offers eligible public entities an interest rate of 1 percent for renewable energy projects, including projects in the development of oilseed crushing capacity and all processes that convert agricultural waste into energy.

On November 7, 2006, Washington voters approved Initiative 937, the Energy Independence Act. This initiative requires large utilities to obtain 15 percent of their electricity from renewable resources such as solar and wind by 2020. The following statement is the initiative's declaration of Washington's intent to promote energy independence.[207]

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

The initiative specified that the following energy sources as renewable resources: water, wind, solar, geothermal, landfill gas, wave, ocean or tidal power, gas from sewage treatment facilities, biodiesel fuel derived from non-food crops and not on land cleared from old growth forests and biomass energy not derived from chemically treated wood chips, black liquor byproduct from paper production, or wood from old growth forests or municipal solid waste.

The initiative also allowed energy companies to trade renewable energy credits. If a company did not want to pursue its own renewable energy power source, it could purchase renewable energy credits from other power companies with credits to sell.

In 2007, the Legislature established greenhouse gas emissions goals for Washington.[208] The legislation also requires the reporting of greenhouse gas emissions to the Legislature and directs the Governor to develop policy recommendations to the Legislature for consideration in the 2008 Legislative Session on how the state can achieve the greenhouse gas reduction goals. The intent section of the bill makes the following statement regarding renewable energy sources:

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[206] HB 1010.

[207] RCW 19.285.020.

[208] ESSB 6001.

> *Washington has been a leader in actions to slow the increase of greenhouse gases emissions, such as being the first state in the nation to adopt a carbon dioxide mitigation program for new thermal electric plants, mandating integrated resource planning for electric utilities to include life-cycle costs of carbon dioxide emissions, adopting clean car standards and stronger appliance energy efficiency standards, **increasing production and use of renewable liquid fuels, and increasing renewable energy sources by electric utilities***

Public Policy Objectives

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

There are three primary public policy objectives justifying these tax preferences. These objectives were derived from the general legislative intent on renewable energy sources and from testimony on the bill enacted in 1996 as well as other relevant subsequent legislation.[209]

Promote Generation of Electricity from Alternative Renewable Energy Sources: One of the public policy objectives of these tax exemptions was to encourage generation of energy from alternative renewable energy sources in Washington by reducing the cost of generating electricity from renewable sources in anticipation of expanding that industry's employment and production in Washington.

Reduce Air Pollution and Greenhouse Gas Effect: Another objective of these tax preferences was to encourage additional utilization of renewable energy to lessen dependence on foreign oil and to reduce air pollution and greenhouse gas emissions.

Encourage purchases of renewable energy equipment: Originally, an objective of these tax preferences was to target the purchase of machinery and equipment used in large-scale electricity generation from solar and wind sources. In 2001, the Legislature lowered the wattage requirement on the purchase of machinery and equipment so homeowners could purchase solar panels for their residences at a lower cost. This change had the public policy objective of encouraging the demand for small scale solar and wind equipment by Washington residents.

Originally, these tax preferences had a reporting requirement to DOR. The exempt company could either provide copies of the retail sales or use tax exemption certificates to DOR or report their exempt sales annually to DOR. In 1999, the Legislature deleted the reporting requirement on the basis that it was obsolete and unworkable. The legislative intent is unclear about how the Legislature wanted to account and evaluate this tax exemption.

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[209] Legislative documentation on HB 2290 (1996), SB 6348 (1998), HB 1623 (1999), HB 1859 (2001) and SB 6490 (2004).

Is there any documentation on the purpose or intent of the tax preference?

Legislative intent on encouraging the generation of electricity from renewable energy sources in Washington is stated in other sections of state law. In addition, the beneficiaries of these tax preferences have been clearly defined in law.

These tax preferences lack any specific stated intent in the statute in which the exemptions are defined. For example, when the Legislature lowered the minimum energy threshold that the machinery and equipment had to achieve, it did not indicate the types of electrical generating equipment it hoped to exempt. In addition, when the Legislature deleted the reporting requirements for this tax exemption, the intent was not clear on how the Legislature wanted to evaluate these tax exemptions since the beneficiaries and value of the exemption are not reported to DOR.

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

Since enactment of these tax preferences in 1996, there has been an increase in the number of wind farms operating in Washington. The increase in electricity generated from wind energy in the state has allowed Washington to use alternative energy for a greater portion of its electrical supply and thus has lowered the reliance on other sources of electricity and reduced air pollution. There is evidence that there has been an increase in electricity generated from wind energy and a reduction in reliance on other sources of electricity since 1996. There is no readily available evidence to show that these tax preferences were an instrumental factor that brought the wind farm businesses to Washington. There is no evidence on employment or revenue generated from wind farms exclusively.

There is little evidence to show that the public policy objective of encouraging new purchases of solar energy equipment or fuel cells has been achieved since purchases of solar energy equipment and fuel cells have not been well documented in the past nor are they currently reported. There is no data to evaluate whether these renewable energy sources are expanding. There is no evidence to determine the importance of these retail sales and use tax exemptions in accomplishing the objective of increasing the purchases of solar energy equipment and fuel cells.

If demand for solar electrical equipment and fuel cells in Washington had increased significantly since enactment of these tax preferences, there would be added incentive to manufacturer solar equipment and fuel cells in Washington. Currently, there is only one solar electrical equipment manufacturer in Washington. One solar equipment manufacturer left the state a few years ago. There is at least one fuel cell manufacturer in Washington.

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

Continuation of these tax preferences will encourage purchases of renewable energy machinery and equipment and the production of electrical energy from wind and solar. At this time, wind energy is the main source of renewable energy that can be evaluated, and even this renewable

energy source cannot be evaluated in terms of employment generated or revenue produced from wind farms. Solar, fuel cells, and landfill gas energy production in Washington are not well documented. Demand for renewable energy equipment like solar panels is also not well documented to state entities. It is difficult to evaluate the effectiveness of continuing these tax 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?

Given the fact that it is unknown exactly how well these public policy objectives are being achieved, better reporting requirements would benefit the Legislature if it intends to monitor the effectiveness of these tax preferences.

The Legislature could modify these tax preferences by requiring businesses receiving these retail sales and use tax exemptions to report their total exempt purchases each year and other economic and revenue related indicators as is required for other tax preferences.[210] In particular, companies utilizing the retail sales and use tax exemption for purchasing machinery and equipment for wind generation have not reported the value of these tax preferences to this industry since enactment.

Another option could be for the Legislature to modify these tax preferences and link qualifying for the retail sales and use tax exemptions for solar energy generating machinery and equipment with the investment cost recovery incentive for purchasers of solar equipment in RCW 82.16.120. This would at least annually identify the purchasers of solar energy equipment. If the information reported to the Department of Revenue was improved by requiring purchasers to report their cost and size/capacity of the solar energy system, then future reviews could have information to evaluate the cost and beneficiaries of this tax preference with improved accuracy.

Beneficiaries

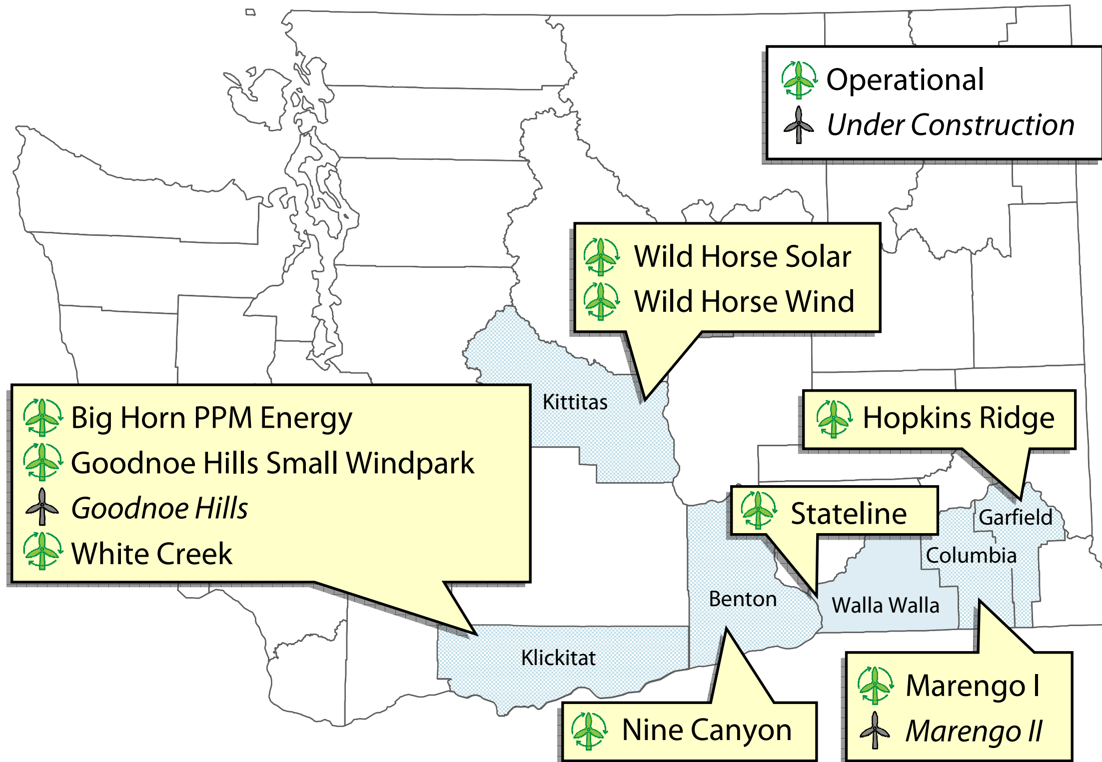
Who are the entities whose state tax liabilities are directly affected by the tax preference?

Wind Farms

According to the Northwest Power and Conservation Council, there are eight wind farms and one solar farm in Washington operational (see exhibit 82 on the following page). Two wind farms and the solar farm are owned by Puget Sound Energy. A single wind farm is owned by each of the following companies: PacificCorp, Energy Northwest, White Creek Wind, Mariah Energy Group, PPM Energy and FPL Energy. The two wind farms, Goodnoe Hills and Marengo II, scheduled to be operational in 2008 are owned by PacificCorp and Windtricity Ventures. The total electrical capacity of the eight wind farms is 1,163.5 (MW).

[210] RCW 82.32.535 through 82.32.710.

Exhibit 82 – Washington's Wind and Solar Projects - As of April 2008



Source: JLARC based on database of Northwest Power and Conservation Council.
* A portion of the Stateline wind farm is in Oregon as well as Washington.

Solar Farms and Solar Panel Purchases

According to the Northwest Power and Conservation Council, there is one 0.5 MW capacity solar farm in Washington in Kittitas County. It began operation in 2007 and is owned by Puget Sound Energy. According to the Department of Revenue database of excise tax return information, five companies received a lower business and occupation tax rate for manufacturing and selling solar panels in Washington. The number of Washington homeowners, businesses, or local government entities that have purchased solar panels for their residential homes and businesses is unknown. There is a reporting requirement to the Department of Revenue for residents, businesses, and government entities that have purchased solar or wind equipment to use to generate electricity for sale back to their utility company.[211] From these applications since July 2005, there have been 581 purchases of solar and wind equipment that qualify for an incentive payment for the electricity generated from these systems. This total number of purchases does not indicate which purchases were made in Washington and which were made from out of state. This application process did not request information on the purchase price or the energy capacity of the renewable energy system purchased.

[211] RCW 82.16.120.

Purchases and Manufacturing of Fuel Cells

Purchasers of fuel cells are beneficiaries of these retail sales and use tax exemptions but the number of beneficiaries each year is unknown. In addition, when fuel cells are manufactured in Washington, the purchaser of machinery and equipment used in the production process would benefit from the retail sales or use tax exemptions. These exemptions would apply to the purchase of fuel cell assemblies; fuel storage and delivery systems; power inverters; transmitters; transformers; power poles and lines and connectors to the utility grid system.

In 2001, Avista Corporation testified to the Finance Committee that it had patented technology to produce fuel cells from non-renewable sources, and the corporation wanted to qualify for the retail sales tax exemption. AvistaLabs produced fuel cells but has recently formed its own company ReliOn. Currently, Avista is no longer producing fuel cells in Washington. According to the Washington State Energy Marketplace Directory, CTED database, half a dozen companies are listed as developing, manufacturing, or distributing fuel cells in Washington.

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

Due to the lack of reporting to DOR of purchases of renewable electrical energy systems and the low threshold of electricity that the equipment must be able to generate, it is not possible to determine if there are unintended beneficiaries of this tax preference.

In addition, JLARC does not have the available data to identify the types of purchases the public is making of renewable energy machinery and equipment that generates at least 200 watts of energy. It is unclear if there are unintended tax exempt purchases which businesses or individuals are making of energy generating machinery and equipment beyond what the Legislature intended.

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?

In the 2004 Tax Exemption Report, the Department of Revenue estimated the taxpayer savings at $13 million in state and $3.8 million local taxpayer savings annually for these exemptions.

According to the 2008 Tax Exemption Report, DOR estimated the taxpayer impact at $4.875 million in state taxes and $1.425 million in local taxes in fiscal year 2008. The 2008 estimate was significantly smaller than the estimate made in 2004. The 2008 estimate only accounted for seven large wind farms in the state. This estimate did not project any smaller purchases of machinery and equipment of alternative energy sources like for solar, fuel cells, or landfill gas.

Since the release of the 2008 Tax Exemption Report, the Department has revised its estimate of the taxpayer savings for the retail sales and use tax exemptions through a fiscal note for HB 3116 in the 2008 Legislative Session. This estimate of these tax exemptions increased the cost per megawatt of electricity produced by the wind farms to $1.6 million.

The JLARC estimate for this report includes not only an estimate of the taxpayer savings for the wind farms statewide but also for the amount of purchases of solar equipment and fuel cells. For the estimate of fuel cells, JLARC assumed a share of a nationwide estimate for consumption of fuel cells. JLARC estimates the total state and local taxpayer savings to be $26.7 million in fiscal year 2008, growing to $36.4 million in fiscal year 2011.

Exhibit 83 – Forecast of Retail Sales and Use Tax Savings for Purchasers of Alternative Energy Equipment

Fiscal Year	Exempt Value ($ billions)	State and Local Tax Savings ($ millions)
2007	$299.60	$25.16
2008	$318.14	$26.72
2009	$352.96	$29.65
2010	$391.23	$32.86
2011	$433.26	$36.39

Source: JLARC.

The taxpayer savings on eight wind projects is estimated to be approximately $19 million in state retail sales tax and $5.5 million in local retail sales tax annually beginning fiscal year 2008. The solar projects and fuel cell purchases are estimated to be more than $35 million annually and correspond to a total taxpayer savings of approximately $665,000 per year in state retail sales and use tax and more than $227,000 per year in local retail sales and use taxes. The taxpayer savings estimates are equivalent to the loss in state and local government revenue from continuing this retail sales and use tax exemption.

If the tax preference were to be terminated, what would be the negative effect 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?

With the termination of these tax preferences, the owners of wind farms and purchasers of solar equipment and fuel cells would be paying $27 million in retail sales and use taxes in 2008.

Due to the fact that Washington's renewable energy industry is not well studied, an examination of the U.S. renewable energy industry can be insightful. The renewable energy industry in the U.S. and Washington would consists of not only the owners and manufacturers of these renewable systems but also the installers, manufacturers of components contained in renewable energy systems, research and development employees, and others. According to nationwide studies, the majority of jobs created by the renewable energy industry are jobs for accountants, engineers, computer analysts, clerks, factory workers, truck drivers, mechanics, etc.[212] Most U.S. studies of the renewable energy industry include the following types of renewable energy:

[212] "Renewable Energy and Energy Efficiency: Economic Drivers for the 21st Century," by Roger Bezdek of the Management Information Services, Inc. for the American Solar Energy Society.

hydroelectricity, biomass, geothermal, wind, photovoltaics, and solar thermal. Exhibit 84 reveals the U.S. estimate of the revenues, direct jobs, and total jobs created with direct and indirect jobs for the renewable energy industry segments. Not all these segments of this industry would be benefiting directly from the retail sales and use tax preferences. Only the first five industry segments–wind, photovoltaics, solar thermal, fuel cells and hydrogen–would be directly impacted if Washington's retail sales and use tax preferences were eliminated. At the national level, these five industry segments constitute 32,490 direct jobs or 17.5 percent of all private sector renewable energy jobs. Washington's share of the U.S. economy is typically around 2 percent if evaluated in terms of population, but Washington's economy consists of a larger share of certain renewable energy sources.

Exhibit 84 – The Renewable Energy Industry in the U.S. - 2006

Industry Segment	Revenue / Budgets ($ billions)	Direct jobs	Total direct + indirect jobs created
Private Industry Only			
1) Wind	**$3.0**	**16,000**	**36,800**
2) Photovoltaics	**1.0**	**6,800**	**15,700**
3) Solar Thermal	**.1**	**800**	**1,900**
4) Fuel Cells	**.9**	**4,800**	**11,100**
5) Hydrogen	**.8**	**4,000**	**9,200**
6) Hydroelectric power	4.0	8,000	19,000
7) Geothermal	2.0	9,000	21,000
8) Biomass BioFuels	6.6	69,750	160,300
9)Biomass Power	17.0	66,000	152,000
Total Private Industry	**$35.40**	**185,150**	**427,000**
Total Government	$3.2	6,900	15,870
Trade and Professional Associations & NGOs	.6	1,500	3,450
Total, All Sectors	**$39.2**	**193,550**	**446,320**

Source: Management Information Services, Inc. and American Solar Energy Society, 2007.

Through the course of this review, JLARC did not find a comprehensive economic and employment analysis for the entire renewable energy industry in Washington. In 2003, a Washington State University (WSU) Energy Program study of Washington's Solar Electric Industry projected 490 employees.[213] JLARC's examination of the Washington Employment Security Department data for 2005 for the companies mentioned in the WSU report identified a total of 375 employees in Washington.

[213] "The Washington Solar Electric Industry: Sunrise or Sunset? A closing window of opportunity," by WSU Energy Program.

The revenue impact of eliminating these retail sales and use tax exemptions would mean higher sales taxes on purchasers of wind and solar equipment and fuel cells. If these tax preferences were eliminated, there would be minimal change on prices, quantity produced, or employment statewide from this policy change alone. Since the total tax loss from these tax preferences is small compared to Washington's total General Fund state cash receipts of $29.4 billion in the 2007-09 Biennium, there would be minimal negative economic impact from eliminating these tax preferences.

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

Since these tax preferences are an exemption from the retail sales and use taxes, there would be no change in the distribution of tax liability of state 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?

Five states, Alaska, Delaware, Montana, New Hampshire, and Oregon, do not have a retail sales or use tax so they are not included in this state survey of similar tax preferences for equipment used in generating electricity from alternative energy sources.

Exhibit 85 – Summary of Other State Survey of Retail Sales and Use Tax Preferences for Renewable Energy Sources

Type of Retail Sales or Use Tax Exemption for Renewable Energy	Number of states	State Details
No Retail Sales and/or Use Tax Preference for Machinery Used to Generate Electricity from Renewable Energy Sources	29	Includes District of Columbia
Retail Sales or Use Tax Preferences for Machinery Used to Generate Electricity from Renewable Energy Sources	16	Includes Washington state
Solar Energy	12	CT, FL, MA, MN, NJ, NY, RI, UT, VT, WA, WI, WY
Wind Energy	9	IA, MA, MN, RI, UT, VT, WA,WI, WY
Fuel Cells	5	SC, UT, VT, WA, WY
Landfill gas or biomass	7	GA (biomass only), WA (landfill gas only), NM, UT (biomass), VT, WI, WY

Source: JLARC.

From a 50-state survey of retail sales and use tax exemptions for alternative energy machinery and equipment, JLARC determined that four states, Utah, Wisconsin, Wyoming and Washington, allow retail sales and use tax exemptions for electrical generating machinery purchases of the following alternative energy sources: fuel cells, solar, and wind. Sixteen states have retail sales and /or use tax exemptions, including Washington. New Mexico has a use tax exemption for one or more alternative energy generating sources. Some 12 states have an exemption for purchases of solar energy generating machinery and equipment. Nine states have an exemption for wind energy equipment and five states have exemptions for purchases of fuel cells. Some seven states have a retail sales tax exemption for either landfill gas or biomass or both.

Twenty-nine states, including Washington DC, had no permanent retail sales and use tax exemptions for purchases of machinery and equipment which generate electricity from alternative energy sources. There are tax incentives in other states for purchases of renewable energy products. North Dakota has a retail sales tax exemption for purchases of energy conservation equipment used to increase efficiency at power plants, oil refineries or gas plants. Virginia has a retail sales tax exemption just for Energy Star Products. Two states, Texas and Maryland, had temporary sales tax holidays or tax-free weekends for purchases of certain alternative energy products.

Recommendations

1) Continue the retail sales and use tax preferences and reexamine these alternative energy tax preferences at a later date to determine their effectiveness in encouraging growth in this industry in Washington.

2) The Legislature should implement reporting requirements and criteria on which to evaluate the tax exemptions and reevaluate the wattage threshold limit to ensure there are not unintended beneficiaries.

Legislation Required: Yes.

Fiscal Impact: See taxpayer savings estimates for 2010 and 2011.

APPENDIX 1 – SCOPE AND OBJECTIVES

2008 Full Tax Preference Performance Reviews

SCOPE AND OBJECTIVES

APRIL 2008

STATE OF WASHINGTON
JOINT LEGISLATIVE AUDIT AND REVIEW COMMITTEE

STUDY TEAM
Gary Benson
Lizbeth Martin-Mahar

PROJECT SUPERVISOR
Keenan Konopaski

LEGISLATIVE AUDITOR
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1300 Quince St. SE
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Mandate

Engrossed House Bill 1069 (2006) established the Citizen Commission for Performance Measurement of Tax Preferences and directed it to develop a schedule for periodic review of the state's tax preferences. The bill also directed the Joint Legislative Audit and Review Committee (JLARC) to conduct the periodic reviews.

Background

Tax preferences are exemptions, exclusions, or deductions from the base of a state tax; a credit against a state tax; a deferral of a state tax; or a preferential state tax rate. The state has more than 550 tax preferences.

Recognizing the need to assess the effectiveness of these tax preferences in meeting their intended objectives, and an orderly process to do so, the Legislature established the Citizen Commission for Performance Measurement of Tax Preferences. The role of the commission is to develop a schedule for the performance review of all tax preferences at least once every ten years. The ten year schedule is to be revised annually.

Omitted from review are several categories of tax preferences identified by statute (e.g., tax preferences required by constitutional law). Any tax preference that the commission determines is a critical part of the structure of the tax system may also be omitted. The commission may recommend an expedited review process for any tax preference that has an estimated biennial fiscal impact of $10 million or less.

JLARC is to review tax preferences according to the schedule developed by the commission, and consistent with guidelines set forth in statute. For each tax preference JLARC is to provide recommendations to (1) continue, (2) modify, (3) add an expiration date and conduct another review prior to the expiration date, or (4) terminate the preference. JLARC may also recommend accountability standards for future reviews of tax preferences.

Full Study Scope

This tax preference performance review will include the tax preferences identified by the Citizen Commission to be reviewed prior to August 30, 2008. These tax preferences were recommended by the Citizen Commission as being subject to full review:

Brief Description	RCW Citation	Year Enacted
1. Private K-12 schools	84.36.050 (1)	1925
2. Private colleges	84.36.050 (1)	1925
3. Intangibles	84.36.070	1931
4. Commercial vessels	84.36.080 (1)	1931
5. Other ships and vessels	84.36.090	1931
6. Exported and imported fuel	82.36.230; 82.38.030	1933
7. Real estate sales	82.04.390	1935
8. Credit losses	82.04.4284	1935
9. Agricultural producers	82.04.330; 82.04.410	1935
10. Insurance premiums	82.04.320	1935
11. Public utilities	82.04.310	1935
12. Tax rate for urban trans. & vessels	82.16.020(1d&e)	1935
13. Items used in interstate commerce	82.08.0261	1949
14. Electric generating equip.; renewable resources	82.08.02567; 82.12.02567	1996

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 2008 JLARC meeting and at the August 2008 meeting of the commission. A final report will be presented to JLARC in November 2008.

JLARC Staff Contact for the Study

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Lizbeth Martin-Mahar	(360) 786-5123	martin-mahar.lizbeth@leg.wa.gov

Tax Preference Review Process

Commission develops and delivers to JLARC schedule of tax preferences for review

↓

JLARC staff conducts reviews of tax preferences

↓

Staff presents preliminary report to JLARC

↓

Staff requests comments from OFM and DOR

↓

JLARC presents preliminary report to commission

↓

Commission conducts public comment session and may provide comments

↓

Proposed Final Report *(with OFM, DOR, and commission comments)* to JLARC for approval to distribute

↓

Final Report transmitted to Legislative Fiscal Committees

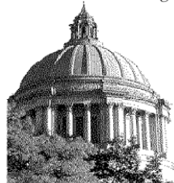
↓

Legislative Fiscal Committees hold joint hearing on Final Report

APPENDIX 2 – TAX PREFERENCE COMMISSION AND AGENCY RESPONSES

- Citizen Commission for Performance Measurement of Tax Preferences
- Office of Financial Management and Department of Revenue
- Department of Licensing

State of Washington



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Citizen Commission for Performance Measurement of Tax Preferences

William A. Longbrake, *Commission Chair*

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Paul Guppy
Vice President for Research
Washington Policy Center

Vacancy

Brian Sonntag
State Auditor

Senator **Phil Rockefeller**
Chair, Joint Legislative Audit and Review Committee

December 5, 2008

To: Joint Legislative Audit and Review Committee

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

Subject: **2008 Tax Preference Reviews**

Thank you for the opportunity to comment on the 2008 Tax Preference Preliminary Review Reports. The Commission has provided a forum for discussion and public comment on the recommendations included in the reviews. Our comments are as follows:

JLARC Recommendation	Commission Position and Adopted Comments
FULL REVIEWS:	
Intangibles Recommendation: The Legislature should continue the property tax exemption for intangible personal property.	Does not endorse and comments as follows: *Given the revenue impact of the exemption ($11 billion in 2008), the dramatic growth of intangible property in the New Economy, and the impact of such a large exemption on the adequacy, efficiency and fairness of the tax system, the Commission recommends that the Legislature study the exemption and consider how to appropriately treat intangible property.*
EXPEDITED REVIEWS:	
Wood biomass fuel: Production Facilities/Sale/Distribution Recommendations: 1) The Legislature should continue the property tax exemption for machinery and equipment used in producing wood biomass fuel. Since this tax preference is not currently being utilized, it should be reviewed for effectiveness in the future once it is used. 2) The Legislature should continue the leasehold excise tax exemption for leasehold interests of machinery and equipment used in producing wood biomass fuel. Since this tax preference is not currently being utilized, it should be reviewed for effectiveness in the future once it is used. 3) The Legislature should continue the retail sales tax exemption for sales of machinery and equipment used in constructing, altering or updating equipment which is used in selling wood biomass fuel. Since this tax preference is not	Does not endorse and comments as follows: *The Commission recommends that these preferences be allowed to expire in 2009 unless there is evidence that taxpayers plan to use them.*

JLARC Recommendation	Commission Position and Adopted Comments
currently being utilized, it should be reviewed for effectiveness in the future once it is used. 4) The Legislature should continue the use tax exemption for use of machinery and equipment used in constructing, altering or updating equipment which is used in selling wood biomass fuel. Since this tax preference is not currently being utilized, it should be reviewed for effectiveness in the future once it is used. 5) The Legislature should continue the business and occupation tax deduction for sales or distribution of wood biomass fuel. Since this tax preference is not currently being utilized, it should be reviewed for effectiveness in the future once it is used.	
FULL REVIEWS:	
Exported and imported fuel Recommendation: The motor vehicle fuel tax and special fuel tax exemption for exported and imported fuel should be continued.	Endorse with the following comment: *The Commission recommends the Legislature consider whether to modify this exemption in light of US Supreme Court decisions subsequent to enactment of this exemption.*
Private K-12 schools Recommendation: The Legislature should continue the property tax exemption for private, nonprofit schools.	Endorse without comment
Private colleges Recommendation: The Legislature should continue the property tax exemption for private, nonprofit schools.	Endorse without comment
Commercial vessels Recommendation: The Legislature should continue the apportionment of commercial vessels for property tax purposes.	Endorse without comment
Other ships and vessels Recommendation: The property tax exemption for other ships and vessels should be continued.	Endorse without comment
Real estate sales/rental/leasing Recommendation: The Legislature should continue the business and occupation tax exemption for income derived from real estate sales, rental and leasing.	Endorse without comment
Business and occupation tax deduction for credit losses Recommendation: The Legislature should continue this business and occupation tax deduction for credit losses incurred by businesses.	Endorse without comment

Citizen Commission for Performance Measurement of Tax Preferences
Page 3
December 5, 2008

JLARC Recommendation	Commission Position and Adopted Comments
FULL REVIEWS (cont.):	
Agricultural producers Recommendation: Given the fact that incomes have increased significantly for some farms since the period of financial hardships when this tax exemption was enacted, the Legislature should consider establishing an income threshold in order to qualify for the business and occupation tax exemption for agricultural producers.	Endorse without comment
Insurance premiums Recommendation: The Legislature should continue the business and occupation tax exemption for income derived from insurance premiums.	Endorse without comment
Public utilities Recommendation: The Legislature should continue the business and occupation tax preference for public utility income.	Endorse without comment
Tax rate for urban trans. & vessels Recommendation: The Legislature should review the policy of taxing transportation related business activity at different public utility tax rates based on where a transportation service takes place or the size of a vessel in which the service is conducted.	Endorse without comment
Items used in interstate commerce Recommendation: The Legislature should clarify the public policy purpose for the retail sales tax exemption for sales of tangible personal property to air, rail, and water private or common carriers to be used in interstate or foreign commerce.	Endorse without comment
Electric generating equip.; renewable resources Recommendations: 1) Continue the retail sales and use tax preferences and reexamine these alternative energy tax preferences at a later date to determine their effectiveness in encouraging growth in this industry in Washington. 2) The Legislature should implement reporting requirements and criteria on which to evaluate the tax exemptions and reevaluate the wattage threshold limit to ensure there are not unintended beneficiaries.	Endorse without comment
EXPEDITED REVIEWS:	
Public utility tax credit losses Recommendation: The Legislature should continue this public utility tax deduction for credit losses incurred by businesses.	Endorse without comment

JLARC Recommendation	Commission Position and Adopted Comments
EXPEDITED REVIEWS (cont.):	
Processing horticultural products Recommendations: The Legislature should continue the business and occupation tax preference for the income earned in receiving, washing, sorting, and packing of fresh horticultural products.	Endorse without comment
Fraternal insurance Recommendation: The Legislature should continue the business and occupation tax preference for fraternal beneficiary organizations.	Endorse without comment
Irrigation water Recommendation: Due to the lack of legislative intent and growth in beneficiaries of the public utility tax deduction for irrigation water, the Legislature should clarify if gross income derived from non-agricultural uses of irrigation water should be allowed for this tax deduction.	Endorse without comment
Sales for resale by water and gas utilities Recommendation: The Legislature should continue the public utility deduction for amounts derived from the sale for resale in Washington by water and gas utilities.	Endorse without comment
Radio and TV broadcasting Recommendations: (1) The Department of Revenue should conform its rule and practice on radio and television broadcasting advertising income to comply with the statute that allows two means for broadcasters to deduct income earned from the sale of network, national, and regional advertising. Since one of these means is no longer operative, broadcasters should deduct only actual sales of network, national, and regional advertising. (2) The Legislature should review the policy of exempting all network, national, and regional advertising from the B&O tax.	Endorse without comment
Minimum gross income filing threshold Recommendation: The Legislature should continue this public utility tax minimum income threshold exemption.	Endorse without comment
Public utility operating property Recommendation: The Legislature should continue these retail sales and use tax exemptions for sales of operating utility property to state and local political subdivisions.	Endorse without comment
Gas tax exemption for handling losses Recommendation: The Legislature should terminate the motor vehicle fuel handling loss deduction.	Endorse without comment

JLARC Recommendation	Commission Position and Adopted Comments
EXPEDITED REVIEWS (cont.):	
Airports owned by cities in other states Recommendation: Given that there are no out-of-state municipalities owning airport property in Washington, the Legislature should terminate this property tax exemption.	Endorse without comment
Farm auction sales Recommendation: Due to the fact that Washington currently does not have uniform tax treatment for all purchases of used farm machinery and equipment regardless of location and method by which the property is acquired, the Legislature should require reporting information of on-farm auction sales and review the policy of these retail sales and use tax exemptions.	Endorse without comment
Alcohol/biodiesel fuel production facilities Recommendations: 1) The Legislature should continue the property tax exemption for machinery and equipment used in producing alcohol fuel, biodiesel and biodiesel feedstock and review for effectiveness in the future once this industry is more developed. 2) The Legislature should continue the leasehold excise tax exemption for leasehold interests of machinery and equipment used in producing alcohol, biodiesel and biodiesel feedstock and review for effectiveness in the future once this industry is more developed. 3) The Legislature should continue the preferred business and occupation tax rate for manufacturers of alcohol and biodiesel fuel and feedstock and review for effectiveness in the future once this industry is more developed.	Endorse without comment

STATE OF WASHINGTON

RECEIVED
AUG 14 2008
JLARC

August 8, 2008

TO: Ruta Fanning, Legislative Auditor
Joint Legislative Audit and Review Committee

FROM: Victor A. Moore, Director
Office of Financial Management

Cindi Holmstrom, Director
Department of Revenue

SUBJECT: JLARC PRELIMINARY REPORTS ON 2008 TAX PREFERENCE PERFORMANCE REVIEW

Thank you for the opportunity to review and comment on the Joint Legislative Audit and Review Committee's (JLARC) preliminary reports on 2008 Tax Preference Performance Reviews.

We appreciate your efforts and those of the Citizen Commission for Performance Measurement of Tax Preferences (Commission) to identify current tax preference legislation for further review by the Legislature. Informed discussion about the original intent and assumptions underlying current tax preferences, and legislative debate about their continuing effectiveness and relevance, can help state government maintain a fair and equitable tax system.

We believe your work could improve the fairness of current tax preferences and add to our capacity to evaluate their impact on an ongoing basis. In examining these issues further, it may help to also look at the administrative burdens that result from a particular tax preference, burdens for both taxpayers and state agencies. We compliment your team for the thorough and thoughtful analysis of the tax preference items selected for review. We also offer the following two items of particular concern to the Department of Revenue.

Private, nonprofit K-12 Schools (Property Tax) pp 11-19 (Full Review)

The preliminary report indicates that the Department of Revenue's administrative rule is broader than the statute and, thus, there may be unintended beneficiaries. To the contrary, we believe the Department's rule controls the application of the K-12 private school exemption so that it stays within the statutory intent. The Department is continuing to work with your staff to address the conclusions in the report. We note, however, that the current rule reflects the pre-2006 statutes. The Legislature amended the applicable law (RCW 84.36.050) in 2006, and the Department continues to work with affected taxpayers on a draft rule reflecting the 2006 changes.

Ruta Fanning
August 8, 2008
Page 2

Radio and TV Broadcasting (B&O tax) pp 57-60 (Expedited review)

The preliminary report indicates that the Department of Revenue should conform its rule and practice on (apportioning) radio and television broadcasting advertising income to comply with the statute. We acknowledge that the statute provides for a standard deduction, based on information received from the Federal Communications Commission (FCC). In the alternative, individual broadcasting stations are required to itemize non-taxable revenues from network, national, and regional advertising. Since the FCC no longer provides this information, a portion of the statute is no longer operative. The Department's current rule allows a standard deduction for out-of-state revenues that relies on industry-provided data. This was adopted in agreement with the industry and we believe is in the spirit of the legislation. Nevertheless, as part of the Department's efforts to update its rules, it is planning to review its current rule and practice regarding the standard deduction.

Again, we appreciate your effort to continuously review and analyze the state's structure of tax liabilities and exemptions. Please continue to consult with the Office of Financial Management, Department of Revenue, and other agencies that would be affected by possible changes to tax preference legislation.

STATE OF WASHINGTON
DEPARTMENT OF LICENSING
PO Box 9020 • Olympia, Washington 98507-9020

RECEIVED
AUG 12 2008
JLARC

August 8, 2008

Ms. Ruta Fanning
Legislative Auditor
Post Office Box 40910
Olympia, Washington 98504-0910

Dear Ms. Fanning:

Thank you for the opportunity to review and comment on the Joint Legislative Audit and Review Committee's (JLARC) preliminary reports on 2008 Full Tax Preference Performance Reviews and 2008 Expedited Tax Preference Performance Reviews.

We appreciate the opportunity to respond to the recommendations in both reports. We support the recommendation on Exported and Imported Fuel that states the motor vehicle fuel tax and special fuel tax exemption for exported and imported fuel should be continued. We have no position on the recommendation on Gas Tax Exemption for Handling Losses that states the Legislature should terminate the motor vehicle handling loss deduction.

We appreciate your effort to continuously review and analyze the state's structure of tax liabilities and exemptions. Please let me know if you have any questions.

Sincerely,

FOR Liz Luce
Director

The department of Licensing has a policy of providing equal access to its services. If you need special accommodation, please call (360) 664-9492 or TTY (360) 664-8885.

APPENDIX 3 – CURRENT LAW

Schools and colleges

RCW 84.36.050

The following property is exempt from taxation:

(1) Property owned or used by or for any nonprofit school or college in this state for educational purposes or cultural or art educational programs as defined in RCW 82.04.4328. Real property so exempt shall not exceed four hundred acres including, but not limited to, buildings and grounds designed for the educational, athletic, or social programs of the institution, the housing of students, religious faculty, and the chief administrator, athletic buildings, and all other school or college facilities, the need for which would be nonexistent but for the presence of the school or college. The property must be principally designed to further the educational, athletic, or social functions of the college or school. If the property is leased, the benefit of the exemption must inure to such school or college.

Property Tax Exemption – Intangible Personal Property

RCW 84.36.070

(1) Intangible personal property is exempt from ad valorem taxation.

(2) "Intangible personal property" means:

(a) All moneys and credits including mortgages, notes, accounts, certificates of deposit, tax certificates, judgments, state, county and municipal bonds and warrants and bonds and warrants of other taxing districts, bonds of the United States and of foreign countries or political subdivisions thereof and the bonds, stocks, or shares of private corporations;

(b) Private nongovernmental personal service contracts, private nongovernmental athletic or sports franchises, or private nongovernmental athletic or sports agreements provided that the contracts, franchises, or agreements do not pertain to the use or possession of tangible personal or real property or to any interest in tangible personal or real property; and

(c) Other intangible personal property such as trademarks, trade names, brand names, patents, copyrights, trade secrets, franchise agreements, licenses, permits, core deposits of financial institutions, noncompete agreements, customer lists, patient lists, favorable contracts, favorable financing agreements, reputation, exceptional management, prestige, good name, or integrity of a business.

(3) "Intangible personal property" does not include zoning, location, view, geographic features, easements, covenants, proximity to raw materials, condition of surrounding property, proximity to markets, the availability of a skilled workforce, and other characteristics or attributes of property.

(4) This section does not preclude the use of, or permit a departure from, generally accepted appraisal practices and the appropriate application thereof in the valuation of real and tangible personal property, including the appropriate consideration of licenses, permits, and franchises granted by a government agency that affect the use of the property.

[1997 c 181 § 1; 1974 ex.s. c 118 § 1; 1961 c 15 § 84.36.070. Prior: 1931 c 96 § 1; RRS § 11111-1. FORMER PART OF SECTION: 1925 ex.s. c 130 § 5, part, now codified in RCW 84.04.080.]

Certain ships and vessels

RCW 84.36.080

(1) All ships and vessels which are exempt from excise tax under RCW 82.49.020(2) and excepted from the registration requirements of RCW 88.02.030(9) shall be and are hereby made exempt from all ad valorem taxes, except taxes levied for any state purpose.

RCW 84.40.036

Exemption for other ships and vessels

RCW 84.36.090

All ships and vessels, other than those partially exempt under RCW 84.36.080 and those described in RCW 84.36.079, are exempt from all ad valorem taxes.

[1983 c 7 § 24; 1961 c 15 § 84.36.090. Prior: 1959 c 295 § 2; 1945 c 82 § 2; 1931 c 81 § 2; Rem. Supp. 1945 § 11111-3.]

Exemptions — Imports, exports, federal sales — Invoice — Certificate — Reporting

RCW 82.36.230

The provisions of this chapter requiring the payment of taxes do not apply to motor vehicle fuel imported into the state in interstate or foreign commerce and intended to be sold while in interstate or foreign commerce, nor to motor vehicle fuel exported from this state by a licensee nor to any motor vehicle fuel sold by a licensee to the armed forces of the United States or to the national guard for use exclusively in ships or for export from this state. The licensee shall report such imports, exports and sales to the department at such times, on such forms, and in such detail as the department may require, otherwise the exemption granted in this section is null and void, and all fuel shall be considered distributed in this state fully subject to the provisions of this chapter. Each invoice covering exempt sales shall have the statement "Ex Washington Motor Vehicle Fuel Tax" clearly marked thereon.

To claim any exemption from taxes under this section on account of sales by a licensee of motor vehicle fuel for export, the purchaser shall obtain from the selling licensee, and such selling licensee must furnish the purchaser, an invoice giving such details of the sale for export as the department 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 motor vehicle fuel in that state or foreign jurisdiction. For the purposes of this section, motor vehicle fuel distributed to a federally recognized Indian tribal reservation located within the state of Washington is not considered exported outside this state.

To claim any refund of taxes previously paid on account of sales of motor vehicle fuel to the armed forces of the United States or to the national guard, the licensee shall be required to execute an exemption certificate in such form as shall be furnished by the department, containing a certified statement by an authorized officer of the armed forces having actual knowledge of the purpose for which the exemption is claimed. The provisions of this section exempting motor vehicle fuel sold to the armed forces of the United States or to the national guard from the tax imposed hereunder do not apply to any motor vehicle fuel sold to contractors purchasing such fuel either for their own account or as the agents of the United States or the national guard for use in the performance of contracts with the armed forces of the United States or the national guard.

The department may at any time require of any licensee any information the department deems necessary to determine the validity of the claimed exemption, and failure to supply such data will constitute a waiver of all right to the exemption claimed. The department is hereby empowered with full authority to promulgate rules and regulations and to prescribe forms to be used by licensees in reporting to the department so as to prevent evasion of the tax imposed by this chapter.

Upon request from the officials to whom are entrusted the enforcement of the motor vehicle fuel tax law of any other state, the District of Columbia, the United States, its territories and possessions, the provinces, or the Dominion of Canada, the department may forward to such officials any information which the department may have relative to the import or export of any motor vehicle fuel by any licensee: PROVIDED, That such governmental unit furnish like information to this state.

[1998 c 176 § 34; 1993 c 54 § 4; 1989 c 193 § 1; 1971 ex.s. c 156 § 2; 1967 c 153 § 3; 1965 ex.s. c 79 § 9; 1961 c 15 § 82.36.230. Prior: 1957 c 247 § 10; prior: 1953 c 150 § 1; 1949 c 220 § 13, part; 1943 c 84 § 4, part; 1939 c 177 § 4, part; 1933 c 58 § 17, part; Rem. Supp. 1949 § 8327-17, part.]

Tax imposed — Rate — Incidence — Allocation of proceeds — Expiration of subsection

RCW 82.38.030

(1) There is hereby levied and imposed upon special fuel licensees, other than special fuel distributors, a tax at the rate of twenty-three cents per gallon of special fuel, or each one hundred cubic feet of compressed natural gas, measured at standard pressure and temperature.

(2) Beginning July 1, 2003, an additional and cumulative tax rate of five cents per gallon of special fuel, or each one hundred cubic feet of compressed natural gas, measured at standard

pressure and temperature shall be imposed on special fuel licensees, other than special fuel distributors. This subsection (2) expires when the bonds issued for transportation 2003 projects are retired.

(3) Beginning July 1, 2005, an additional and cumulative tax rate of three cents per gallon of special fuel, or each one hundred cubic feet of compressed natural gas, measured at standard pressure and temperature shall be imposed on special fuel licensees, other than special fuel distributors.

(4) Beginning July 1, 2006, an additional and cumulative tax rate of three cents per gallon of special fuel, or each one hundred cubic feet of compressed natural gas, measured at standard pressure and temperature shall be imposed on special fuel licensees, other than special fuel distributors.

(5) Beginning July 1, 2007, an additional and cumulative tax rate of two cents per gallon of special fuel, or each one hundred cubic feet of compressed natural gas, measured at standard pressure and temperature shall be imposed on special fuel licensees, other than special fuel distributors.

(6) Beginning July 1, 2008, an additional and cumulative tax rate of one and one-half cents per gallon of special fuel, or each one hundred cubic feet of compressed natural gas, measured at standard pressure and temperature shall be imposed on special fuel licensees, other than special fuel distributors.

(7) Taxes are imposed when:

(a) Special fuel is removed in this state from a terminal if the special fuel is removed at the rack unless the removal is to a licensed exporter for direct delivery to a destination outside of the state, or the removal is by a special fuel supplier for direct delivery to an international fuel tax agreement licensee under RCW 82.38.320;

(b) Special fuel is removed in this state from a refinery if either of the following applies:

(i) The removal is by bulk transfer and the refiner or the owner of the special fuel immediately before the removal is not a licensee; or

(ii) The removal is at the refinery rack unless the removal is to a licensed exporter for direct delivery to a destination outside of the state, or the removal is to a special fuel supplier for direct delivery to an international fuel tax agreement licensee under RCW 82.38.320;

(c) Special fuel enters into this state for sale, consumption, use, or storage, unless the fuel enters this state for direct delivery to an international fuel tax agreement licensee under RCW 82.38.320, if either of the following applies:

(i) The entry is by bulk transfer and the importer is not a licensee; or

(ii) The entry is not by bulk transfer;

(d) Special fuel is sold or removed in this state to an unlicensed entity unless there was a prior taxable removal, entry, or sale of the special fuel;

(e) Blended special fuel is removed or sold in this state by the blender of the fuel. The number of gallons of blended special fuel subject to tax is the difference between the total number of gallons of blended special fuel removed or sold and the number of gallons of previously taxed special fuel used to produce the blended special fuel;

(f) Dyed special fuel is used on a highway, as authorized by the internal revenue code, unless the use is exempt from the special fuel tax;

(g) Dyed special fuel is held for sale, sold, used, or is intended to be used in violation of this chapter;

(h) Special fuel purchased by an international fuel tax agreement licensee under RCW 82.38.320 is used on a highway; and

(i) Special fuel is sold by a licensed special fuel supplier to a special fuel distributor, special fuel importer, or special fuel blender and the special fuel is not removed from the bulk transfer-terminal system.

[2007 c 515 § 21; 2005 c 314 § 102; 2003 c 361 § 402; 2002 c 183 § 2; 2001 c 270 § 6; 1998 c 176 § 51; 1996 c 104 § 7; 1989 c 193 § 3; 1983 1st ex.s. c 49 § 30; 1979 c 40 § 3; 1977 ex.s. c 317 § 5; 1975 1st ex.s. c 62 § 1; 1973 1st ex.s. c 156 § 1; 1972 ex.s. c 135 § 2; 1971 ex.s. c 175 § 4.]

Business and Occupation Tax Exemption – Real Estate Sales

RCW 82.04.390

This chapter shall not apply to gross proceeds derived from the sale of real estate. This however, shall not be construed to allow a deduction of amounts received as commissions from the sale of real estate, nor as fees, handling charges, discounts, interest or similar financial charges resulting from, or relating to, real estate transactions. [1961 c 15 § 82.04.390. Prior: 1959 ex.s. c 5 § 8; 1959 c 197 § 23; prior: 1945 c 249 § 2, part; 1943 c 156 § 4, part; 1941 c 178 § 6, part; 1939 c 225 § 5, part; 1937 c 227 § 4, part; 1935 c 180 § 11, part; Rem. Supp. 1945 § 8370-11, part.]

RCW 82.04.040

(1) "Sale" means any transfer of the ownership of, title to, or possession of property for a valuable consideration and includes any activity classified as a "sale at retail" or "retail sale" under RCW 82.04.050. It includes lease or rental, conditional sale contracts, and any contract under which possession of the property is given to the purchaser but title is retained by the vendor as security for the payment of the purchase price. It also includes the furnishing of food, drink, or meals for compensation whether consumed upon the premises or not.

(2) "Casual or isolated sale" means a sale made by a person who is not engaged in the business of selling the type of property involved.

(3)(a) "Lease or rental" means any transfer of possession or control of tangible personal property for a fixed or indeterminate term for consideration. A lease or rental may include future options to purchase or extend. "Lease or rental" includes agreements covering motor

vehicles and trailers where the amount of consideration may be increased or decreased by reference to the amount realized upon sale or disposition of the property as defined in 26 U.S.C. Sec. 7701(h)(1), as amended or renumbered as of January 1, 2003. The definition in this subsection (3) shall be used for sales and use tax purposes regardless if a transaction is characterized as a lease or rental under generally accepted accounting principles, the United States internal revenue code, Washington state's commercial code, or other provisions of federal, state, or local law.

(b) "Lease or rental" does not include:

(i) A transfer of possession or control of property under a security agreement or deferred payment plan that requires the transfer of title upon completion of the required payments;

(ii) A transfer of possession or control of property under an agreement that requires the transfer of title upon completion of required payments, and payment of an option price does not exceed the greater of one hundred dollars or one percent of the total required payments; or

(iii) Providing tangible personal property along with an operator for a fixed or indeterminate period of time. A condition of this exclusion is that the operator is necessary for the tangible personal property to perform as designed. For the purpose of this subsection (3)(b)(iii), an operator must do more than maintain, inspect, or set up the tangible personal property.

[2004 c 153 § 402; 2003 c 168 § 103; 1961 c 15 § 82.04.040. Prior: 1959 ex.s. c 5 § 1; 1959 ex.s. c 3 § 1; 1955 c 389 § 5; prior: 1949 c 228 § 2, part; 1945 c 249 § 1, part; 1943 c 156 § 2, part; 1941 c 178 § 2, part; 1939 c 225 § 2, part; 1937 c 227 § 2, part; 1935 c 180 § 5, part; Rem. Supp. 1949 § 8370-5, part.]

Business and Occupation Tax – Credit Losses

RCW 82.04.4284

(1) In computing tax there may be deducted from the measure of tax bad debts, as that term is used in 26 U.S.C. Sec. 166, as amended or renumbered as of January 1, 2003, on which tax was previously paid.

(2) For purposes of this section, "bad debts" do not include:

(a) Amounts due on property that remains in the possession of the seller until the full purchase price is paid;

(b) Expenses incurred in attempting to collect debt;

(c) Sales or use taxes payable to a seller; and

(d) Repossessed property.

(3) If a deduction is taken for a bad debt and the debt is subsequently collected in whole or in part, the tax on the amount collected must be paid and reported on the return filed for the period in which the collection is made.

(4) Payments on a previously claimed bad debt must be applied under RCW 82.08.037(4) and 82.12.037, according to such rules as the department may prescribe.

[2004 c 153 § 307; 1980 c 37 § 5. Formerly RCW 82.04.430(4).]

Business and Occupation Tax – Agricultural Producers

RCW 82.04.330

This chapter shall not apply to any farmer that sells any agricultural product at wholesale or to any farmer who grows, raises, or produces agricultural products owned by others, such as custom feed operations. This exemption shall not apply to any person selling such products at retail or to any person selling manufactured substances or articles.

This chapter shall also not apply to any persons who participate in the federal conservation reserve program or its successor administered by the United States department of agriculture with respect to land enrolled in that program.

[2001 c 118 § 3; 1993 sp.s. c 25 § 305; 1988 c 253 § 2; 1987 c 23 § 4. Prior: 1985 c 414 § 10; 1985 c 148 § 1; 1965 ex.s. c 173 § 7; 1961 c 15 § 82.04.330; prior: 959 c 197 § 17; prior: 1945 c 249 § 2, part; 1943 c 156 § 4, part; 1941 c 178 § 6, part; 1939 c 225 § 5, part; 1937 c 227 § 4, part; 1935 c 180 § 11, part; Rem. Supp. 1945 § 8370-11, part.]

RCW 82.04.410

This chapter shall not apply to amounts derived by persons engaged in the production and sale of hatching eggs or poultry for use in the production for sale of poultry or poultry products.

[1967 ex.s. c 149 § 15; 1961 c 15 § 82.04.410. Prior: 1959 c 197 § 25; prior: 1945 c 249 § 2, part; 1943 c 156 § 4, part; 1941 c 178 § 6, part; 1939 c 225 § 5, part; 1937 c 227 § 4, part; 1935 c 180 § 11, part; Rem. Supp. 1945 § 8370-11, part.]

RCW 82.04.213

(1) "Agricultural product" means any product of plant cultivation or animal husbandry including, but not limited to: A product of horticulture, grain cultivation, vermiculture, viticulture, or aquaculture as defined in RCW 15.85.020; plantation Christmas trees; short-rotation hardwoods as defined in RCW 84.33.035; turf; or any animal including but not limited to an animal that is a private sector cultured aquatic product as defined in RCW 15.85.020, or a bird, or insect, or the substances obtained from such an animal. "Agricultural product" does not include animals defined as pet animals under RCW 16.70.020.

(2) "Farmer" means any person engaged in the business of growing, raising, or producing, upon the person's own lands or upon the lands in which the person has a present right of possession, any agricultural product to be sold. "Farmer" does not include a person growing, raising, or producing such products for the person's own consumption; a person selling any animal or substance obtained therefrom in connection with the person's business of operating a stockyard or a slaughter or packing house; or a person in respect to the business of taking, cultivating, or raising timber.

[2001 c 118 § 2; 2001 c 97 § 3; 1993 sp.s. c 25 § 302.]

Business and Occupation Tax – Insurance Premiums Exemption

RCW 82.04.320

This chapter shall not apply to any person in respect to insurance business upon which a tax based on gross premiums is paid to the state: PROVIDED, That the provisions of this section shall not exempt any person engaging in the business of representing any insurance company, whether as general or local agent, or acting as broker for such companies: PROVIDED FURTHER, That the provisions of this section shall not exempt any bonding company from tax with respect to gross income derived from the completion of any contract as to which it is a surety, or as to any liability as successor to the liability of the defaulting contractor.

RCW 48.14.040

(1) If pursuant to the laws of any other state or country, any taxes, licenses, fees, deposits, or other obligations or prohibitions, in the aggregate, or additional to or at a net rate in excess of any such taxes, licenses, fees, deposits or other obligations or prohibitions imposed by the laws of this state upon like foreign or alien insurers and their agents and solicitors, are imposed on insurers of this state and their agents doing business in such other state or country, a like rate, obligation or prohibition may be imposed by the commissioner, as to any item or combination of items involved, upon all insurers of such other state or country and their agents doing business in this state, so long as such laws remain in force or are so applied.

(2) For the purposes of this section, an alien insurer may be deemed to be domiciled in the state wherein it has established its principal office or agency in the United States. If no such office or agency has been established, the domicile of the alien insurer shall be deemed to be the country under the laws of which it is formed.

(3) For the purposes of this section, the regulatory surcharge imposed by RCW 48.02.190 shall not be included in the calculation of any retaliatory taxes, licenses, fees, deposits, or other obligations or prohibitions imposed under this section.

[2007 c 153 § 4; 1988 c 248 § 8; 1949 c 190 § 21, part; 1947 c 79 § .14.04; Rem. Supp. 1949 § 45.14.04.]

Business and Occupation Tax – Public Utility Income

RCW 82.04.310

(1) This chapter shall not apply to any person in respect to a business activity with respect to which tax liability is specifically imposed under the provisions of chapter 82.16 RCW including amounts derived from activities for which a deduction is allowed under RCW 82.16.050.

(2) This chapter does not apply to amounts received by any person for the sale of electrical energy for resale within or outside the state.

(3)(a) This chapter does not apply to amounts received by any person for the sale of natural or manufactured gas in a calendar year if that person sells within the United States a total amount of natural or manufactured gas in that calendar year that is no more than twenty percent of the amount of natural or manufactured gas that it consumes within the United States in the same calendar year.

(b) For purposes of determining whether a person has sold within the United States a total amount of natural or manufactured gas in a calendar year that is no more than twenty percent of the amount of natural or manufactured gas that it consumes within the United States in the same calendar year, the following transfers of gas are not considered to be the sale of natural or manufactured gas:

(i) The transfer of any natural or manufactured gas as a result of the acquisition of another business, through merger or otherwise; or

(ii) The transfer of any natural or manufactured gas accomplished solely to comply with federal regulatory requirements imposed on the pipeline transportation of such gas when it is shipped by a third-party manager of a person's pipeline transportation.

[2007 c 58 § 1; 2000 c 245 § 2; 1989 c 302 § 202; 1961 c 15 § 82.04.310. Prior: 1959 c 197 § 15; prior: 1945 c 249 § 2, part; 1943 c 156 § 4, part; 1941 c 178 § 6, part; 1939 c 225 § 5, part; 1937 c 227 § 4, part; 1935 c 180 § 11, part; Rem. Supp. 1945 § 8370-11, part.]

Public utility tax imposed — Additional tax imposed — Deposit of moneys

RCW 82.16.020

(1) There is levied and there shall be collected from every person a tax for the act or privilege of engaging within this state in any one or more of the businesses herein mentioned. The tax shall be equal to the gross income of the business, multiplied by the rate set out after the business, as follows:

(d) Urban transportation business: Six-tenths of one percent;

(e) Vessels under sixty-five feet in length, except tugboats, operating upon the waters within the state: Six-tenths of one percent.

Exemptions — Sales of personal property for use connected with private or common carriers in interstate or foreign commerce.

RCW 82.08.0261

The tax levied by RCW 82.08.020 shall not apply to sales of tangible personal property (other than the type referred to in RCW 82.08.0262) for use by the purchaser in connection with the business of operating as a private or common carrier by air, rail, or water in interstate or foreign commerce: PROVIDED, That any actual use of such property in this state shall, at the time of such actual use, be subject to the tax imposed by chapter 82.12 RCW.

[1980 c 37 § 28. Formerly RCW 82.08.030(10).]

Retail Sales Tax Exemption – Machinery and Equipment Used in Generating Electricity

RCW 82.08.02567

(1) The tax levied by RCW 82.08.020 shall not apply to sales of machinery and equipment used directly in generating electricity using fuel cells, wind, sun, 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, but only if the purchaser develops with such machinery, equipment, and labor a facility capable of generating not less than two hundred watts of electricity and provides the seller with an exemption certificate in a form and manner prescribed by the department. The seller shall retain a copy of the certificate for the seller's files.

(2) For purposes of this section and RCW 82.12.02567:

(a) "Landfill gas" means biomass fuel of the type qualified for federal tax credits under 26 U.S.C. Sec. 29 collected from a landfill. "Landfill" means a landfill as defined under RCW 70.95.030;

(b) "Machinery and equipment" means industrial fixtures, devices, and support facilities that are integral and necessary to the generation of electricity using fuel cells, wind, sun, or landfill gas as the principal source of power;

(c) "Machinery and equipment" does not include: (i) Hand-powered tools; (ii) property with a useful life of less than one year; (iii) repair parts required to restore machinery and equipment to normal working order; (iv) replacement parts that do not increase productivity, improve efficiency, or extend the useful life of machinery and equipment; (v) buildings; or (vi) 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;

(d) Machinery and equipment is "used directly" in generating electricity with fuel cells or by wind energy, solar energy, or landfill gas power if it provides any part of the process that captures the energy of the wind, sun, 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;

(e) "Fuel cell" means an electrochemical reaction that generates electricity by combining atoms of hydrogen and oxygen in the presence of a catalyst.

(3) This section expires June 30, 2009.

[2004 c 152 § 1; 2001 c 213 § 1; 1999 c 358 § 4; 1998 c 309 § 1; 1996 c 166 § 1.]

Use Tax Exemption – Machinery and Equipment Used in Generating Electricity

RCW 82.12.02567

(1) The provisions of this chapter shall not apply with respect to machinery and equipment used directly in generating not less than two hundred watts of electricity using fuel cells, wind, sun, or landfill gas as the principal source of power, or to the use of labor and services rendered in respect to installing such machinery and equipment.

(2) The definitions in RCW 82.08.02567 apply to this section.

(3) This section expires June 30, 2009.