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

2013 Tax Preference Performance Reviews

Preliminary Report

August 2013

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Audit Authority

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

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

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

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REPORT SUMMARY

What Is a Tax Preference?

Tax preferences are defined in statute as exemptions, exclusions, or deductions from the base of a state tax; a credit against a state tax; a deferral of a state tax; or a preferential state tax rate. The total number of tax preferences changes as they are added or expire; currently there are 613.

Why a Review of Tax Preferences?

Legislature Creates a Process to Review Tax Preferences

In 2006, the Legislature expressly stated that periodic reviews of tax preferences are needed to determine if their continued existence or modification serves the public interest. The Legislature enacted Engrossed House Bill 1069 to provide for an orderly process for the review of tax preferences (now found in Chapter 43.136, Revised Code of Washington). The legislation assigns specific roles in the process to two different entities.

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

Citizen Commission Sets the Schedule

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

The Commission conducts its reviews based on analysis prepared by JLARC staff. In addition, the Commission may elect to rely on information supplied by the Department of Revenue. This volume includes 16 chapters covering 22 preferences (similar preferences may be combined in one chapter) completed by JLARC staff in 2013. One additional preference, a sales and use tax exemption for local residential and coin-operated telephone services, was scheduled for review in 2013. However, the Legislature repealed the preference in June 2013 prior to publication of this report and this preference was not reviewed. Analysis of preferences completed in previous years is found on the Commission's website: http://www.citizentaxpref.wa.gov/

JLARC Staff's Approach to the Tax Preference Reviews

Statute guides the 11 questions typically covered in the reviews.

Public Policy Objectives:

1. What are the public policy objectives that provide a justification for the tax preference? Is there any documentation on the purpose or intent of the tax preference? (RCW 43.136.055(b))
2. What evidence exists to show that the tax preference has contributed to the achievement of any of these public policy objectives? (RCW 43.136.055(c))
3. To what extent will continuation of the tax preference contribute to these public policy objectives? (RCW 43.136.055(d))
4. If the public policy objectives are not being fulfilled, what is the feasibility of modifying the tax preference for adjustment of the tax benefits? (RCW 43.136.055(g))

Beneficiaries:

5. Who are the entities whose state tax liabilities are directly affected by the tax preference? (RCW 43.136.055(a))
6. To what extent is the tax preference providing unintended benefits to entities other than those the Legislature intended? (RCW 43.136.055(e))

Revenue and Economic Impacts:

7. What are the past and future tax revenue and economic impacts of the tax preference to the taxpayer and to the government if it is continued? (This includes an analysis of the general effects of the tax preference on the overall state economy, including the effects on consumption and expenditures of persons and businesses within the state.) (RCW 43.136.055(h))
8. If the tax preference were to be terminated, what would be the negative effects on the taxpayers who currently benefit from the tax preference and the extent to which the resulting higher taxes would have an effect on employment and the economy? (RCW 43.136.055(f))
9. If the tax preference were to be terminated, what would be the effect on the distribution of liability for payment of state taxes? (RCW 43.136.055(i))
10. For those preferences enacted for economic development purposes, what are the economic impacts of the tax preference compared to the economic impacts of government activities funded by the tax? (RCW 43.136.055(j))

Other States:

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

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

JLARC Staff's Analysis Process

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

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

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

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

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

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

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

Summary of the Results from JLARC Staff's Reviews

The table beginning on page 5 provides a summary of the recommendations from JLARC staff's analysis. Of the preferences, JLARC staff recommends the Legislature:

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

Organization of this Report

The Commission selected several preferences related to health care for JLARC staff to review in 2013. The report is divided into two sections. The first section includes eight reviews of preferences related to health care, followed by the remaining reviews presented in alphabetical order. For those accessing the information electronically, a link is provided with each summary to "jump" to the detailed analysis. The current appendices provide the Scope and Objectives and the text of current law for each preference.

In addition to the preferences reviewed in this report, information on 48 other preferences considered by the Commission in 2013 can be found in the *2013 Expedited Tax Preferences*. Information on these preferences was provided by the Department of Revenue.

Summary of 2013 Tax Preference Performance Reviews			
What the Preference Does	**Public Policy Objective**	**Est. Beneficiary Savings**	**Legislative Auditor Recommendation**
Preferences Related to Medical Items and Services			
Government Payments to Public and Nonprofit Hospitals (B&O Tax) / RCW 82.04.4311			Detail on page 13
Provides a B&O tax deduction to public or nonprofit hospitals, or nonprofit community health centers for amounts received under a health service program paid for by the federal or state government.	The Legislature stated the public policy objective for the preference was to not tax amounts paid to public or nonprofit hospitals under a government-subsidized health care program for the care of elderly, low income, or disabled people, as providing health care for such persons is a recognized, necessary, and vital governmental function.	$162.7 million in the 2015-17 Biennium	**Review and clarify:** Because it is unclear why for-profit hospitals that provide government-subsidized health care are excluded from the preference.
Health Maintenance Organizations (B&O Tax) / RCW 82.04.322			Detail on page 25
Exempts health maintenance organizations and health care service contractors from B&O tax on income from premiums and prepayments that are taxed under the insurance premium tax.	The Legislature did not state the public policy objective of the tax preference. JLARC staff infer the public policy objective was to avoid double taxation of health maintenance organization and health care service contractor premium and prepayment income.	$53.1 million in the 2015-17 Biennium	**Continue:** Because it is fulfilling the inferred public policy objective of avoiding double taxation of this income.
Medicare and Basic Health Plan Receipts (Insurance Premium Tax) / RCWs 48.14.0201(6)(a), 48.14.0201(6)(b)			Detail on page 33
Exempts health maintenance organizations and health care service contractors from insurance premium tax for: 1) Certain federal payments for Medicare; and 2) Subsidized enrollees in the state Basic Health Plan and medical care services for certain persons.	The Legislature did not state the public policy objectives of the tax preferences. JLARC staff infer the public policy objectives were to: 1) Comply with federal law prohibiting states from taxing federal Medicare prepayments; and 2) Reduce costs to the state by exempting state-funded Basic Health Plan and certain medical care services.	$89.4 million in the 2011-13 Biennium	**Continue:** Because the preferences are meeting the inferred public policy objectives of: 1) keeping Washington in compliance with federal law that prohibits states from taxing Medicare receipts; and 2) reducing state medical care costs.

Summary of 2013 Tax Preference Performance Reviews			
What the Preference Does	**Public Policy Objective**	**Est. Beneficiary Savings**	**Legislative Auditor Recommendation**
Dentistry Prepayments (Insurance Premium Tax) / RCWs 48.14.0201(6)(c)			Detail on page 41
Exempts health care service contractors from insurance premium tax on prepayments received for dentistry services. Effective July 28, 2013, the exemption becomes available to health maintenance organizations and life and disability insurers.	The Legislature did not state the public policy objective for the tax preference. JLARC staff infer the tax preference was intended to be temporary while health care service contractors offering dentistry services transitioned into certified health plans.	$22.4 million in the 2015-17 Biennium	**Terminate:** Because the inferred public policy objective of providing a temporary exemption during the transition of health care service contractors to certified health plans is no longer applicable.
Prescription Drug Administration (B&O Tax) / RCW 82.04.620			Detail on page 49
Provides a B&O tax deduction to physicians and medical clinics for sales to patients of certain prescription drugs covered under Medicare Part B that are infused or injected.	The Legislature did not state the public policy objective for the tax preference. JLARC staff infer the public policy objectives were: 1) To lower costs for physicians and medical clinics that infuse or inject drugs covered under Medicare Part B; and 2) To help keep these physicians' offices and medical clinics open to provide better patient access to these drugs.	$6.1 million in the 2015-17 Biennium	**Review and clarify:** Because while the preference is meeting the inferred public policy objective of lowering costs, the Legislature may want to consider adding reporting or other accountability requirements to provide better information on the effectiveness of the preference.
Medical Items, Dietary Supplements, Insulin, and Kidney Dialysis Devices (Sales and Use Tax) / RCWs 82.08.0283, 82.12.0277, 82.08.925, 82.12.925, 82.08.985, 82.12.985, 82.08.945, 82.12.945			Detail on page 57
These four preferences provide sales and use tax exemptions for the following medical and health care related items for human use: • Medical items, including prescribed prosthetic devices, naturopath-prescribed medicines, prescribed medical oxygen systems, and repair labor and services for any of these items; • Prescribed dietary supplements; • Insulin; and • Kidney dialysis devices.	The Legislature did not state the public policy objective for any of the tax preferences. JLARC staff infer the public policy objective was to selectively address the regressive nature of sales tax by exempting certain "medically necessary" items for basic human needs.	**Medical Devices:** $122.9 million in the 2015-17 Biennium **Dietary Supplements:** $12.2 million in the 2015-17 Biennium **Insulin:** $52.4 million in the 2015-17 Biennium **Kidney Dialysis Devices:** $8.8 million in the 2015-17 Biennium	**Continue:** Because the preferences are meeting the inferred public policy objective of reducing the regressive nature of Washington's sales and use tax by exempting certain medical items and services that meet basic human needs.

Summary of 2013 Tax Preference Performance Reviews			
What the Preference Does	**Public Policy Objective**	**Est. Beneficiary Savings**	**Legislative Auditor Recommendation**
Nonprofit Blood and Tissue Banks (B&O Tax, Sales and Use Tax) / RCWs 82.04.324, 82.08.02805, 82.12.02747			Detail on page 73
Exempts nonprofit blood and tissue banks from: 1) B&O tax on revenue from collection, storage, and distribution of blood and tissue if the income is also exempt from federal income tax, and 2) Sales and use taxes on purchases of qualified medical supplies, chemicals, and materials.	The Legislature did not state the public policy objective for the tax preferences in 2004. JLARC staff infer the public policy objective was to provide the same tax treatment to nonprofit blood and tissue banks as the federal law required states to provide to the American Red Cross.	**B&O Tax:** $4.7 million in the 2015-17 Biennium **Sales and Use Tax:** $17.9 million in the 2015-17 Biennium	**Continue:** Because the 2004 preferences are achieving the inferred public policy objective of providing the same tax treatment to nonprofit blood and tissue banks as to the American Red Cross.
Prescription Drug Resellers (B&O Tax) / RCW 82.04.272			Detail on page 81
Provides a reduced B&O tax rate for businesses that warehouse and resell prescription drugs.	The Legislature did not state the public policy objective for the tax preference. JLARC staff infer the Legislature intended to reduce a competitive disadvantage for drug resellers operating warehouses in Washington relative to businesses that distribute drugs in the state without nexus and that owe no B&O tax.	$29.9 million in the 2015-17 Biennium	**Continue:** Because the preference is meeting the inferred public policy objective of reducing a competitive disadvantage for wholesalers operating Washington warehouses relative to out-of-state drug distributors that have no nexus to Washington and pay no B&O tax.

Summary of 2013 Tax Preference Performance Reviews			
What the Preference Does	**Public Policy Objective**	**Est. Beneficiary Savings**	**Legislative Auditor Recommendation**
Other Preferences			
Artistic and Cultural Organizations (B&O Tax, Sales and Use Tax) / RCWs 82.04.4322, 82.04.4324, 82.04.4326, 82.04.4327, 82.08.031, 82.12.031			Detail on page 91
These preferences provide nonprofit artistic and cultural organizations with: **B&O tax** deductions for income from: • Government funding and support; • The value of items manufactured for their own use; • Tuition program charges; and • Income earned from business activities. **Sales and use tax** exemptions for purchases or acquisitions of: • Objects of art; • Objects of cultural value; • Objects used to create art; and • Objects used to display art objects or present artistic or cultural performances.	The Legislature did not state public policy objectives for any of the tax preferences. JLARC staff infer the public policy objectives were: 1) To offset funding reductions experienced by artistic and cultural organizations during a time when their government support had been reduced; 2) To make taxation of artistic and cultural organization income in Washington consistent with the federal government and other states; and 3) To support Washington's nonprofit artistic and cultural organizations.	**B&O Tax:** $7.6 million in the 2015-17 Biennium **Sales and Use Tax:** $6 million in the 2013-15 Biennium	**Review and clarify:** Because although the preferences appear to have achieved or partially achieved the inferred public policy objectives: 1) the Legislature has not yet identified if it intends any long-term offsetting relationship between beneficiary savings for artistic and cultural organizations and government funding levels for such organizations; and 2) the B&O tax exemption is broader than that provided by the federal government and other states that follow the federal exemption.
Fishing Boat Fuel (Sales and Use Tax) / RCWs 82.08.0298, 82.12.0298			Detail on page 103
Exempts commercial deep sea fishing and commercial passenger charter fishing businesses from sales and use tax on purchases of diesel fuel for use in their watercraft.	The Legislature did not state the public policy objective for the tax preference. JLARC staff infer the public policy objectives may have been: 1) To support Washington's commercial fishing industry, coastal communities, and businesses by removing a disincentive for fishing boats to buy fuel in Washington; and 2) To provide tax treatment of fuel for commercial and charter fishing vessels that is equitable with the tax treatment of fuel for vessels conducting interstate and foreign commerce.	$12.2 million in the 2015-17 Biennium	**Review and clarify:** Because the preference is not meeting the inferred public policy objective of providing equitable tax treatment on fuel for Washington commercial deep sea fishing and charter fishing boats when compared to tax treatment on fuel for commercial fishing vessels engaged in interstate and foreign commerce. In addition, the $5,000 minimum gross receipts level has not been reviewed since 1987.

Summary of 2013 Tax Preference Performance Reviews			
What the Preference Does	**Public Policy Objective**	**Est. Beneficiary Savings**	**Legislative Auditor Recommendation**
Fuel Used in Commercial Vessels (B&O Tax) / RCW 82.04.433			Detail on page 111
Provides a B&O tax deduction to businesses selling fuel for consumption outside of U.S. territorial waters by commercial vessels used primarily in foreign commerce.	The Legislature did not state the public policy objective for the tax preference. JLARC staff infer the public policy objectives may have been: 1) To treat income from marine fuel sales delivered in Washington for use in vessels conducting foreign commerce the same as income from sales of goods delivered out-of-state, and 2) To keep marine fuel sellers from moving out of Washington.	$8.1 million in the 2015-17 Biennium	**Review and clarify:** To consider if the Legislature wants to add reporting or other accountability requirements that would provide better information on the effectiveness of this preference in keeping marine fuel sellers from moving out of Washington.
Nonprofit Youth Recreation Services and Local Government Physical Fitness Classes (Sales and Use Tax) / RCWs 82.08.0291, 82.12.02917			Detail on page 121
Exempts the following from sales tax: • Amusement and recreation services provided by nonprofit youth organizations to their members (also exempt from use tax); • Physical fitness services provided by nonprofit youth organizations to their members; and • Physical fitness classes provided by local governments.	The Legislature did not state a public policy objective for the tax preference. JLARC staff infer the public policy objective of the exemption for amusement and recreation services and personal services classified as retail services by nonprofit youth organizations is to support and recognize that such organizations provide for the public good. JLARC staff infer the public policy objective for the local government physical fitness class exemption is to reduce costs for patrons of such classes.	$29.6 million in the 2015-17 Biennium	**Review and clarify:** Because while the preference appears to be achieving the inferred public policy objective of recognizing the general public good provided by character-building nonprofit youth organizations, the preference benefits adults as well as youth. In addition, the exemption for personal services classified as retail sales technically includes services not generally provided by nonprofit youth organizations.

Summary of 2013 Tax Preference Performance Reviews			
What the Preference Does	**Public Policy Objective**	**Est. Beneficiary Savings**	**Legislative Auditor Recommendation**
Retailing (B&O Tax) / RCW 82.04.250(1)			Detail on page 131
Provides a lower B&O tax rate for retailers than the rate paid by manufacturers and wholesalers.	The Legislature did not state the public policy objective for the tax preference. JLARC staff infer that, at the time of enactment, the Legislature wanted to lessen the financial impact of a sales tax increase on retailers by not imposing a B&O tax increase on them at the same time.	$47.1 million in the 2015-17 Biennium	**Review and clarify:** Because sales tax-related changes since 1983 may impact the rationale for the level of preferential rate provided to the retail industry compared to other businesses.
Rural County and CEZ New Jobs (B&O Tax) / RCWs 82.62.030, 82.62.045			Detail on page 141
Provides a B&O tax credit to manufacturing, research and development, and commercial testing businesses that hire workers in rural counties or in Community Empowerment Zones (CEZs).	The Legislature did not state the public policy objective when it enacted this preference in 1986, but included intent language in 1997 when it amended the tax preference. The Legislature stated the public policy objective is to assist rural distressed areas in their efforts to address above average unemployment rates and below average employment growth.	$4.3 million in the 2015-17 Biennium	**Review and clarify:** To determine if the new jobs are located where the Legislature intended and if the number of new jobs is what the Legislature intended.
Tree Trimming Under Power Lines (Sales and Use Tax) / RCW 82.04.050(3)(e)			Detail on page 155
Exempts line clearing activities performed by or for an electric utility from sales tax. These activities are instead subject to B&O tax under the service classification.	The Legislature never intended to extend sales tax to utility line clearing when it defined landscaping services as a retail sale. Its public policy objective in enacting the 1995 legislation was to clarify this fact by specifically excluding line clearing from the list of taxable activities.	$0	**Continue:** The language clarifies that landscaping services subject to sales tax do not include line clearing services performed by or for electric utilities.
Use Tax on Rental Value (Use Tax) / RCW 82.12.010(7)(c)			Detail on page 161
Provides that out-of-state businesses that bring property temporarily into Washington for business purposes owe use tax on a reduced, "reasonable rental value" instead of on the full purchase price of the property.	The Legislature did not state the public policy objective for this preference. JLARC staff infer the Legislature enacted the tax preference in order to end a tax dispute with Oregon by reducing the costs to businesses doing work temporarily in Washington.	$3.3 million in the 2015-17 Biennium	**Continue:** Because the inferred public policy objective of resolving a 1980s tax dispute with Oregon by reducing costs to businesses temporarily working in Washington has been achieved.

GOVERNMENT PAYMENTS TO PUBLIC AND NONPROFIT HOSPITALS (B&O TAX)

Report Summary			
What the Preference Does	**Public Policy Objectives**	**Estimated Beneficiary Savings**	**Auditor Recommendation**
Provides a B&O tax deduction to public or nonprofit hospitals, or nonprofit community health centers for amounts received under a health service program paid for by the federal or state government.	The Legislature stated the public policy objective for the preference was to not tax amounts paid to public or nonprofit hospitals under a government-subsidized health care program for the care of elderly, low income, or disabled people, as providing health care for such persons is a recognized, necessary, and vital governmental function.	$162.7 million in the 2015-17 Biennium	**Review and clarify:** Because it is unclear why for-profit hospitals that provide government-subsidized health care are excluded from the preference.

GOVERNMENT PAYMENTS TO PUBLIC AND NONPROFIT HOSPITALS (B&O TAX)

Current Law

When calculating their B&O tax, public hospitals, nonprofit hospitals, and nonprofit community health centers or networks of such centers may deduct amounts they receive under a health service program paid for by the federal or state government, either directly or through a third party.

Deductible amounts may be for services covered by Medicare, Medicaid, or other state health care programs under Chapter 74.09 RCW or Chapter 70.47 RCW. The deduction does not apply to amounts received from patient co-payments or deductibles.

Public or nonprofit hospitals are hospitals as defined in RCW 70.41.020 that are operated as nonprofit corporations or owned by political subdivisions of the state (e.g., a county hospital district). A **nonprofit community health center** is a federally qualified health center defined in federal statute.

See Exhibit 1, below, for a summary of the preference's application and applicable B&O tax rates.

Exhibit 1 – Current B&O Taxability of Hospitals and Community Health Centers

Type of Facility	Qualifies for the B&O Tax Preference to Deduct Government Payments?	B&O Tax Rate as of 7/01/2013
Public hospitals	Yes	1.5%
Nonprofit hospitals	Yes	1.5%
Nonprofit community health centers	Yes	1.5%
For-profit hospitals	No	1.5%

Source: JLARC staff analysis of RCW 82.04.4311 and WAC 458-20-168.

See page A3-3 in Appendix 3 for the current statute, RCW 82.04.4311, as well as RCW 82.04.431, which defines health and social welfare organizations, and a related statute, RCW 82.04.4297.

Legal History

Prior to 1935, property tax was the primary tax in Washington. Hospitals were exempted from property tax when it was first enacted in 1854, as "benevolent, charitable, literary, or scientific" institutions. A 1895 law established that hospitals had to be supported in whole by public appropriation or private charity, or had to ensure all income and profits were devoted to charitable purposes to qualify for property tax exemption.

1935 When the Legislature enacted the B&O tax, it continued the tax exempt treatment previously received by publicly owned or private charitable hospitals under property tax, exempting publicly owned or private charitable hospitals from B&O tax on their gross income.

1937-1978 In 1937, the Legislature revised the hospital B&O tax exemption so that the exemption did not apply to for-profit hospitals or where the income benefited any physician, surgeon, stockholder, or individual by ownership or control of the hospital. Evidence suggests there were several hospitals owned and operated by individuals or physicians at the time. Nonprofit and public hospitals remained exempt from B&O tax.

Between 1937 and 1978, although the Legislature continued to alter and redefine the statutes providing a B&O tax exemption for nonprofit and public hospitals, the exemption was maintained. Throughout this time, private, for-profit hospitals remained subject to B&O tax.

1979 The Legislature enacted a new B&O tax deduction under a different statute (RCW 82.04.4297) for health or social welfare organizations, municipal corporations, and political subdivisions.

The new deduction represented a different approach to how the Legislature provided exemptions for hospitals. Previously, exemptions or deductions for hospital income were based on the entity's ownership or structure, such as exemptions for nonprofit hospitals or publicly owned hospitals. In 1979, the Legislature also based the deduction on who paid for the services. Payments received from federal or state governments were exempted for providers that met the health and social welfare organization requirements.

The deduction was for amounts received from the federal, state, or local governments as payment for or to support health or social welfare services these entities provided. Since income received by nonprofit and publicly owned hospitals from federal and state governments had been exempt since 1937, the new deduction provided a duplicate B&O tax exemption for most of them. The new deduction extended the B&O tax exemption to nonprofit community health centers.

The Legislature defined "health or social welfare organizations" as not-for-profit corporations that met certain structural criteria. They included various service organizations, including those providing health care services, such as hospitals and community health centers.

1993 The Legislature passed the Health Care Reform Act. As part of the legislation, the Legislature repealed the B&O tax deductions provided since 1937 for nonprofit and publicly owned hospitals. Nonprofit and public hospitals became subject to B&O tax under a new "nonprofit & public hospital" classification on their income from patient care, which would include income from federal and state governments, such as Medicare and Medicaid. For-profit hospitals, which had been subject to B&O tax on such income since 1937, remained taxed under the service and other classification.

The Legislature did not repeal RCW 82.04.4297, the other statute providing a deduction to health and social welfare organizations for income from health care and related services. This allowed nonprofit and publicly owned hospitals and nonprofit community health centers to continue deducting payments they received from the federal or state government.

1995 The Legislature repealed much of the 1993 Health Care Reform Act. Nonprofit and public

hospital income remained taxable under the B&O tax.

1996-2000 Department of Revenue (DOR) auditors began assessing B&O tax on amounts received by nonprofit and public hospitals paid for by federal and state government but received through third party managed health care providers. The Department reasoned B&O tax was due on this income because the payments were not directly paid by the government and thus did not qualify for the deduction provided under RCW 82.04.4297.

2001 The Legislature amended the RCW 82.04.4297 deduction to include payments received from third party managed care providers that contract with the federal or state government to provide health services, limiting the deduction to nonprofit and public hospitals.

In explaining the amendment, the Legislature stated the B&O tax deduction was "intended to provide government with greater purchasing power when government provides financial support" in providing health or social welfare services to benefited classes of persons. The Legislature noted this objective would be "thwarted to a significant degree" if a B&O tax deduction was not allowed to health and social welfare organizations participating in managed care for government-funded health programs.

2002 The Legislature moved the 2001 B&O tax deduction for public and nonprofit hospitals into a new, separate statute. The Legislature indicated its purpose in doing so was to provide a "clear and understandable" deduction for amounts received by public or nonprofit hospitals for payments received from federal or state government either directly or through third party managed care providers. The Legislature stated that providing health services to various disadvantaged people who receive federal or state-subsidized health care benefits is a "recognized, necessary, and vital governmental function." The Legislature further found:

> . . . it would be inconsistent with that governmental function to tax amounts received by a public hospital or nonprofit hospital qualifying as a health and social welfare organization, when the amounts are paid under a health service program subsidized by federal or state government.

2005 The Legislature extended the government payment B&O deduction to nonprofit community health centers or networks of such centers. Testimony at a Senate hearing noted the deduction had applied to such centers since 1979, but the 2001 legislation had drawn the revised deduction that included government payments made directly or through third-party managed care providers narrowly to only apply to nonprofit or public hospitals.

Exhibit 2 on the following page illustrates the history of B&O tax on income received by for-profit hospitals, nonprofit and publicly owned hospitals, and nonprofit community health centers.

Exhibit 2 – B&O Taxation of Health Care Related Income Through the Years

	For-Profit Hospitals		Nonprofit and Publicly Owned Hospitals		Nonprofit Community Health Centers	
Year	**Medicare, Medicaid, Other State Payments**	**Other Income**	**Medicare, Medicaid, Other State Payments**	**Other Income**	**Medicare, Medicaid, Other State Payments**	**Other Income**
1935	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable
1937	Taxable	Taxable	Exempt	Exempt	Taxable	Taxable
1979	Taxable	Taxable	Exempt	Exempt	Exempt	Taxable
1993	Taxable	Taxable	Exempt	Taxable	Exempt	Taxable
1996	Taxable	Taxable	Taxable if from 3rd party payers	Taxable	Taxable if from 3rd party payers	Taxable
2001	Taxable	Taxable	Exempt	Taxable	Taxable if from 3rd party payers	Taxable
2005	Taxable	Taxable	Exempt	Taxable	Exempt	Taxable

Source: JLARC staff analysis of statutory history.

Public Policy Objectives

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

The Legislature stated the public policy objective for this preference in 2002 when it established a separate statute for the deduction:

> The legislature finds that the provision of health services to those people who receive federal or state subsidized health care benefits by reason of age, disability, or lack of income is a **recognized, necessary, and vital governmental function. As a result, the legislature finds that it would be inconsistent with that governmental function to tax amounts received by a public hospital or nonprofit hospital qualifying as a health and social welfare organization, when the amounts are paid under a health service program subsidized by federal or state government.** Further, the tax status of these amounts should not depend on whether the amounts are received directly from the qualifying program or through a managed health care organization under contract to manage benefits for a qualifying program. Therefore, the legislature adopts this act to provide a clear and understandable deduction for these amounts, and to provide refunds for taxes paid as specific in section 4 of this act.

Thus, the Legislature's public policy objective was to not tax amounts paid under a government-subsidized health care service program. The Legislature chose to provide the preference to nonprofit and public hospitals qualifying as health and social welfare organizations, consistent with historical tax treatment for such hospitals.

In the case of nonprofit community health centers, the Legislature did not state a public policy objective when it included them in the deduction in 2005. JLARC staff infer the objective was the same as in 2002 – to not tax government-subsidized health care services to elderly, poor, or disabled people. As nonprofit organizations providing health programs, community health centers had qualified for and received a B&O tax exemption since 1979 under a separate statute.

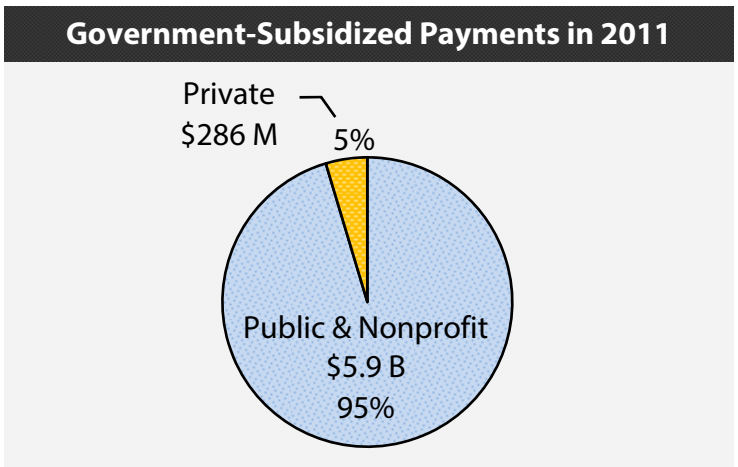
What evidence exists to show that the tax preference has contributed to the achievement of any of these public policy objectives?

Hospitals

Nonprofit and public hospitals do provide government-subsidized health care services to the aged, poor, and disabled people, as well as to children. However, for-profit hospitals also provide such care and receive payment from federal and state government health care programs. There are currently 90 nonprofit or public and eight for-profit hospitals in Washington.

The Legislature's public policy objective for this preference is to not tax the provision of health services that is paid for through federal or state subsidies. One way to check for the provision of such services is to see if hospitals received government-subsidized payments. In 2011, Washington nonprofit and public hospitals received $5.9 billion in net income from government-funded payments for patient care, while the nine for-profit hospitals then operating in Washington received $286 million. Nonprofit and public hospitals are providing this care, as are the for-profit hospitals. See Exhibit 3, below.

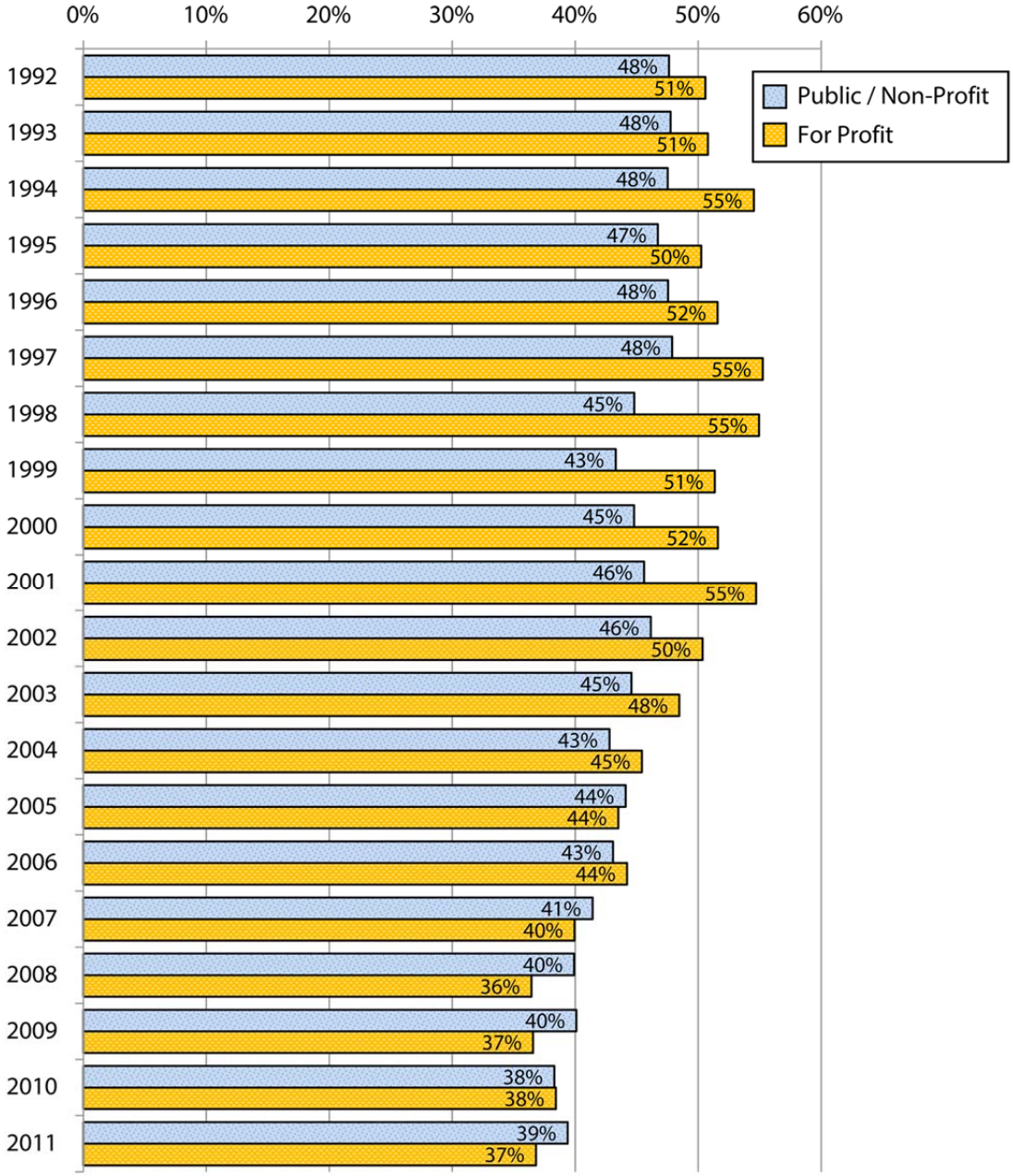
Exhibit 3 – Government Payments are Received by Nonprofit/Public Hospitals and For-Profit Hospitals



Sources: JLARC staff analysis of WA Department of Health hospital deduction data.

Exhibit 4, below, shows the percentage of income from Medicaid or Medicare for both hospital types. This illustrates that public, nonprofit, **and for-profit hospitals** have been and continue to provide care paid for with government funds. During the 20-year period JLARC reviewed, the percentage of net hospital income from government payments for public and nonprofit hospitals ranged from 38 percent to 48 percent of net hospital revenue. The percentage of net hospital revenue comprised of government-subsidized payments received by for-profit hospitals ranged from 36 percent to 55 percent during the same time-span.

Exhibit 4 – Government Payments as a Percent of Net Hospital Income by Ownership Type

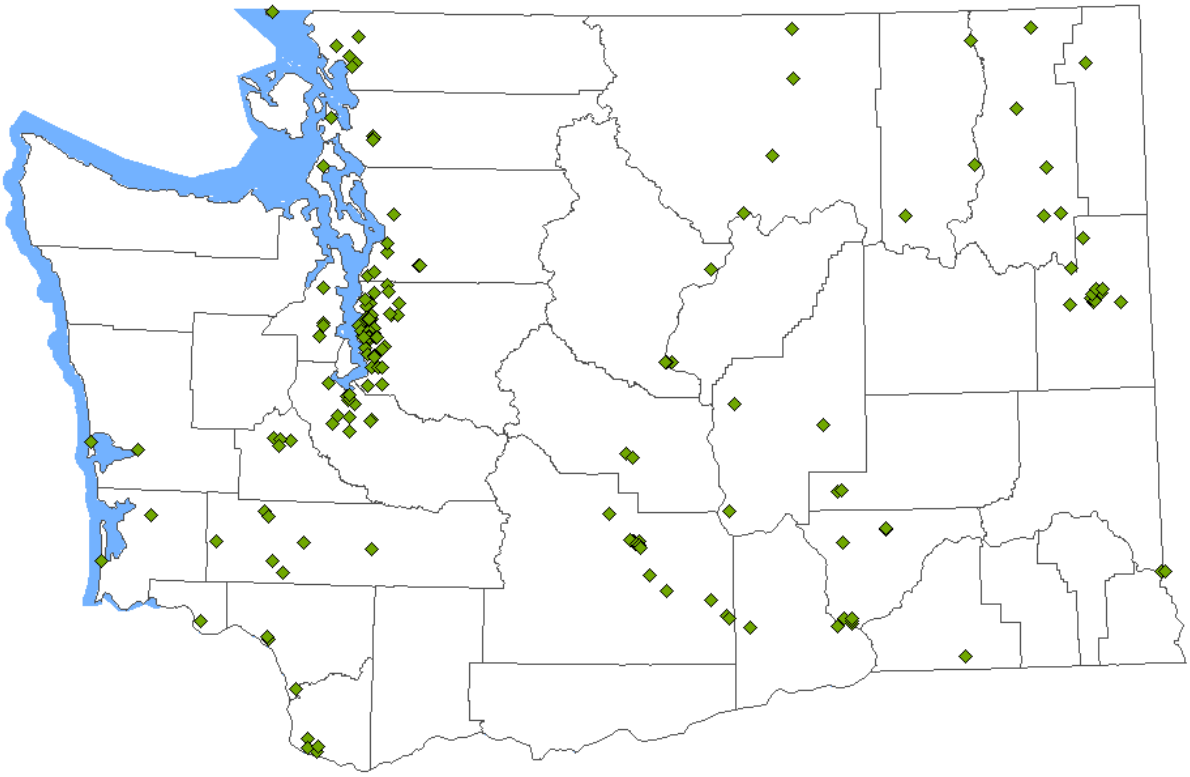


Source: JLARC staff analysis of Department of Health hospital deduction data.

Nonprofit Community Health Centers

Nonprofit community health centers are also providing government-subsidized health care services, as evidenced by the government-subsidized payments they received. In 2011, 81.5 percent of the $465 million collected by Washington nonprofit community centers was paid by Medicare, Medicaid, or other government funding. Exhibit 5, below, shows where these centers are located throughout the state.

Exhibit 5 – Washington's Community Health Centers (as of January 1, 2013)



Source: WA Assn. of Community & Migrant Health Centers, 2013 snapshot

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

Maintaining the tax preference will continue to recognize that federal and state-funded health services for the aged, low income, and disabled are "recognized, necessary, and vital" government functions and should not be subject to B&O tax. Continuing the preference as it now exists in statute allows public and nonprofit hospitals, and nonprofit community health centers to deduct compensation for care covered by federal and state programs from their measure of B&O tax.

However, private, for-profit hospitals also provide care to patients paid for by federal or state health service program funds. Taxing private, for-profit hospitals on this income does not contribute to the public policy objective of not taxing payments for such care.

Beneficiaries

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

Beneficiaries of the tax preference are nonprofit hospitals, publicly-owned hospitals, and nonprofit community health centers (and networks of such centers). As of January 1, 2013, there are:

- 47 nonprofit hospitals;
- 43 publicly-owned hospitals; and
- 26 nonprofit community health centers or center networks in the state at over 180 service delivery sites.

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 staff estimate the beneficiary savings for this preference at $74.9 million in Fiscal Year 2012 and $163 million in the 2015-17 Biennium.

If this tax preference were not available, some government payments would remain exempt under RCW 82.04.4297, the B&O tax exemption for direct government payments to nonprofit health and social welfare organizations. However, approximately 80 percent of the payments received by health care providers from federal or state sponsored programs are now received through third party managed care providers. These payments would likely not be deductible under RCW 84.04.4297 and thus are beneficiary savings specific to this preference, RCW 82.04.4311. See Exhibit 6, below.

Exhibit 6 – Estimated 2015-17 Beneficiary Savings for B&O Tax Deduction for Government-Subsidized Payments to Public and Nonprofit Hospitals

Fiscal Year	Estimated Payments Eligible for This Preference	Beneficiary Savings
2010	$5,053,847,000	$ 71,318,000
2011	$4,825,111,000	$73,287,000
2012	$4,931,264,000	$74,899,000
2013	$5,010,164,000	$76,098,000
2014	$5,110,367,000	$76,656,000
2015	$5,217,685,000	$78,265,000
2016	$5,363,780,000	$80,457,000
2017	$5,481,786,000	$82,227,000
2015-17 Biennium	**$10,845,564,000**	**$162,684,000**

Source: 2010-2011 public and nonprofit data from WA Dept. of Health; 2010-2011 community health center data from U.S. Dept. of Health and Social Services, Health Resources and Services Administration patient-related revenue. Growth predicted using Economic Revenue and Forecast Council projected health services growth, Table A2.1.

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 this preference were terminated, some payments received by nonprofit and public hospitals and nonprofit community health centers directly from Medicare, Medicaid, or other state-funded programs for patient care would still be deductible from B&O tax under RCW 82.04.4297. That preference allows a deduction for payments from the federal government, state of Washington, or any municipal corporation or political subdivision thereof, as payment for or to support health or social welfare services rendered by health and social welfare organizations (which includes nonprofit hospitals and nonprofit community health centers) or a municipal corporation or political subdivision (which includes public hospital districts).

However, the deduction provided under RCW 82.04.4297 does not cover payments from governments through third party health service providers. Thus, if this preference were terminated, about 80 percent of the payments would become taxable under B&O tax, as this is roughly the percentage of Medicaid, Medicare, and other state program payments made via third party managed health care organizations.

Other States

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

Unlike in Washington, the primary business tax in most states is a net income tax rather than a gross receipts tax. Net income taxes generally exempt nonprofit organizations and governmental entities. Therefore, a meaningful comparison is not available.

Legislative Auditor Recommendation

The Legislature should review and clarify this preference for government payments to hospitals providing subsidized health care because it is unclear why for-profit hospitals that provide government-subsidized health care are excluded from the preference.

Legislation Required: Yes.

Fiscal Impact: Depends on legislative action.

HEALTH MAINTENANCE ORGANIZATIONS (B&O TAX)

Report Summary			
What the Preference Does	**Public Policy Objectives**	**Estimated Beneficiary Savings**	**Auditor Recommendation**
Exempts health maintenance organizations and health care service contractors from B&O tax on income from premiums and prepayments that are taxed under the insurance premium tax.	The Legislature did not state the public policy objective of the tax preference. JLARC staff infer the public policy objective was to avoid double taxation of health maintenance organization and health care service contractor premium and prepayment income.	$53.1 million in the 2015-17 Biennium	**Continue:** Because it is fulfilling the inferred public policy objective of avoiding double taxation of this income.

HEALTH MAINTENANCE ORGANIZATIONS (B&O TAX)

Current Law

Health maintenance organizations (HMOs) and health care service contractors (HCSCs) are exempt from business and occupation (B&O) tax on income from premiums and prepayments that is taxed under the insurance premium tax. Insurance premiums are taxed at the rate of 2 percent, while the current B&O tax on service income is 1.5 percent.

Both HMOs and HCSCs are managed care organizations that accept premiums or prepayments in exchange for provision of comprehensive health care services. HMOs and HCSCs differ in how they provide services to their subscribers or members:

- An HMO generally provides services directly through its own physicians and hospitals, supplemented through contracted networks of providers that offer physician and hospital services. Coverage is typically restricted to the HMO's defined set of providers. Group Health is the largest HMO operating in Washington.
- An HCSC operates by contracting for medical services to establish its network of providers. Enrollees may use out-of-network providers, but must pay more out of pocket for the coverage. The first HCSCs in Washington formed as groups of physicians or hospitals known as "medical service bureaus" or medical societies. The largest HCSC operating in Washington is Regence BlueShield.

HMO and HCSC income that is not subject to the insurance premium tax, such as patient deductibles and co-payments, is subject to the B&O tax.

JLARC staff reviewed two other related tax preference in 2013 for HMOs and HCSCs that pay insurance premium tax on premium and prepayment income:

1) An insurance premium tax exemption for dentistry prepayments; and
2) An insurance premium tax exemption for federal payments for Medicare and state payments for the Basic Health Plan and medical care services for persons who qualify for certain state services.

See page A3-5 in Appendix 3 for the current statute, RCW 82.04.322.

Legal History

Before 1993, HMOs and HCSCs paid the B&O tax on their premium and prepayment income under the B&O tax service classification. However, two B&O tax deductions reduced the tax obligation of these carriers:

1) All HMOs and HCSCs received a deduction for payments to providers. According to data from the Office of the Insurance Commissioner (OIC), between 85 and 87 percent of these organizations' premium and prepayment income is reduced by payments to providers. HMOs and HCSCs were not assessed B&O tax on this income.

2) Some HMOs and HCSCs qualified for a second deduction if they met the definition of a "nonprofit health and social welfare organization." This was a more limited deduction for receipts from state and federal governments for health care services. The deduction included receipts received from programs such as Medicare, Medicaid, and the state's Basic Health Plan.

1993 The Legislature enacted comprehensive health care reform and expanded the Basic Health Plan (BHP) for the low-income uninsured. To pay for implementing health care reform, the Legislature increased taxes on a number of products and services, including HMOs and HCSCs.

The Legislature increased taxes on HMOs and HCSCs by shifting taxation of their premium and prepayment income from the B&O tax to the insurance premium tax, beginning January 1, 1994. This action increased HMO and HCSC taxes in two ways:

1) The insurance premium tax has a higher rate (2 percent) than the service B&O tax rate (before 1993, 1.5 percent); and

2) The action of the Legislature effectively eliminated the nonprofit health and social welfare deduction and the deduction for payments to providers that are allowed under the B&O tax but not under the insurance premium tax.

- According to the DOR fiscal note, taxes on HMOs and HCSCs were expected to increase by an estimated $89.7 million in the 1993-95 Biennium. The revenues from the insurance premium tax on health care were to be deposited in the General Fund until March 1996, and then in the newly created health services account afterward. (These insurance premium taxes are now deposited in the General Fund as of July 1, 2009.)

  This tax preference was enacted at the same time to statutorily exempt health care premiums and prepayments from the B&O tax. Without this preference, HMO and HCSC income from premiums and prepayments would have been taxed under both the insurance premium tax and the B&O tax.

Public Policy Objectives

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

The Legislature did not explicitly state the public policy objective for exempting premium and prepayment income of HMOs and HCSCs from the B&O tax.

The Legislature created the preference at the same time that it switched taxation of HMO and HCSC premium and prepayment income from the B&O tax to the insurance premium tax. JLARC staff infer that the Legislature enacted the exemption because it wanted to avoid double taxation of this income.

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

The tax preference has achieved the inferred public policy objective of avoiding double taxation of HMO and HCSC income from premiums and prepayments. HMOs and HCSCs pay taxes on some income under the B&O tax, but only on non-premium income such as patient deductibles and co-payments.

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

Continuation of the tax preference will continue to avoid double taxation of this income.

Beneficiaries

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

The beneficiaries of the tax preference are the 37 HMOs and HCSCs that pay insurance premium tax and that are exempt from B&O tax. The largest HCSC in terms of premiums is Regence BlueShield, and the largest HMO is Group Health Cooperative. Together, premium income of Group Health and Regence represents 39 percent of the total health care premiums written in Washington.

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 7, on the following page, shows that HMOs and HCSCs saved an estimated $27.1 million in Fiscal Year 2012 under the exemption from the B&O tax. They are estimated to save $53.1 million in the 2015-17 Biennium.

JLARC staff assume that the beneficiaries would pay both the B&O tax and the insurance premium tax if the preference were repealed. Staff also assume that the organizations would still be entitled to: 1) the nonprofit health and social welfare deduction; and 2) the deduction for payments to providers, just as they were under the B&O tax through 1993. To calculate the beneficiary savings, JLARC staff subtracted an estimate of the allowable B&O tax deductions from gross premium income reported to the Office of the Insurance Commissioner (OIC). Based on information provided by OIC, an estimated 87 percent of premiums would be allowed as a deduction from the B&O tax.

Exhibit 7 – Estimated 2015-17 Beneficiary Savings for the Health Maintenance Organization Exemption from the B&O Tax

FY	Gross Income	Deductions Allowed under B&O Tax 1) & 2) on prior page	B&O Taxable Income	B&O Taxes
2010	$10,875,000,000	$9,461,000,000	$1,414,000,000	$21,900,000
2011	$11,492,000,000	$9,998,000,000	$1,494,000,000	$26,900,000
2012	$11,582,000,000	$10,076,000,000	$1,506,000,000	$27,100,000
2013	$11,819,000,000	$10,283,000,000	$1,536,000,000	$27,700,000
2014	$12,288,000,000	$10,691,000,000	$1,597,000,000	$24,000,000
2015	$12,827,000,000	$11,159,000,000	$1,668,000,000	$25,000,000
2016	$13,366,000,000	$11,629,000,000	$1,737,000,000	$26,100,000
2017	$13,872,000,000	$12,069,000,000	$1,803,000,000	$27,000,000
2015-17 Biennium				**$53,100,000**

Source: Office Of the Insurance Commissioner and Department of Revenue taxpayer records.

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

If the tax preference were terminated, HMOs and HCSCs would pay the B&O tax and would continue to pay insurance premium tax, because the tax preference under review prevents this double taxation. Without the tax preference, these organizations would pay an estimated $53.1 million more in the 2015-17 Biennium.

HMOs and HCSCs might try to pass some or all of the increased taxes on to their subscribers or members in the form of premium and prepayment rate increases. OIC regulates insurance rates and reports that it approves rate increases that are reasonable in relation to benefits, with allowances for expenses, profits, and sufficient reserves.

Other States

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

In addition to Washington, 31 states and the District of Columbia tax gross premiums and prepayments of managed care organizations under an insurance premium tax. Five states also tax the net income of these organizations under a corporate income tax.

Legislative Auditor Recommendation

The Legislature should continue the B&O tax preference for premium and prepayment income of Health Maintenance Organizations and Health Care Service Contractors because the exemption is fulfilling the inferred public policy objective of avoiding double taxation of this income.

Legislation Required: No.

Fiscal Impact: None.

MEDICARE AND BASIC HEALTH PLAN RECEIPTS (INSURANCE PREMIUM TAX)

Report Summary			
What the Preference Does	**Public Policy Objectives**	**Estimated Beneficiary Savings**	**Auditor Recommendation**
Exempts health maintenance organizations and health care service contractors from insurance premium tax for: 1) Certain federal payments for Medicare; and 2) Subsidized enrollees in the state Basic Health Plan and medical care services for certain persons.	The Legislature did not state the public policy objectives of the tax preferences. JLARC staff infer the public policy objectives were to: 1) Comply with federal law prohibiting states from taxing federal Medicare prepayments; and 2) Reduce costs to the state by exempting state-funded Basic Health Plan and certain medical care services.	$89.4 million in the 2011-13 Biennium	**Continue:** Because the preferences are meeting the inferred public policy objectives of: 1) keeping Washington in compliance with federal law that prohibits states from taxing Medicare receipts; and 2) reducing state medical care costs.

MEDICARE AND BASIC HEALTH PLAN RECEIPTS (INSURANCE PREMIUM TAX)

Current Law

Under current law, health maintenance organizations (HMOs) and health care service contractors (HCSCs) receive insurance premium tax exemptions for certain state and federal premiums and prepayments for health services. Insurance premium taxes are paid on gross premiums and prepayments of insurers and managed care organizations at the rate of 2 percent.

The three exemptions in this review are for:

1) Federal payments for Medicare;
2) State payments for subsidized enrollees in the Washington Basic Health Plan (BHP); and
3) State payments for medical care services for persons who:
    - Are temporarily incapacitated from employment;
    - Qualify for aged, blind, or disabled services; or
    - Qualify for alcohol and drug addiction services.

HMOs and HCSCs are managed care organizations that accept premiums or prepayments in exchange for comprehensive health care services. The two types of entities differ in how they provide services:

- An HMO generally provides services directly through its own physicians or facilities. Group Health Cooperative is an example of an HMO.
- An HCSC contracts for medical services to form a network of preferred providers and facilities. Premera Blue Cross and Regence BlueShield are examples of HCSCs.

Organizations that pay the insurance premium tax on their premium and prepayment income are required to pay business and occupation (B&O) tax on revenue that is not subject to the insurance premium tax. Examples of managed care income subject to the B&O tax are medical deductibles and co-payments.

JLARC staff reviewed two other related tax preferences in 2013 for HMOs and HCSCs that pay insurance premium tax on premium and prepayment income:

1) A B&O tax exemption for income taxed under the insurance premium tax; and
2) An insurance premium tax exemption for dentistry prepayments.

See page A3-5 in Appendix 3 for the current statutes, RCWs 48.14.0201(6)(a) and 48.14.0201(6)(b).

Legal History

Managed Care Premiums and Prepayments Taxed Under B&O Tax Through 1993

Before 1993, HMOs and HCSCs paid the business and occupation (B&O) tax on their premium and prepayment income under the B&O tax service classification. However, two B&O tax deductions reduced the tax obligation of these carriers:

1) All HMOs and HCSCs received a deduction for payments to providers. According to data from the Office of the Insurance Commissioner (OIC), between 85 and 87 percent of these organizations' premium and prepayment income is reduced by payments to providers. HMOs and HCSCs were not assessed B&O tax on this income.
2) Some HMOs and HCSCs qualified for a second deduction if they met the definition of a "nonprofit health and social welfare organization." This was a more limited deduction for receipts from state and federal governments for health care services. The deduction included receipts from programs such as Medicare, Medicaid, and the state's Basic Health Plan.

Taxation of Managed Care Premiums and Prepayments Under 1993 Health Care Reform Act

In 1993, the Legislature enacted comprehensive health care reform and expanded the Basic Health Plan (BHP) for the low-income uninsured. To pay for implementing health care reform, the Legislature increased taxes on a number of products and services, including HMOs and HCSCs.

The Legislature increased taxes on HMOs and HCSCs by shifting taxation of their premium and prepayment income from the B&O tax to the insurance premium tax, effective January 1, 1994. This action increased HMO and HCSC taxes in two ways:

1) Insurance premium tax has a higher rate (2 percent) than the service B&O tax rate (before 1993, 1.5 percent); and
2) The action of the Legislature effectively eliminated the nonprofit health and social welfare deduction and the deduction for payments to providers which are allowed under the B&O tax but not under the insurance premium tax.

In the same bill, the Legislature granted the first of the tax preferences in this review, an insurance premium tax exemption for federal Medicare receipts. The Medicare exemption was scheduled to expire in 1997. State payments for BHP and certain medical care services were taxable until the Legislature exempted these payments in 2005.

Taxation of Managed Care Premiums and Prepayments After 1993

1995 The Legislature repealed much of the 1993 Health Care Reform Act. However, HMOs and HCSCs remained subject to the insurance premium tax.

1997 The Legislature made permanent the temporary exemption for federal Medicare receipts before the exemption expired, in part because the state failed to receive the federal waivers necessary to tax this activity. Federal law prohibits states from taxing federal prepayments for Medicare services.

2005 The Legislature expanded the tax preference to state-funded payments for BHP, general assistance for the temporarily unemployed (GAU, renamed "disability lifeline"), and a pilot Medicaid program for elderly or disabled persons. The pilot Medicaid program ended on July 1, 2009.

2011 The Legislature terminated the disability lifeline program effective October 31, 2011, and established medical care services for persons who: 1) are temporarily incapacitated from employment; 2) qualify for aged, blind, or disabled services; or 3) qualify for alcohol and drug addiction services. State payments for these medical care services are exempt from the insurance premium tax.

Public Policy Objectives

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

The Legislature did not explicitly state the public policy objective for providing an insurance premium tax exemption for federal payments for Medicare and for state payments for BHP and certain medical care services.

However, JLARC staff infer that the Legislature enacted these tax preferences in order to:

1) **Comply with federal law**, since federal law prohibits states from taxing federal Medicare prepayments; and
2) **Reduce costs to the state** by exempting state-funded BHP and certain medical care services.

Comply with federal law: The original 1993 act included a temporary exemption for federal prepayments for Medicare, with that provision set to expire in 1997. According to testimony, the Legislature provided an expiration date because it anticipated that the state would receive a federal waiver that would allow the taxation of all Medicare prepayments through state certified health plans. However, the state did not receive the waiver and the Legislature repealed the provision for certified health plans in 1995.

When Congress established Medicare Advantage in 1997 as a managed care alternative to traditional Medicare, it prohibited states from taxing federal prepayments for this program.

Reduce costs to the state: In 2005, testimony by the prime sponsor and agency representatives indicated that the exemptions for state payments for BHP and certain medical care services would reduce costs for the state. At the time, the state was transitioning clients into managed care plans to help control health care costs. Without the deduction, the HMOs and HCSCs would have had to pay a 2 percent insurance premium tax on these state payments and could pass these taxes on to the state.

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

The tax preferences are achieving the inferred public policy objectives.

1) The state is complying with the federal law that preempts states from taxing federal Medicare prepayments.
2) By exempting state payments for BHP and certain medical care services, the Legislature is reducing state health care costs.

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

Continuation of the tax preferences maintains compliance with federal law and continues to reduce the cost of medical care provided through certain state-funded medical care services.

Beneficiaries

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

Altogether, 15 managed care organizations benefit from the insurance premium tax exemptions. One organization benefits from all three exemptions:

- Fourteen organizations are exempt from tax on federal Medicare prepayments;
- Five organization are exempt from tax on BHP payments; and
- One organization is exempt from tax on state payments for certain medical care services.

Revenue Impacts

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

Beneficiaries of the insurance premium tax deductions are estimated to save $89.4 million in the current 2011-2013 Biennium. See Exhibit 8, below. JLARC staff did not forecast beneficiary savings for future years because future savings depend on the next state biennial budget and changes in health care under the federal Affordable Care Act.

Exhibit 8 – Estimated 2011-13 Beneficiary Savings for Insurance premium tax Deductions for Medicare, BHP, and Certain Medical Care Services

Fiscal Year	Fed Payments	State Payments		Total	Beneficiary Savings (Total × 2%)
	Medicare	Aged, Blind, Disabled	Basic Health Plan		
2010	$1,588,400,000	$42,500,000	$233,000,000	$1,863,900,000	$37,278,000
2011	$1,792,400,000	$63,200,000	$156,100,000	$2,011,700,000	$40,234,000
2012	$2,010,700,000	$40,800,000	$126,200,000	$2,177,700,000	$43,554,000
2013	$2,137,400,000	$33,000,000	$124,100,000	$2,294,500,000	$45,890,000
2011 – 2013 Biennium				**$4,472,100,000**	**$89,444,000**

Source: JLARC staff Analysis of Office of the Insurance Commissioner reports and the 2011-2013 Biennial Budget.

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

If the tax preferences were terminated, taxes paid by the HMOs and HCSCs and, in turn, premiums and prepayments paid by the state could increase. Because federal Medicare prepayments are exempt under federal law, these amounts would continue to be exempt.

Other States

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

States are prohibited from taxing federal prepayments to managed care organizations under Medicare Advantage. Washington is one of ten states that exempt payments from state-funded health care programs from an insurance premium tax.

Legislative Auditor Recommendation

The Legislature should continue the insurance premium tax exemptions for 1) federal Medicare prepayments, 2) state payments for the Basic Health Plan, and 3) state payments for certain medical care services because the exemptions are meeting the two inferred public policy objectives:

- **The exemption for federal Medicare prepayments keeps Washington in compliance with the federal law that prohibits states from taxing such Medicare receipts; and**
- **The exemptions for state payments for BHP and certain medical care services are reducing state medical care costs.**

Legislation Required: No.

Fiscal Impact: None.

DENTISTRY PREPAYMENTS (INSURANCE PREMIUM TAX)

Report Summary			
What the Preference Does	**Public Policy Objectives**	**Estimated Beneficiary Savings**	**Auditor Recommendation**
Exempts health care service contractors from insurance premium tax on prepayments received for dentistry services. Effective July 28, 2013, the exemption becomes available to health maintenance organizations and life and disability insurers.	The Legislature did not state the public policy objective for the tax preference. JLARC staff infer the tax preference was intended to be temporary while health care service contractors offering dentistry services transitioned into certified health plans.	$22.4 million in the 2015-17 Biennium	**Terminate:** Because the inferred public policy objective of providing a temporary exemption during the transition of health care service contractors to certified health plans is no longer applicable.

DENTISTRY PREPAYMENTS (INSURANCE PREMIUM TAX)

Current Law

Under current law (as of July 28, 2013), health care service contractors (HCSCs), health maintenance organizations (HMOs), and life and disability insurers are allowed an insurance premium tax exemption for prepayments for certain dentistry services. Prepayments are fixed amounts per enrollee paid in advance of receiving dental care.

What Entities Are Exempt?

Both HMOs and HCSCs are managed care organizations that accept premiums or prepayments in exchange for providing comprehensive health care services. Unlike HMOs that generally provide services directly through their own physicians or facilities, HCSCs contract for medical services to form a network of preferred providers and facilities. Life and disability insurers accept premiums and provide coverage in the event the policy holder dies or becomes disabled.

Until July 28, 2013, only HCSCs are allowed a dentistry exemption. Some HCSCs provide dentistry services only, such as Washington Dental Service. Other HCSCs offer dentistry services along with comprehensive medical coverage, such as Regence BlueShield. HCSCs originated in Washington as medical service bureaus such as the King County Medical Service Bureau which formed in 1933 and later became part of Regence.

How Are Dentistry Prepayments Taxed?

Prepayments received for dentistry services are taxed differently than prepayments received for other health care services. Generally, prepayments are taxed under the insurance premium tax at the rate of 2 percent. Insurer income that is not taxed under the insurance premium tax (for example, co-payments and deductibles) is taxed under the business and occupation (B&O) tax. Because dentistry prepayments are exempt from insurance premium tax, they are taxable under the B&O tax at the lower rate of 1.5 percent.

Beginning January 1, 2015, **pediatric** oral services are taxable under the insurance premium tax when offered as part of an essential coverage plan under the Affordable Care Act.

JLARC staff reviewed two other related tax preference in 2013 for HMOs and HCSCs that pay insurance premium tax on premium and prepayment income:

1) A B&O tax exemption for income taxed under the insurance premium tax; and
2) An insurance premium tax exemption for federal prepayments for Medicare and state prepayments for the Basic Health Plan and medical care services for persons who qualify for certain state services.

See page A3-6 in Appendix 3 for the current statutes, RCW 48.14.0201(6)(c).

Legal History

Before 1993, HMOs and HCSCs paid the B&O tax on their premium and prepayment income under the B&O tax service classification. However, two B&O tax deductions reduced the tax obligation of these carriers:

1) All HMOs and HCSCs received a deduction for payments to providers. According to data from the Office of the Insurance Commissioner (OIC), between 85 and 87 percent of these organizations' premium and prepayment income is reduced by payments to providers. HMOs and HCSCs were not assessed B&O tax on this income.

2) Some HMOs and HCSCs qualified for a second deduction if they met the definition of a "nonprofit health and social welfare organization." This was a more limited deduction for receipts from state and federal governments for health care services. The deduction included receipts received from programs such as Medicare, Medicaid, and the state's Basic Health Plan.

1935 As part of the 1935 Revenue Act, the Legislature enacted a B&O tax on gross income of a business without deductions for costs of goods sold, labor costs, or any "other expense whatsoever."

1936 The Tax Commission stopped assessing tax on medical service bureaus (precursors to HCSCs) until it determined how the bureaus should be taxed under the 1935 Revenue Act.

1940 The Tax Commission resolved how medical service bureaus should be taxed. It began taxing the bureaus, but allowed them to deduct claims payments to providers under contract to perform services when the bureau acted as an agent for the provider. An agent collects payments from customers on behalf of a third party provider, but renders no services of its own to the customer, and the customer is liable for the payment. The Commission did not put this practice into a written rule (WAC 458-20-233) until 1956.

1993 The Legislature enacted comprehensive health care reform and expanded the Basic Health Plan (BHP) for the low-income uninsured. To pay for implementing health care reform, the Legislature increased taxes on a number of products and services, including HMOs and HCSCs.

Tax Treatment of Health Care Prepayments: The Legislature increased taxes on HMOs and HCSCs by shifting taxation of their premium and prepayment income from the B&O tax to the insurance premium tax, beginning January 1, 1994. This action increased HMO and HCSC taxes in two ways:

1) The insurance premium tax has a higher rate (2 percent) than the service B&O tax rate (before 1993, 1.5 percent); and

2) The action of the Legislature effectively eliminated the nonprofit health and social welfare deduction and the deduction for payments to providers that are allowed under the B&O tax but not under the insurance premium tax.

Transition to Certified Health Plans (CHPs): The 1993 act required all state residents, including employees under employer-provided benefit plans, to be covered under "certified health plans" (CHPs) by July 1, 1999. By that time, HCSCs had to be certified as CHPs or contract with CHPs. This included HCSCs that offered dentistry services.

Temporary Exemption for Medicare and Dentistry: As part of the bill, the Legislature granted two temporary exemptions to the insurance premium tax: an exemption for federal Medicare payments set to expire in 1997, and this tax preference, scheduled to last while HCSCs made the transition to CHPs. The bill called for dentistry prepayments received by CHPS to be taxed once the transition from HCSCs to CHPs took place.

1995 The Legislature repealed provisions of the 1993 law that implemented CHPS, in part because the state failed to receive the necessary federal waivers to require employers to provide health care through CHPs. The repeal had the effect of making the dentistry exemption to the insurance premium tax permanent. This effect occurred because the law continued to state dentistry prepayments were only to be taxable when HCSCs transitioned into CHPs.

The Legislature continued to tax all other HCSC health care prepayments under the insurance premium tax.

1997 The Legislature made permanent the insurance premium tax exemption for federal Medicare prepayments, and the bill removed the remaining references to CHPs in the insurance premium tax statute. The insurance premium tax exemption for dentistry HCSCs remained, and they continued to be taxed under the B&O tax.

2013 The Legislature extended the insurance premium tax to pediatric oral services offered as essential coverage under the federal Affordable Care Act, but retained the exemption for other dental services. The bill also extended the exemption for other dental services to HMOs and life and disability insurers.

Exhibit 9, on the following page, illustrates how prepayments for dentistry are taxed differently than prepayments for other health care services. Dentistry services that are taxed under the B&O tax may receive two deductions: 1) the deduction for payments to providers, and 2) the deduction for nonprofit health and social welfare organizations. An estimated 85 percent of dentistry prepayments are paid out to providers, so that income is not taxed. The remaining 15 percent of dentistry prepayment income is taxed at the B&O rate of 1.5 percent.

Other prepayments for health care are taxed at a higher tax rate and on a larger percentage of income. The insurance premium tax (2 percent) is paid on 79 percent of gross prepayment income after deductions for certain state and federal government prepayments (see the Medicare and Basic Health Plan Receipts chapter in this 2013 report).

Exhibit 9, below, illustrates that for each $1 million in prepayment income, dentistry prepayments are taxed at $2,250 under the B&O tax, and all other prepayments are taxed at $15,800.

Exhibit 9 –Dentistry Prepayments Are Taxed Differently Than Other Prepayments

Prepayment	Tax Type	Tax Rate	Estimated % of Income Taxed	Tax per $1 Million in Prepayments
Dentistry prepayments	B&O tax	1.5%	15%	$2,250
All other health care prepayments	Insurance premium tax	2.0%	79%	$15,800
Difference in Tax per $1 Million in Gross Income				**$13,550**

Source: JLARC staff analysis of 2011 Office of the Insurance Commissioner and Department of Revenue tax records.

Public Policy Objectives

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

The Legislature did not explicitly state a public policy objective for exempting from the insurance premium tax the amounts received by HCSCs as prepayments for dentistry.

JLARC staff infer that the tax preference was **intended to be temporary** while HCSCs offering dentistry services transitioned into certified health plans (CHPs).

The Legislature provided for implementation of CHPs and directed that all managed care prepayments, including dentistry prepayments, be taxed under the insurance premium tax once CHPs became mandatory in 1999. The Legislature provided the exemption for dentistry prepayment income while HCSCs made the transition to CHPs.

The Legislature repealed most references to CHPs in 1995 in part because the state failed to get necessary waivers from the federal government. When the Legislature removed references to CHPs, it had the effect of making the exemption for HCSC dentistry prepayments permanent.

When the 1997 Legislature removed some remaining references to CHPs in the tax section, the bill title and bill report only note a change to the Medicare exemption. Neither the bill title nor the bill report mention any intentional change to the dentistry exemption.

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

The inferred public policy objective for providing a temporary tax exemption for dentistry prepayments during the transition to CHPs is no longer applicable because the Legislature repealed the provisions that implemented CHPs in 1995.

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

The tax preference is not contributing to the inferred public policy objective of providing a temporary tax exemption for dentistry prepayments because the preference is now permanent. Continuing the preference allows dentistry prepayments to continue to be taxed differently than all other health care prepayments.

Beneficiaries

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

Currently, eight HCSCs that receive prepayments for dentistry services are 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?

Beneficiaries of the dentistry exemption saved an estimated $9.3 million in insurance premium taxes in Fiscal Year 2012. Beneficiaries are estimated to save $22.4 million in the 2015-2017 Biennium. The beneficiary savings estimates include adjustments for two B&O tax deductions: 1) payments to providers; and 2) government payments to nonprofit health and social welfare organizations. These amounts would be taxed if dentistry prepayments were instead subject to the insurance premium tax (the difference is calculated in Exhibit 10, below).

Exhibit 10 – Estimated 2015-17 Beneficiary Savings for the HCSC Dentistry Prepayment Exemption from the Insurance Premium tax

Fiscal Year	Prepayments – B&O Deductions	× B&O Tax Rate = (A)	Prepayments	× Ins. Prems. Tax Rate = (B)	(A) – (B) = Beneficiary Savings
2010	$79,173,000	$1,425,000	$527,822,000	$10,556,000	$9,131,000
2011	$79,872,000	$1,438,000	$532,478,000	$10,650,000	$9,212,000
2012	$80,496,000	$1,449,000	$536,638,000	$10,733,000	$9,284,000
2013	$82,146,000	$1,232,000	$547,640,000	$10,953,000	$9,721,000
2014	$85,406,000	$1,281,000	$569,372,000	$11,387,000	$10,106,000
2015	$89,148,000	$1,337,000	$594,321,000	$11,886,000	$10,549,000
2016	$92,899,000	$1,393,000	$619,327,000	$12,387,000	$10,993,000
2017	$96,415,000	$1,446,000	$642,766,000	$12,855,000	$11,409,000
2015-2017 Biennium					**$22,402,000**

Source: JLARC staff analysis based on information from the Office of the Insurance Commissioner and the Economic and Revenue Forecast Council. Estimates do not include the impact of removing the exemption for certain pediatric oral services or expanding the exemption to HMOs and life and disability insurers.

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

If the tax preference were eliminated, amounts received as prepayments for dentistry services would be subject to the insurance premium tax instead of the B&O tax, and taxes on these services would increase. Carriers might try to pass some or all of the increase on to their customers. The Office of the Insurance Commissioner regulates premium rates and reports that it approves rates that are reasonable in relation to benefits, with allowances for expenses, profits, and sufficient reserves.

Other States

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

In addition to Washington, 31 states and the District of Columbia tax gross premiums and prepayments of managed care organizations under an insurance premium tax. JLARC staff can find no state that exempts prepayments for dentistry services from the insurance premium tax.

Legislative Auditor Recommendation

The Legislature should terminate the insurance premium tax exemption for all dentistry prepayments because the inferred public policy objective of providing a temporary exemption during the transition to certified health plans (CHPS) is no longer applicable.

The insurance premium tax exemption for dentistry was intended to be temporary until the transition to CHPS. That transition never took place because the Legislature repealed major portions of the 1993 health care reform act. While the Legislature modified the preference in 2013, the underlying purpose of the dentistry exemption was to be temporary. Nothing in the 2013 record changes the intent that the tax preference be temporary.

Legislation Required: Yes.

Fiscal Impact: $22.4 million in the 2015-17 Biennium.

PRESCRIPTION DRUG ADMINISTRATION (B&O TAX)

Report Summary			
What the Preference Does	**Public Policy Objectives**	**Estimated Beneficiary Savings**	**Auditor Recommendation**
Provides a B&O tax deduction to physicians and medical clinics for sales to patients of certain prescription drugs covered under Medicare Part B that are infused or injected.	The Legislature did not state the public policy objective for the tax preference. JLARC staff infer the public policy objectives were: 1) To lower costs for physicians and medical clinics that infuse or inject drugs covered under Medicare Part B; and 2) To help keep these physicians' offices and medical clinics open to provide better patient access to these drugs.	$6.1 million in the 2015-17 Biennium	**Review and clarify:** Because while the preference is meeting the inferred public policy objective of lowering costs, the Legislature may want to consider adding reporting or other accountability requirements to provide better information on the effectiveness of the preference.

PRESCRIPTION DRUG ADMINISTRATION (B&O TAX)

Current Law

When calculating their business and occupation (B&O) tax, physicians and medical clinics may deduct amounts they receive for sales to patients of prescription drugs that are infused or injected. The deduction is limited to amounts for which the federal government (under Medicare) will reimburse the physician or clinic. The deduction may be taken only if:

- The drugs are covered or required under a health care program subsidized by the federal or state government;
- The charges are separately stated on the billing statement; and
- The amount received does not exceed the current federal government reimbursement rate under Medicare Part B.

If the reimbursement received by the physician or clinic for the drug exceeds the current federal reimbursement rate under Medicare Part B, the health care provider is not entitled to any deduction for the drugs.

See page A3-7 in Appendix 3 for the current statute, RCW 82.04.620.

Legal History

Since the B&O tax was enacted in 1935, physicians and medical clinics paid B&O tax on their gross business income, including any amounts received for drugs infused or injected into their patients.

2003 The Medicare Modernization Act of 2003 was enacted on the federal level, restructuring traditional Medicare and changing reimbursement rates.

2006 The Legislature considered two bills to provide B&O tax deductions to physicians and clinics for anti-cancer and chemotherapy prescription drugs they infused or injected. In a House Committee hearing, the sponsor of one of the bills stated that as Medicare became more efficient after 2003, all of the profit had been taken out of sales of drugs by physicians. He noted doctors were now often reimbursed less than their costs for such drugs. Bill proponents also noted that most (public and nonprofit) hospitals had a B&O tax exemption for such amounts, while private physicians and clinics did not. Neither bill was enacted.

2007 The Legislature enacted this deduction that applied to certain drugs infused or injected by physicians and clinics and covered by a federal or state subsidized health care service program. The preference has not been altered since it was enacted.

Other Relevant Background

What is Medicare Part B?

Medicare Part B is a federal health care program that provides coverage for certain physician, outpatient hospital, laboratory, and other services to beneficiaries who pay monthly premiums. Medicare Part B coverage includes a specific set of injectable and infusible drugs that are not usually self-administered, and that are furnished and administered as part of a physician's service. These

drugs include, but are not limited to, vaccines, anticancer, and chemotherapy drugs. The drugs may be administered in a variety of settings, including physician's offices, clinics, and hospitals.

Public Policy Objectives

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

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

JLARC staff infer two public policy objectives:

1) To lower costs for physicians and medical clinics that infuse or inject drugs covered under Medicare Part B; and
2) To help keep these physicians' offices and medical clinics open as a way to offer patients access to these drugs without having to go to a hospital to receive them.

Lowering Costs for Physicians and Clinics

The prime sponsor and proponents for this preference testified in committee hearings, claiming that changes in Medicare reimbursement rates in 2003 eliminated any profit margins for doctors and clinics that provided such drug treatments. Proponents noted some doctors and clinics were being reimbursed less than their costs for certain infused or injected drugs.

Keep Physicians and Clinics Open to Offer Patients Access

Proponents testified that after the Medicare reimbursement rate changes in 2003, some oncologists moved their practices into hospitals. They testified further that other oncologists sent their patients to hospitals for infused or injected drug treatments and that others closed their practices altogether. Proponents and the prime sponsor said they wanted patients to have the option to receive treatments in a setting other than a hospital. They stated that such options would be more convenient for patients and would allow patients with compromised immune systems to avoid exposure to other illnesses.

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

Lowering Costs for Physicians and Clinics

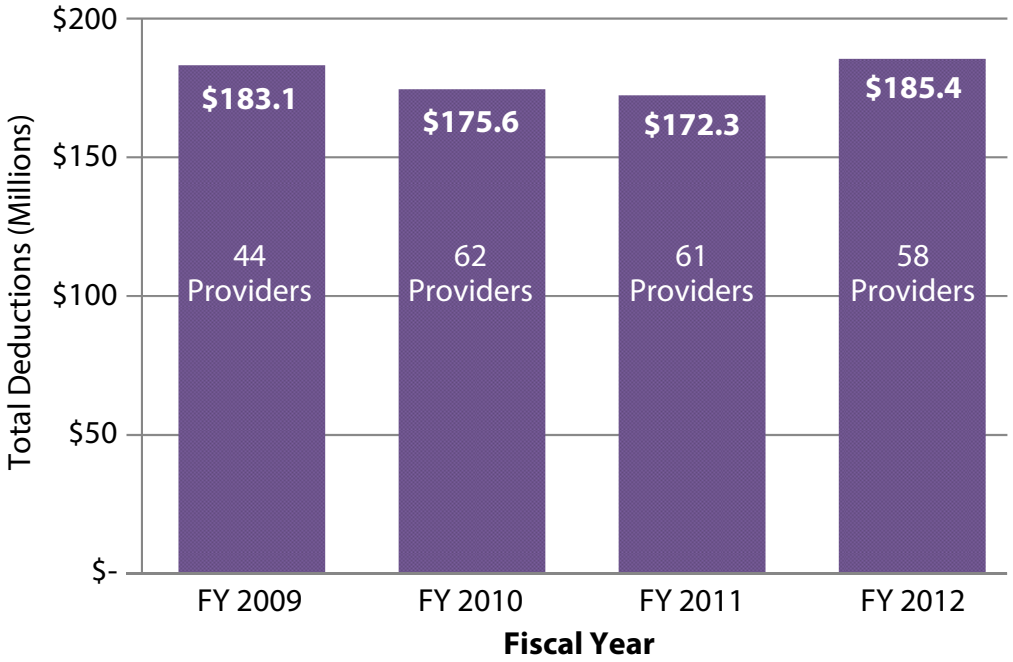
The inferred public policy objective to lower costs for physicians and medical clinics that infuse or inject drugs covered is being achieved. Physicians and medical clinics do not pay B&O tax on amounts received for drugs that they infuse or inject.

Keep Physicians and Clinics Open to Offer Patients Access

JLARC staff cannot provide a definitive answer as to whether the preference is achieving the second inferred public policy objective of helping to keep these clinics and offices open as a way to offer patients access to these drugs without having to go to a hospital.

Department of Revenue (DOR) tax return data for Fiscal Years 2009 – 2012 reflects that some physicians and clinics are taking the deduction provided by the preference. Presumably these physicians and clinics are providing injections and infusions to patients in a non-hospital setting. See Exhibit 11, below.

Exhibit 11 – Some Providers are Claiming the Deduction for Infused or Injected Drugs (Fiscal Years 2009-2012)



Source: JLARC staff analysis of DOR tax return data.

However, information is not available that would provide more insight into whether the preference is a factor in keeping physicians' offices and clinics open. For example:

- There is no accurate count of the population of physicians and clinics that have used the preference. According to DOR, audits of physicians and clinics reveal that the number of health care providers using the preference and the value of the preference is greater than what is being reported on DOR tax returns. Some businesses are simply not including the nontaxable amounts on their tax returns. Although DOR instructs businesses using the preference to deduct qualifying amounts on their tax form, it is not required that they do so to use the preference.
- There is not a complete picture of the value of the preference in comparison to the qualifying providers' gross income. Again, this is because there is no requirement for businesses to

deduct the income attributable to infused or injected drugs on their tax returns or to otherwise report their use of the preference.

- There is not a complete picture of which physicians and clinics that provided this service to their patients have gone out of business or have opened a business in the time period before and after the preference was enacted.

Due to these and other data limitations, JLARC staff did not attempt an analysis to explore a causal relationship between the preference and these businesses staying open.

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

Maintaining the preference will continue to lower the costs of physicians' offices and clinics that infuse or inject qualifying prescription drugs. However, adequate information is not available to assess whether or not the preference is providing more treatment options to patients or whether or not the B&O tax reduction has impacted providers staying in business.

Beneficiaries

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

Beneficiaries of the preference are physicians' offices and various medical clinics that provide prescription drugs covered under Medicare Plan B via injection or infusion to their patients.

According to Department of Revenue tax return data, 58 businesses deducted $185.4 million under this preference in Fiscal Year 2012. These health care providers included cancer treatment centers, renal centers, eye clinics, physicians' offices, and other health care providers. It is likely other physicians and clinics are taking advantage of the preference by netting-out the amounts covered by the preference, rather than deducting it on their tax return.

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 staff estimate the beneficiary savings for Fiscal Year 2012 to be $3.3 million and $6.1 million in the 2015-17 Biennium based on Department of Revenue tax return data. See Exhibit 12 on the following page.

Exhibit 12 – Estimated 2015-17 Beneficiary Savings for Prescription Drug Administration B&O Tax Deduction

FY	Total Deductions	Tax Rate	Beneficiary Savings
2010	$174,565,000	1.55%	$2,706,000
2011	$172,305,000	1.80%	$3,101,000
2012	$185,439,000	1.80%	$3,338,000
2013	$188,406,000	1.80%	$3,391,000
2014	$192,174,000	1.50%	$2,883,000
2015	$196,209,000	1.50%	$2,943,000
2016	$201,703,000	1.50%	$3,026,000
2017	$206,140,819	1.50%	$3,092,000
		2015-17 Biennium	**$6,118,000**

Source: JLARC Staff analysis of FY 2010-12, DOR Tax Return data. FY 13-17 estimated by JLARC staff using Economic Revenue Forecast Council growth rate for health services, Table A2.1, Sept. 2012.

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

If the tax preference were terminated, physicians, cancer treatment centers, and other health clinics and providers would owe B&O tax on amounts billed for providing prescription drugs via injection or infusion to their patients.

Other States

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

Unlike in Washington, the primary business tax in most states is a net income tax rather than a gross receipts tax. Under an income tax, physicians and clinics might be able to deduct the cost of prescription drugs sold to patients as a business expense. However, JLARC staff could not identify a tax preference that specifically listed prescription drug administration as a deduction in other states that impose an income tax.

Ohio imposes a commercial activity tax (CAT) on the gross receipts of businesses generating more than $150,000 in a calendar year. A specific CAT exemption is provided for income from administering cancer drugs in a physician's office to patients with cancer.

Legislative Auditor Recommendation

The preference is meeting the inferred public policy objective of lowering costs for the physicians' offices and clinics that provide infused or injected drugs to their patients. However, JLARC staff cannot provide a definitive answer as to whether the preference is meeting the second inferred public policy objective of helping to keep these clinics and offices open as a way to offer patients access to these drugs without having to go to a hospital.

The Legislature should review and clarify the B&O tax deduction for infused or injected drugs, because while the preference is meeting the inferred public policy objective of lowering costs, the Legislature may want to consider adding reporting or other accountability requirements that would provide better information into the effectiveness of this preference on patient access.

Legislation Required:	Yes.
Fiscal Impact:	Depends on legislation.

MEDICAL ITEMS, DIETARY SUPPLEMENTS, INSULIN, AND KIDNEY DIALYSIS DEVICES (SALES AND USE TAX)

Report Summary			
What the Preference Does	**Public Policy Objectives**	**Estimated Beneficiary Savings**	**Auditor Recommendation**
These four preferences provide sales and use tax exemptions for the following medical and health care related items for human use: • Medical items, including prescribed prosthetic devices, naturopath-prescribed medicines, prescribed medical oxygen systems, and repair labor and services for any of these items; • Prescribed dietary supplements; • Insulin; and • Kidney dialysis devices.	The Legislature did not state the public policy objective for any of the tax preferences. JLARC staff infer the public policy objective was to selectively address the regressive nature of sales tax by exempting certain "medically necessary" items for basic human needs.	**Medical Devices:** $122.9 million in 2015-17 Biennium **Dietary Supplements:** $12.2 million in 2015-17 Biennium **Insulin:** $52.4 million in 2015-17 Biennium **Kidney Dialysis Devices:** $8.8 million in 2015-17 Biennium	**Continue:** Because the preferences are meeting the inferred public policy objective of reducing the regressive nature of Washington's sales and use tax by exempting certain medical items and services that meet basic human needs.

MEDICAL ITEMS, DIETARY SUPPLEMENTS, INSULIN, AND KIDNEY DIALYSIS DEVICES (SALES AND USE TAX)

Current Law

This tax preference review covers four statutes that provide sales and use tax exemptions for the purchase or use of a variety of **prescribed** (except for insulin) medical and health-related items for human use. The exemptions are primarily for individuals and cover the following:

1) **Certain medical items**, including:
   - **Prosthetic devices** (and component parts) fitted or furnished by a licensed professional;
   - **Medicines of mineral, animal, and botanical origin** prescribed, administered, dispensed, or used to treat a patient by a licensed naturopath;
   - **Medically prescribed oxygen systems;** and
   - **Labor and services to repair, clean, alter, or improve** any of the above items.
2) **Prescribed dietary supplements**.
3) **Insulin** (does not require a prescription).
4) **Kidney dialysis devices.**

The exemption for medically prescribed oxygen includes, but is not limited to:

- Oxygen concentrator systems,
- Oxygen enricher systems,
- Liquid oxygen systems, and
- Gaseous, bottled oxygen systems.

The exemption for kidney dialysis devices includes repair and replacement parts, and labor and services to repair, clean, alter, or improve such devices. The exemption does not include other equipment or tools used in conjunction with a kidney dialysis device.

The statute that establishes the exemptions for certain medical items specifically excludes durable medical equipment (such as hospital beds or IV stands) and mobility enhancing equipment (such as wheelchairs or walkers).

The Legislature specifically excluded the sales and use tax exemption for prescription drugs from a JLARC performance audit review.

See page A3-8 in Appendix 3 for the current statutes for these preferences.

Legal History

From territorial days, Washington's property tax was the principal revenue source for both state and local governments. A 1930 report to the Legislature noted a retail sales tax on all commodities would produce much revenue but would be regressive in nature, applying disproportionately to low income households whose expenditures for goods represented a greater proportion of their total income than for higher income households.

The Legislature enacted the Revenue Act of 1935, laying the foundation for the state's current tax structure. The Act maintained a limited property tax, made the B&O tax permanent, and adopted a sales and use tax on sales of tangible personal property.

The Legislature has exempted certain categories of basic human needs from taxation to address the regressivity of the sales and use tax. Over the years, the Legislature, the Department of Revenue (DOR), and the courts have worked to define and clarify which medical and health-related items are considered basic human needs.

1974 The Legislature passed a sales and use tax exemption for prescription drugs for humans or animals when under the written direction of a dentist, physician, veterinarian, or other authorized person. "Prescription drug" included "any medicine, drug, prescription lens, or other substance other than food for use in the diagnosis, cure, mitigation, treatment, or prevention of disease or other ailment in humans or animals." The Governor vetoed the exemption for drugs for animals prescribed by veterinarians, noting they were not a basic human need.

To further define "prescription drug," DOR issued a Washington Administrative Code (WAC) explaining the exemption was only for drugs, medicines, prescription lenses, and other substances that met certain criteria.

The WAC defined "prescription" and noted that **dietary supplements**, even when prescribed, did not qualify because they were food items, not drugs. DOR also determined that **prescribed medical oxygen** and **prescribed insulin** were both exempt from sales tax.

1975 The Legislature added separate sales and use tax exemptions for **insulin, prosthetic devices,** and **medically prescribed oxygen**. Neither insulin nor prosthetic devices (which were not defined) required prescriptions for exemption. The Legislature also amended the prescription drug exemption to incorporate DOR's 1974 WAC language.

The Department issued an advisory (ETB 498) using standard and medical dictionary definitions to provide guidance in administering the newly adopted prosthetic device sales tax exemption. ETB 498 stated prosthetic devices were "artificial substitutes which replace missing parts of the human body, such as a limb, bone, joint, eye, tooth, or other internal or external organ or part thereof." Prosthetic devices did not include materials used primarily for cosmetic purposes or devices "used primarily to assist or supplement the functioning of existing parts of the body, such as wheelchairs, crutches, orthopedic shoes, hearing aids, pacemakers, trusses, braces, slings, casts, and the like."

In a ruling involving a kidney dialysis facility, DOR allowed the **prosthetic exemption for kidney dialysis machines**, noting the machines "replace missing parts of the human body."

1980 The Legislature added a requirement that tax exempt **prosthetic devices** be prescribed by a licensed chiropractor, physician, or osteopath, and extended the exemption to **prescribed orthotic devices** and **non-prescribed ostomic items**. "Orthotic devices" and "ostomic items" were not defined.

Without specific definitions, the Department of Revenue had to determine qualifying criteria. DOR issued an advisory (ETB 518) defining "prescribed orthotic devices" as "fitted

surgical apparatus designed to activate or supplement a weakened or atrophied limb or function," noting braces, collars, casts, splints, and other fitted apparatus, and component parts qualified. Durable medical equipment such as wheelchairs, crutches, walkers, canes, stockings, arch pads, and bandages did not qualify. ETB 518 also defined "ostomic items" to include certain medical supplies used by colostomy, ileostomy, and urostomy patients.

Pursuant to an appeal, DOR allowed the **prosthetic exemption for pacemakers** and revised ETB 498 accordingly.

1984 In an unpublished ruling, DOR determined that **sutures and staples qualified as prosthetic devices**.

1986 The Legislature expanded the **prosthetic device exemption to include hearing aids** dispensed or fitted by a licensed professional. In a taxpayer outreach publication, the Department of Revenue originally stated the exemption **extended to repair labor and services for hearing aids**. Later, DOR determined the law did not exempt repair labor and services. However, they continued to allow businesses to follow the initial guidance.

1987 In February, DOR revised its WAC regarding medical devices, clarifying its position that medical devices that merely assist existing body parts in function but do not physically replace a missing or absent part of the body did not qualify as exempt prosthetic devices. In September, the Board of Tax Appeals (BTA) affirmed DOR's policy exempting **kidney dialysis machines** (1975) and **pacemakers** (1980).

1988 The Department published an advisory (ETB 536) noting that kidney dialysis machines and heart pacemakers qualified as exempt prosthetics, stating while they did not technically meet the definition of "prosthetic device," they "substantially qualify" for like-treatment.

1990 The Washington Court of Appeals, Division 2, affirmed a lower court decision that prescribed nutrition products, including **dietary supplements**, qualified for the prescription drug exemption as "other substances."

1991 The Legislature expanded the **prescribed oxygen** exemption to include various types of oxygen systems. The stated intent was to bring sales and rentals of individual oxygen systems within the existing exemption and to extend the exemption to more modern equipment.

1992 Following recent court cases, for the first time DOR clarified in its WAC that **kidney dialysis machines, heart pacemakers,** and **prescribed dietary supplements** were all exempt.

1996 The Legislature added a new exemption under RCW 82.08.0283 (medical devices) for **medicines "of mineral, animal, and botanical origin" prescribed by licensed naturopaths**. Previously, DOR determined that medicines prescribed by naturopaths, who are separately licensed from chiropractors, physicians, or osteopaths, did not qualify for exemption.

1997 The Legislature added a new sales and use tax exemption **for labor and services to repair, clean, alter, or improve hearing instruments**, clarifying that all facets of hearing aid purchases and repair were exempt.

1998 The Legislature **extended the repair labor and services sales and use tax exemption to apply to all medical devices** exempted from tax at original purchase. In addition, the Legislature **extended the prosthetic exemption to dental appliances and restorations**, including dentures, crowns, inlays, and braces, other dental lab products, and to component parts of prosthetics.

2001 The Legislature **extended the prosthetic exemption to items prescribed by podiatrists.** The legislation resulted from a DOR audit that noted the statutory exemption did not specify prosthetics prescribed by podiatrists.

2003 In an effort to bring Washington's tax system into compliance with the Streamlined Sales and Use Tax Agreement (SSUTA), the Legislature adopted **uniform SSUTA definitions for many medical-related items.** The SSUTA is a multi-state tax agreement to coordinate state tax laws so they are simpler and more uniform. Adopting the SSUTA required the following statutory changes to the sales and use tax exemptions:

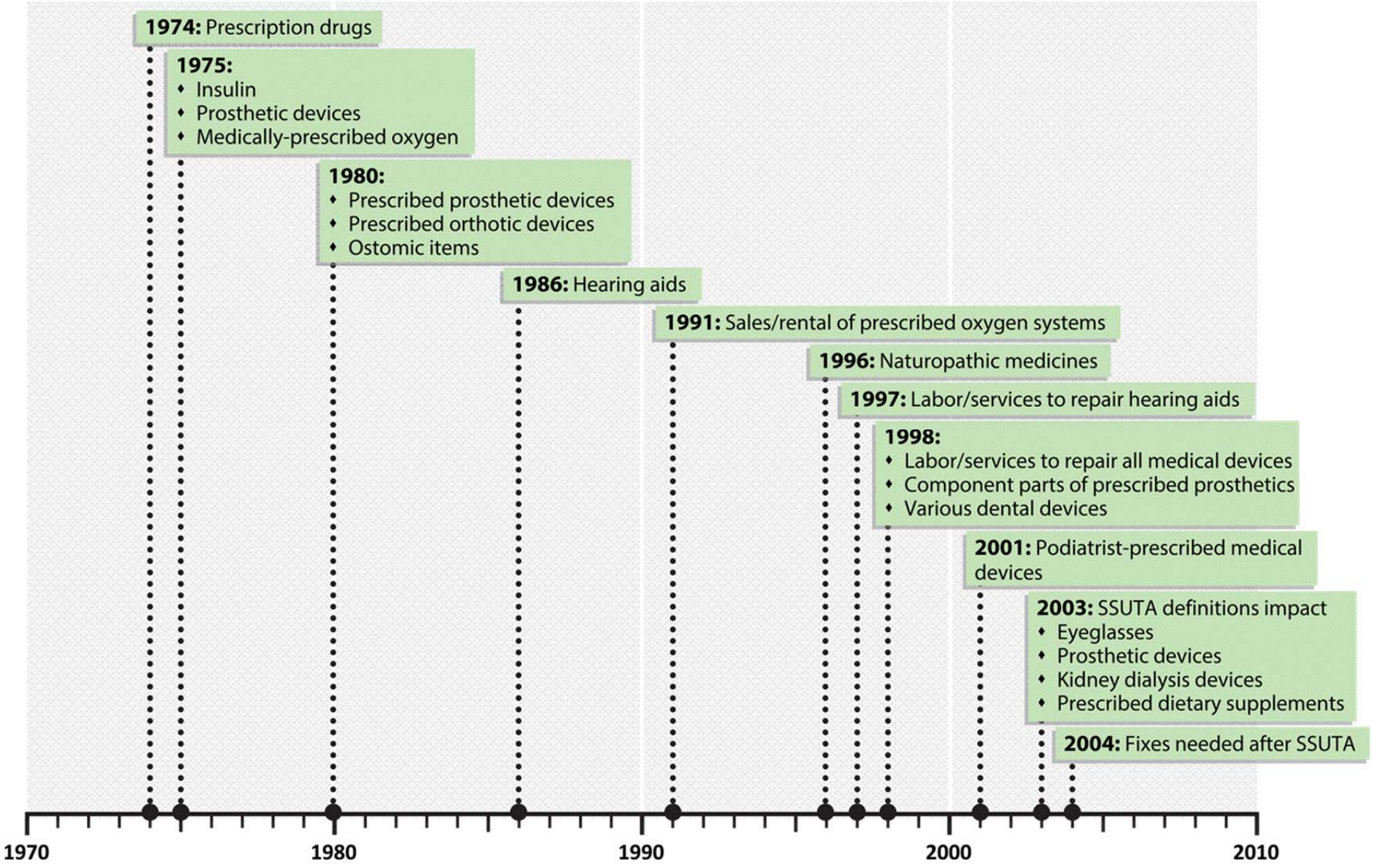
- Defined **eyeglasses to include the frames**. Previously, Washington exempted prescription eyeglass lenses but taxed the frames.
- Defined **prosthetic devices** to include some items Washington had previously taxed, such as slings and repair parts.
- Specifically exempted **kidney dialysis devices**, any replacement or component parts, and repair labor and services. Previously these exemptions were covered under the prosthetics exemption.
- Specifically exempted **prescribed dietary supplements**. Following a 1990 court decision, DOR had allowed this exemption, though it had not been specified in statute.

2004 After the SSUTA was adopted in 2003, DOR found a number of previously exempt medical devices would become taxable when the SSUTA took effect on July 1, 2004. At DOR's request, the Legislature restored certain sales and use tax exemptions in place before 2003:

- **Prosthetics** prescribed by dentists, audiologists, ocularists, opticians, and optometrists;
- **Food and food ingredients** prescribed by **naturopaths**;
- **Over the counter insulin and ostomic items**; and
- Parts and services to **repair and service kidney dialysis devices**.

Exhibit 13 on the following page summarizes the Legislature's adoption over time of sales and use tax exemptions for a variety of medical and health-related items and services. All of these actions followed the 1974 sales and use tax exemption for prescription drugs.

Exhibit 13 – Legislature Expands and Clarifies Sales and Use Exemptions for Medical Items Over 30 Years



Source: JLARC staff analysis of statutory history.

Other Relevant Background

Since first adopting a sales and use tax exemption for "prescription drugs" in 1974, statute indicates that the Legislature has defined and made specific choices about exempting particular medical items and services from sales and use tax while continuing to tax other items. Exhibit 14, below, summarizes these decisions.

Exhibit 14 – Statutory Tax Treatment of Specific Medical Items and Services

	Sales/Use Tax Treatment if:	
Medical Item	**Prescribed**	**Non-prescribed**
Prosthetic Devices, Component Parts, and Repairs	Exempt	Taxed
Naturopathic Medicines	Exempt	Taxed
Oxygen Systems, Component Parts, and Repairs	Exempt	Taxed
Dietary Supplements	Exempt	Taxed
Insulin	Exempt	Exempt
Kidney Dialysis Machines, Component Parts, and Repairs	Exempt	Taxed
Durable Medical Equipment, Component Parts, and Repairs	Taxed	Taxed
Mobility Enhancing Equipment, Component Parts, and Repairs	Taxed	Taxed

Source: JLARC staff analysis of Washington statutes.

Public Policy Objectives

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

The Legislature has never explicitly stated a public policy objective for any of the medically-related sales and use tax exemptions it has provided to consumers since prosthetics, medically prescribed oxygen, and insulin were first exempted in 1975.

A 1930 report to the Legislature acknowledged that imposition of a sales tax would disproportionately burden low-income households. Efforts in the 1960s and 1970s to restructure Washington's tax system to be less regressive were consistently rejected by Washington voters. Subsequently, the Legislature addressed aspects of regressivity by exempting certain categories of basic needs from the sales tax.

JLARC staff infer the public policy objective was to selectively address the regressive nature of sales tax by exempting certain "medically necessary" items for basic human needs.

In more recent years, the Legislature has responded to developments in medical technology and treatments and Washington's adoption of SSUTA by adjusting the tax base and applicable definitions of basic needs.

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

The tax preferences appear to be achieving the inferred public policy objective of reducing the regressive nature of sales and use tax by exempting certain medical items for basic human needs. The tax preferences currently under review remove the sales and use tax from purchases or use of certain medical items and devices.

Exhibit 15, below, summarizes the percentage of pre-tax income spent on health care for varying income levels in 2011. Taxing these items would burden lower-income individuals more than those with higher incomes because those with lower incomes spend a greater portion of their income on health care.

Exhibit 15 – Health Care Expenditures Consume a Greater Percentage of Income for Low-Income Households

2011 Consumer Income Before Taxes	Annual Health Care Expenditures	Percentage of Income Spent on Health Care
$5,000 to $9,999	$1,098	14%
$10,000 to $14,999	$1,578	12%
$15,000 to 19,999	$2,024	12%
$20,000 to $29,999	$2,646	11%
$30,000 to $39,999	$2,751	8%
$40,000 to $49,999	$3,317	7%
$50,000 to $69,999	$3,722	6%
$70,000 and more	$4,742	4%

Source: Bureau of Labor and Statistics 2011 Consumer Expenditure Survey, Table II.

Sales and use tax exemptions for prosthetic devices, oxygen systems, kidney dialysis devices (including parts and repair labor for each), as well as naturopathic medicines and dietary supplements (all of which are prescribed), and non-prescribed insulin, help to reduce the regressive nature of the sales tax by exempting certain items of basic medical need from taxation.

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

Maintaining the preference will continue to make Washington's tax structure less regressive by providing sales and use tax exemptions to Washington citizens on various medical items and devices that meet basic needs.

Beneficiaries

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

The beneficiaries of all but one of these preferences are Washington citizens who do not pay sales or use taxes on their purchases of certain items. Although it is not possible to determine the exact number of beneficiaries for each of the preferences, JLARC staff have identified some related information on beneficiaries, detailed in Exhibit 16, below.

Exhibit 16 – A Variety of Beneficiaries are Affected by Preferences for Medical Items and Services

Preference	Beneficiaries *(Est. Number)*	Additional Information
Orthotic and prosthetic devices	Users of these devices *(Unknown)*	Nationally, demand for orthotic and prosthetic devices and services is expected to increase by 25% for orthotic care and 47% for prosthetic care by 2020.
Naturopathic prescriptions	Naturopathic patients *(Unknown)*	Washington is one of 16 states and the District of Columbia that license naturopathic doctors. An estimated 850 naturopathic doctors currently practice in Washington and prescribe medications to their patients.
Prescribed oxygen systems	Home oxygen users *(Approximately 39,000)*	The Center for Disease Control notes the prevalence of diagnosed lung disease in Washington in 2010 was 3.9 percent - about 265,000 state residents. Another estimated 300,000 state residents remain undiagnosed. Oxygen system industry estimates suggest there are approximately 1.8 million home oxygen system users in the U.S., with 39,000 located in Washington. About 72 percent of home oxygen users are prescribed both a stationary and portable oxygen system.
Prescribed dietary supplements	Individuals *(Unknown)*	It is unclear the number of Washington residents that may purchase various types of dietary supplements under a prescription.
Insulin	Diabetics using insulin *(Over 512,000)*	The Center for Disease Control notes the prevalence of diagnosed diabetes in Washington in 2010 was 7.6 percent. This amounts to over 512,000 state citizens diagnosed with diabetes in 2010. The national average was 6.9 percent for 2010.
Kidney dialysis devices	Kidney dialysis facilities, hospitals, and home users *(76 kidney dialysis centers; others unknown)*	In 2011, 6,094 Washington residents received kidney dialysis treatments according to the Northwest Renal Network. Washington dialysis patients predominantly utilize in-center hemodialysis (87 percent), with various in-home treatments comprising the rest. Therefore, most of the beneficiaries are dialysis centers purchasing qualifying equipment. Hospitals and individuals are beneficiaries to a lesser degree.

Source: JLARC staff analysis of above-noted sources.

Revenue and Economic Impacts

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

The following charts reflect JLARC staff's estimated beneficiary savings for the four tax preferences under review.

Prescribed Medical Items and Repair Labor and Services:

For the sales and use tax exemption provided under RCWs 82.08.0283 and 82.12.0277, consumers purchasing prescribed prosthetic devices, naturopathic medicines, and oxygen systems, or any repair or maintenance labor or services for these items are estimated to save $53.2 million in Fiscal Year 2012 and nearly $123 million in the 2015-17 Biennium. See Exhibit 17, below.

Exhibit 17 – Estimated 2015-17 Beneficiary Savings for Prescribed Medical Devices and Repair Labor and Services

				Sales and Use Tax		
FY	Prosthetic Expenditures	Naturopathic Medicines	Prescribed Oxygen	State	Local	Total
2010	$426,000,000	$84,809,000	$46,870,000	$36,259,000	$13,343,000	$49,602,000
2011	$442,726,000	$88,234,000	$47,614,000	$37,514,000	$13,947,000	$51,461,000
2012	$456,940,000	$91,800,000	$48,370,000	$38,812,000	$14,402,000	$53,214,000
2013	$473,624,000	$93,636,000	$49,137,000	$40,066,000	$15,134,000	$55,200,000
2014	$491,056,000	$95,509,000	$49,917,000	$41,371,000	$15,627,000	$56,998,000
2015	$509,369,000	$97,419,000	$50,710,000	$42,737,000	$16,143,000	$58,880,000
2016	$525,477,000	$99,367,000	$51,515,000	$43,963,000	$16,606,000	$60,569,000
2017	$542,181,000	$101,355,000	$52,332,000	$45,231,000	$17,085,000	$62,316,000
			2015-17 Biennium:	**$89,194,000**	**$33,691,000**	**$122,885,000**

Source: Prosthetics: Market research estimates for U.S. orthotic, prosthetic, dental devices, limb prostheses, and hearing aids, adjusted for Washington per 2010 census population. Growth rates vary depending on market industry estimates. Naturopathic Med: Interview with industry rep, naturopathic and average monthly cost of naturopathic doctor prescriptions. Growth estimated at 2 percent annually. Oxygen: Market industry research and U.S. Government Accountability Office report. Growth estimated at 1.5 percent annually.

Dietary Supplements:

For the sales and use tax exemption provided under RCWs 82.08.925 and 82.12.925, consumers purchasing dietary supplements via a prescription are estimated to save $5.5 million in Fiscal Year 2012 and $12.2 million in the 2015-17 Biennium. See Exhibit 18, on the following page.

Exhibit 18 – Estimated 2015-17 Beneficiary Savings for Prescribed Dietary Supplements

		Sales and Use Tax		
FY	**Prescribed Dietary Supplements**	**State**	**Local**	**Total**
2010	$59,815,000	$3,888,000	$1,431,000	$5,319,000
2011	$61,011,000	$3,966,000	$1,474,000	$5,440,000
2012	$62,231,000	$4,045,000	$1,501,000	$5,546,000
2013	$63,476,000	$4,126,000	$1,558,000	$5,684,000
2014	$64,746,000	$4,208,000	$1,590,000	$5,798,000
2015	$66,040,000	$4,293,000	$1,621,000	$5,914,000
2016	$67,361,000	$4,378,000	$1,654,000	$6,032,000
2017	$68,708,000	$4,466,000	$1,687,000	$6,153,000
	2015-17 Biennium	**$8,844,000**	**$3,341,000**	**$12,185,000**

Source: National Institute of Health information sheet on dietary supplement use. Growth estimated at 2 percent annually.

Insulin:

For the sales and use tax exemption provided under RCWs 82.08.985 and 82.12.985, consumers purchasing insulin are estimated to save $17.7 million in Fiscal Year 2012 and $52.4 million in the 2015-17 Biennium. See Exhibit 19, below.

Exhibit 19 – Estimated 2015-17 Beneficiary Savings for Insulin Sales

		Sales and Use Tax		
FY	**Insulin Sales**	**State**	**Local**	**Total**
2010	$165,755,000	$10,774,000	$3,965,000	$14,739,000
2011	$182,149,000	$11,839,000	$4,402,000	$16,241,000
2012	$198,542,000	$12,905,000	$4,789,000	$17,694,000
2013	$216,411,000	$14,067,000	$5,313,000	$19,380,000
2014	$235,888,000	$14,333,000	$5,791,000	$21,124,000
2015	$57,118,000	$16,713,000	$6,313,000	$23,025,000
2016	$280,258,000	$18,217,000	$6,881,000	$25,098,000
2017	$305,482,000	$19,856,000	$7,500,000	$27,356,000
	2015-17 Biennium	**$38,073,000**	**$14,381,000**	**$52,454,000**

Source: Market drug sales data, Center for Disease Control (CDC) info on Washington diabetes rates. Growth estimated per CDC diabetes growth rate in Washington from 1995-2010.

Kidney Dialysis Devices:

For the sales and use tax exemption provided under RCWs 82.08.945 and 82.12.945, kidney dialysis treatment centers, hospitals, and individuals buying or renting dialysis devices for home use are estimated to save $3.9 million in Fiscal Year 2012 and $8.8 million in the 2015-17 Biennium. See Exhibit 20, below.

Exhibit 20 – Estimated 2015-17 Beneficiary Savings for Kidney Dialysis Machine Purchases, Rentals, and Repair Labor and Services

		Sales and Use Tax		
FY	**Kidney Dialysis Machines Purchases, Rentals, Repairs**	**State**	**Local**	**Total**
2010	$42,183,000	$2,742,000	$1,009,000	$3,751,000
2011	$43,176,000	$2,806,000	$1,043,000	$3,850,000
2012	$44,169,000	$2,871,000	$1,065,000	$3,936,000
2013	$45,185,000	$2,937,000	$1,109,000	$4,046,000
2014	$46,224,000	$3,005,000	$1,135,000	$4,139,000
2015	$47,287,000	$3,074,000	$1,161,000	$4,235,000
2016	$48,375,000	$3,144,000	$1,188,000	$4,332,000
2017	$49,488,000	$3,217,000	$1,215,000	$4,432,000
	2015-17 Biennium	**$6,361,000**	**$2,403,000**	**$8,764,000**

Source: Northwest Renal Network information. Growth estimated per United States Renal Data System.org data.

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

Terminating the tax preferences would likely increase health care costs for individuals and for the entities that primarily pay for the health care (Medicare, Medicaid, and private insurers), as purchases of the various medical and health-related items covered within this review would be subject to sales or use tax.

When the costs are borne by individuals, their costs for the various products now exempted under these four sales and use tax preferences would increase by 7.0 to 9.5 percent (depending on the applicable sales tax rate). In the case of publicly supported or privately insured health care, the effects would depend upon the extent that increased costs would be absorbed or passed on to individuals.

Other States

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

Of the 45 states that impose sales and use taxes, 24 (including Washington) are members of the Streamlined Sales and Use Tax Agreement (SSUTA). These states share uniform definitions for a number of medically related items. Because definitions of medically related items can vary widely for other states, JLARC staff limited its review to SSUTA states, which represent over half of the states that impose sales and use taxes and 31 percent of the U.S. population.

Exhibit 21 on pages 69 - 70 shows how each SSUTA state taxes the various medical devices, equipment, and items covered in this review. Along with Washington, Kansas, New Jersey, Vermont, and Wyoming provide the most sales and use tax exemptions for the categories listed.

The areas with the most discrepancy in tax treatment are dietary supplements and naturopathic medicines. Of the 24 SSUTA states, Washington and four other states exempt prescribed dietary supplements while five states exempt dietary supplements regardless of whether they are prescribed. The remaining 14 states tax dietary supplements.

Six SSUTA member states license naturopathic doctors (Washington, Kansas, Minnesota, North Dakota, Utah, and Vermont). Washington is the only SSUTA state that specifically exempts prescribed naturopathic medicines. The other five SSUTA states that exempt naturopathic medicines do so under a broad dietary supplement exemption.

Legislative Auditor Recommendation

The Legislature should continue the sales and use tax exemptions for certain prescribed medical items, prescribed dietary supplements, insulin, prescribed kidney dialysis equipment, and repair labor and services on such exempt equipment because they are meeting the inferred public policy objective of reducing the regressive nature of Washington's sales and use tax by exempting certain medical items and services that meet basic human needs.

Legislation Required: No.

Fiscal Impact: None.

Exhibit 21 – How Does Washington Tax Various Medical Items in Comparison to Other SSUTA States?

	Prescribed Prosthetics	Prescribed Naturopathic Medicines	Prescribed Oxygen	Insulin	Prescribed Dietary Supplements	Prescribed Kidney Dialysis Machines
Washington	Exempt	Exempt *(naturopaths licensed)*	Exempt	Exempt *(no prescript. needed)*	Exempt	Exempt
Arkansas	Exempt *(prescribed eyeglasses, contacts, dental prosthesis only exempt when paid by Medicare or Medicaid)*	Naturopaths not licensed	Exempt	Exempt *(no prescript. needed)*	Taxed	Exempt
Georgia	Exempt	Naturopaths not licensed	Exempt	Exempt *(no prescript. needed)*	Taxed	Exempt
Indiana	Exempt	Naturopaths not licensed	Exempt *(no prescript. needed)*	Exempt *(no prescript. needed)*	Taxed	Exempt
Iowa	Exempt	Naturopaths not licensed	Exempt *(no prescript. needed)*	Exempt *(no prescript. needed)*	Taxed	Exempt
Kansas	Exempt	Exempt *(under dietary suppl. – naturopaths licensed)*	Exempt	Exempt *(no prescript. needed)*	Exempt	Exempt
Kentucky	Exempt *(prescribed eyeglasses, contacts, dental prosthesis only exempt when paid by Medicare or Medicaid)*	Naturopaths not licensed	Exempt	Exempt *(if prescribed)*	Exempt	Exempt
Michigan	*Only prescribed eyeglasses and hearing aids exempt; contacts exempt only if paid by Medicare or Medicaid*	Exempt *(under dietary suppl.)*	Exempt	Exempt *(no prescript. needed)*	Exempt *(no prescript. needed)*	Taxable *(unless prescribed and for home use)*
Minnesota	Exempt	Naturopaths licensed	Exempt *(no prescript. needed)*	Exempt *(no prescript. needed)*	Taxed	Exempt *(no prescript. needed)*
Nebraska	Exempt *(only if Medicaid eligible)*	Naturopaths not licensed	Exempt	Exempt *(no prescript. needed)*	Taxed	Exempt *(only if Medicaid eligible)*
Nevada	Exempt	Naturopaths not licensed	Exempt	Exempt *(no prescript. needed)*	Exempt	Exempt
New Jersey	Exempt *(no prescript. needed)*	Exempt *(under dietary suppl.)*	Exempt *(no prescript. needed)*	Exempt *(no prescript. needed)*	Exempt *(no prescript. needed)*	Exempt *(only for home use or paid by Medicaid, no prescript. needed)*

	Prescribed Prosthetics	Prescribed Naturopathic Medicines	Prescribed Oxygen	Insulin	Prescribed Dietary Supplements	Prescribed Kidney Dialysis Machines
North Carolina	Exempt *(no prescript. needed)*	Naturopaths not licensed	Exempt	Exempt *(no prescript. needed)*	Taxed	Exempt
North Dakota	Exempt	Naturopaths licensed	Exempt	Exempt *(if prescribed)*	Taxed	Exempt *(only for home use or paid by Medicaid, no prescript. needed)*
Ohio	Exempt *(except eyeglasses, contacts, dental prostheses)*	Naturopaths not licensed	Exempt	Exempt *(no prescript. needed)*	Taxed	Exempt *(only for home use)*
Oklahoma	Exempt *(except eyeglasses, contacts, hearing aids not paid by Medicaid or Medicare)*	Naturopaths not licensed	Exempt *(no prescript. needed)*	Exempt *(no prescript. needed)*	Taxed	Exempt *(only if paid by Medicaid or Medicare)*
Rhode Island	Exempt	Naturopaths not licensed	Exempt *(no prescript. needed)*	Exempt *(no prescript. needed)*	Exempt	Exempt *(only for home use, no prescript. needed)*
South Dakota	Exempt	Naturopaths not licensed	Exempt	Exempt *(no prescript. needed)*	Taxed	Exempt
Tennessee	Exempt *(except eyeglasses and contacts)*	Naturopaths not licensed	Exempt	Exempt *(no prescript. needed)*	Taxed	Exempt *(no prescript. needed)*
Utah	Exempt *(except eyeglasses, contacts, non-prescribed dental prostheses)*	Naturopaths licensed	Exempt	Exempt *(if prescribed)*	Taxed	Exempt *(only for home use)*
Vermont	Exempt	Exempt *(under dietary suppl. – naturopaths licensed)*	Exempt *(no prescript. needed)*	Exempt *(no prescript. needed)*	Exempt *(no prescript. needed)*	Exempt *(no prescript. needed)*
West Virginia	Exempt	Naturopaths not licensed	Exempt	Exempt *(no prescript. needed)*	Exempt *(no prescript. needed)*	Exempt
Wisconsin	Exempt *(no prescript. needed)*	Naturopaths not licensed	Exempt	Exempt *(if prescribed)*	Taxed	Exempt *(only if for home use or paid by Medicare or Medicaid)*
Wyoming	Exempt	Exempt *(under dietary suppl.)*	Exempt	Exempt *(if prescribed)*	Exempt *(no prescript. needed)*	Exempt

Source: Streamlined Sales Tax Taxability Matrix, checked 12/19/2012; JLARC analysis of CCH data on dietary.

NONPROFIT BLOOD AND TISSUE BANKS (B&O AND SALES AND USE TAXES)

Report Summary			
What the Preference Does	**Public Policy Objectives**	**Estimated Beneficiary Savings**	**Auditor Recommendation**
Exempts nonprofit blood and tissue banks from: 1) B&O tax on revenue from collection, storage, and distribution of blood and tissue if the income is also exempt from federal income tax, and 2) Sales and use taxes on purchases of qualified medical supplies, chemicals, and materials.	The Legislature did not state the public policy objective for the tax preferences in 2004. JLARC staff infer the public policy objective was to provide the same tax treatment to nonprofit blood and tissue banks as the federal law required states to provide to the American Red Cross.	**B&O Tax:** $4.7 million in the 2015-17 Biennium **Sales and Use Tax:** $17.9 million in the 2015-17 Biennium	**Continue:** Because the preferences are achieving the inferred public policy objective of providing the same tax treatment to nonprofit blood and tissue banks as to the American Red Cross.

NONPROFIT BLOOD AND TISSUE BANKS (B&O AND SALES AND USE TAXES)

Current Law

Nonprofit blood and tissue banks are exempt from the business and occupation (B&O) tax on revenue from the collection, storage, and distribution of blood and tissue, and related services if the revenue is also exempt from federal income tax. To be exempt from federal income tax, revenue must be related to the charitable purpose of the nonprofit.

Also, state law exempts purchases of medical supplies, chemicals, or materials by a qualifying blood and tissue bank from sales and use taxes. Qualified purchases include equipment used to procure blood or tissue, chemical additives used to process and test, or packaging materials used for distribution of the product. The sales and use tax exemptions do not apply to purchases of construction materials, office equipment, building equipment, administrative supplies, or vehicles.

Blood banks must be primarily in the business of collecting, preparing, and processing blood, and they must be registered with the U.S. Food and Drug Administration (FDA).

Tissue banks must be primarily in the business of recovering, processing, storing, labeling, packaging, or distributing human bone tissue, ligament tissue, and similar musculoskeletal tissue, skin tissue, heart valve tissue, or human eye tissue, and they must be registered with the FDA.

The Legislature enacted SSB 5882 in June 2013, modifying these preferences. Effective October 1, 2013, the definitions of qualifying blood bank and qualifying blood and tissue bank will expand to include testing or processing of blood, on behalf of itself or another qualifying blood bank or qualifying blood and tissue bank. The expansion allows nonprofit organizations that only test or process blood to qualify for the B&O tax and sales and use tax exemptions. Prior to this expansion, only organizations that collect, prepare and process blood qualified. The B&O tax exemption is capped at $150,000 per calendar year only for those beneficiaries that do not conduct all three activities.

The expanded B&O tax and sales and use tax exemptions expire July 1, 2016, at which time the preferences revert to their pre-October 2013 form and will apply only to qualified nonprofit blood and tissue banks that collect, prepare, and process blood.

The American Red Cross blood collection facilities are exempt from B&O and sales and use taxes under separate statutes exempting relief organizations incorporated by the United States. Comprehensive cancer centers are explicitly excluded from the blood and tissue bank exemptions because they have their own similar exemptions. Organ procurement organizations have similar B&O and sales and use tax exemptions. Exemptions for organ procurement and comprehensive cancer centers are included in JLARC's 2013 expedited reviews. The Red Cross exemptions are statutorily omitted from review.

Nonprofit blood and tissue banks also receive a property tax exemption which JLARC staff reviewed in 2011. Beginning October 1, 2013, **the property tax exemption** will also be expanded to include nonprofit organizations that only test or process blood (as noted on the previous page for the B&O tax and sales and use tax preferences.) The expansion expires July 1, 2016.

See page A3-11 in Appendix 3 for the current statutes, RCW 82.04.324 for the B&O tax exemption, and RCW 82.08.02805 and 82.12.02747 for the sales and use tax exemptions.

Legal History

Before 1995, blood and tissue banks paid wholesaling or retailing B&O tax on sales of their products to hospitals and other customers. Laboratory services, such as blood typing performed for others, were taxed at the service B&O tax rate. Sales of medical supplies, chemicals, and materials to blood and tissue banks were taxable under the sales and use taxes.

1995 The Legislature authorized the B&O and sales and use tax preferences for blood, bone, or tissue banks. The original bill exempted blood banks only, but the House Finance Committee amended the bill to include exemptions for nonprofit bone or tissue banks. However, the title of the bill related to blood banks and not to bone or tissue banks.

2003 The Thurston County Superior Court ruled that the 1995 act violated the "subject-in-title" provision of the state Constitution because the bone and tissue banks were not included in the bill title.[1] As a result of the court ruling, bone or tissue banks no longer received the exemptions as they had since 1995. Blood banks continued to receive the tax exemptions authorized in 1995.

2004 The Legislature re-enacted the B&O and sales and use tax exemptions for tissue banks. The new law allowed both blood and tissue banks an exemption if they qualified as nonprofit charitable organizations under federal tax law. A new provision required blood and tissue banks to be registered with the FDA. The definition of tissue now included human bone tissue.

2013 The Legislature modified the B&O tax and sales and use tax exemptions to apply to entities that test or process blood on behalf of themselves or for another qualifying blood bank or qualifying blood and tissue bank. The expansion takes effect October 1, 2013, and expires July 1, 2016.

Other Relevant Background

The American Red Cross is a nonprofit, charitable organization chartered by Congress to fulfill certain federal commitments such as disaster relief. The Red Cross is exempt from federal taxes as a charitable organization and is exempt from state taxes because it is considered a "federal instrumentality."

During World War II, the Red Cross began a national blood collection program to supply the armed forces, and transitioned after the war to a nationwide civilian blood collection program.

[1] *Fred Hutchinson Cancer Research Center v. DOR,* No. 012017095 (Thurston County Super. Ct., 2003)

At the same time, local community blood banks formed in Washington, including Puget Sound Blood Center in 1944; the Inland Northwest Blood Center, which began as the Spokane Community Blood Bank in 1945; and Cascade Regional Blood Services, which began as the Tacoma-Pierce County Blood Bank in 1946. These same three blood banks are the current beneficiaries of the tax preferences. The Red Cross and the three community blood banks perform similar functions and serve similar customers such as hospitals and health care facilities.

In the 1980s and 1990s, concerns about the safety of the blood supply led to increased regulatory requirements at the federal level for monitoring and testing. This increased costs for both the Red Cross and the community blood banks prior to the time this tax preference was adopted.

Currently, all three community blood banks and the Red Cross facilities in Vancouver are registered with the FDA as both blood and tissue banks. JLARC staff could not identify any nonprofit tissue banks operating separately from a blood bank that qualified under these tax preferences.

Public Policy Objectives

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

The Legislature did not explicitly state the public policy objective when it originally provided B&O and sales and use tax exemptions to nonprofit blood and tissue banks in 2004.

JLARC staff infer that the objective was to provide the same tax treatment to nonprofit blood and tissue banks as the federal law required states to provide to the American Red Cross. Evidence for this objective comes from 1995 public testimony indicating that nonprofit blood and tissue banks performed the same functions as the American Red Cross and should receive a similar exempt status.

In 2013 when the Legislature modified the B&O tax and sales and use tax exemptions, it specifically noted its intent was "to allow flexibility for nonprofit organizations where qualifying activities will be provided by more than one organization." The Legislature also noted it did not intend to expand which activities qualified for the preferences. Further, the Legislature stated its intent to reassess the changes made in 2013 to ensure the actual fiscal impact reasonably conforms with the fiscal note estimate for the legislation.

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

The tax preferences are contributing to the achievement of the 2004 inferred public policy objective by giving the same tax treatment to nonprofit blood and tissue banks as state and federal law provides to the Red Cross.

Locally-organized blood and tissue banks and the Red Cross perform similar blood collection, storage, and distribution activities and serve similar customers. Both are organized as charitable

nonprofits and are exempt from federal income tax on revenues related to their charitable purpose. The Red Cross is exempt from all B&O and sales and use taxes because it is considered an instrumentality of the U.S. government. The community blood and tissue banks are exempt from the same taxes under state law.

It is too early for JLARC staff to determine whether the 2013 public policy objective has been achieved.

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

By continuing the B&O and sales and use tax exemptions for nonprofit blood banks, the Legislature is contributing to the inferred public policy objective of providing similar tax treatment to nonprofit blood and tissue banks and the Red Cross. Both perform similar functions and serve similar customers.

Beneficiaries

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

Beneficiaries of the tax preference are three nonprofit blood and tissue banks currently operating in the state. The largest of the beneficiaries, the Puget Sound Blood Center, maintains 13 facilities throughout Western Washington and reported $148.4 million in federally exempt program revenue in 2010. All three organizations are registered with the FDA as both blood and tissue banks. See Exhibit 22, below, for details.

Exhibit 22 – Nonprofit Blood and Tissue Banks Earned an Estimated $182.2 Million in Tax Exempt Revenue in 2010

Non-Profit Blood and Tissue Centers	Location	Revenue	% of Total Revenue
Cascade Regional Blood Services	Tacoma	$11,905,000	7%
Inland Northwest Blood Center	Spokane	$21,926,000	12%
Puget Sound Blood Center	13 locations in Western WA	$148,394,000	81%
Total		**$182,225,000**	**100%**

Source: Internal Revenue Service Form 990 for charitable organizations and U.S. Food and Drug Administration registration data.

Starting October 1, 2013, through June 30, 2016, beneficiaries will also include nonprofit organizations that only test or process blood, either for themselves or for one of the three qualifying nonprofit blood and tissue banks noted above.

Revenue and Economic Impacts

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

In 2012, beneficiaries are estimated to save $2.6 million in state B&O tax on their income, and $7.8 million in state and local sales and use taxes on purchases of exempt medical supplies, chemicals, and materials. Beneficiaries are estimated to save $4.7 million in state B&O taxes and $17.9 million in state and local sales and use taxes in the 2015-17 Biennium. The sales and use tax estimate includes additional beneficiary savings estimated by the Department of Revenue for the period October 1, 2013, through June 30, 2016, due to the 2013 modification of the preferences. The Department indicated it was not able to estimate the impact to the B&O tax collections. See Exhibit 23, below.

Exhibit 23 – Estimated 2015-17 Beneficiary Savings for Nonprofit Blood and Tissue Banks

	B&O Tax	Sales and Use Tax		
Fiscal Year	**Total**	**State**	**Local**	**Total**
2010	$2,254,000	$5,563,000	$2,047,000	$7,610,000
2011	$2,601,000	$5,616,000	$2,067,000	$7,683,000
2012	$2,627,000	$5,671,000	$2,087,000	$7,758,000
2013	$2,652,000	$5,726,000	$2,107,000	$7,833,000
2014	$2,276,000	$6,730,000	$2,486,000	$9,216,000
2015	$2,299,000	$7,042,000	$2,604,000	$9,646,000
2016	$2,320,000	$7,166,000	$2,649,000	$9,815,000
2017	$2,341,000	$5,951,000	$2,190,000	$8,141,000
2015-17 Biennium	**$4,661,000**	**$13,117,000**	**$4,839,000**	**$17,956,000**

Source: JLARC staff estimates based on Internal Revenue Service Form 990 for charitable organizations and on data provided by Puget Sound Blood Center. Savings are estimated to grow at the rate of Washington's population growth. Estimates for 2014-2016 include Department of Revenue estimates from SSB 5882 fiscal note for the modification to the sales and use tax preference.

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

If the tax preferences were to be terminated, blood and tissue banks would pay B&O tax on their income, and sales and use taxes on their purchases. This would increase costs for the three beneficiaries. It is not known the extent to which they would absorb the cost or pass their higher costs onto their customers and increase the cost of health care.

Other States

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

Sales and Use Tax Exemptions

Thirty states and the District of Columbia provide sales and use tax exemptions to charitable organizations, including nonprofit blood and tissue banks. Two additional states specifically exempt nonprofit blood banks but not tissue banks. Thirteen states do not exempt these organizations. The remaining five states do not levy sales and use taxes.

B&O Tax Exemption

Unlike Washington, the primary business tax in most states is a net income tax rather than a gross receipts tax like the B&O tax. Generally, states with net income taxes exempt the income of charitable organizations that receive a federal tax exemption.

Legislative Auditor Recommendation

The Legislature should continue the 2004 B&O and sales and use tax exemptions for blood and tissue banks because the tax preferences are achieving the inferred public policy objective of providing the same tax treatment to nonprofit blood and tissue banks as to the American Red Cross.

Legislation Required: No.

Fiscal Impact: None.

This recommendation does not apply to the 2013 modification that is scheduled to expire June 30, 2016.

PRESCRIPTION DRUG RESELLERS (B&O TAX)

Report Summary			
What the Preference Does	**Public Policy Objectives**	**Estimated Beneficiary Savings**	**Auditor Recommendation**
Provides a reduced B&O tax rate for businesses that warehouse and resell prescription drugs.	The Legislature did not state the public policy objective for the tax preference. JLARC staff infer the Legislature intended to reduce a competitive disadvantage for drug resellers operating warehouses in Washington relative to businesses that distribute drugs in the state without nexus and that owe no B&O tax.	$29.9 million in the 2015-17 Biennium	**Continue:** Because the preference is meeting the inferred public policy objective of reducing a competitive disadvantage for wholesalers operating Washington warehouses relative to out-of-state drug distributors that have no nexus to Washington and pay no B&O tax.

PRESCRIPTION DRUG RESELLERS (B&O)

Current Law

Current law provides a reduced business and occupation (B&O) tax rate for businesses that warehouse and resell prescription drugs. The reduced rate is 0.138 percent compared to the general wholesaling rate of 0.484 percent.

In order to qualify, prescription drug wholesalers must:

- Buy prescription drugs for human use from a manufacturer or another wholesaler and warehouse these drugs;
- Resell to retailers, hospitals, clinics, and other health care providers, but not to end consumers; and
- Be registered with the federal Drug Enforcement Administration and licensed by the Pharmacy Quality Assurance Commission.

The prescription drugs owned by businesses that qualify for the preferential tax rate can be sold from warehouses located inside or outside of Washington.

See page A3-12 in Appendix 3 for the current statutes, RCW 82.04.272.

Legal History

Prior to 1998 businesses that warehoused and resold prescription drugs in Washington paid B&O tax at the general wholesaling rate of 0.484 percent.

1998 The Legislature enacted the reduced rate for businesses that warehouse and resell prescription drugs, with a delayed effective date of July 1, 2001. The statute defined reselling of prescription drugs without specifying where the warehouse had to be located. The Department of Revenue (DOR) interpreted the preferential tax rate to only apply to sales from pharmaceutical warehouses located in Washington.

2002 DOR-request legislation attempted to clarify that the lower rate applied to wholesale sales of drugs warehoused in Washington and then sold in this state. The bill had no fiscal note because the language reflected current administrative practice. The bill did not pass; however, DOR continued to interpret the preferential rate to apply only to sales made from in-state warehouses.

2008 Axcan Scandipharm, an out-of-state pharmaceutical distributor, appealed a DOR tax assessment to the state Board of Tax Appeals (BTA) claiming that it qualified for the preferential tax rate. DOR had assessed tax at the higher wholesaling rate because the company did not sell the drugs from an in-state warehouse. Axcan argued that the statute did not require drugs to be sold out of a Washington warehouse, and that such a requirement would violate the Commerce Clause of the federal Constitution.

Before the Board of Tax Appeals heard the case, DOR began allowing the preferential rate for prescription drug resellers no matter where the warehouse was located, and DOR

provided refunds to businesses that had previously paid tax at the higher rate. As a result, the appeal was not heard.

2011 In a different case, the BTA upheld DOR's position that the preference did not apply to sales to the end consumer. Sales must be to a retailer, hospital, clinic, or other health care provider.

Other Relevant Background

Prescription Drugs Are Distributed Through a Variety of Channels

In prior years, drug resellers traditionally purchased prescription drugs from manufacturers, stored them in their own warehouses close to their customers, and resold them to retail chains, hospitals and other dispensers. Today, prescription drugs are also sold through numerous other channels that bypass the traditional wholesaling and warehousing arrangements. The other channels include:

- Wholesale mail service – wholesalers ship drugs to retailers by mail or common carrier from a warehouse located at a distance from their customers.
- Manufacturer direct – drugs are shipped directly from the manufacturer to the retailer without being stored in a warehouse. This is known as "drop shipment."
- Self-warehousing – retail chains, other mass merchandisers such as food stores, and hospitals may buy drugs directly from the manufacturer and warehouse the drugs themselves.
- Mail order – individuals fill their own prescriptions by mail order. Mail order is the fastest growing segment of the pharmaceutical distribution industry, increasing from 5 percent of all sales in 1990 to 17 percent of sales in 2011.

According to a federal court decision in the year the Legislature enacted the tax preference, the major drug wholesalers operating regional warehouses had been faced with increased competition that required them to lower prices, and to merge and acquire other companies to broaden their markets and achieve economies of scale.

Drug Resellers Owe Tax in Washington if They Have Nexus

Businesses that sell goods in Washington owe B&O tax if they have established a physical presence (or nexus) in this state. Typically, a business has physical presence in this state if:

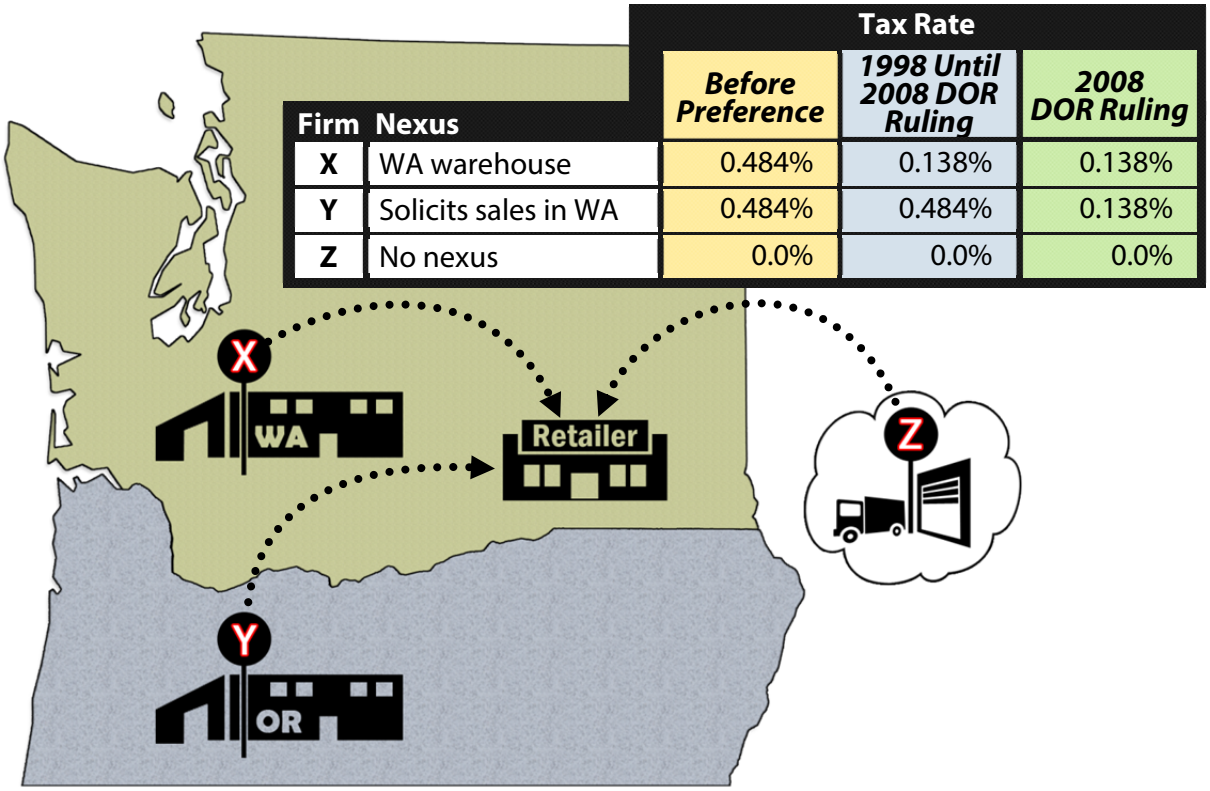
- The business has facilities, such as warehouses, or employees in this state, or
- The business engages in activities to establish or maintain a market for its products in this state, such as maintaining a stock of goods or using an agent or representative to solicit sales.

Delivery of goods into Washington does not in itself create nexus if the seller has not established physical presence by locating facilities or employees in this state or by engaging in sales activities that create nexus.

Exhibit 24, below, shows an example of three pharmaceutical distributors (Firms X, Y, and Z) that sell drugs at wholesale in Washington. Firm X has established nexus by operating a warehouse in Washington. Out-of-state Firm Y has established nexus because it solicits sales using a sales staff in Washington. Both X and Y first warehouse pharmaceuticals and then sell them to a Washington retailer. Out-of-state Firm Z arranges for delivery of pharmaceuticals to a Washington retailer by "drop shipment" through a common carrier, but it has not established nexus by operating a warehouse or soliciting sales in Washington.

The table in Exhibit 24, below, shows how B&O tax treatment of Firms X and Y changed before and after the Legislature enacted the tax preference and after DOR broadened its interpretation of the tax preference in 2008. Initially, only Firm X, with a warehouse in Washington, benefited from the tax preference. After DOR's 2008 ruling, Firm Y also benefited from the tax preference. Washington's B&O tax places both X and Y at a competitive disadvantage relative to Firm Z because Firm Z does not pay Washington's B&O tax, but the lower rate provided by the tax preference reduces that disadvantage.

Exhibit 24 – Sales in Washington Are Taxed if Business Has Nexus



Firm	Nexus	Tax Rate: Before Preference	Tax Rate: 1998 Until 2008 DOR Ruling	Tax Rate: 2008 DOR Ruling
X	WA warehouse	0.484%	0.138%	0.138%
Y	Solicits sales in WA	0.484%	0.484%	0.138%
Z	No nexus	0.0%	0.0%	0.0%

Source: JLARC staff analysis of tax law.

Public Policy Objectives

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

The Legislature did not explicitly state the public policy objective in statute.

However, JLARC staff infer that the Legislature intended to **reduce a competitive disadvantage** for existing drug resellers operating warehouses in Washington relative to businesses that distribute drugs in this state without nexus and that owe no B&O tax. The preferential tax rate reduced the B&O tax rate for drug resellers from 0.484 percent to 0.138 percent of gross income.

In 1998, the testimony in favor of the preference focused on businesses with warehouses in Washington. A representative of the wholesale drug industry testified that drug resellers faced pressure to relocate their Washington warehouses elsewhere because of increasing competition from drug distributors without Washington nexus. The industry representative added that the prescription drug warehouses provided family wages for over 500 employees throughout the state.

At first, DOR administered the tax preference to apply only to sales from Washington drug warehouses, even though the Legislature never stated its intention to limit the preference in this way. After a constitutional challenge, DOR changed its interpretation in 2008 to apply more broadly to any drug reseller paying B&O tax whether or not it operated an in-state warehouse.

Now, using Firms X, Y, and Z from Exhibit 24 on the previous page, the current interpretation of the statute reduces the competitive disadvantage for both Firms X and Y relative to Firm Z which owes no Washington tax.

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

The tax preference reduced a competitive disadvantage for drug resellers operating Washington warehouses by reducing their B&O tax rate relative to drug resellers that have no Washington nexus. The same major pharmaceutical distributors operating warehouses in Washington before the tax preference are still located in Washington.

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

Although the tax preference now applies more broadly to any pharmaceutical distributor with Washington nexus, it continues to contribute to the public policy objective. The tax preference reduces the rate for drug resellers with Washington warehouses relative to drug resellers that owe no B&O tax.

Beneficiaries

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

The wholesale drug market is dominated by three vertically-integrated firms operating in global markets. These three firms operate warehouses in Washington as well as elsewhere, and their sales make up 85 percent of prescription drug sales in Washington.

In 2012, a total of 33 firms benefited from the tax preference. Exhibit 25, below, shows that ten drug resellers with at least one warehouse in Washington, including the top three firms, are responsible for 89 percent of Washington pharmaceutical wholesale sales. Another 23 distributors currently benefit from the preferential tax rate and distribute drugs from warehouse facilities located exclusively outside of Washington.

Exhibit 25 – In 2012, 33 Prescription Drug Wholesalers with Taxable Sales in Washington Benefitted from the Preference

Firms in Exhibit 24	Wholesaler Distributes from:	WA Sales	Number of Firms	Percent of WA Taxable Sales
Firm X	At least one warehouse in WA (including top 3 firms)	$3.3 billion	10	89%
Firm Y	Have nexus in WA but warehouse located outside of the state	$418 million	23	11%
Total **Taxable** Sales		$3.7 billion	33	100%

Source: State Pharmacy Quality Assurance Commission and 2012 DOR tax return data.

Businesses in the category of Firm Z are not beneficiaries because their sales are not taxable in Washington.

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

The testimony in 1998 centered on warehouses and the associated family wage jobs in Washington, but the Legislature did not include language to restrict application of the preference to businesses with warehouses in Washington. The Legislature then declined to act on a bill to clarify the beneficiaries of the preference to drug resellers with Washington warehouses a year after the preference became effective. Therefore, JLARC staff conclude that the current out-of-state beneficiaries can be deemed to be intended beneficiaries.

Revenue and Economic Impacts

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

Beneficiaries saved an estimated $12.8 million in taxes in 2012 and are estimated to save $29.9 million in the 2015-17 Biennium from the tax preference. See Exhibit 26, below.

Exhibit 26 – Estimated 2015-17 Beneficiary Savings from the Preferential B&O Tax Rate for Firms That Warehouse and Resell Drugs

Fiscal Year	Taxable Income	B&O Tax at 0.138%	B&O Tax at 0.484%	Beneficiary Savings
2010	$3,500,400,000	$4,831,000	$16,942,000	$12,111,000
2011	$3,597,100,000	$4,964,000	$17,410,000	$12,446,000
2012	$3,692,000,000	$5,095,000	$17,869,000	$12,774,000
2013	$3,777,900,000	$5,214,000	$18,285,000	$13,071,000
2014	$3,924,300,000	$5,416,000	$18,994,000	$13,578,000
2015	$4,076,300,000	$5,625,000	$19,729,000	$14,104,000
2016	$4,234,200,000	$5,843,000	$20,494,000	$14,651,000
2017	$4,398,200,000	$6,070,000	$21,287,000	$15,217,000
			2015-17 Biennium	**$29,868,000**

Source: JLARC staff analysis using DOR tax returns, State Pharmacy Quality Assurance Commission licenses, and Economic and Revenue Forecast Council growth rate for consumer spending on drugs.

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 preferential tax rate were terminated, beneficiaries would pay an additional $29.9 million B&O tax in the 2015-17 Biennium.

Currently, as long as a firm has nexus, there is no benefit to locating a warehouse in Washington because the rate is the same for firms operating warehouses inside and outside of Washington. Warehouses continue to be located in Washington. It is unclear whether in-state warehouses would be relocated if the preference were terminated.

Other States

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

Unlike in Washington, the primary business tax in most states is a net income tax rather than a gross receipts tax like the B&O tax. In general, net income taxes provide specific credits and deductions instead of preferential rates for specific industries. JLARC could not find a state with a specific credit for prescription drug wholesaling income.

Legislative Auditor Recommendation

The Legislature should continue the B&O preferential tax rate for drug resellers because it is meeting the inferred public policy objective of reducing a competitive disadvantage for wholesalers operating Washington warehouses relative to out-of-state drug distributors that have no nexus to Washington and that pay no B&O tax.

Legislation Required: No.

Fiscal Impact: None.

ARTISTIC AND CULTURAL ORGANIZATIONS (B&O TAX, SALES AND USE TAX)

Report Summary			
What the Preference Does	**Public Policy Objectives**	**Estimated Beneficiary Savings**	**Auditor Recommendation**
These preferences provide nonprofit artistic and cultural organizations with: **B&O tax** deductions for income from: • Government funding and support; • The value of items manufactured for their own use; • Tuition program charges; and • Income earned from business activities. **Sales and use tax** exemptions for purchases or acquisitions of: • Objects of art; • Objects of cultural value; • Objects used to create art; and • Objects used to display art objects or present artistic or cultural performances.	The Legislature did not state public policy objectives for any of the tax preferences. JLARC staff infer the public policy objectives were: 1) To offset funding reductions experienced by artistic and cultural organizations during a time when their government support had been reduced; 2) To make taxation of artistic and cultural organization income in Washington consistent with the federal government and other states; and 3) To support Washington's nonprofit artistic and cultural organizations.	**B&O Tax:** $7.6 million in the 2015-17 Biennium **Sales and Use Tax:** $6 million in the 2013-15 Biennium	**Review and clarify:** Because although the preferences appear to have achieved or partially achieved the inferred public policy objectives: 1) the Legislature has not yet identified if it intends any long-term offsetting relationship between beneficiary savings for artistic and cultural organizations and government funding levels for such organizations; and 2) the B&O tax exemption is broader than that provided by the federal government and other states that follow the federal exemption.

ARTISTIC AND CULTURAL ORGANIZATIONS (B&O TAX, SALES AND USE TAX)

Current Law

Artistic and cultural organizations (ACOs) are currently provided:

1. **Business and occupation (B&O) tax deductions** from gross income for amounts:
   - Received from federal, state, or local governments to fund or support artistic or cultural exhibitions, performances, or programs for the general public ("contributed income");
   - Attributable to the value of items manufactured (normally subject to manufacturing B&O tax) by an ACO when the items are for their own use in displaying art objects or presenting artistic or cultural exhibitions, performances, or programs for the general public;
   - Collected as tuition charges for artistic or cultural education programs; and
   - Earned from business activities conducted by ACOs.
2. **Sales and use tax exemptions** for purchases or acquisitions of:
   - Objects of art;
   - Objects of cultural value;
   - Objects used to create a work of art (not including tools); and
   - Objects used to display art objects or present artistic or cultural performances.

What are artistic or cultural organizations, and what events qualify?

Statute defines "artistic and cultural organizations" as entities **organized and operated exclusively** for the purpose of providing artistic or cultural exhibitions, presentations, or performances, or cultural or art education programs, to be viewed or attended by the general public. The organization **must be a nonprofit corporation** under Chapter 24.03 RCW and meet other statutory requirements.

RCW 82.04.4328 states that the term "artistic or cultural exhibition, presentation, or performance or cultural or art education programs" **includes and is limited to**:

- An exhibition or presentation of art or objects of cultural or historical significance, such as those commonly displayed in art or history museums (Department of Revenue published determinations have held the statutory language shows legislative intent to limit qualifying exhibits to those commonly displayed in art or history museums.);
- A musical or dramatic performance or series of performances; or
- An educational seminar or program, or series of such programs, offered by the organization to the general public on an artistic, cultural, or historical subject.

Other tax preferences provided for nonprofit artistic and cultural organizations include:

- **Property tax exemptions** for art, scientific or historical collections and all real and personal property for certain ACOs organized and operated exclusively for artistic, scientific,

historical, literary, musical, dance, dramatic, or educational purposes. JLARC staff reviewed this preference in 2007.

- A **B&O exemption** for certain nonprofit organizations (including ACOs) for income from qualified fundraising activities.
- A **sales tax exemption** for sales of goods made by nonprofit organizations (including ACOs) as part of qualified fundraising activities.

See page A3-13 in Appendix 3 for the applicable current statutes.

Legal History

Beginning in territorial days, the Legislature provided property tax exemptions for arts organizations and closely related activities. However, there were no exemptions from sales and use tax or B&O tax for ACOs until more recently.

1980 Archival documents from this time note that Department of Revenue (DOR) audits had discovered issues with nonprofit arts organizations not paying B&O tax on their income and sales and use tax on all of their acquisitions. Prior to the 1981 legislative session, arts advocates planned to request legislation to exempt nonprofit arts organizations from several taxes. These included B&O tax exemptions for all sources of income, and sales and use tax exemptions for purchased or donated art, objects used to create art, or objects used in performances.

Arts advocates indicated concern that escalating costs and tax liabilities would compound nonprofit organizations' fiscal problems. They estimated the proposed exemptions' impact to state tax revenues would be "insignificant."

1981 The country entered a recession as the start of 1981.

A bill was introduced that provided four B&O tax exemptions for certain types of ACO income, as well as sales and use tax exemptions for purchases or acquisitions of objects of art or cultural value, objects used to create art, objects used to display art, and objects used in performances.

As the regular session drew to a close, the prime sponsor withdrew his support for the bill, and he unsuccessfully tried to strip all but the use tax exemptions from it. However, the Legislature passed this bill that:

- Exempted all ACO income except certain business income from B&O tax;
- Provided sales and use tax exemptions for objects of art as noted above;
- Defined "artistic and cultural organization" for purposes of the exemptions;
- Established specific organizational requirements, and
- Limited the types of objects and programs qualifying for the preferences.

The prime sponsor recommended that the Governor veto all but the use tax exemptions, citing concerns that the exemptions "create a highly undesirable precedent." DOR also recommended that the Governor veto the sales tax exemption, noting it would set a precedent for similar exemptions in a variety of areas that could eventually result in "very

substantial" revenue losses. DOR reasoned, "The more limited use tax exemption and B&O tax deductions . . . can be justified on the grounds that these organizations will be losing substantial amounts of their federal support." The Governor signed the bill into law with no veto.

Also in 1981, the Legislature cut the combined state arts commission and cultural enrichment program budgets by more than 50 percent.

1982 After the 1981 session, the Governor convened an Arts Task Force to study the impact of the recession and government budget reductions on the arts in Washington, and to make recommendations for long-term support of the arts. The Task Force's report, released in May 1982, noted the "magnitude of the financial crisis now facing the arts in Washington State is due almost entirely to the abrupt withdrawal of significant support by the government, both national and state." One of its recommendations was to eliminate taxes that "inhibit or adversely affect" support for the arts.

1984 A bill to exempt nonprofit arts organizations' business income (also referred to as "earned income") from B&O tax was introduced but not enacted.

1985 The Legislature added a B&O tax exemption for ACO income from admissions and other business activities. This effectively eliminated qualifying ACOs from any B&O tax obligation.

Public Policy Objectives

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

The Legislature did not state a public policy objective when it enacted the four B&O tax exemptions in 1981 and 1985, and the sales and use tax exemption for certain "objects" in 1981.

JLARC staff infer three possible public policy objectives:

1) To offset funding reductions experienced by ACOs during a time when their government support had been reduced;
2) To make taxation of ACO income in Washington consistent with the federal government and other states; or
3) To support Washington's nonprofit artistic and cultural organizations.

Offset Funding Reductions when Government Support Was Reduced

Responding to the economic and financial impacts of the 1981 recession, the Legislature met three times that year to balance the state budget with combinations of cuts, tax increases, and other actions. By enacting the package of preferences in 1981, the Legislature may have been trying to offset government funding reductions experienced by ACOs. In the 1981 budget, the state's Arts Commission funding was cut by more than 50 percent from the prior biennium, and federal funding was cut approximately 16 percent. In its letter to the Governor, DOR suggested that the use tax exemption and B&O tax deductions could be justified because the ACOs would be losing substantial amounts of their federal support.

Tax ACO Income Consistent with the Federal Government and Other States

A newspaper article from the time stated the prime sponsor of the 1985 bill to exempt ACO business income said Washington should follow the federal government's example and not tax ACOs. Other proponents testified at a 1985 House committee hearing that neither the federal government nor any other state taxed earned income from ACOs.

Support Washington's Artistic and Cultural Organizations

The prime sponsor of the 1985 bill to exempt ACO business income was quoted by a newspaper that he saw "no reason why these organizations should continue to be inappropriately used as revenue sources by state and local governments."

Arts proponents testified at a 1985 House committee hearing that the Legislature had exempted ACO "contributed income" in 1981 and that they were now seeking an "earned income" exemption. They noted arts organizations had experienced dynamic growth during the last several years and, with that, additional costs. They stated a B&O exemption on ACO revenue would help them provide more programs to the public.

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

Offset Funding Reductions when Government Support Was Reduced

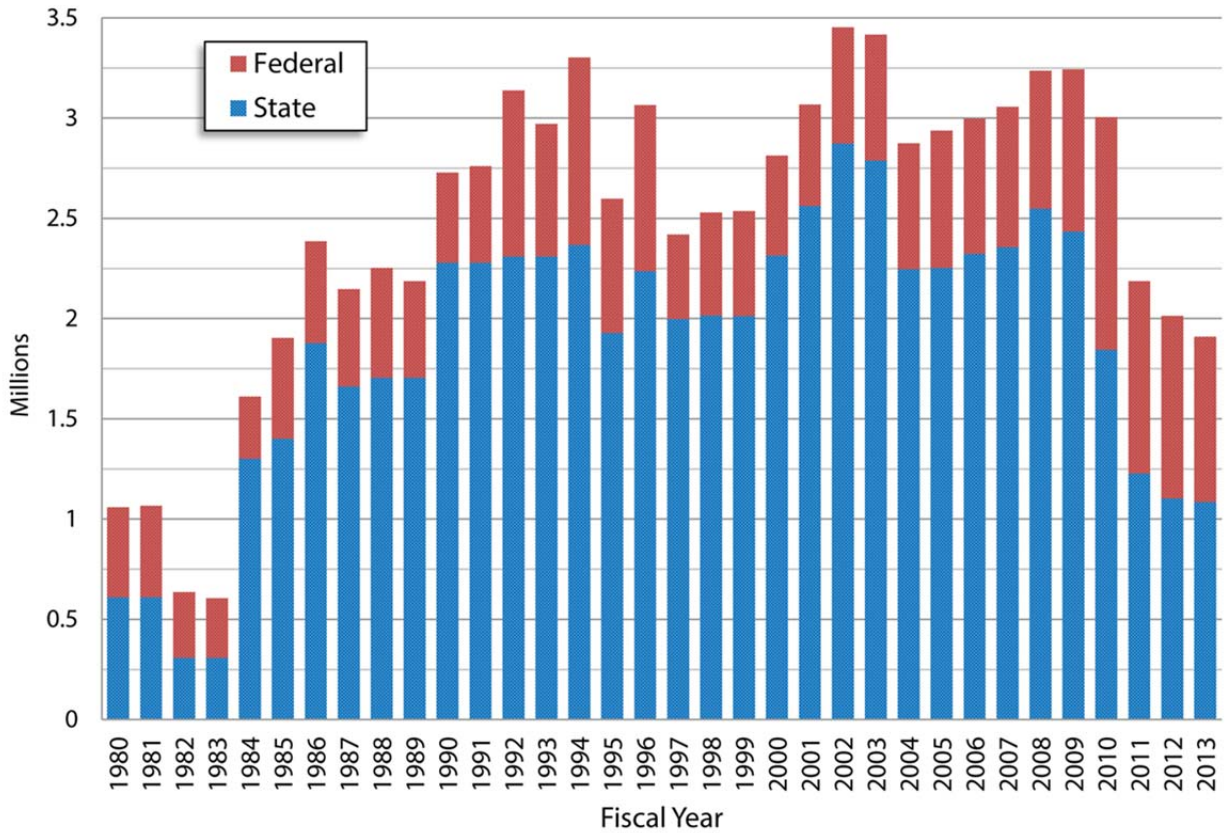
If the Legislature's public policy objective was to mitigate government funding reductions for ACOs during the 1981-82 recession, then the preferences achieved that public policy objective. The set of preferences reduced ACOs' tax obligations and presumably helped ACOs cope with government funding cuts made during the 1981-83 Biennium.

It is unclear whether the Legislature intended any long-term, offsetting relationship between beneficiary savings for artistic and cultural organizations and government funding levels. Information is available on how government funding for the arts have fluctuated over time.

Exhibit 27 on the following page reflects government funding for the state arts agency (Washington State Arts Commission, now known as ArtsWA). The graph reflects ACO funding for Fiscal Years 1980 through 2013 (not adjusted for inflation) and includes funds paid for by state funds and from the National Endowment for the Arts (NEA). Money from both state funds and NEA funds is

provided to ArtsWA. ArtsWA then distributes the funding in the form of grants and financial support to various arts groups or projects throughout the state.

Exhibit 27 – Funding for Washington State Arts Commission Varies – Fiscal Years1980-2013
(Dollars not adjusted for inflation)

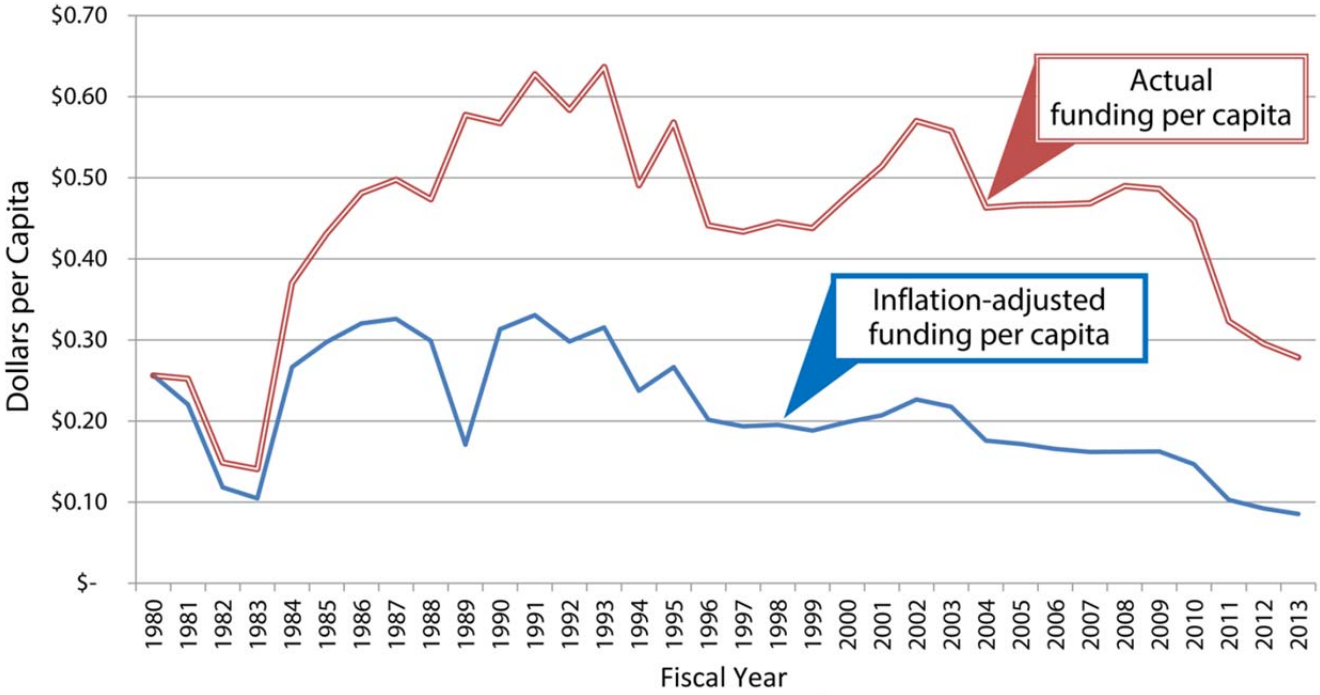


Note: "Federal" funds provided by the National Endowment for the Arts (NEA).

Source: Data for state FY1980-1985 and federal 1984-85 appropriations from State Arts Commission archival papers. Remaining data provided by ArtsWA from state and NEA budget appropriation data.

Exhibit 28 on page 96 reflects the state's funding on a per capita basis from Fiscal Years 1980 through 2013, adjusted for inflation. The exhibit shows Washington's per capita General Fund support of the arts has decreased as measured in 1980 dollars from $0.26 in 1980 to $0.09 in 2013.

Exhibit 28 – Current General Fund Spending for the Arts on a Per Capita Basis Is Below 1980 Levels in Inflation-Adjusted Dollars



Source: JLARC staff analysis of ArtsWA budget data; per capita calculation using Office of Financial Management population growth data and Economic and Revenue Forecast Council consumer price index data for 1979-2013.

Tax ACO Income Consistent with the Federal Government and Other States

If the public policy objective was to tax ACO business income in the same manner as the federal government and other states, that objective is being only partially achieved.

The federal government delineates between related and unrelated business income for tax exempt organizations such as nonprofit ACOs. Several states follow this federal practice. The federal government **does not tax** "related business income," which is income from activities substantially related to the charitable, educational, or other purpose upon which the organization's federal tax exemption is based.

The federal government **does tax** "unrelated income," which it defines as income from a trade or business that is not substantially related to the organization's purpose, for example income from renting a museum facility after hours for a special event like a wedding. Washington's law exempts all of this income from taxation, providing a broader exemption than what federal law provides.

Support Washington's Artistic and Cultural Organizations

If the public policy objective was to support ACOs by not subjecting them to B&O taxation or sales and use tax for purchases or acquisitions of certain objects, that objective is being achieved.

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

Continuation of the preferences will continue to support Washington ACOs. However, in terms of the remaining inferred public policy objectives, it is unclear whether the Legislature intended any long-term offsetting relationship between ACO beneficiary savings and government funding levels. In addition, continuing the preferences would continue to provide ACOs with a broader tax exemption than that they receive from the federal government and other states that follow federal exemption practices.

Beneficiaries

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

The beneficiaries of these preferences are certain nonprofit ACOs that provide artistic and cultural exhibitions, presentations, or performances or cultural or art education programs, all for the general public. The National Center for Charitable Statistics notes there were 816 "artistic, cultural, and humanities" nonprofit organizations in Washington in 2012.

B&O Tax Beneficiaries

In Fiscal Year 2012, 484 organizations took an "artistic and cultural" B&O tax deduction on their DOR tax return. However, these figures likely do not include all of the beneficiaries of this preference. Because their income is not subject to B&O tax, it is likely there are many more beneficiaries that use the preference but do not file a tax return. There is no accountability reporting required that would identify all beneficiaries.

Sales and Use Tax Beneficiaries

Because there is no reporting or accountability mechanism for the sales and use tax exemption, JLARC staff cannot determine the number of beneficiaries for this preference. The preference would be used by qualifying ACOs that purchase objects within or outside of Washington that fit under any of the four statutory conditions, that may receive donations of objects, or that may host travelling exhibitions.

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

It is possible that unintended benefits have been provided with regard to the sales and use tax exemption. While the statute exempts purchases or acquisitions of objects of art or cultural value, objects used to display or create qualifying objects, and objects used in performances or exhibitions, "objects" is not defined in the statute.

Construction activities are classified for tax purposes as retail services. The Department of Revenue's WAC 458-20-249 states DOR interprets the term "objects" to include only tangible personal property. In recent years, DOR has allowed the sales and use tax exemptions for certain costs associated with construction contracts by qualifying ACOs, such as for shelving case work,

lighting systems for displays, and hanging points for art. However, it is unclear whether such retail service construction costs are the "objects" the Legislature intended. The Department states it is currently working to review and clarify this issue.

Revenue and Economic Impacts

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

B&O Tax Preferences

JLARC staff estimate the beneficiary savings for the four B&O tax preferences to be $4.2 million in Fiscal Year 2012 and $7.6 million for the 2015-17 Biennium. This figure is likely underestimated, because not all beneficiaries report their use of the preferences on their tax returns. See Exhibit 29, below.

Exhibit 29 – Estimated 2015-17 Biennial Artistic and Cultural Organization B&O Tax Exemptions

Fiscal Year	B&O Tax Exemption
2010	$ 3,431,000
2011	$ 4,103,000
2012	$ 4,189,000
2013	$ 4,265,000
2014	$ 3,644,000
2015	$ 3,720,000
2016	$ 3,791,000
2017	$ 3,849,000
2015-17 Biennium	**$ 7,650,000**

Source: JLARC staff analysis of 2010 IRS Form 990 revenue data for top 30 artistic and cultural organizations taking 2010 B&O deductions. Growth for 2011- on calculated using Economic Revenue Forecast Council Consumer Price Base Table, June 2012.

Sales and Use Tax Exemptions

The Department of Revenue estimated the beneficiary savings for this preference at $3 million for Fiscal Year 2012 and $6 million for the 2013-15 Biennium. Although the accuracy of this estimate is unclear, JLARC staff did not identify a better method to estimate the taxpayer savings. Based on DOR's Fiscal Year 2012 estimate, qualifying statewide ACO purchases, acquisitions, or use would have been about $35 million.

For the use tax component, there is no requirement for beneficiaries to report, file, deduct, or otherwise document their use of qualifying objects. DOR is unable to estimate the beneficiary savings and JLARC staff did not identify a method to generate an estimate. The use tax preference exempts such items as art or cultural objects acquired outside the state (where an exemption

certificate would not be used), objects donated by individuals or foundations, or art or cultural objects displayed in the state via travelling exhibitions, such as the *Picasso: Masterpieces from the Musée National Picasso, Paris*, in 2010-11, or the *Tutankhamun – The Golden King and the Great Pharaohs* exhibit in 2012-13.

If the tax preferences were to be terminated, what would be the negative effects on the taxpayers who currently benefit from the tax preferences?

If the tax preferences were terminated, artistic and cultural organizations would be subject to **B&O tax** on income earned from or attributable to:

- Contributions from the state, local, or federal governments;
- Manufacturing of goods that they use themselves;
- Tuition charges; and
- Admissions, events, and other business income.

ACOs would also be subject to **sales tax or use tax** on purchases or acquisitions of:

- Art objects;
- Objects of cultural value;
- Objects used to create art or cultural objects;
- Objects used to display art or cultural objects; and
- Objects used in artistic, cultural, musical performances, presentations, or exhibitions.

The effect on employment and the economy would depend on the ability of nonprofit ACOs to either absorb the increased costs or pass them on to customers through higher membership costs or entrance fees, or by seeking additional donations and funds through fundraising efforts.

Other States

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

B&O Tax Exemptions

Unlike in Washington, the primary business tax in most states is a net income tax rather than a gross receipts tax. In the 47 states that impose a corporate income or franchise tax (Texas), all exempt nonprofit artistic and cultural organizations in the same manner as does the federal government.

Sales and Use Tax Exemptions

Of the 45 states and the District of Columbia that impose a sales and use tax:

- Twenty states provide sales and use tax exemptions to all 501(c)(3) organizations for purchases related to their purpose. Maryland and Kentucky limit it to resident 501(c)(3) organizations and those exempt in their home state.

- Eight states (including Washington) and the District of Columbia provide exemptions to nonprofit artistic and cultural organizations or to "charitable organizations" on certain purchases of personal property. Indiana also exempts services.
- Four states provide exemptions to nonprofit corporations that are museums or historical societies.
- Oklahoma, Mississippi, and Nebraska limit the exemption to museums only.
- Arkansas and Alabama specifically identify museums or organizations that are exempt.
- California exempts art purchased by nonprofit organizations and donations to museums.
- North Carolina refunds sales tax paid by artistic and cultural organizations on their purchases.
- South Dakota provides a use tax exemption only for donations; South Carolina provides a use tax exemption only for out-of-state acquisitions.
- Four states (Arizona, Hawaii, Louisiana, and North Dakota) provide no sales or use tax exemptions.

Legislative Auditor Recommendation

The Legislature should review and clarify the preferences because, although the tax preferences appear to have achieved or partially achieved the inferred public policy objectives:

- **The Legislature has not yet identified whether it intends any long-term offsetting relationship between beneficiary savings for art and cultural organizations and government funding levels for such organizations; and**

- **The B&O tax exemption provided for ACO income is broader than that provided by the federal government and other states that follow the federal exemption.**

Legislation Required: Yes.

Fiscal Impact: Depends on legislation.

FISHING BOAT FUEL (SALES AND USE TAX)

Report Summary			
What the Preference Does	**Public Policy Objectives**	**Estimated Beneficiary Savings**	**Auditor Recommendation**
Exempts commercial deep sea fishing and commercial passenger charter fishing businesses from sales and use tax on purchases of diesel fuel for use in their watercraft.	The Legislature did not state the public policy objective for the tax preference. JLARC staff infer the public policy objectives may have been: 1) To support Washington's commercial fishing industry, coastal communities, and businesses by removing a disincentive for fishing boats to buy fuel in Washington; and 2) To provide tax treatment of fuel for commercial and charter fishing vessels that is equitable with the tax treatment of fuel for vessels conducting interstate and foreign commerce.	$12.2 million in the 2015-17 Biennium	**Review and clarify:** Because the preference is not meeting the inferred public policy objective of providing equitable tax treatment on fuel for Washington commercial deep sea fishing and charter fishing boats when compared to tax treatment on fuel for commercial fishing vessels engaged in interstate and foreign commerce. In addition, the $5,000 minimum gross receipts level has not been reviewed since 1987.

FISHING BOAT FUEL (SALES AND USE TAX)

Current Law

Commercial deep sea fishing businesses and commercial passenger (charter) fishing boat businesses are exempt from paying sales and use tax on diesel fuel they purchase for use in their watercraft. The businesses must be "regularly engaged" in conducting commercial deep sea or passenger fishing operations outside the territorial waters of Washington ("the three mile limit").

To meet the "regularly engaged" requirement, a business must have gross receipts from fishing activities of $5,000 or more a year. The business must provide a tax exemption certificate to the fuel seller when making an exempt fuel purchase. The exemption applies to all diesel fuel that qualified fishing businesses purchase, regardless of whether the fuel is used within or outside of Washington territorial waters.

Generally, diesel fuel used for off-road purposes (including in boats) is subject to sales and use tax in Washington, while on-road diesel fuel use is subject to special fuel tax.

See page A3-18 in Appendix 3 for the current statutes, RCW 82.08.0298 and RCW 82.12.0298.

Legal History

1935-1946 Fuel sold in Washington for use in any watercraft was subject to retail sales tax.

1947 The Tax Commission adopted a new policy requiring vessels that engaged in interstate and foreign commerce to provide an estimate to a fuel seller of the portion of fuel they purchased that would be consumed in Washington waters. The fuel seller collected sales tax only on the estimated in-state portion; the balance of the fuel was treated as an export and exempt from sales and use taxes.

1949 The Legislature enacted Tax Commission request legislation that, among other things, provided a sales tax exemption for tangible personal property (including fuel) purchased by a business operating as a private or common carrier by water, air, and rail in interstate or foreign commerce. Any actual use of such property in the state was instead subject to use tax. This effectively codified the Commission's 1947 policy of taxing fuel consumed in Washington while exempting fuel consumed out-of-state. The exemption did not extend to fuel used in commercial fishing or commercial charter fishing watercraft.

1986 Bills were introduced to provide commercial deep sea and passenger fishing operations with sales and use tax exemptions on purchases of diesel fuel used in conducting fishing operations. The bills were not enacted.

1987 The Legislature enacted this preference providing a sales and use tax exemption for diesel fuel used to operate commercial deep sea or commercial passenger fishing vessels that are "regularly engaged" in fishing operations outside of Washington territorial waters. The statute has not been altered since then.

Other Relevant Background

Watercraft owners and operators pay sales or use tax on purchases of fuel in Washington unless a specific exemption applies. Private or common watercraft carriers that operate in interstate or foreign commerce are exempt from retail sales tax on purchases of fuel in Washington that will be used in connection with their operations.

However, any actual use of the fuel while in Washington territorial waters is subject to use tax. Common carriers registered to do business in Washington report the actual fuel used in state territorial waters and pay use tax on that fuel to the Department of Revenue. If a common carrier is not registered as a Washington business, the Washington-based seller of the fuel must calculate the amount of fuel the carrier will use in-state and collect the use tax from the carrier.

Public Policy Objectives

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

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

JLARC staff infer the public policy objectives may have been:

1) To support Washington's commercial fishing industry, coastal communities, and businesses therein by removing a disincentive for fishing boats to purchase fuel in Washington; and
2) To provide tax treatment of fuel for commercial fishing vessels and charters that is equitable with the tax treatment of fuel provided to vessels conducting interstate and foreign commerce.

Removing a disincentive

Proponents of the legislation testifying in a 1987 House committee hearing stated the sales tax on fuel was a major deterrent in attracting commercial and charter fishing boats to Washington. They testified that about two-thirds of Washington-based commercial fishing boats travelled to Oregon to purchase fuel. (Oregon did not tax fuel for boats.) They noted that in addition to purchasing fuel, commercial fishers also bought supplies and food, had repairs and services performed, and took their fish to local processors. The proponents concluded the tax on fuel was causing the state to lose much business activity in its coastal communities. The prime sponsor stated the state would gain more tax revenue than it lost by eliminating the sales tax on fuel used by commercial fishing and charter boats.

Equitable tax treatment for fuel sales

Proponents also testified in 1987 legislative committee hearings that an objective was to provide Washington commercial fishing and charter fishing businesses equitable treatment with private

and commercial common carriers operating in interstate/foreign commerce regarding their fuel purchases.

Common carriers operating in interstate/foreign commerce had been exempt from sales and use tax on fuel they used outside of Washington territorial waters since 1949. However, they paid use tax on fuel used in Washington territorial waters. In contrast, commercial fishing and charter fishing businesses owed sales or use tax on fuel they used both within and outside of Washington territorial waters. A proponent for the exemption testified "this exemption would be for fuel consumed outside of Washington territorial waters, an important distinction that needs to be noted in the record."

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

Removing a disincentive

This preference does remove a possible disincentive for fishing boats to purchase fuel in Washington rather than in Oregon.

Equitable tax treatment for fuel sales

The preference is not meeting the inferred public policy objective of providing equitable tax treatment on fuel for Washington deep sea fishing and charter fishing boats when compared to tax treatment on fuel for commercial vessels engaged in interstate and foreign commerce. Vessels engaged in interstate and foreign commerce owe use tax on the fuel they use in Washington's territorial waters. In contrast, all of the vessel fuel purchased by qualified commercial fishing and charter boat fishing businesses is exempt from both sales and use tax.

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

Continuation of the preference will continue to remove a possible disincentive for fishing boats to purchase fuel in Washington.

However, continuing the preference as currently provided in statute will not contribute to the inferred objective of providing equitable tax treatment for fuel purchases between Washington commercial fishing and charter fishing boat operators, and commercial and private common carriers engaged in interstate and foreign commerce.

The $5,000 gross receipts minimum business activity level has not been reviewed by the Legislature since it was established in 1987. When adjusted for inflation, $5,000 in 1987 dollars equates to $10,136 in 2013 dollars.

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

To achieve the inferred public policy objective of providing equitable tax treatment, the Legislature could amend the statute to specify that the sales and use tax exemption for fuel used

by commercial and charter fishing vessels applies only to fuel used outside the territorial waters of Washington. The Legislature could assess use tax on the fuel fishing vessels use within Washington territorial waters.

Beneficiaries

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

The direct beneficiaries of this preference are commercial fishing and commercial charter fishing businesses that purchase fuel in Washington.

While the exact number of beneficiaries is unknown, state law requires any business that commercially fishes for food fish or shellfish or operates a charter boat or commercial fishing vessel to obtain a license through the Department of Fish and Wildlife (WDFW). There were 1,614 vessels listed on commercial fishing licenses issued by WDFW in 2012. Commercial charter fishing licenses issued in 2012 by WDFW listed 178 vessels.

Any Washington business that engaged in commercial deep sea fishing or commercial passenger charter fishing, that generated over $5,000 a year from such activities, and that purchased fuel for the vessel in Washington could be a beneficiary.

Revenue and Economic Impacts

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

JLARC staff estimate the beneficiary savings for this preference at $6.8 million in Fiscal Year 2012 and $12.2 million in the 2015-17 Biennium. See Exhibit 30 on the following page.

Exhibit 30– Estimated 2015-17 Beneficiary Savings for Fishing Vessel Diesel Fuel Exemption

		Sales and Use Tax		
Fiscal Year	**Estimated Fuel Value**	**State**	**Local**	**Total**
2010	$46,969,000	$3,053,000	$1,124,000	$4,177,000
2011	$73,193,000	$4,758,000	$1,769,000	$6,526,000
2012	$75,868,000	$4,931,000	$1,830,000	$6,761,000
2013	$70,117,000	$4,558,000	$1,722,000	$6,279,000
2014	$70,356,000	$4,573,000	$1,727,000	$6,300,000
2015	$69,553,000	$4,521,000	$1,708,000	$6,229,000
2016	$68,517,000	$4,454,000	$1,682,000	$6,136,000
2017	$67,955,000	$4,417,000	$1,668,000	$6,085,000
2015-17 Beneficiary Savings		**$8,871,000**	**$3,350,000**	**$12,221,000**

Source: Fishing boat fuel use estimate from 2004 CA statewide commercial harbor craft survey. Diesel fuel prices 2010-2013 from U.S. Energy Information Administration. Future fuel prices for 2013-17 from Economic Revenue and Forecast Council's Table 1.1, Nov. 2012.

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

If the preference were terminated, commercial fishing and passenger charter fishing businesses would pay sales or use tax on diesel fuel purchased in Washington. This would increase their fuel expenses and overall operating costs.

Any effect on Washington coastal communities' employment and the local and state economy would depend on the commercial fishing and charter fishing businesses' ability to absorb the higher cost or pass it on to their customers in the form of higher prices. Boats that operate close to Oregon might elect to purchase fuel in Oregon, which does not impose sales tax on diesel fuel.

Other States

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

Of the 30 states (including Washington) and the District of Columbia that border a coast, the Great Lakes, or other waterway, 27 impose sales and use taxes. Of these, JLARC staff found:

- Fifteen states exempt all fuel used in commercial fishing vessels from sales and use tax.
- Hawaii allows commercial fishers a refundable income tax credit for fuel tax paid on fuel.

- Minnesota exempts fishing boat fuel when the fish are ultimately sold at retail.
- Pennsylvania exempts fuel sold to vessels operated principally outside the state.
- Texas exempts all diesel fuel from sales tax and provides a specific exemption for non-highway fuel use up to 10,000 gallons a month.
- Washington exempts diesel fuel sold to commercial deep sea and passenger fishing vessels regularly operating outside the state.
- Six states and the District of Columbia provide no sales or use tax exemption for commercial fishing vessel fuel.

Legislative Auditor Recommendation

The Legislature should review and clarify the preference because it is not meeting the inferred public policy objective of providing equitable tax treatment on fuel for Washington commercial deep sea fishing and charter fishing boats when compared to tax treatment on fuel for commercial vessels engaged in interstate and foreign commerce. In addition, the $5,000 minimum gross receipts level has not been reviewed since 1987.

Legislation Required: **Yes.**

Fiscal Impact: **Depends on legislative action.**

FUEL USED IN COMMERCIAL VESSELS (B&O TAX)

Report Summary			
What the Preference Does	**Public Policy Objectives**	**Estimated Beneficiary Savings**	**Auditor Recommendation**
Provides a B&O tax deduction to businesses selling fuel for consumption outside of U.S. territorial waters by commercial vessels used primarily in foreign commerce.	The Legislature did not state the public policy objective for the tax preference. JLARC staff infer the public policy objectives may have been: 1) To treat income from marine fuel sales delivered in Washington for use in vessels conducting foreign commerce the same as income from sales of goods delivered out-of-state, and 2) To keep marine fuel sellers from moving out of Washington.	$8.1 million in the 2015-17 Biennium	**Review and clarify:** To consider if the Legislature wants to add reporting or other accountability requirements that would provide better information on the effectiveness of this preference in keeping marine fuel sellers from moving out of Washington.

FUEL USED IN COMMERCIAL VESSELS (B&O TAX)

Current Law

Businesses selling fuel to commercial vessels may take a business and occupation (B&O) tax deduction for sales of fuel for consumption outside of United States' territorial waters by vessels used primarily in foreign commerce. Such fuel is commonly referred to as "bunker fuel" or "marine fuel."

Businesses making sales of fuel to these vessels include Washington refineries and marine fuel traders. Fuel traders purchase the fuel from refineries or others and resell it to the vessel owners. To qualify for this preference, the seller must receive a signed certificate from the buyer that:

- Identifies the vessel for which the fuel was purchased;
- Confirms the vessel is primarily used in foreign commerce; and
- Estimates the amount of fuel purchased that will be consumed outside of U.S. territorial waters.

See page X in Appendix 3 for the current statute, RCW 82.04.433.

Legal History – Deduction for Fuel Used in Commercial Vessels

Archival evidence suggests that, prior to enactment of this preference, some sellers of fuel to vessels operating in foreign commerce were paying retailing B&O tax on their income from such sales.

1984 In an unpublished determination, the Department of Revenue (DOR) denied a fuel distributor's request for a refund of B&O tax paid on sales of marine fuel to vessel operators engaged in foreign commerce. The Department reasoned marine fuel sales to vessels for use in foreign commerce were not "exports," which were defined in DOR rule as articles originating in Washington destined for a purchaser in a foreign country. DOR noted that such sales were local transactions and taxing them did not violate the federal Commerce Clause because the sale was completed when delivery was made in Washington waters.

1985 The Legislature enacted this preference, providing a B&O tax deduction for sales of fuel used outside of U.S. territorial waters by vessels operating primarily in foreign commerce. This resulted in refineries and marine fuel traders being exempt from a portion of their wholesaling and retailing B&O taxes under the new preference.

2009 Litigation was brought by a refinery seeking application of this preference to its manufacturing activities in addition to its wholesaling and retailing activities. As discussed on page 114 in the related legal history on the multiple activities tax credit, businesses that manufactured and sold their own marine fuel had been exempt from taxation for a period of time on their manufacturing activities, under a different tax preference.

The Legislature amended the B&O tax deduction to clarify that it applied **only** to wholesaling and retailing activities and specifically noted it **did not** apply to manufacturing activities. The Legislature stated that the clarification applied both retroactively and prospectively.

2012 The Washington State Supreme Court held in *Tesoro v. Department of Revenue*[2] that the plain language of the 1985 statute indicated the preference applied **only** to B&O taxes on wholesaling and retailing activities, not to manufacturing activities.

Related Legal History – Multiple Activities Tax Credit

This section describes the history of another B&O tax preference used by some businesses selling marine fuel. This second preference began as the "multiple activities exemption" (MAE) and later became the multiple activities tax credit (MATC). The history of this second preference is included because fuel sellers who receive a retailing or wholesaling B&O tax credit under the MATC are not counted in this review as beneficiaries of the tax preference for fuel used in commercial vessels.

1935 The Legislature provided businesses conducting both manufacturing and selling activities within the state with a **multiple activities exemption (MAE)**. These businesses paid B&O tax on their manufacturing activities, then received an exemption from their wholesaling or retailing B&O tax on products that were both manufactured and sold in-state. This tax treatment applied to Washington fuel sellers such as refineries that manufactured their product in-state. Wholesaling or retailing B&O tax applied to out-of-state manufacturers on their sales of goods in Washington.

1948 The Washington State Supreme Court ruled in *Columbia Steel Co. v. State* that the MAE violated the federal Commerce Clause.

1950 The Legislature responded to the 1948 Washington State Supreme Court decision by replacing the selling MAE with a manufacturing MAE. In-state manufacturers continued to pay only one B&O tax, but the tax now applied to their wholesaling or retailing activity, not their manufacturing activity. Out-of-state manufacturers that sold and delivered products to customers in Washington were subject to either wholesaling or retailing activity if they had a taxable presence in Washington.

1986 The Washington State Supreme Court decided two companion cases brought by several in-state and out-of-state businesses claiming the MAE violated the federal Commerce Clause. The State Supreme Court upheld Washington's B&O tax and the MAE in both cases. The cases followed a 1984 U.S. Supreme Court decision[3] that West Virginia's gross receipt tax on manufacturing (which, at the time, was much like Washington's) discriminated against interstate commerce and was unconstitutional. Both cases were subsequently appealed to the U.S. Supreme Court.

1987 In June, the U.S. Supreme Court overruled the combined Washington cases, finding that Washington's MAE discriminated against interstate commerce and was unconstitutional.[4]

In August, the Legislature responded to the U.S. Supreme Court decision by enacting a **multiple activities tax credit (MATC)** to replace the MAE. The MATC's purpose was to assure that B&O tax would be paid only once by businesses conducting more than one

[2] *Tesoro Refining and Marketing Company Inc. v. Department of Revenue,* 173 Wn2d 551 (2012)

[3] *Armco, Inc. v. Hardesty*, 467 U.S. 638 (1984)

[4] *Tyler Pipe v. Department of Revenue*, 483 U.S. 232 (1987)

taxable activity in Washington connected with the same end product, for example manufacturing and selling marine fuel. Out-of-state manufacturers that sold products in Washington also received the B&O tax credit for gross receipts taxes paid to taxing jurisdictions outside of Washington.

With passage of the B&O tax preference for fuel used in commercial vessels in 1985, refineries that manufactured marine fuel paid neither manufacturing B&O tax nor wholesaling or retailing B&O tax on their sales of fuel. When the MAE was replaced by the MATC in 1987, refineries began to owe B&O tax on their manufacturing activity.

Exhibit 31, below, describes the taxability through the years of businesses that both manufacture and sell marine fuel. Marine fuel traders have been benefitting from the preference for fuel used in commercial vessels since 1985.

Exhibit 31 – History of B&O Taxability for Businesses that both Manufacture and Sell Marine Fuel in Washington

Time Period	Taxability for Manufacturing Activity	Taxability for Retailing or Wholesaling Activity
1935	**Taxable**	**Exempt** (MAE)
1950	**Exempt** (MAE)	**Taxable**
1985-June 1987	**Exempt** (MAE)	**Exempt** (82.04.433)
August 1987	**Taxable** (MAE removed)	**Exempt** (MATC and 82.04.433)
2009	**Taxable** (Legislature confirmed 82.04.433 applies only to sale activities)	**Exempt** (MATC and 82.04.433)
2012	**Taxable** (WA State Supreme Court confirmed 82.04.433 applies only to sale activities)	**Exempt** (MATC and 82.04.433)

Source: JLARC staff analysis of 82.04.440; 82.04.433.

Other Relevant Background

Marine Fuel Use May Change in the Future

The preference applies to sales of any type of fuel used in commercial vessels primarily operating in foreign commerce that is consumed outside of U.S. territorial waters.

Marine fuel is fuel burned by ocean-going ships at sea. "Bunker fuel" has historically been the primary type of marine fuel. Bunker fuel is considered a waste product of traditional fuel oil processing, a cross between a solid and liquid that is too thick for road vehicles and small ships to burn efficiently. Its high sulfur content makes this fuel a cheap power source for ocean-going ships. The shipping industry moved to using bunker fuel in the 1950s as a primary power source as it became more available due to increased petroleum refining. The term "bunkering" also refers to the process of taking on fuel.

Beginning in August 2012, ships operating along the North American West Coast are obligated to burn lower sulfur fuels due to new North American Emission Control Area (ECA) regulations. The regulations require all vessels to comply with a mandatory limit of 1.0 percent sulfur content for use in ECA waters within 200 nautical miles of the coast. In 2015, the limit drops to 0.1 percent. This change may result in changes in marine fuel use, composition, and overall sales. As a result, it may impact which businesses are beneficiaries of the tax preference.

Taxation of Goods Sold and Delivered Out-of-State

When the prime sponsor was speaking in favor of this preference, he made a comparison to the taxation of goods sold into other states. Businesses selling goods that are delivered to customers outside the state are exempt from wholesaling or retailing B&O tax on these interstate sales. If the goods are received by the out-of-state buyer in Washington, then the wholesaling or retailing B&O tax applies.

Public Policy Objectives

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

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

JLARC staff infer that the public policy objectives may have been twofold:

1) **To treat income/gross receipts from marine fuel sales delivered in Washington for consumption in vessels conducting foreign commerce in the same manner as income from sales of goods delivered out-of-state**

   In 1985, the prime sponsor of the bill stated on the House floor that the bill provided:

   > . . . a deduction for the amount of revenue obtained from selling oil to the ships that would consume that oil on the high seas. At the present time when sales are made out-of-state, that revenue is deducted from gross revenues when computing the B&O tax. There is currently an ambiguity in the problem arising between the Department of Revenue and those wholesalers who are supplying fuel to those ships in deep water ports. This amendment would treat those ships that are going on the high seas the same way we treat those sales into other states.

2) **To keep marine fuel sellers from moving out of Washington**

   During the same 1985 House floor debate, the prime sponsor also stated:

   > It has been clear from testimony before the Ways & Means committee that these wholesalers cannot stay in business in this state if the Department collects that revenue as they are now intending to do and trying to do. The plans are under way, so I understand, to actually remove those facilities to Oregon. Passage of this amendment will clarify that problem and will allow the deduction for the value of the fuel sold. In doing so, we will keep the wholesalers here and we will have

> consistency within the tax code. To vote against this amendment is, in all probability, to eliminate that particular segment from the state.

In 2009, the Legislature specifically stated its intent as to the scope of the preference, clarifying the preference was intended to **only apply** to wholesaling or retailing activities and **not** to manufacturing activities.

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

1) **Treating marine fuel sales in Washington in the same manner as sales of goods delivered out-of-state**

   The inferred objective is being achieved because the B&O deduction for marine fuel delivered to the buyer in-state results in income from such sales not being taxed, just as income from sales of goods sold and delivered out-of-state is not taxed. However, unlike the tax exemption for goods delivered out-of-state, which is required by the U.S. Constitution, no such constitutional prohibition exists for imposing B&O tax on Washington businesses that sell and deliver fuel in-state.

2) **Keep Washington marine fuel sellers from moving out-of-state**

   JLARC staff cannot offer a definitive conclusion about the achievement of this second inferred public policy objective.

   Washington refineries receive a B&O tax credit under the MATC for wholesale and retail sales of marine fuel they manufacture, thus they are not the businesses targeted by this preference. The question is thus whether the preference has impacted marine fuel trading business decisions on whether to move out-of-state.

   There is evidence that marine fuel transfers are taking place in Washington. Department of Ecology (DOE) data indicates transfers of more than 500 million gallons annually since 2010. A representative of the marine fuel trading industry estimates that about 70 percent of sales are made through marine fuel traders, with the remaining 30 percent sold directly by refineries. The Department of Revenue reports it has found evidence of sales by marine fuel traders in its audits of businesses.

   However, information is not available that would provide more insight into whether this preference has been a factor in keeping marine fuel traders from moving out-of-state. For example:

   - There is no accurate count of the marine fuel traders that have used the preference. There is no specific tax return deduction for businesses that detail their use of this preference. Some businesses may include the deduction under a broader deduction for interstate and foreign sales.
   - There is not a complete picture of the value of the preference in comparison to the fuel traders' gross income.

- There is not a complete picture of which marine fuel traders have left Washington or have opened businesses in Washington in the time period before and after the preference was enacted.

Due to these and other data limitations, JLARC staff did not attempt an analysis to explore a causal relationship between the preference and keeping marine fuel traders from moving out-of-state.

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

1) **Treating marine fuel sales in Washington in the same manner as sales of goods delivered out-of-state**

   Maintaining this preference will continue to accomplish the inferred public policy objective of treating sales of marine fuel sold in-state the same as sales of goods delivered out-of-state.

2) **Keep Washington marine fuel sellers from moving out-of-state**

   Maintaining this preference will continue to provide a B&O tax deduction to marine fuel traders and to refineries selling fuel that they did not manufacture. However, adequate information is not available to assess whether the preference is making a difference in keeping marine fuel traders from moving out-of-state.

Beneficiaries

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

Beneficiaries of the preference are marine fuel traders and refineries that sell fuel they do not manufacture themselves. Since there is no specific tax return deduction for businesses to detail this deduction, the specific businesses using the preference cannot be identified.

Department of Revenue records show 131 businesses classified as wholesale fuel traders conducting business in Washington in Fiscal Year 2012. It is unclear how many of these businesses deal in marine fuel.

While three of Washington's five refineries produce and sell marine fuel, they are already exempt from B&O tax on sales of fuel they manufacture due to the MATC. Refineries would be beneficiaries under this preference only for sales of marine fuel they purchase from other sources and resell to vessels or other distributors.

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 staff estimate the beneficiary savings for Fiscal Year 2012 at $4.9 million and for the 2015-17 Biennium, a beneficiary savings of $8.1 million. See Exhibit 32 on the following page.

Exhibit 32 – Estimated 2015-17 Beneficiary Savings for B&O Tax Deduction on Fuel Used in Commercial Vessels

Fiscal Year	Estimated Bunker Fuel Sales in WA (gallons)	Estimated Value of Sales	Approximately 70 Percent of Sales Covered Under Preference	Beneficiary Savings
2010	592,052,000	$1,012,409,000	$708,686,000	$3,338,000
2011	524,330,000	$1,263,635,000	$884,544,000	$4,166,000
2012	562,908,000	$1,486,076,000	$1,040,253,000	$4,900,000
2013	563,000,000	$1,463,800,000	$1,024,550,000	$4,826,000
2014	563,000,000	$1,379,350,000	$965,545,000	$4,548,000
2015	563,000,000	$1,306,160,000	$914,312,000	$4,306,000
2016	563,000,000	$1,249,860,000	$874,902,000	$4,121,000
2017	563,000,000	$1,210,450,000	$847,315,000	$3,991,000
2015 – 17 Biennium				**$8,112,000**

Source: Dept. of Ecology bunker fuel sales data 2010-2012; For 2010-2012 oil price per gallon, used Energy Information Administration figures. For 2013 on, used Economic Revenue Forecast Council's Sept. 2012 oil price per barrel estimates.

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

If the preference were terminated, beneficiaries would owe B&O tax on their sales of fuel to ocean-going vessels. Refineries that manufacture and sell their own marine fuel would not be affected because they would have the benefit of the MATC. The effect on employment and the economy would depend on the ability of businesses to either absorb the B&O tax themselves or pass the costs on to their customers in the form of increased prices.

Other States

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

Unlike in Washington, the primary business tax in most states is a net income tax rather than a gross receipts tax like the B&O tax. JLARC staff could not find a meaningful comparison with any other states.

Legislative Auditor Recommendation

The preference is meeting the inferred public policy objective of treating marine fuel sales in Washington in the same manner as sales of goods delivered out-of-state. JLARC staff cannot provide a definitive answer as to whether the preference is meeting the second inferred public policy objective of keeping marine fuel sellers from moving out of Washington.

The Legislature should review and clarify the B&O deduction for fuel used in commercial vessels to consider if it wants to add reporting or other accountability requirements that would provide better information on the effectiveness of this preference in keeping marine fuel sellers from moving out of Washington.

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

NONPROFIT YOUTH RECREATION SERVICES AND LOCAL GOVERNMENT PHYSICAL FITNESS CLASSES (SALES AND USE TAX)

Report Summary			
What the Preference Does	**Public Policy Objectives**	**Estimated Beneficiary Savings**	**Auditor Recommendation**
Exempts the following from sales tax: • Amusement and recreation services provided by nonprofit youth organizations to their members (also exempt from use tax); • Physical fitness services provided by nonprofit youth organizations to their members; and • Physical fitness classes provided by local governments.	The Legislature did not state a public policy objective for the tax preference. JLARC staff infer the public policy objective of the exemption for amusement and recreation services and personal services classified as retail services by nonprofit youth organizations is to support and recognize that such organizations provide for the public good. JLARC staff infer the public policy objective for the local government physical fitness class exemption is to reduce costs for patrons of such classes.	$29.6 million in the 2015-17 Biennium	**Review and clarify:** Because while the preference appears to be achieving the inferred public policy objective of recognizing the general public good provided by character-building nonprofit youth organizations, the preference benefits adults as well as youth. In addition, the exemption for personal services classified as retail sales technically includes services not generally provided by nonprofit youth organizations.

Nonprofit Youth Recreation Services and Local Government Physical Fitness Classes (Sales and Use Tax)

Current Law

The following services and activities are exempt from sales tax under current law:

1) Amusement and recreation services provided by nonprofit youth organizations (NYOs) to their members;
2) Physical fitness services provided by nonprofit youth organizations to their members; and
3) Physical fitness classes provided by local governments.

Amusement and recreation services provided by nonprofit youth organizations (NYOs) are also exempt from use tax. There is no use tax exemption provided in the law for physical fitness services or classes. The Department of Revenue (DOR) considers it unlikely that use tax obligations would arise for physical fitness services.

Other businesses providing amusement and recreation services (such as tennis clubs) or physical fitness services (such as health clubs) are required to collect sales tax on charges to customers.

Qualifying NYOs are nonprofit organizations or associations that are engaged in youth "character-building" and are exempt from property tax under RCW 84.36.030. Examples include YMCAs and various youth sports groups.

"Character-building" refers to activities for youth under age 18 that "are for the general public good" and include activities that may "build, improve or enhance a child's moral constitution by developing moral or ethical strength, leadership, integrity, self-discipline, fortitude, self-esteem, and reputation" (Washington Administrative Code (WAC) 458-16-230(2)(a)).

Exhibit 33, below, reflects the current taxability of amusement and recreation services, physical fitness services, and physical fitness classes.

Exhibit 33 – Taxability of Amusement and Recreation Services and Physical Fitness Activities Varies by the Activity and Who Provides the Services

	Amusement & Recreation Activities		Physical Fitness Services		Physical Fitness Classes	
	Sales Tax	Use Tax	Sales Tax	Use Tax	Sales Tax	Use Tax
Nonprofit Youth Organizations	Exempt	Exempt	Exempt	*Unlikely to arise, per DOR*	Exempt	*Unlikely to arise, per DOR*
Local Governments	Taxable	Taxable	Taxable		Exempt	
Private Businesses	Taxable	Taxable	Taxable		Taxable	

Source: JLARC staff analysis of RCWs 82.08.0291, 82.12.02917.

NYOs receive other additional tax preferences under Washington law:

- A property tax exemption for NYOs engaged in character-building of youth under age 18. JLARC staff reviewed this preference in 2007.
- A business and occupation (B&O) tax exemption for NYO membership fees and dues, and for charges for camping and other recreational services or facilities provided by the organizations. This preference is subject to an expedited review in 2013 by the Citizen Commission for Performance Measurement of Tax Preferences.
- A B&O tax exemption for amounts received from fundraising activities and a sales tax exemption for items sold during fundraising activities conducted by NYOs and other nonprofit organizations.

See page A3-19 in Appendix 3 for the current statutes, RCWs 82.08.0291 and 82.12.02917.

Legal History

Nonprofit youth organizations (such as YMCAs) engaged in character-building activities have been exempt from property taxes in Washington since 1933. However, at that time income from dues and membership fees for various activities was subject to B&O tax under the general services classification.

1961 The Legislature expanded the definition of "retail sale" to include sales of or charges made for certain personal, business, or professional services including "amusement and recreation activities." Amusement and recreation activities initially included, but were not limited to: golf, pool, billiards, skating, and ski lifts and tows. Such activities became subject to sales tax and retailing B&O tax, rather than the service B&O tax. No exemptions from the tax were provided for NYOs.

1962 - 1980 DOR discovered in audits conducted during the late 1970s through 1980 that YMCAs were not consistently collecting sales tax or paying B&O tax on their activities.

1981 The Legislature provided a sales tax exemption for amusement and recreation services provided by NYOs to their members. Qualifying NYOs had to provide character-building activities and also had to be exempt from property tax. The exemption was available to services provided to all members, regardless of age.

DOR archival documents reflect that a number of YMCAs claimed to be unaware of their tax obligations until they were audited. DOR internal memos from the time noted random audits of NYOs found their tax reporting to be "spotty." The memos noted that, when tax was assessed in such audits, it resulted in "time consuming appeals and media publicity." DOR stated much of the revenue was not currently being collected, and therefore a tax exemption for NYOs would not result in a reduction in revenue to the state.

1993 The Legislature extended sales tax to a number of personal services, including physical fitness services. This required NYOs that provided physical fitness services or facilities to collect sales tax from members on charges for such activities, beginning July 1, 1993.

1994 The Legislature extended the NYO amusement and recreation exemption to include personal services that were classified as retail sales in 1993, including physical fitness services. The list of exempt personal services also included tanning salon services, tattoo parlor services, steam baths, Turkish baths, escort services, and dating services, if provided by NYOs to members. The fiscal note for the bill noted just one NYO provided physical fitness services at numerous localities throughout the state. The fiscal note did not indicate any of the other personal services were being conducted by NYOs.

In addition, the Legislature provided a sales tax exemption for physical fitness classes provided by local governments, such as counties, cities, or parks departments.

1999 The Legislature added a use tax exemption for amusement and recreation services provided by NYOs. DOR explained the exemption was technically necessary to comply with the 1995 *Jefferson Lines* U.S. Supreme Court ruling[5] and would ensure NYO members did not owe use tax on services that were purchased outside of Washington but took place in-state. An example would be if an NYO member purchased a white water rafting trip in Oregon but the rafting trip actually took place in Washington.

Other Relevant Background

Definitions

Statute and rule define the activities covered under this preference.

"**Amusement and recreation services**" is defined in statute to include, but not be limited to: golf; pool; billiards; skating; bowling; ski lifts and tows; day trips for sightseeing purposes; and others, when provided to consumers.

- To administer the law and clarify what services qualify as amusement and recreation activities, DOR published WAC 458-20-183. In addition to those noted above, WAC 458-20-183 lists other amusement and recreation services, including:
  - Basketball, racquet ball, handball, squash, tennis, batting cages;
  - Providing facilities such as basketball courts, tennis courts, handball courts, swimming pools;
  - Providing outdoor camping and living facilities, such as summer camps, and
  - Charges for providing an opportunity to dance.

  WAC 458-20-183 also notes amusement and recreation services **do not include** instructional lessons to learn an activity, such as tennis, archery, or swimming lessons.

"**Physical fitness services**" is not defined in statute.

- WAC 458-20-183 defines physical fitness services to include, but not be limited to:
  - All exercise classes (aerobic, dance, water, jazzercise, etc.);
  - Providing running tracks, weight lifting, weight training, use of exercise equipment (such as treadmills, bicycles, stair-masters, and rowing machines); and
  - Personal training services.

[5] *Oklahoma Tax Commission v. Jefferson Lines,514 U.S. 175 (1995)*

WAC 458-20-183 notes physical fitness services **do not include** instructional lessons, such as self-defense, martial arts, stress-management, or instructional lessons for activities like tennis, golf, or swimming. A DOR advisory further clarifies how to determine the taxability of specialized exercise and conditioning activities.

"**Physical fitness classes**" is not defined in statute.

- DOR's WAC 458-20-189 does not define the term but lists aerobics classes as an example. The rule notes physical fitness classes **do not include** charges for other physical fitness activities, such as weight lifting, using exercise equipment, and running tracks.

Changes in Providing Youth Amusement and Recreation Activities

Prior to 1954, most of the organized sports experiences for youth occurred within social agencies such as the YMCAs, Boys and Girls Clubs, Boy Scouts, and Girl Scouts. However, since the advent of Little League Baseball in 1954, opportunities for youth to participate in sports programs have expanded from social agencies to nonprofit sports programs, like youth baseball and youth soccer.

Public Policy Objectives

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

The Legislature did not explicitly state a public policy objective when it enacted sales tax exemptions for:

- Amusement and recreation services provided by NYOs (1981) and the use tax exemption that followed (1999);
- Personal services defined as retail services provided by NYOs (1994); or
- Physical fitness services provided by local governments (1994).

Amusement and Recreation Services by NYOs

Based on archival legislative and Department of Revenue documents, JLARC staff infer the public policy objective for the **sales tax exemption** was to support and recognize that such youth character-building nonprofit organizations provided for the "general public good."

"General public good" is defined in property tax law to mean that community members derive a benefit from the use of nonprofit organization property or services. JLARC staff attributed the same public policy objective to a NYO property tax exemption it reviewed in 2007. In that review, JLARC staff noted the property tax exemption's objective was to recognize NYOs targeted programs for youth that provided a "general public good," with the assumption that the proceeds from these organizations would be directed back into their youth character-building work. Initial passage of the sales tax exemption in 1981 followed various YMCA tax compliance issues discovered during DOR audits.

JLARC staff infer the public policy objective for the amusement and recreation activities **use tax exemption** was to ensure that use tax was not assessed on certain activities that might be sold to

character-building NYO members outside the state, but take place in state. No similar use tax exemption was enacted for physical fitness services. The Department of Revenue notes that physical fitness services would not likely be sold in a state other than where the activity takes place.

Personal Services Classified as Retail Sales

JLARC staff infer the public policy objective of extending the preference to include physical fitness services, which were classified as retail sales in 1993, was again to support and recognize the youth character-building and general social good provided by nonprofit youth organizations.

It is unclear why the Legislature chose to provide the exemption for all personal services classified as retail sales under RCW 82.04.050(3)(g) rather than limiting it to just physical fitness services. The current exemption technically includes several services not generally provided by NYOs: tanning salon services, tattoo parlor services, steam baths, Turkish baths, escort services, and dating services.

Local Government Physical Fitness Classes

JLARC staff infer the public policy objective for exempting local government physical fitness classes may have been to reduce costs for patrons of local government classes. Patrons include at-risk youth, senior citizens, and other disadvantaged citizens.

The prime sponsor of the legislation testified that, when the Legislature extended sales tax to physical fitness activities in 1993, it did not mean to apply sales tax to taxpayer-supported parks and recreation departments. Additional testimony by proponents, including several city parks departments, stated that at-risk youth, senior citizens, and other disadvantaged customers had not previously paid sales tax on fitness classes.

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

Amusement and Recreation Services by NYOs

The preference appears to be achieving the inferred public policy objective of supporting and recognizing nonprofit youth character-building organizations and the general public good they provide by exempting their membership and club fees from sales tax. The preference is now also used by YMCAs, NYOs that operate camps for their members, and numerous youth athletic organizations, such as youth football, baseball, basketball, and soccer leagues.

The YMCA appears to have been the primary organization the Legislature had in mind when it enacted this preference. However, YMCAs have large memberships that include more than just youth under age 18. The sales and use tax exemptions are provided to all YMCA members, not just those under 18 years of age.

Personal Services Classified as Retail Sales

The preference appears to be achieving the inferred public policy objective by supporting character-building NYOs and recognizing the general public good such organizations provide.

However, the preference also provides sales tax exemptions for a number of personal services that are not generally conducted by character-building NYOs. Instead of specifying the sales tax

exemption was for **physical fitness services** provided by NYOs to members, the preference is for **all** personal services under RCW 82.04.050(3)(g). These services are: tanning salon services, tattoo parlor services, steam and Turkish baths, escort services, and dating services.

Local Government Physical Fitness Classes

The preference appears to be achieving the inferred public policy objective of reducing the cost of local government fitness classes for participants, including at-risk youth, senior citizens, or other disadvantaged citizens. However, this exemption applies to all patrons of local government physical fitness classes, not just at-risk youth, seniors, or other disadvantaged citizens.

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

Maintaining the preferences would continue to support and recognize nonprofit youth character-building organizations and to lower costs for participants in local government physical fitness classes. Adult members of NYOs would continue to benefit as well.

Beneficiaries

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

The direct beneficiaries of this preference are members of Washington character-building nonprofit youth organizations and local government physical fitness class participants. These individuals do not pay sales tax on the fees, dues, or charges on the amusement and recreation or physical fitness activities in which they participate.

The primary organizations providing these activities and services are: YMCAs and YWCAs; NYOs that operate camps; a wide variety of youth sports organizations, such as youth soccer, football, basketball, volleyball, or baseball leagues and clubs; and local governments.

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

Members of organizations classified as character-building NYOs who are over age 18 may be unintended beneficiaries of this preference. For example, based on national YMCA and YWCA figures, JLARC staff estimate about 261,000 adults and 196,000 children are currently members at YMCA branches throughout Washington.

The inferred public policy objective in 1981 was to recognize organizations with programs targeted at youth character-building and that provided a "general public good." However, adults could have been beneficiaries as well, because the preference was not limited to those 18 years or younger. In addition, when the Legislature expanded the preference to physical fitness and other personal services in 1994, it increased the number of adults benefiting from the preference because adults participate in activities classified as physical fitness services.

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 staff estimate the beneficiary savings for Fiscal Year 2012 to be $12.9 million and for the 2015-17 Biennium to be $29.6 million. See Exhibit 34, below.

Exhibit 34 – Estimated 2015-17 Beneficiary Savings for Nonprofit Youth Amusement and Recreation Services, Physical Fitness Services, and Local Government Fitness Classes Sales and Use Tax Exemption

FY	Nonprofit Youth Amusement and Recreation/ Physical Fitness Services	State Sales Tax	Local Sales Tax	Total State and Local Sales Tax
2010	$136,404,000	$8,866,000	$3,263,000	$12,129,000
2011	$143,129,000	$9,303,000	$3,459,000	$12,762,000
2012	$144,732,000	$9,408,000	$3,491,000	$12,899,000
2013	$147,320,225	$9,576,000	$3,617,000	$13,193,000
2014	$153,066,000	$9,949,000	$3,758,000	$13,707,000
2015	$158,117,000	$10,278,000	$3,882,000	$14,160,000
2016	**$163,177,000**	**$10,607,000**	**$4,006,000**	**$14,613,000**
2017	**$167,909,000**	**$10,914,000**	**$4,123,000**	**$15,037,000**
2015-17 Biennium				**$29,650,000**

Sources: NP Youth Amusement & Rec/Physical Fitness: National Center for Charitable Statistics at the Urban Institute filing detail and revenue for FY 2010 through 2013 for WA nonprofit YMCAs and sports and rec orgs for basketball, baseball/softball, soccer, and football. Local govt. fitness class income: WA State Auditor's Office BARS report for city, county, and park district activity income. Growth for 2013 - on estimated with Economic Revenue and Forecast Council real personal income growth estimates, Sept. 2012.

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

If the preference were terminated, members of qualifying nonprofit youth organizations would pay sales tax on fees for amusement and recreation activities and physical fitness services. Patrons of local government physical fitness classes would also pay sales tax. Currently, private, for-profit businesses that provide amusement and recreation services and physical fitness activities charge retail sales tax on such fees.

Other States

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

Of the 45 states and the District of Columbia that impose sales tax:

- 18 states and the District of Columbia do not subject amusement and recreation activities and/or physical fitness services to sales tax;
- 11 provide nonprofit 501(c)(3) organizations with sales tax exemptions on charges for such activities and or exempt their member dues from sales tax;
- 9 states (including Washington) exempt certain nonprofit youth organizations from collecting sales tax on amusement and recreation and/or physical fitness services; and
- 7 states tax amusement and recreation and/or physical fitness services without exceptions.

Legislative Auditor Recommendation

The Legislature should review and clarify this preference because, while the preference appears to be achieving the inferred public policy objective of recognizing the general public good provided by character-building nonprofit youth organizations, the preference benefits adults as well as youth. In addition, the exemption for personal services classified as retail sales technically includes services not generally provided by nonprofit youth organizations.

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

RETAILING (B&O TAX)

Report Summary			
What the Preference Does	**Public Policy Objectives**	**Estimated Beneficiary Savings**	**Auditor Recommendation**
Provides a lower B&O tax rate for retailers than the rate paid by manufacturers and wholesalers.	The Legislature did not state the public policy objective for the tax preference. JLARC staff infer that, at the time of enactment, the Legislature wanted to lessen the financial impact of a sales tax increase on retailers by not imposing a B&O tax increase on them at the same time.	$47.1 million in the 2015-17 Biennium	**Review and clarify:** Because sales tax-related changes since 1983 may impact the rationale for the level of preferential rate provided to the retail industry compared to other businesses.

RETAILING (B&O TAX)

Current Law

Under current law, retailers pay a lower businesses and occupation (B&O) tax rate than the rate paid by manufacturers and wholesalers. The lower retailing B&O tax rate is considered a tax preference because before 1983, retailers, manufacturers, and wholesalers paid the same rate.

Currently, manufacturers and wholesalers pay B&O tax at the rate of 0.484 percent. Retailers pay B&O tax at the rate of 0.471 percent.

The retailing B&O tax rate applies to sales of goods and also to sales of certain services that statute defines as retail sales, such as construction, automotive repair, lodging, and food services. Businesses that owe taxes under the retailing B&O classification must also collect sales tax from their customers, unless the sale is exempt.

See page A3-20 in Appendix 3 for the current statute, RCW 82.04.250(1).

Legal History

1935 The Legislature created the B&O tax that imposed a tax on the privilege of engaging in business activities in Washington. The B&O tax consisted of two rates:

1) A 0.25 percent rate on activities such as retailing, manufacturing, and wholesaling; and
2) A 0.5 percent rate on service and other activities.

The Legislature also imposed a sales tax at the rate of 2 percent.

The Legislature changed the B&O tax rate on retailing, manufacturing, and wholesaling seven times prior to 1983 in a series of permanent rate increases and temporary surtaxes. The rate had increased to 0.471 percent prior to 1983, and the Legislature had increased the sales tax rate to 5.4 percent.

1983 In an omnibus tax package that increased revenues, the Legislature imposed a temporary surtax on B&O tax classifications, with some exceptions. With the surtax, rates on manufacturing and wholesaling activities increased to 0.581 percent. Enacted in February, the surtax was effective for four months from March 1 through June 30, 1983.

The Legislature also made changes to the retailing B&O tax rate and to the state sales tax rate, prescribing rates in four counties bordering Oregon (Clark, Cowlitz, Klickitat, and Skamania) that were different from the rates it prescribed in the other 35 counties. The Legislature left the existing 5.4 percent sales tax rate in place in the four border counties but increased the B&O retailing rate in those counties to 0.581 percent, a rate that matched the new higher B&O rates on manufacturing and wholesaling. In the 35 remaining counties, the Legislature raised the state sales tax rate to 6.5 percent but chose to leave the retailing B&O tax rate in these counties unchanged at 0.471 percent.

Exhibit 35, below, summarizes these differences in B&O and sales tax rates imposed on all retailers before 1983 and on retailers in border and non-border counties in 1983. The Legislature retained the lower B&O retailing rate in those counties where retailers had to collect the higher sales tax.

Exhibit 35 – Differences in B&O and Sales Tax Rates for Retailers

Type and Location of Retailer	Retailing B&O Tax	Sales & Use Tax
Tax Rates Before 1983		
All retailers	0.471%	5.4%
Tax Rates During 1983		
Retailers in border counties	0.581%	5.4%
Retailers in 35 other counties	0.471%	6.5%

Source: JLARC staff analysis of tax law.

The temporary B&O surtaxes were in effect from March 1 through June 30, 1983. Two weeks before the expiration date, the Legislature partially rolled back the B&O manufacturing and wholesaling rate increases to 0.484 percent and extended the expiration date to 1985.

1984 The Washington Supreme Court in *Bond v. Burrows*[6] invalidated the differential sales tax and retailing B&O tax rates in border counties on constitutional grounds. As a result of the court decision, the statewide retailing B&O tax rate became 0.471 percent, and the statewide sales tax rate became 6.5 percent, effective January 1, 1985. These are the current tax rates.

1985 The Legislature conformed the tax statutes to the Supreme Court's 1984 ruling.

1993 The Legislature chose to apply temporary tax increases on all B&O tax classifications except retailing.

[6] *Bond v. Burrows*, 103 Wn2d 153 (1984)

Exhibit 36, below, shows B&O tax rate changes for manufacturing, wholesaling, and retailing. Rates for the three classifications increased and decreased together seven times from 1935 through 1982. In 1983, the Legislature maintained the lower retailing B&O rate for 35 non-border counties, and then adopted the lower retailing rate statewide as a result of a state Supreme Court decision.

Exhibit 36 – Rates for Retailing, Manufacturing, and Wholesaling Changed Uniformly Until 1983

Effective Date	Manufacturing	Wholesaling	Retailing
5/1/1935	0.25%	0.25%	0.25%
11/1/1951	0.30%	0.30%	0.30%
5/1/1995	0.40%	0.40%	0.40%
4/1/1959	0.44%	0.44%	0.44%
6/1/1976	0.4664%	0.4664%	0.4664%
7/1/1979	0.44%	0.44%	0.44%
4/1/1982	0.458%	0.458%	0.458%
7/1/1982	0.471%	0.471%	0.471%
4/1/1983	0.581%	0.581%	0.471% / 0.581%
7/1/1983	0.484%	0.484%	0.471% / 0.581%
1/1/1985	0.484%	0.484%	0.471%

Source: JLARC staff analysis of tax law. Note: retailing B&O tax rates increased in 1983 in four border counties.

Other Relevant Background

At the time the preference was enacted, some legislators expressed concern about increasing the B&O rate on retailers at the same time the Legislature implemented a sales tax increase. Part of the concern expressed by legislators was that consumers might respond to the sales tax increase by making fewer purchases in Washington venues, causing a financial impact to the retailers. Consumers might make fewer purchases altogether, or they might make purchases where they did not have to pay sales tax.

Since the time of enactment, further changes have taken place related to sales tax collection and potential financial impacts to retailers. For example:

- While the state sales tax rate has remained the same since 1983, options for local jurisdictions to impose local sales and use taxes have increased. The Legislature authorized an optional additional 0.5 percent local sales and use tax in 1982 and has since authorized local sales and use taxes to fund a variety of purposes such as high capacity transportation systems, criminal justice programs, and public facilities. Local sales tax rates may influence if and where consumers make purchases, with a corresponding financial impact on retailers.

- At the time the preference was enacted, consumers could choose to make their purchases through catalogs or other mail-order businesses rather than in Washington stores. These mail-order businesses generally did not collect sales tax. Now consumers can choose from a vast array of Internet retailers. While buyers are supposed to pay sales tax on these purchases, many do not. The Department of Revenue (DOR) estimates Washington will lose $513 million in uncollected sales tax in Fiscal Year 2014 from these "remote sales." These represent purchases that were not made from Washington retailers.
- More recently, the Legislature has taken steps like the streamlined sales tax agreement to make it easier for online and catalog retailers to collect state and local sales taxes. Currently, Congress is considering legislation to require all online and catalog retailers to collect sales tax. Changes in this direction may lessen the financial impact on Washington retailers by reducing the opportunity for consumers to avoid the sales tax.

Public Policy Objectives

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

The Legislature did not explicitly state the public policy objective for providing a preferential retailing B&O tax rate.

JLARC staff infer that, at the time of enactment, the Legislature wanted to lessen the financial impact of a sales tax increase on retailers by not imposing two tax increases at the same time. At that time, the Legislature increased the sales tax rate to 6.5 percent in most counties, while choosing to retain the retailing B&O tax rate at 0.471 percent. The Legislature raised the manufacturing and wholesaling B&O rates but left the existing retailing rate in place.

This objective is further evidenced by the Legislature's initial action on the four Oregon border counties. In the four counties where the Legislature did not raise the state sales tax, the Legislature imposed a higher B&O retailing rate. The court decision later invalidated the differential tax treatment in the border counties, but the Legislature chose to retain a statewide B&O tax for retailing that is lower than the B&O rates it established for manufacturing and wholesaling.

The lower retailing B&O tax rate has remained in effect since 1985, while temporary surtaxes or rate increases have been imposed on other B&O classifications in following years.

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

At the time of enactment, the tax preference achieved the inferred public policy objective of not imposing two tax increases at the same time that may have a financial impact on retailers.

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

Since the establishment of the preferential B&O retailing rate, further changes have taken place with regard to sales tax collection that may have a financial impact on retailers.

Beneficiaries

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

Beneficiaries of the tax preference are businesses that make retail sales. In Fiscal Year 2012, 195,000 businesses reported retailing activity on tax returns filed with DOR. Beneficiaries also include service industries that provide services defined as retailing, such as physical fitness services, landscaping, and abstract and title services. Also, construction, lodging, and food services are defined as retailing.

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 staff estimate the beneficiary savings from the lower retailing B&O tax rate at $18.9 million in Fiscal Year 2012, and estimate the 2015-2017 Biennium savings at $47.1 million.

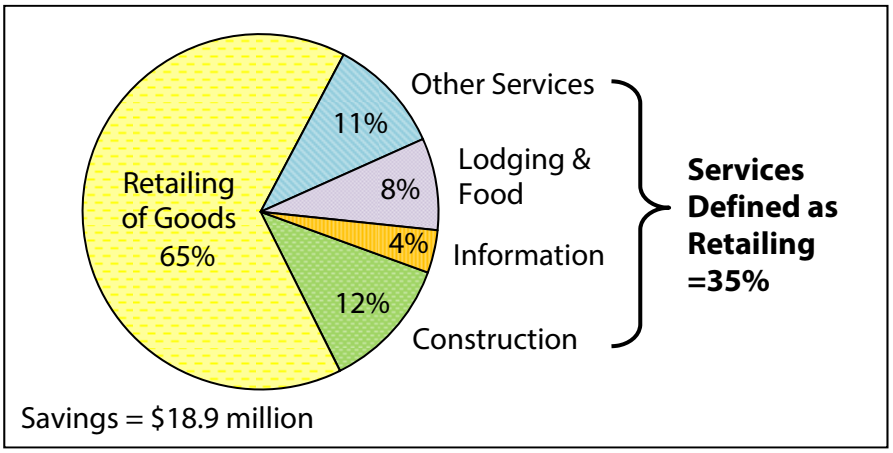
Exhibit 37 – Estimated 2015-17 Beneficiary Savings for Retailing B&O Tax Rate

Fiscal Year	Retailing Tax Base ($Billions)	Preferential Rate	Manufacturing/ Wholesaling Rate	Difference is Savings ($Millions)
2010	$137.1	0.471%	0.484%	$17.8
2011	$142.4	0.471%	0.484%	$18.5
2012	$145.1	0.471%	0.484%	$18.9
2013	$152.1	0.471%	0.484%	$19.8
2014	$159.9	0.471%	0.484%	$20.8
2015	$168.5	0.471%	0.484%	$21.9
2016	$176.8	0.471%	0.484%	$23.0
2017	$185.5	0.471%	0.484%	$24.1
2015-2017 Biennium				**$47.1**

Source: JLARC staff analysis of Department of Revenue and Economic and Revenue Forecast Council data.

Exhibit 38, below, shows that retailers of goods received 65 percent of the tax savings in Fiscal Year 2012. Services defined in statute as retailing received the remaining 35 percent of the tax savings.

Exhibit 38 – Retailers of Tangible Goods Received 65 Percent of the Savings in FY 2012



Source: JLARC staff analysis of Department of Revenue 2012 tax returns.

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

If the tax preference were terminated, the retailing B&O tax rate would increase from 0.471 percent to 0.484 percent. This higher tax rate would result in retailers owing an additional 13 cents in B&O tax on a $1,000 sale. The effect on employment and the economy would depend on the ability of these businesses to either absorb the increased cost or pass it on to their purchasers in the form of higher prices.

Other States

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

Unlike Washington, the primary business tax in most states is a net income tax rather than a gross receipts tax like the B&O tax. In general, net income taxes provide specific credits and deductions instead of preferential rates for specific industries. Therefore, a meaningful comparison is not available.

Legislative Auditor Recommendation

At the time of its enactment in 1983, the preferential B&O rate for retailers met the inferred public policy objective of not imposing both sales and B&O tax increases on Washington retailers at the same time. However, there have been a number of sale tax-related changes since 1983, for example:

- The proliferation of remote sellers and the changes in sales tax collection; and
- The rate of local sales taxes.

The Legislature should review and clarify the preferential B&O tax rate for retailers because these sales tax-related changes may impact the rationale for the level of preferential rate provided to the retail industry compared to other businesses.

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

RURAL COUNTY AND CEZ NEW JOBS (B&O TAX)

Report Summary			
What the Preference Does	**Public Policy Objectives**	**Estimated Beneficiary Savings**	**Auditor Recommendation**
Provides a B&O tax credit to manufacturing, research and development, and commercial testing businesses that hire workers in rural counties or in Community Empowerment Zones (CEZs).	The Legislature did not state the public policy objective when it enacted this preference in 1986, but included intent language in 1997 when it amended the tax preference. The Legislature stated the public policy objective is to assist rural distressed areas in their efforts to address above average unemployment rates and below average employment growth.	$4.3 million in the 2015-17 Biennium	**Review and clarify:** To determine if the new jobs are located where the Legislature intended and if the number of new jobs is what the Legislature intended.

RURAL COUNTY AND CEZ NEW JOBS (B&O TAX)

Current Law

Current law provides a business and occupation (B&O) tax credit to manufacturing, research and development, and commercial testing businesses that hire workers in rural counties or in Community Empowerment Zones (CEZs).

The statutory definition of a "rural county" is a county with a population density less than 100 persons per square mile or a county smaller than 225 square miles. The rural county designation applies to 31 out of 39 counties in Washington.

Statute defines a CEZ as a sub-county area designated by a city or county for development having the majority of households with incomes below 80 percent of the county median income and having an unemployment rate at least 20 percent higher than the county average. Four non-rural counties contain five CEZs.

The B&O tax credit for businesses in rural counties and CEZs is equal to:

- $4,000 for each new employment position with wages and benefits greater than $40,000 a year; and
- $2,000 for each new employment position with wages and benefits of $40,000 or less a year.

A business that applies for the credit is eligible to keep the credit if it increases its employment within one year by at least 15 percent from the date of the first hire. A business that applies for the credit but that fails to increase employment by 15 percent must repay the credit with interest. Businesses must submit applications to the Department of Revenue (DOR) within 90 days after hiring begins. No beneficiary may use the tax credit to decertify a union or to displace existing jobs elsewhere in the state.

The statewide credit amount is capped at $7.5 million a fiscal year. If a beneficiary does not have enough tax liability to use all of the credit in the first year, the credit may be carried over to subsequent years until used. Beneficiaries must report employment information to DOR the year after hiring begins.

See page A3-20 in Appendix 3 for the current statutes, providing a B&O tax credit in rural counties, RCW 82.62.030 and providing a B&O tax credit in CEZs, RCW 82.62.045.

Legal History

Legislature Initially Targeted Distressed Areas, Defined by Unemployment and Household Income Level

1986 The Legislature enacted this B&O tax preference that provided a tax credit of $1,000 per job created by manufacturing, research and development, and commercial testing businesses in **"distressed areas."** The legislation defined distressed areas as counties with unemployment rates at least 20 percent higher than the state average for the preceding three years.

The legislation required a business to apply for the credit before hiring began and expand full-time employment by 15 percent within the year in order to qualify for the credit. The bill capped the credit at $300,000 per taxpayer and $15 million a biennium statewide. The credit became effective on April 1, 1986, and was set to expire on July 1, 1988.

1988 The Legislature extended the expiration date to July 1, 1994, and also provided the credit to businesses in a metropolitan statistical area in which the unemployment rate exceeded the state unemployment rate by 20 percent for one year. The new provision only applied to the Tri-Cities which had experienced layoffs due to federal cutbacks.

1993 The Legislature extended the B&O tax credit to July 1, 1998, and added "neighborhood reinvestment" and "timber impact" areas to the list of eligible areas. The same requirements of the tax credit applied to these new areas. The legislation defined neighborhood reinvestment areas as areas with a majority of households having incomes 80 percent or lower than the county median income and unemployment rates at least 20 percent higher than the county average for the preceding year. The bill identified timber impact areas as areas that had experienced job losses in the lumber and wood products industries.

1994 The Legislature renamed "neighborhood reinvestment areas" to "community empowerment zones" (CEZs) without changing the definition or the eligibility requirements.

1996 The Legislature overrode a Governor's veto and passed a provision that increased the credit from $1,000 to $2,000 for each new employment position.

Also in 1996, the Legislature expanded eligible areas to also allow counties to qualify due to household income levels. Counties with median household income less than 75 percent of the state median household income for the previous three years qualified for the preference. This change added Asotin and Whitman counties.

1997 As part of a rural area marketing plan, the Legislature enacted an array of tax changes and business assistance programs intended to assist **"rural" distressed areas**, without defining "rural" area. The legislation included an increase in the distressed area tax credit to $4,000 for each job created that provided a wage greater than $40,000 per year and removed the $300,000 per beneficiary cap on the credit. The Legislature also tried to remove the requirement that the applying business increase its employees by at least 15 percent, but the Governor vetoed this section, arguing that this would be a "windfall" to companies that would have added employees regardless of the tax incentive.

Legislature Shifts Eligibility to Rural Counties, Defined by Population Density and Square Mileage

1999 The Legislature changed the definition of an eligible county from "distressed" counties to "rural" counties and removed references to metropolitan statistical and timber impact areas. The legislation defined a rural county as a county with a population density less than 100 persons per square mile. The number of eligible counties grew from 26 to 31, adding Lincoln, San Juan, Wahkiakum, Walla Walla, and Whatcom counties because of their rural designation. All distressed counties met the definition of rural counties.

In addition, the legislation required employers in community empowerment zones to hire residents of the zone in order to qualify for the B&O credit.

2004 The Legislature extended the definition of a rural county to a county smaller than 225 square miles, which added Island County.

2007 The Legislature made it easier to qualify for the B&O tax credit in a number of ways. Businesses that hired later in the year had four quarters to meet the job growth requirement, regardless of when in the calendar year hiring took place. The legislation made the credit available to businesses that applied for the credit within 90 days after hiring had begun and to seasonal employers by allowing them to count new employees in full-time equivalent positions.

Other Relevant Background

Before 1999, the Legislature had defined eligible areas as **distressed areas**, which included:

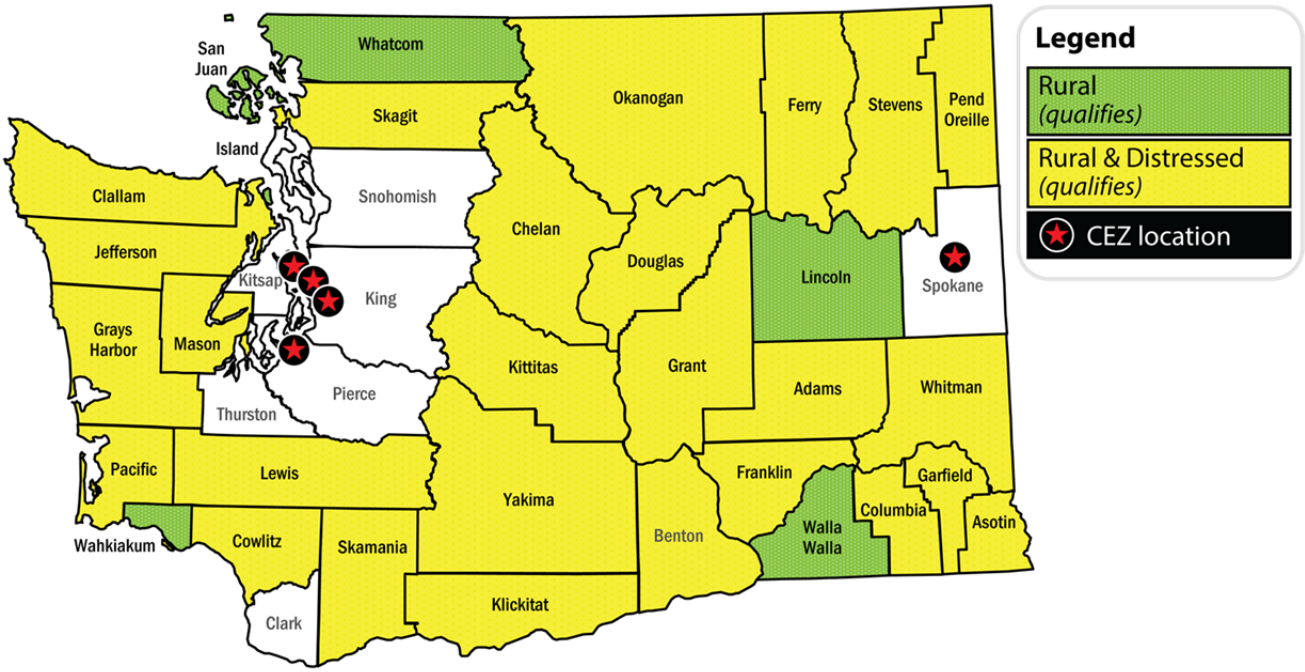
- A county with an unemployment rate at least 20 percent higher than the state average for the preceding three years;
- A county with median household income less than 75 percent of the state median household income for the preceding three years; or
- A CEZ with the majority of households having incomes below 80 percent of the county median income and an unemployment rate at least 20 percent higher than the county average for the preceding one year.

In 1999, the Legislature changed the definition of eligible areas to **rural counties and CEZs**. County eligibility became based on population density and square mileage rather than unemployment rates and household income levels. A rural county has a population density less than 100 persons per square mile and in 2004 included a county less than 225 square miles.

Exhibit 39, on the top of the following page, indicates that in 1999, all of the counties that had previously qualified because they were distressed continued to qualify because they were rural counties. In addition, five new counties now qualified as rural counties, but they were not distressed counties.

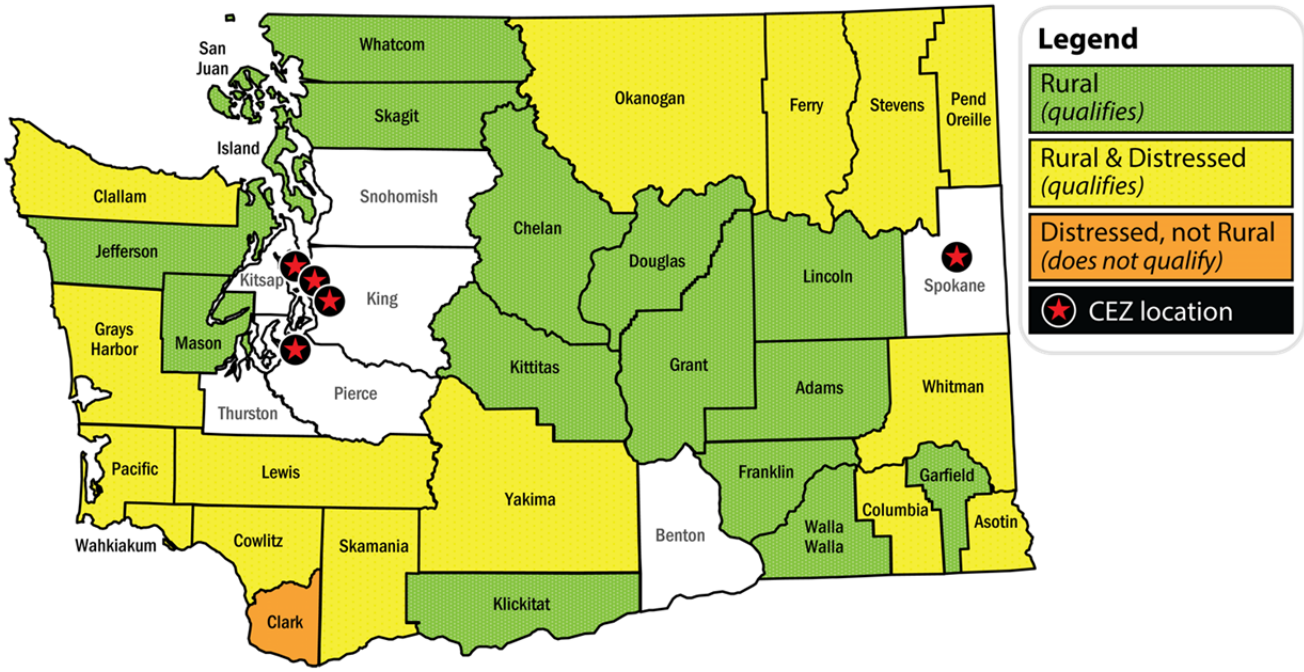
Exhibit 40, on the bottom of the following page, shows how the distinction between "rural" and "distressed" counties has changed since 1999. As of 2012, there are now 16 counties that meet the definition of "rural" but not the definition of "distressed." Fifteen distressed counties qualify because they are rural. One county (Clark) meets the definition of "distressed" because of its unemployment rate, but it does not qualify for the preference because it is not "rural."

Exhibit 39 – In 1999, All Distressed Counties Qualified Because They Were Rural Counties



Source: JLARC staff analysis of tax law.

Exhibit 40 – In 2012, 16 of the Rural Counties Qualifying for the Preference Were Not Distressed



Source: JLARC staff analysis of tax law.

Public Policy Objectives

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

The legislation enacting the tax preference in 1986 was included in a bill with another program and did not contain intent language specific to just the tax preference provision.

The 1997 Legislature included intent language in a larger economic development bill that amended the tax preference. The Legislature stated the public policy objective is **to assist rural distressed areas in their efforts to address above average unemployment rates and below average employment growth** as part of the legislation as a whole**.** The Legislature also established the following six public policy goals for the legislation as a whole:

1) *Promote the ongoing operation of business in rural distressed areas;*
2) *Promote the expansion of existing businesses in rural distressed areas;*
3) *Attract new businesses to rural distressed areas;*
4) *Assist in the development of new businesses from within rural distressed areas;*
5) *Provide family wage jobs to the citizens of rural distressed areas; and*
6) *Promote the development of communities of excellence in rural distressed areas.*

The 1999 legislation that changed eligibility from distressed areas to rural counties was also part of a larger economic development bill. In the intent section for the larger 1999 bill, the Legislature discusses the problems of uneven growth between metropolitan and rural areas which has created "two Washingtons." The Legislature did not explain the rationale for this shift from its earlier emphasis on reducing unemployment in rural distressed areas. At the time of enactment, all distressed counties qualified as rural as well. Currently, 16 rural counties are not distressed.

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

JLARC staff did not attempt to conduct econometric analyses to determine a direct relationship between the B&O tax credit and the growth of employment. However, businesses that apply for and retain this tax credit are required to report information related to job growth. Because of this and other business reporting, JLARC staff are able to provide information on the number of businesses that have applied for and qualified to keep the credit, the number of jobs associated with the credit, and the county location of these businesses and jobs.

The following summary statistics provided in this review are based on tax returns and applications for the credit provided by DOR and employment data for qualifying firms provided by the Employment Security Department (ESD).

Promoting Existing Businesses and Attracting New Businesses (Goals 1-4)

Exhibit 41, below, shows a total of 79 firms qualified for the B&O tax credit at least once in years 2006 through 2010 and increased employment by 2,387 jobs during the years they earned the credit. Twenty-two of those firms appear to be new businesses because they had no employees the year before earning the credit.

Exhibit 41 – 79 Firms Qualified for the Credit Adding 2,387 Jobs, 2006-2010

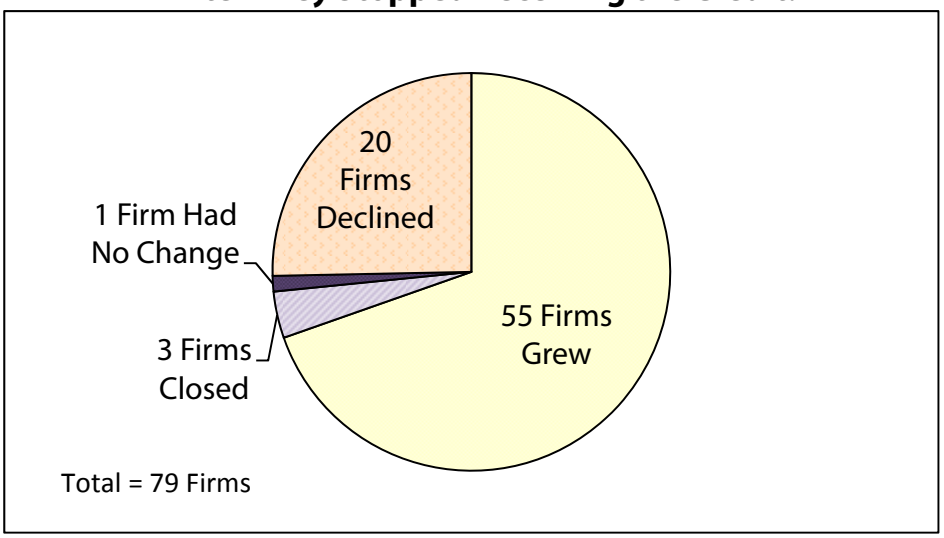
Firms that Qualified:	Number of Firms	Number of Jobs Added
New Firms	22	716
Existing firm growth – **15% or more**	57	1672
Total Firms that Qualified	**79**	**2,387**

Source: JLARC staff analysis of Employment Security Department and Department of Revenue records for 2006 through 2010.

Beneficiaries claimed $8.8 million in B&O tax credit and increased employment by 2,387 jobs in the years in which they earned the credit. Dividing the amount of tax credit claimed by the 2,387 new jobs equates to a cost of $3,700 per job.

Exhibit 42, below, shows what happened to qualifying businesses in the year after they stopped receiving the credit. Of the 79 firms that qualified for the credit during 2006 through 2010, 55 continued to increase employment in the year after they stopped receiving the credit. Of the remaining firms, three closed, 20 reduced employment, and one kept employment at the same level relative to the year in which they qualified.

Exhibit 42 – What Happened to Qualifying Firms After They Stopped Receiving the Credit?



Source: JLARC staff analysis of Employment Security Department and Department of Revenue records.

Information is also available on the number of businesses that applied for the credit but that failed to increase employment within one year by the required 15 percent. A business that fails to increase employment by at least 15 percent must repay any credit taken plus interest. Exhibit 43, below, indicates 22 firms applied for the credit and added new employees, but the businesses were not able to keep the credit because their employment increased by less than 15 percent.

Exhibit 43 – 22 Firms Added Employees but Did Not Qualify, 2006-2010

Firms that Did Not Qualify:	Number of Firms	Number of Jobs Added
Growth 10% up to 15%	6	42
Growth 5% up to 10%	12	122
Growth less than 5%	4	5
Total Firms that Did Not Qualify	**22**	**169**

Source: JLARC staff analysis of Employment Security Department and Department of Revenue records for 2006 through 2010.

Providing Family Wage Jobs (Goal 5)

"Family wage jobs" are not defined in statute. JLARC staff compared wages that beneficiaries paid new employees to the median income for rural counties. In 2011 and 2012, beneficiaries paid wages of more than $40,000 to 57 percent of their new employees. The median household income in rural counties is $43,000.

Are New Jobs Located Where the Legislature Intended?

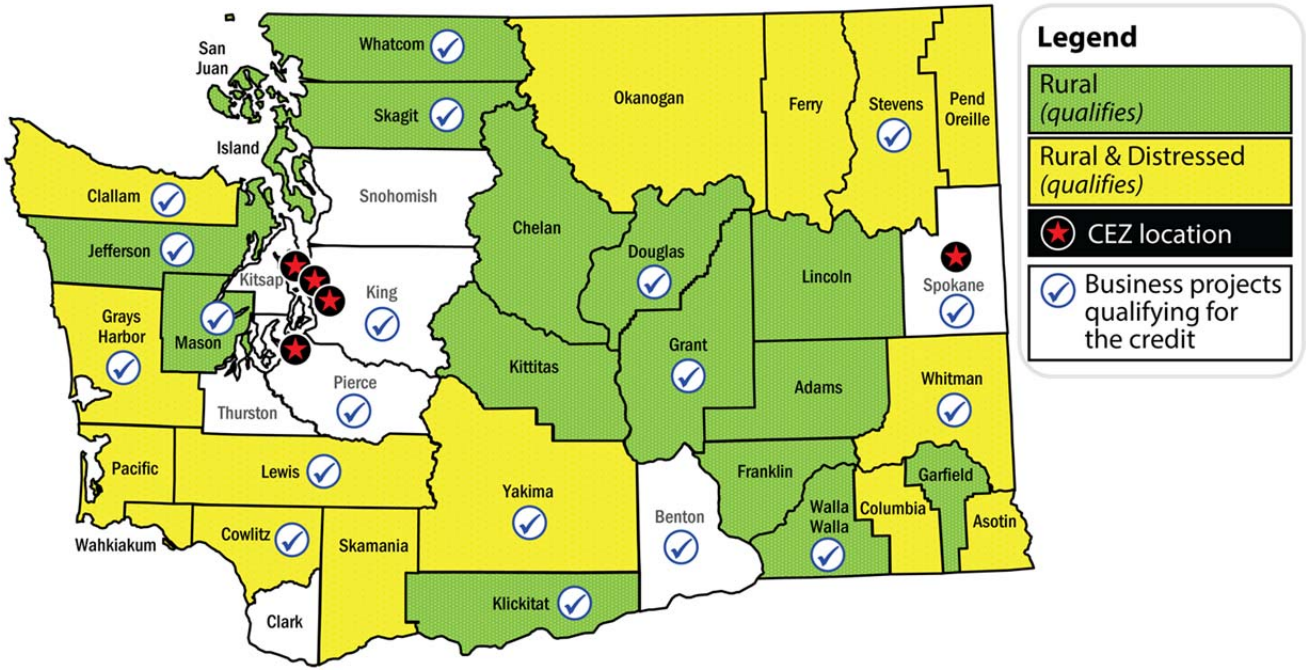
Before 1999, the Legislature's objective for this preference was to reduce unemployment in distressed areas. In 1999, the Legislature did not revise its goals for assisting distressed counties when it changed the definition of eligible areas for this preference to rural counties. At the time, all distressed counties also qualified as rural counties, and five counties qualified as rural but were not distressed. This situation has changed since 1999. Currently, 16 counties qualify as rural counties but are not distressed, and one county that is distressed does not qualify because it is not rural. Refer to Exhibits 39 and 40.

The earlier exhibits illustrate which counties are eligible locations for the credit. Information is also available on the county location of the businesses that actually took the credit during 2006 through 2010. Exhibit 44, below, shows that businesses in 16 of the 31 eligible rural counties claimed the B&O tax credit in 2006 through 2010. Six of those counties are also distressed counties based on their unemployment rate, and one county is a distressed county based on its household income levels. Currently, Benton County no longer qualifies as a rural county.

Businesses qualified for the credit in three CEZs in King, Pierce, and Spokane counties.

Exhibit 44 also shows, in the 15 remaining eligible counties, no businesses claimed the credit. This includes six counties that met the definition of distressed because of their unemployment rates.

Exhibit 44 – Firms Took Credit in 16 Counties, Of Which 7 Are Distressed, 2006-2010



Source: JLARC staff analysis of Employment Security Department and Department of Revenue records for 2006 through 2010.

Is the Number of New Jobs What the Legislature Intended?

The Legislature did not specify a number of jobs sufficient to achieve the public policy objective of providing family wage jobs. It is possible that the Legislature intended the statewide annual credit cap of $7.5 million to simply be an upper limit on expenditures and not related to a jobs target. It is also possible that the Legislature set the $7.5 million to serve as a target for the expected number of jobs to be provided. If businesses claimed the maximum of $7.5 million in credit, 2,027 jobs would have been added per year based on the average cost per job of $3,700. In the five-year period analyzed by JLARC staff, businesses benefiting from the credit added an average of 477 jobs per year.

Exhibit 45, below, illustrates that businesses claimed an average of 26 percent of the statewide maximum allowable credit during the years 2006 through 2010.

Exhibit 45 – 26 Percent of Maximum Credit Claimed (2006-2010, in $Millions)

Year	Statewide Maximum Credit	Credit Claimed / Percent of Maximum	Amount of Unused Credit
2006	$7.5 $M	$1.7 / 22%	$5.8
2007	$7.5 $M	$2.1 / 28%	$5.4
2008	$7.5 $M	$2.6 / 34%	$4.9
2009	$7.5 $M	$2.6 / 34%	$4.9
2010	$7.5 $M	$0.7 / 9%	$6.8
5-Year Totals	$37.5 $M	$9.6 / 26%	$27.9

Source: JLARC staff analysis of Department of Revenue tax return data.

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

If the Legislature wanted to target rural distressed areas for the B&O tax credit, then it may need to reconsider the current designation of rural county defined by population density and square mileage. Businesses in rural counties with lower unemployment rates are eligible for the credit, and businesses in non-rural counties that become distressed because of high unemployment rates, such as Clark County, are not eligible for the credit.

Beneficiaries

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

Beneficiaries of the preference are manufacturing, research and development, and commercial testing businesses taking the B&O tax credit in rural counties and CEZs. Of the businesses qualifying for the B&O tax credit during the five-year study period, 72 were located in rural counties, and seven were located in CEZs. Ten percent of firms claimed 62 percent of the B&O tax credit.

Revenue and Economic Impacts

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

Beneficiaries of the B&O tax credit for jobs in rural counties and CEZs saved $2.0 million in taxes in Fiscal Year 2012, the last year for which tax return data is available. Beneficiaries are estimated to save $4.3 million in the 2015-17 Biennium. The amount of the credit declined in Fiscal Years 2010 and 2011, possibly reflecting an increase in state unemployment during those years.

Exhibit 46 – Estimated 2015-17 Beneficiary Savings for the B&O Tax Credit for Jobs in Rural Counties and CEZs

Fiscal Year	Estimated Beneficiary Savings
2009	$2,581,000
2010	$655,000
2011	$563,000
2012	$1,984,000
2013	$2,046,000
2014	$2,083,000
2015	$2,117,000
2016	$2,143,000
2017	$2,168,000
2015-17 Biennium	**$4,311,000**

Source: JLARC staff analysis of Department of Revenue tax returns.

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

If the tax preference were terminated, businesses that increase employment by 15 percent in rural counties would not qualify for a B&O tax credit averaging $3,700 per new employee. It is not known if these businesses would increase employment as much as 15 percent or would forego hiring without the B&O tax credit.

Other States

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

JLARC staff identified 33 states including Washington that have some type of tax credit for businesses that increase their payrolls in rural areas or designated economically disadvantaged areas.

Legislative Auditor Recommendation

The Legislature should review and clarify the B&O tax credit for businesses in rural counties and community empowerment zones to determine if the new jobs are located where the Legislature intended and if the number of new jobs is what the Legislature intended.

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

TREE TRIMMING UNDER POWER LINES (SALES AND USE TAX)

Report Summary			
What the Preference Does	**Public Policy Objectives**	**Estimated Beneficiary Savings**	**Auditor Recommendation**
Exempts line clearing activities performed by or for an electric utility from sales tax. These activities are instead subject to B&O tax under the service classification.	The Legislature never intended to extend sales tax to utility line clearing when it defined landscaping services as a retail sale. Its public policy objective in enacting the 1995 legislation was to clarify this fact by specifically excluding line clearing from the list of taxable activities.	$0	**Continue:** The language clarifies that landscaping services subject to sales tax does not include line clearing services performed by or for electric utilities.

Tree Trimming Under Power Lines (Sales and Use Tax)

Current Law

Under current law, clearing, trimming, and pruning trees and brush, and removing stumps near power utility lines (all referred to as "line clearing") are not part of the definition of a retail sale if the service is performed by or for an electric utility. This means that businesses that contract with utilities for line clearing services are taxed at the service business and occupation (B&O) tax rate, and sales of these services are not subject to state and local sales taxes.

Landscape services performed for non-utility customers such as trimming and pruning trees for size, shape, and aesthetics are defined as a retail sale and are subject to the sales tax. Landscaping businesses must pay the retailing B&O tax and collect the state and local retail sales taxes from their customers.

See page A3-22 in Appendix 3 for the current statutes, RCW 82.04.050(3)(e).

Legal History

1993 As part of a comprehensive tax package that increased tax revenues, the Legislature imposed the retail sales tax on certain previously exempt discretionary services such as guided tours, physical fitness services, and landscape maintenance. The statute did not specifically define "landscape maintenance" services.

1994 In a proposed rule, the Department of Revenue (DOR) interpreted "landscape maintenance" to include line clearing services performed by or for utilities, thereby subjecting this activity to the retail sales tax.

The electric utilities contested this interpretation in hearings before the Joint Administrative Rules Review Committee (JARRC), a bipartisan committee of legislators that provides advisory opinions on agency rules. JARRC concluded that the Legislature intended to impose the sales tax on discretionary services within the "commonly understood definition of landscaping," and not on services required for public safety such as line clearing near power lines.

DOR did not alter its decision to publish the rule despite the JARRC objection.

1995 The Legislature amended the definition of a retail sale to exclude line clearing services for electric utilities.

Additionally, the intent section of the bill stated that it never intended to extend retail sales tax to utility line clearing and that DOR had "misinterpreted" the original intent of the Legislature. The Governor subsequently vetoed the intent section reasoning that the language might encourage utilities to seek refunds if they had paid taxes prior to the July 1, 1995 effective date. However, the Governor approved the provision excluding line clearing services from the sales tax.

1999 Thirty-one municipal utilities, public utility districts, cooperatives, and investor-owned utilities sued the Department of Revenue for refunds arguing that the Legislature did not intend to include utility line clearing as "landscape maintenance" in the 1993 Act.

The court ruled in favor of the utilities, indicating that the legislative intent is clear given that the plain meaning (or dictionary definition) of "landscape" is to improve by "landscape architecture or gardening." Definitions of "landscape architect" and "landscape gardener" refer to landscaping to achieve decorative and aesthetic effects. The court required DOR to refund taxes paid by utilities from 1993 to 1995.

Public Policy Objectives

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

The Legislature never intended to extend retail sales taxes to utility line clearing. Its public policy objective in enacting the 1995 legislation was to clarify this fact by specifically excluding line clearing from the list of taxable activities.

In language subsequently vetoed by the Governor, the Legislature further clarified that its 1993 legislation extended sales taxes to "discretionary spending on landscape maintenance and horticultural services." Line clearing services "generally require nondiscretionary expenditures by electric utilities in the interests of public safety and minimizing unplanned power interruptions."

Both JARRC and the court concluded that the plain meaning or "commonly-understood definition" of landscape maintenance did not include transmission line clearing.

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

Both the 1995 legislation, which clarifies that utility line clearing is not a taxable activity, and the 1999 court decision, which clarifies the definition of "landscaping," have helped to achieve the public policy objective of not taxing utility line clearing services.

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

Continuation of the clarifying language prevents a possible alternate interpretation of landscape services.

Beneficiaries

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

There are no beneficiaries of the exclusion of line clearing from the definition of a retail sale because line clearing services for utilities were never intended to be taxed when legislation to tax other services was passed in 1993.

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?

Excluding line clearing services from the definition of a retail sale has no effect on taxpayer savings because these services were never intended to be taxed.

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?

Terminating the line clearing exclusion would have no effect on taxpayers because the court has determined that the law that existed before the clarifying language was passed in 1995 already excluded utility line clearing.

Other States

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

In addition to Washington, 20 states impose the sales tax on landscaping services. JLARC staff found six states of these 20 states that exempt utility line clearing services from the sales tax either specifically or as a general exemption for tree trimming and brush clearing.

Legislative Auditor Recommendation

The Legislature should continue the clarifying language that landscaping services subject to the sales tax does not include line clearing services performed by or for electric utilities.

Legislation Required: No.

Fiscal Impact: None.

USE TAX ON RENTAL VALUE (USE TAX)

Report Summary			
What the Preference Does	**Public Policy Objectives**	**Estimated Beneficiary Savings**	**Auditor Recommendation**
Provides that out-of-state businesses that bring property temporarily into Washington for business purposes owe use tax on a reduced, "reasonable rental value" instead of on the full purchase price of the property.	The Legislature did not state the public policy objective for this preference. JLARC staff infer the Legislature enacted the tax preference in order to end a tax dispute with Oregon by reducing the costs to businesses doing work temporarily in Washington.	$3.3 million in the 2015-17 Biennium	**Continue:** Because the inferred public policy objective of resolving a 1980s tax dispute with Oregon by reducing costs to businesses temporarily working in Washington has been achieved.

USE TAX ON RENTAL VALUE (USE TAX)

Current Law

Under current law, out-of-state businesses that bring property temporarily into Washington for business purposes owe use tax on a reduced value of the property. The use tax rate is multiplied by a "reasonable rental value" instead of the full purchase price (or retail price) of the property. To qualify, property, such as equipment, vehicles, and materials, may be used in Washington for no more than 180 days out of 365 consecutive days. Use tax is due on the full value of the property if it is used more than 180 days in Washington.

"Reasonable rental value" is the typical fee charged to rent similar articles. At a minimum, the rental value should allow the rental company to recover its costs over the life of the article.

This tax preference only applies to use of property purchased in states with no sales tax or a sales tax rate lower than Washington's because tax paid in another state is subtracted from Washington's use tax under a multi-state compact. Of Washington's nearest neighbors, Oregon has no sales tax, and Idaho's sales tax rate is 6 percent. Washington's local sales tax rates vary by location, but the total of state and local taxes averages 8.9 percent.

Manufacturing machinery and equipment, vehicles used temporarily in Washington, and certain other articles brought into the state for business purposes are fully exempt from the use tax under separate statutes. These other tax preferences further narrow the specific application of this tax preference to non-manufacturers bringing articles into the state for temporary work, such as the construction industry.

See page X in Appendix 3 for the current statute, RCW 82.12.010(7)(c).

Legal History

1935 The Legislature adopted the Revenue Act of 1935, enacting the retail sales tax and its companion use tax. Consumers owed sales tax on articles purchased in the state, and they owed use tax on articles purchased out of state or when sales tax had not been paid.

1937 The U.S. Supreme Court upheld Washington's use tax in *Henneford v. Silas Mason* as it applied to machinery and equipment brought into the state by an out-of-state contractor working on the Grand Coulee Dam.[7]

1983 Oregon changed the calculation of its personal income tax rate to include the entire income of nonresident married couples if one spouse worked in Oregon. Previously, Oregon based its income tax rate solely on the income of wages earned in Oregon. At the time, Oregon had seven income tax brackets beginning with a 4.2 percent rate at the lowest income bracket and a 10.8 percent rate at the highest bracket for taxable income greater than $5,000.

As a hypothetical example, if a married couple lived in Washington and one spouse earned $4,000 in Oregon and the other earned $26,000 in Washington, their combined income of

[7] *Henneford v. Silas Mason Co.,* 300 U.S. 577, (1937)

$30,000 would have been included in Oregon's income tax rate calculation. This would have increased their tax bracket from 7.6 percent to 10.8 percent. Only their Oregon income would have been taxed, but at a higher rate.

1984 Washington's Attorney General filed a suit in Oregon's tax court disputing the constitutionality of the new calculation of Oregon's income tax rate, claiming that it discriminated against Washington residents.

The Washington Legislature passed a "commuter tax" on Oregon residents working in Washington. The tax did not go into effect until 1985, which – according to newspaper accounts – gave the Oregon Legislature time to repeal its 1983 income tax change.

Washington and Oregon legislators formed an ad hoc workgroup to settle the tax disputes between the two states.

1985 After the ad hoc workgroup discussions, the Washington Legislature adopted this tax preference and repealed the "commuter tax." Oregon repealed its 1983 income tax provision that affected Washington residents.

At first, the Washington Legislature limited the tax preference to property used in Washington 90 days or less, or about 3 months out of a 12-month period.

1994 The Legislature increased the qualifying period that out-of-state property could be used in Washington from 90 days to 180 days out of a year.

Other Relevant Background

As mentioned earlier, other use tax preferences narrow the application of this tax preference to businesses from states with no or lower sales taxes than Washington's, such as Oregon, and to specific businesses such as the construction industry. The following other use tax preferences are available to out-of-state businesses:

- A credit for sales tax paid in another state (RCW 82.12.035, reviewed in 2011);
- Machinery and equipment of manufacturers and research and development operations (RCW 82.12.02565, this preference is omitted from the review process under Chapter 43.136 RCW);
- Interstate transportation equipment and vehicles used temporarily in Washington for business purposes (RCW 82.12.0254, reviewed in 2010);
- Farm equipment bought at auction (RCW 82.12.0258, reviewed in 2008);
- Display items used in trade shows (RCW 82.12.0272, reviewed in 2011);
- Bailed personal property (RCW 82.12.0265, reviewed in 2010); and
- Film production equipment (RCW 82.12.0315, currently scheduled for review in 2014).

Public Policy Objectives

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

The Legislature did not explicitly state the public policy objective for reducing use taxes on property temporarily brought into the state for business purposes.

JLARC staff infer that the Legislature enacted the tax preference in order to end a tax dispute with Oregon by reducing the costs to businesses doing work temporarily in Washington.

Events that led up to the tax preference began when Oregon changed the calculation of its personal income tax rate to include the entire income of nonresident married couples if one spouse worked in Oregon. Washington subsequently adopted a commuter tax that applied to Oregon residents working in Washington. In 1985, before the commuter tax became effective and following a meeting of an ad hoc workgroup of Oregon and Washington legislators, Washington reduced its use tax on Oregon businesses by enacting this tax preference. That same year, Washington also repealed its commuter tax and Oregon repealed its new income tax rate provision that affected Washington residents.

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

The inferred public policy objective of ending a tax dispute with Oregon has been achieved because Oregon repealed its income tax provision that affected Washington residents. Washington has maintained this tax preference in statute and has not enacted a commuter tax.

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

The Legislature enacted the tax preference 28 years ago based on the inferred public policy objective of ending a tax dispute with Oregon. Continuing the tax preferences will continue to reduce costs for Oregon businesses doing work temporarily in Washington. It is not known whether continuing the tax preference will contribute to resolving potential tax disputes with Oregon in the future.

Beneficiaries

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

JLARC staff identified 130 Oregon construction businesses and 70 construction businesses from other western states that could **potentially qualify** for the tax preference. Beneficiaries of the tax preference transport equipment from out of state and are less likely to transport equipment from mid-west and eastern states. These businesses pay Washington use tax but have no employees or physical addresses in Washington.

Revenue and Economic Impacts

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

Beneficiaries of the tax preference saved an estimated $1.4 million in state and local use taxes in Fiscal Year 2012 and $3.3 million in state and local use taxes in the 2015-2017 Biennium. See Exhibit 47, below.

To determine the amount of use tax paid on rental value, JLARC staff selected construction firms from Oregon and other western states with low or no sales tax that paid use tax in Washington but that had no employees in Washington. The taxable amount that these selected firms report to the Department of Revenue (DOR) represents the rental value of the property. JLARC staff then estimated the full value of property by using DOR's seven year depreciation rate for construction equipment and DOR's assumption that property is temporarily located in Washington for 90 days on average.

The estimated beneficiary savings is the difference between use tax on estimated full value versus use tax reported on rental value.

Exhibit 47 – Estimated 2015-17 Beneficiary Savings for Use Tax on Rental Value

Fiscal Year	State Use Tax Savings	Local Use Tax Savings	Total State and Local Use Tax Savings
2010	$957,000	$353,000	$1,310,000
2011	$995,000	$367,000	$1,362,000
2012	$1,013,000	$374,000	$1,387,000
2013	$1,061,000	$392,000	$1,453,000
2014	$1,111,000	$410,000	$1,521,000
2015	$1,151,000	$425,000	$1,576,000
2016	$1,197,000	$442,000	$1,639,000
2017	$1,245,000	$460,000	$1,705,000
2015-17 Biennium	**$2,442,000**	**$902,000**	**$3,344,000**

Source: JLARC staff analysis using Employment Security Department and Department of Revenue taxpayer records and Department Of Revenue tables on assessing construction property.

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?

Terminating the tax preference would increase costs for out-of-state businesses temporarily doing work in Washington. It is not known if these increased costs would create a disincentive for Oregon contractors to do construction work in Washington or begin a tax dispute between the two states.

Other States

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

JLARC staff identified three states – Idaho, New York, and Vermont – that include statutory provisions to exempt personal property temporarily brought into the state for business purposes. There are 46 states, including Washington, that impose a use tax on out-of-state purchases.

Legislative Auditor Recommendation

The Legislature should continue the tax preference because the inferred public policy objective of resolving a 1980s tax dispute with Oregon by reducing costs to businesses temporarily working in Washington has been achieved.

Legislation Required: No.

Fiscal Impact: None.

APPENDIX 1 – SCOPE AND OBJECTIVES

2013
TAX PREFERENCE PERFORMANCE REVIEWS

SCOPE AND OBJECTIVES

SEPTEMBER 2012

STATE OF WASHINGTON
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Why a JLARC Study of Tax Preferences?

Engrossed House Bill 1069 (2006) established the Citizen Commission for Performance Measurement of Tax Preferences and directed it to develop a schedule for periodic review of the state's tax preferences. The bill also directed the Joint Legislative Audit and Review Committee (JLARC) to conduct the periodic reviews.

Background

Tax preferences are exemptions, exclusions, or deductions from the base of a state tax; a credit against a state tax; a deferral of a state tax; or a preferential state tax rate. JLARC estimates the state currently has 602 tax preferences.

Recognizing the need to assess the effectiveness of these tax preferences through an orderly process, the Legislature established the Citizen Commission for Performance Measurement of Tax Preferences. One of the Commission's roles is to develop a schedule for the orderly review of all tax preferences at least once every ten years. The ten-year schedule is to be revised annually.

Omitted from review are several categories of tax preferences identified by statute (e.g., tax preferences required by constitutional law). Any tax preference the Commission determines is critical to the structure of the tax system may also be omitted. Additionally, the Commission may recommend an expedited process for any tax preference.

JLARC is to review tax preferences according to the schedule developed by the Commission. For each tax preference the Commission selects for a performance review, JLARC is to provide a recommendation to either: (1) continue; (2) allow to expire; (3) continue and modify the expiration date; (4) review and clarify; or (5) terminate the preference.

Study Scope

The Citizen Commission selected the following tax preferences for a performance review by JLARC in 2013:

	Brief Description and Tax Type	RCW Citation	Year Enacted
1.	Artistic and Cultural Organizations (B&O Tax)	82.04.4322; 82.04.4324; 82.04.4326; 82.04.4327	1981
2.	Artistic and Cultural Organizations (Sales and Use Tax)	82.08.031; 82.12.031	1981
3.	Basic Health Plan Receipts (Insurance Premiums Tax)	48.14.0201(6)(b)	2005
4.	Dentistry (Insurance Premiums Tax)	48.14.0201(6)(c)	1993
5.	Dietary Supplements (Sales and Use Tax)	82.08.925; 82.12.925	2003
6.	Fishing Boat Fuel (Sales and Use Tax)	82.08.0298; 82.12.0298	1987
7.	Fuel Used in Commercial Vessels (B&O Tax)	82.04.433	1985
8.	Health Maintenance Organizations (B&O Tax)	82.04.322	1993
9.	Insulin (Sales and Use Tax)	82.08.985; 82.12.985	2004
10.	Kidney Dialysis Equipment (Sales and Use Tax)	82.08.945; 82.12.945	2003

Brief Description and Tax Type		RCW Citation	Year Enacted
11.	Local Residential and Coin-Op Telephone Service (Sales Tax)	82.08.0289	1983
12.	Medical Devices (Sales and Use Tax)	82.08.0283; 82.12.0277	1975
13.	Medicare and Basic Health Plan Receipts by Public and Nonprofit Hospitals (B&O Tax)	82.04.4311	2002
14.	Medicare Receipts (Insurance Premiums Tax)	48.14.0201(6)(a)	1993
15.	Nonprofit Blood, Bone, and Tissue Banks (B&O Tax)	82.04.324	1995
16.	Nonprofit Blood, Bone, and Tissue Banks (Sales and Use Tax)	82.08.02805; 82.12.02747	1995
17.	Nonprofit Youth Recreation Services and Local Government Fitness Classes (Sales and Use Tax)	82.08.0291; 82.12.02917	1981
18.	Prescription Drug Administration (B&O Tax)	82.04.620	2007
19.	Prescription Drugs Resellers (B&O Tax)	82.04.272	1998
20.	Retailing (B&O Tax)	82.04.250(1)	1983
21.	Rural County and CEZ New Jobs (B&O Tax)	82.62.030; 82.62.045	1986
22.	Tree Trimming Under Power Lines (Sales and Use Tax)	82.04.050(3)(e)	1995
23.	Use Tax on Rental Value (Use Tax)	82.12.010(7)(c)	1985

In addition, using the expedited process, the Commission will consider the following tax preferences. The expedited process is based on information published by the Department of Revenue in its most recent statutorily required tax exemption study.

Brief Description and Tax Type		RCW Citation	Year Enacted
1.	Alternative Fuel Vehicles (Sales and Use Tax)	82.08.809; 82.12.809	2005
2.	Baseball Stadiums (Leasehold Excise Tax)	82.29A.130(14)	1995
3.	Baseball Stadiums (Sales and Use Tax)	36.100.090	1995
4.	Biodiesel and Alcohol Fuel Production Facilities (Leasehold Excise Tax)	82.29A.135(1)(a)-(d),(2)	1980
5.	Biodiesel and Alcohol Fuel Production Facilities (Property Tax)	84.36.635	2003
6.	Biodiesel and E85 Fuel Distribution (Sales and Use Tax)	82.08.955; 82.12.955	2003
7.	Biodiesel and E85 Fuel Sales (B&O Tax)	82.04.4334	2003
8.	Boats Under 16 Feet (Watercraft Excise Tax)	82.49.020(3)	1983
9.	Bonneville Power Admin Program (B&O Tax)	82.04.310(4)	2010
10.	Competitive Telephone Service (Sales and Use Tax)	82.04.050(1)(a)	1981
11.	Comprehensive Cancer Centers (B&O Tax)	82.04.4265	2005
12.	Comprehensive Cancer Centers (Sales and Use Tax)	82.08.808; 82.12.808	2005
13.	Core Deposits and Tire Fees (Sales and Use Tax)	82.08.036; 82.12.038	1989
14.	Drug Delivery Systems (Sales and Use Tax)	82.08.935; 82.12.935	2003
15.	Fish Cleaning (B&O Tax)	82.04.2403	1994
16.	Foreclosure Relocation Assistance (Real Estate Excise Tax)	82.45.030(3)	2011
17.	Forest Derived Biomass (B&O Tax)	82.04.4494	2009
18.	Forest Land Special Assessments (Property Tax)	84.33.210(1)	1992
19.	Free Public Hospitals (Sales and Use Tax)	82.08.02795; 82.12.02745	1993
20.	Hanford Lease Fees (Leasehold Excise Tax)	82.29A.020(2)	1991

Brief Description and Tax Type		RCW Citation	Year Enacted
21.	Horse Race Tracks (Sales and Use Tax)	82.66.040	1995
22.	Human Body Parts (Sales and Use Tax)	82.08.02806; 82.12.02748	1996
23.	Inmate Employment Programs (Leasehold Excise Tax)	82.29A.130(12)	1992
24.	Life Sciences Discovery Fund (B&O Tax)	82.04.4263	2005
25.	Local Government Business Income (B&O Tax)	82.04.419	1983
26.	Nebulizers (Sales and Use Tax)	82.08.803; 82.12.803	2004
27.	Nonfuel Use of Petroleum (Oil Spill Tax)	82.23B.045	1991
28.	Nonprofit Cancer Treatment Clinics (Property Tax)	84.36.046	1997
29.	Nonprofit Credit and Debt Counseling (B&O Tax)	82.04.368	1993
30.	Nonprofit Dialysis Facilities (Property Tax)	84.36.040(1)(f)	1987
31.	Nonprofit Emergency or Transitional Housing (Property Tax)	84.36.043	1983
32.	Nonprofit Fundraising (Property Tax)	84.36.550	1993
33.	Nonprofit Homes for Aging (Property Tax)	84.36.041	1989
34.	Nonprofit Medical Research and Training Facilities (Property Tax)	84.36.045	1975
35.	Organ Procurement (B&O Tax)	82.04.326	2002
36.	Organ Procurement (Sales and Use Tax)	82.08.02807; 82.12.02749	2002
37.	Ostomic Items (Sales and Use Tax)	82.08.804; 82.12.804	2004
38.	Performing Arts (Property Tax)	84.36.060(1)(b)	1981
39.	Secondary Transportation (Oil Spill Tax)	82.23B.030	1991
40.	Testing and Safety Labs (B&O Tax)	82.04.434	1991
41.	Trade Shows (B&O Tax)	82.04.4282(6)	1989
42.	Tuna, Mackerel, and Jack Fish (Enhanced Food Fish Tax)	82.27.010	1995
43.	Used Mobile Homes (Sales and Use Tax)	82.08.033; 82.12.033	1979
44.	Vaccine Association (B&O Tax)	82.04.640	2010
45.	Wax and Ceramic Materials to Create Molds (Sales and Use Tax)	82.08.983; 82.12.983	2010
46.	Wood Biomass Fuel Manufacturing (B&O Tax)	82.04.260(1)(f)	2003
47.	Wood Biomass Fuel Production Facilities (Leasehold Excise Tax)	82.29A.135(1)(e),(2)	2003
48.	Wood Biomass Fuel Production Facilities (Property Tax)	84.36.640	2003

Study Objectives

In response to the legislative directive, each performance review may answer questions relevant to the tax preference from the following list of questions.

Public Policy Objectives:

1. What are the public policy objectives that provide a justification for the tax preference? Is there any documentation on the purpose or intent of the tax preference? (RCW 43.136.055(b))
2. What evidence exists to show that the tax preference has contributed to the achievement of any of these public policy objectives? (RCW 43.136.055(c))
3. To what extent will continuation of the tax preference contribute to these public policy objectives? (RCW 43.136.055(d))
4. If the public policy objectives are not being fulfilled, what is the feasibility of modifying the tax preference for adjustment of the tax benefits? (RCW 43.136.055(g))

Beneficiaries:

5. Who are the entities whose state tax liabilities are directly affected by the tax preference? (RCW 43.136.055(a))
6. To what extent is the tax preference providing unintended benefits to entities other than those the Legislature intended? (RCW 43.136.055(e))

Revenue and Economic Impacts:

7. What are the past and future tax revenue and economic impacts of the tax preference to the taxpayer and to the government if it is continued? (This includes an analysis of the general effects of the tax preference on the overall state economy, including the effects on consumption and expenditures of persons and businesses within the state.) (RCW 43.136.055(h))
8. If the tax preference were to be terminated, what would be the negative effects on the taxpayers who currently benefit from the tax preference and the extent to which the resulting higher taxes would have an effect on employment and the economy? (RCW 43.136.055(f))
9. If the tax preference were to be terminated, what would be the effect on the distribution of liability for payment of state taxes? (RCW 43.136.055(i))
10. For those preferences enacted for economic development purposes, what are the economic impacts of the tax preference compared to the economic impact of government activities funded by the tax? (This analysis involves conducting an economic impact study using OFM's input-output model.) (RCW 43.136.055(j))

Other States:

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

Timeframe for the Study

A preliminary audit report will be presented at the July 2013 JLARC meeting and at the August 2013 meeting of the Commission. A final report will be presented to JLARC in January 2014.

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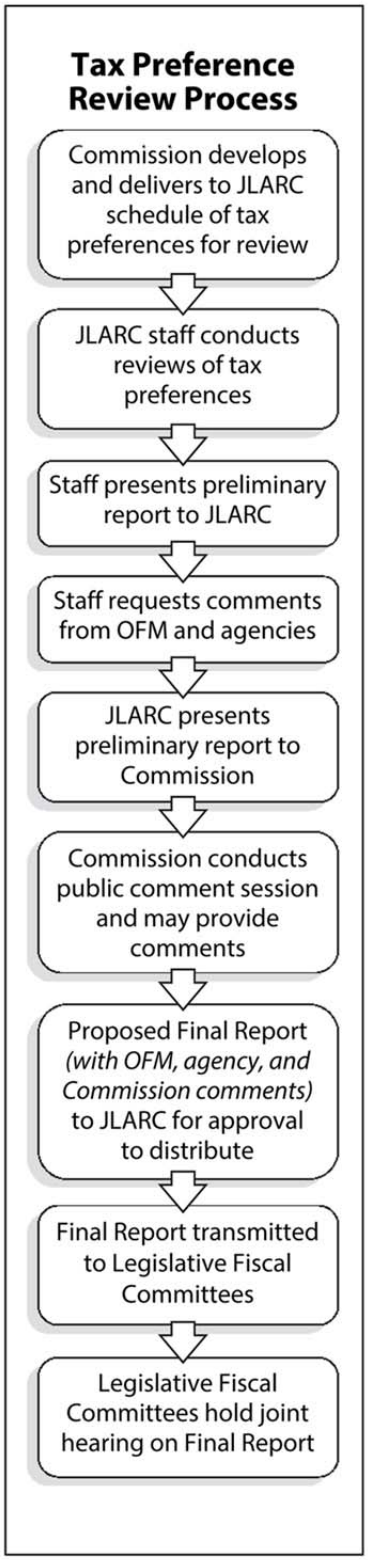

APPENDIX 2 – AGENCY RESPONSES

Agency responses will be included in the final report.

APPENDIX 3 – CURRENT LAW

Government Payments to Public and Nonprofit Hospitals (B&O Tax)

RCW 82.04.4311

Deductions — Compensation received under the federal medicare program by certain hospitals or health centers.

(1) A public hospital that is owned by a municipal corporation or political subdivision, or a nonprofit hospital, or a nonprofit community health center, or a network of nonprofit community health centers, that qualifies as a health and social welfare organization as defined in RCW 82.04.431, may deduct from the measure of tax amounts received as compensation for health care services covered under the federal medicare program authorized under Title XVIII of the federal social security act; medical assistance, children's health, or other program under chapter 74.09 RCW; or for the state of Washington basic health plan under chapter 70.47 RCW. The deduction authorized by this section does not apply to amounts received from patient copayments or patient deductibles.

(2) As used in this section, "community health center" means a federally qualified health center as defined in 42 U.S.C. 1396d as existing on August 1, 2005.

[2005 c 86 § 1; 2002 c 314 § 2.]

RCW 82.04.431

"Health or social welfare organization" defined — Conditions for exemption — "Health or social welfare services" defined.

(1) The term "health or social welfare organization" means an organization, including any community action council, which renders health or social welfare services as defined in subsection (2) of this section, which is a domestic or foreign not-for-profit corporation under chapter 24.03 RCW and which is managed by a governing board of not less than eight individuals none of whom is a paid employee of the organization or which is a corporation sole under chapter 24.12 RCW. Health or social welfare organization does not include a corporation providing professional services as authorized in chapter 18.100 RCW. In addition a corporation in order to be exempt under RCW 82.04.4297 must satisfy the following conditions:

(a) No part of its income may be paid directly or indirectly to its members, stockholders, officers, directors, or trustees except in the form of services rendered by the corporation in accordance with its purposes and bylaws;

(b) Salary or compensation paid to its officers and executives must be only for actual services rendered, and at levels comparable to the salary or compensation of like positions within the public service of the state;

(c) Assets of the corporation must be irrevocably dedicated to the activities for which the exemption is granted and, on the liquidation, dissolution, or abandonment by the corporation, may not inure directly or indirectly to the benefit of any member or individual except a nonprofit organization, association, or corporation which also would be entitled to the exemption;

(d) The corporation must be duly licensed or certified where licensing or certification is required by law or regulation;

(e) The amounts received qualifying for exemption must be used for the activities for which the exemption is granted;

(f) Services must be available regardless of race, color, national origin, or ancestry; and

(g) The director of revenue must have access to its books in order to determine whether the corporation is exempt from taxes within the intent of RCW 82.04.4297 and this section.

(2) The term "health or social welfare services" includes and is limited to:

(a) Mental health, drug, or alcoholism counseling or treatment;

(b) Family counseling;

(c) Health care services;

(d) Therapeutic, diagnostic, rehabilitative, or restorative services for the care of the sick, aged, or physically, developmentally, or emotionally-disabled individuals;

(e) Activities which are for the purpose of preventing or ameliorating juvenile delinquency or child abuse, including recreational activities for those purposes;

(f) Care of orphans or foster children;

(g) Day care of children;

(h) Employment development, training, and placement;

(i) Legal services to the indigent;

(j) Weatherization assistance or minor home repair for low-income homeowners or renters;

(k) Assistance to low-income homeowners and renters to offset the cost of home heating energy, through direct benefits to eligible households or to fuel vendors on behalf of eligible households;

(l) Community services to low-income individuals, families, and groups, which are designed to have a measurable and potentially major impact on causes of poverty in communities of the state; and

(m) Temporary medical housing, as defined in RCW 82.08.997, if the housing is provided only:

(i) While the patient is receiving medical treatment at a hospital required to be licensed under RCW 70.41.090 or at an outpatient clinic associated with such hospital, including any period of recuperation or observation immediately following such medical treatment; and

(ii) By a person that does not furnish lodging or related services to the general public.

[2011 1st sp.s. c 19 § 3; 2008 c 137 § 1; 1986 c 261 § 6; 1985 c 431 § 3; 1983 1st ex.s. c 66 § 1; 1980 c 37 § 80; 1979 ex.s. c 196 § 6.]

RCW 82.04.4297

Deductions — Compensation from public entities for health or social welfare services — Exception.

In computing tax there may be deducted from the measure of tax amounts received from the United States or any instrumentality thereof or from the state of Washington or any municipal corporation or political subdivision thereof as compensation for, or to support, health or social welfare services rendered by a health or social welfare organization, as defined in RCW 82.04.431, or by a municipal corporation or political subdivision, except deductions are not allowed under this section for amounts that are received under an employee benefit plan.

[2011 1st sp.s. c 19 § 2; 2002 c 314 § 3; 2001 2nd sp.s. c 23 § 2; 1988 c 67 § 1; 1980 c 37 § 17. Formerly RCW 82.04.430(16).]

Health Maintenance Organizations (B&O Tax)

RCW 82.04.322

Exemptions — Health maintenance organization, health care service contractor, certified health plan.

This chapter does not apply to any health maintenance organization, health care service contractor, or certified health plan in respect to premiums or prepayments that are taxable under RCW 48.14.0201.

[1993 c 492 § 303.]

Medicare and Basic Health Plan Receipts (Insurance Premium Tax)

RCW 48.14.0201

Premiums and prepayments tax — Health care services — Exemptions — State preemption.

(1) As used in this section, "taxpayer" means a health maintenance organization as defined in RCW 48.46.020, a health care service contractor as defined in RCW 48.44.010, or a self-funded multiple employer welfare arrangement as defined in RCW 48.125.010.

(2) Each taxpayer must pay a tax on or before the first day of March of each year to the state treasurer through the insurance commissioner's office. The tax must be equal to the total amount of all premiums and prepayments for health care services collected or received by the taxpayer under RCW 48.14.090 during the preceding calendar year multiplied by the rate of two percent. For tax purposes, the reporting of premiums and prepayments must be on a written basis or on a paid-for basis consistent with the basis required by the annual statement.

(3) Taxpayers must prepay their tax obligations under this section. The minimum amount of the prepayments is the percentages of the taxpayer's tax obligation for the preceding calendar year recomputed using the rate in effect for the current year. For the prepayment of taxes due during the first calendar year, the minimum amount of the prepayments is the percentages of the taxpayer's tax obligation that would have been due had the tax been in effect during the previous calendar year.

The tax prepayments must be paid to the state treasurer through the commissioner's office by the due dates and in the following amounts:

(a) On or before June 15, forty-five percent;

(b) On or before September 15, twenty-five percent;

(c) On or before December 15, twenty-five percent.

(4) For good cause demonstrated in writing, the commissioner may approve an amount smaller than the preceding calendar year's tax obligation as recomputed for calculating the health maintenance organization's, health care service contractor's, self-funded multiple employer welfare arrangement's, or certified health plan's prepayment obligations for the current tax year.

(5) Moneys collected under this section are deposited in the general fund.

(6) The taxes imposed in this section do not apply to:

(a) Amounts received by any taxpayer from the United States or any instrumentality thereof as prepayments for health care services provided under Title XVIII (medicare) of the federal social security act.

(b) Amounts received by any taxpayer from the state of Washington as prepayments for health care services provided under:

(i) The medical care services program as provided in RCW 74.09.035; or

(ii) The Washington basic health plan on behalf of subsidized enrollees as provided in chapter 70.47 RCW.

(c) Amounts received by any health care service contractor, as defined in RCW 48.44.010, as prepayments for health care services included within the definition of practice of dentistry under RCW 18.32.020.

[2011 c 47 § 8; 2009 c 479 § 41. Prior: 2005 c 405 § 1; 2005 c 223 § 6; 2005 c 7 § 1; 2004 c 260 § 24; 1998 c 323 § 1; 1997 c 154 § 1; 1993 sp.s. c 25 § 601; 1993 c 492 § 301.]

Dentistry Prepayments (Insurance Premium tax)

RCW 48.14.0201

Premiums and prepayments tax — Health care services — Exemptions — State preemption.

(1) As used in this section, "taxpayer" means a health maintenance organization as defined in RCW 48.46.020, a health care service contractor as defined in RCW 48.44.010, or a self-funded multiple employer welfare arrangement as defined in RCW 48.125.010.

(2) Each taxpayer must pay a tax on or before the first day of March of each year to the state treasurer through the insurance commissioner's office. The tax must be equal to the total amount of all premiums and prepayments for health care services collected or received by the taxpayer under RCW 48.14.090 during the preceding calendar year multiplied by the rate of two percent. For tax purposes, the reporting of premiums and prepayments must be on a written basis or on a paid-for basis consistent with the basis required by the annual statement.

(3) Taxpayers must prepay their tax obligations under this section. The minimum amount of the prepayments is the percentages of the taxpayer's tax obligation for the preceding calendar year recomputed using the rate in effect for the current year. For the prepayment of taxes due during the first calendar year, the minimum amount of the prepayments is the percentages of the taxpayer's tax obligation that would have been due had the tax been in effect during the previous calendar year. The tax prepayments must be paid to the state treasurer through the commissioner's office by the due dates and in the following amounts:

(a) On or before June 15, forty-five percent;

(b) On or before September 15, twenty-five percent;

(c) On or before December 15, twenty-five percent.

(4) For good cause demonstrated in writing, the commissioner may approve an amount smaller than the preceding calendar year's tax obligation as recomputed for calculating the health maintenance organization's, health care service contractor's, self-funded multiple employer welfare arrangement's, or certified health plan's prepayment obligations for the current tax year.

(5) Moneys collected under this section are deposited in the general fund.

(6) The taxes imposed in this section do not apply to:

(a) Amounts received by any taxpayer from the United States or any instrumentality thereof as prepayments for health care services provided under Title XVIII (medicare) of the federal social security act.

(b) Amounts received by any taxpayer from the state of Washington as prepayments for health care services provided under:

(i) The medical care services program as provided in RCW 74.09.035; or

(ii) The Washington basic health plan on behalf of subsidized enrollees as provided in chapter 70.47 RCW.

(c) Amounts received by any health care service contractor, as defined in RCW 48.44.010, as prepayments for health care services included within the definition of practice of dentistry under RCW 18.32.020.

[2011 c 47 § 8; 2009 c 479 § 41. Prior: 2005 c 405 § 1; 2005 c 223 § 6; 2005 c 7 § 1; 2004 c 260 § 24; 1998 c 323 § 1; 1997 c 154 § 1; 1993 sp.s. c 25 § 601; 1993 c 492 § 301.]

Prescription Drug Administration (B&O Tax)

RCW 82.04.620

Exemptions — certain prescription drugs.

In computing tax there may be deducted from the measure of tax imposed by RCW 82.04.290(2) amounts received by physicians or clinics for drugs for infusion or injection by licensed physicians or their agents for human use pursuant to a prescription, but only if the amounts: (1) Are separately stated on invoices or other billing statements; (2) do not exceed the then current federal rate; and (3) are covered or required under a health care service program subsidized by the federal or state

government. The federal rate means the rate at or below which the federal government or its agents reimburse providers for prescription drugs administered to patients as provided for in the medicare, part B, drugs average sales price information resource as published by the United States department of health and human services, or any successor index thereto.

[2007 c 447 § 1.]

Medical Items, Dietary Supplements, Insulin, and Kidney Dialysis Devices (Sales and Use Tax)

RCW 82.08.0283

Exemptions — Certain medical items.

(1) The tax levied by RCW 82.08.020 shall not apply to sales of:

(a) Prosthetic devices prescribed, fitted, or furnished for an individual by a person licensed under the laws of this state to prescribe, fit, or furnish prosthetic devices, and the components of such prosthetic devices;

(b) Medicines of mineral, animal, and botanical origin prescribed, administered, dispensed, or used in the treatment of an individual by a person licensed under chapter 18.36A RCW; and

(c) Medically prescribed oxygen, including, but not limited to, oxygen concentrator systems, oxygen enricher systems, liquid oxygen systems, and gaseous, bottled oxygen systems prescribed for an individual by a person licensed under chapter 18.57 or 18.71 RCW for use in the medical treatment of that individual.

(2) In addition, the tax levied by RCW 82.08.020 shall not apply to charges made for labor and services rendered in respect to the repairing, cleaning, altering, or improving of any of the items exempted under subsection (1) of this section.

(3) The exemption in subsection (1) of this section shall not apply to sales of durable medical equipment, other than as specified in subsection (1)(c) of this section, or mobility enhancing equipment.

(4) The definitions in this subsection apply throughout this section.

(a) "Prosthetic device" means a replacement, corrective, or supportive device, including repair and replacement parts for a prosthetic device, worn on or in the body to:

(i) Artificially replace a missing portion of the body;

(ii) Prevent or correct a physical deformity or malfunction; or

(iii) Support a weak or deformed portion of the body.

(b) "Durable medical equipment" means equipment, including repair and replacement parts for durable medical equipment that:

(i) Can withstand repeated use;

(ii) Is primarily and customarily used to serve a medical purpose;

(iii) Generally is not useful to a person in the absence of illness or injury; and

(iv) Is not worn in or on the body.

(c) "Mobility enhancing equipment" means equipment, including repair and replacement parts for mobility enhancing equipment that:

(i) Is primarily and customarily used to provide or increase the ability to move from one place to another and that is appropriate for use either in a home or a motor vehicle;

(ii) Is not generally used by persons with normal mobility; and

(iii) Does not include any motor vehicle or equipment on a motor vehicle normally provided by a motor vehicle manufacturer.

(d) The terms "durable medical equipment" and "mobility enhancing equipment" are mutually exclusive.

[2007 c 6 § 1101; 2004 c 153 § 101; 2003 c 168 § 409; 2001 c 75 § 1; 1998 c 168 § 2; 1997 c 224 § 1; 1996 c 162 § 1; 1991 c 250 § 2; 1986 c 255 § 1; 1980 c 86 § 1; 1980 c 37 § 48. Formerly RCW 82.08.030(30).]

RCW 82.12.0277

Exemptions — Certain medical items.

(1) The provisions of this chapter shall not apply in respect to the use of:

(a) Prosthetic devices prescribed, fitted, or furnished for an individual by a person licensed under the laws of this state to prescribe, fit, or furnish prosthetic devices, and the components of such prosthetic devices;

(b) Medicines of mineral, animal, and botanical origin prescribed, administered, dispensed, or used in the treatment of an individual by a person licensed under chapter 18.36A RCW; and

(c) Medically prescribed oxygen, including, but not limited to, oxygen concentrator systems, oxygen enricher systems, liquid oxygen systems, and gaseous, bottled oxygen systems prescribed for an individual by a person licensed under chapter 18.57 or 18.71 RCW for use in the medical treatment of that individual.

(2) In addition, the provisions of this chapter shall not apply in respect to the use of labor and services rendered in

(3) The exemption provided by subsection (1) of this section shall not apply to the use of durable medical equipment, other than as specified in subsection (1)(c) of this section, or mobility enhancing equipment.

(4) "Prosthetic device," "durable medical equipment," and "mobility enhancing equipment" have the same meanings as in RCW 82.08.0283.

[2007 c 6 § 1102; 2004 c 153 § 109. Prior: 2003 c 168 § 412; 2003 c 5 § 8; 2001 c 75 § 2; 1998 c 168 § 3; 1997 c 224 § 2; 1996 c 162 § 2; 1991 c 250 § 3; 1986 c 255 § 2; 1980 c 86 § 2; 1980 c 37 § 75. Formerly RCW 82.12.030(25).]

RCW 82.08.925

Exemptions — Dietary supplements.

The tax levied by RCW 82.08.020 shall not apply to sales of dietary supplements for human use dispensed or to be dispensed to patients, pursuant to a prescription. "Dietary supplement" has the same meaning as in RCW 82.08.0293.

[2003 c 168 § 302.]

RCW 82.12.925

Exemptions — Dietary supplements.

The provisions of this chapter shall not apply to the use of dietary supplements dispensed or to be dispensed to patients, pursuant to a prescription, if the dietary supplements are for human use. "Dietary supplement" has the same meaning as in RCW 82.08.0293.

[2003 c 168 § 304.]

RCW 82.08.985

Exemptions — Insulin.

The tax levied by RCW 82.08.020 shall not apply to sales of insulin for human use.

[2004 c 153 § 102.]

RCW 82.12.985

Exemptions — Insulin.

The provisions of this chapter shall not apply in respect to the use of insulin by humans.

[2004 c 153 § 103.]

RCW 82.08.945

Exemptions — Kidney dialysis devices.

The tax levied by RCW 82.08.020 shall not apply to sales of kidney dialysis devices, including repair and replacement parts, for human use pursuant to a prescription. In addition, the tax levied by RCW 82.08.020 shall not apply to charges made for labor and services rendered in respect to the repairing, cleaning, altering, or improving of kidney dialysis devices.

[2004 c 153 § 110; 2003 c 168 § 410.]

RCW 82.12.945

Exemptions — Kidney dialysis devices.

The provisions of this chapter shall not apply to the use of kidney dialysis devices, including repair and replacement parts, for human use pursuant to a prescription. In addition, the provisions of this chapter shall not apply in respect to the use of labor and services rendered in respect to the repairing, cleaning, altering, or improving of kidney dialysis devices.

[2004 c 153 § 111; 2003 c 168 § 411.]

Nonprofit Blood and Tissue Banks (B&O and Sales and Use Taxes)

Note: Legislation in the 2013 Session modified this section. See ESSB 5882, sec. 1202.

RCW 82.04.324

Exemptions — Qualifying blood, tissue, or blood and tissue banks.

(1) This chapter does not apply to amounts received by a qualifying blood bank, a qualifying tissue bank, or a qualifying blood and tissue bank to the extent the amounts are exempt from federal income tax.

(2) For the purposes of this section:

(a) "Qualifying blood bank" means a blood bank that qualifies as an exempt organization under 26 U.S.C. 501(c)(3) as existing on June 10, 2004, is registered pursuant to 21 C.F.R., part 607 as existing on June 10, 2004, and whose primary business purpose is the collection, preparation, and processing of blood. "Qualifying blood bank" does not include a comprehensive cancer center that is recognized as such by the national cancer institute.

(b) "Qualifying tissue bank" means a tissue bank that qualifies as an exempt organization under 26 U.S.C. 501(c)(3) as existing on June 10, 2004, is registered pursuant to 21 C.F.R., part 1271 as existing on June 10, 2004, and whose primary business purpose is the recovery, processing, storage, labeling, packaging, or distribution of human bone tissue, ligament tissue and similar musculoskeletal tissues, skin tissue, heart valve tissue, or human eye tissue. "Qualifying tissue bank" does not include a comprehensive cancer center that is recognized as such by the national cancer institute.

(c) "Qualifying blood and tissue bank" is a bank that qualifies as an exempt organization under 26 U.S.C. 501(c)(3) as existing on June 10, 2004, is registered pursuant to 21 C.F.R., part 607 and part 1271 as existing on June 10, 2004, and whose primary business purpose is the collection, preparation, and processing of blood, and the recovery, processing, storage, labeling, packaging, or distribution of human bone tissue, ligament tissue and similar musculoskeletal tissues, skin tissue, and heart valve tissue. "Qualifying blood and tissue bank" does not include a comprehensive cancer center that is recognized as such by the national cancer institute.

[2004 c 82 § 1; 1995 2nd sp.s. c 9 § 3.]

RCW 82.08.02805

Exemptions — Sales to qualifying blood, tissue, or blood and tissue banks.

(1) The tax levied by RCW 82.08.020 does not apply to the sale of medical supplies, chemicals, or materials to a qualifying blood bank, a qualifying tissue bank, or a qualifying blood and tissue bank. The exemption in this section does not apply to the sale of construction materials, office equipment, building equipment, administrative supplies, or vehicles.

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

(a) "Medical supplies" means any item of tangible personal property, including any repair and replacement parts for such tangible personal property, used by a qualifying blood bank, a qualifying

tissue bank, or a qualifying blood and tissue bank for the purpose of performing research on, procuring, testing, processing, storing, packaging, distributing, or using blood, bone, or tissue. The term includes tangible personal property used to:

(i) Provide preparatory treatment of blood, bone, or tissue;

(ii) Control, guide, measure, tune, verify, align, regulate, test, or physically support blood, bone, or tissue; and

(iii) Protect the health and safety of employees or others present during research on, procuring, testing, processing, storing, packaging, distributing, or using blood, bone, or tissue.

(b) "Chemical" means any catalyst, solvent, water, acid, oil, or other additive that physically or chemically interacts with blood, bone, or tissue.

(c) "Materials" means any item of tangible personal property, including, but not limited to, bags, packs, collecting sets, filtering materials, testing reagents, antisera, and refrigerants used or consumed in performing research on, procuring, testing, processing, storing, packaging, distributing, or using blood, bone, or tissue.

(d) "Research" means basic and applied research that has as its objective the design, development, refinement, testing, marketing, or commercialization of a product, service, or process.

(e) The definitions in RCW 82.04.324 apply to this section.

[2004 c 82 § 2; 1995 2nd sp.s. c 9 § 4.]

RCW 82.12.02747

Exemptions — Use of medical products by qualifying blood, tissue, or blood and tissue banks.

(1) The provisions of this chapter do not apply in respect to the use of medical supplies, chemicals, or materials by a qualifying blood bank, a qualifying tissue bank, or a qualifying blood and tissue bank. The exemption in this section does not apply to the use of construction materials, office equipment, building equipment, administrative supplies, or vehicles.

(2) The definitions in RCW 82.04.324 and 82.08.02805 apply to this section.

[2004 c 82 § 3; 1995 2nd sp.s. c 9 § 5.]

Prescription Drug Resellers (B&O)

RCW 82.04.272

Tax on warehousing and reselling prescription drugs.

(1) Upon every person engaging within this state in the business of warehousing and reselling drugs for human use pursuant to a prescription; as to such persons, the amount of the tax shall be equal to the gross income of the business multiplied by the rate of 0.138 percent.

(2) For the purposes of this section:

(a) "Prescription" and "drug" have the same meaning as in RCW 82.08.0281; and

(b) "Warehousing and reselling drugs for human use pursuant to a prescription" means the buying of drugs for human use pursuant to a prescription from a manufacturer or another wholesaler, and reselling of the drugs to persons selling at retail or to hospitals, clinics, health care providers, or other providers of health care services, by a wholesaler or retailer who is registered with the federal drug enforcement administration and licensed by the state board of pharmacy.

[2003 c 168 § 401; 1998 c 343 § 1.]

Artistic and Cultural Organizations (B&O Tax, Sales and Use Tax)

RCW 82.04.4322

Deductions — Artistic or cultural organization — Compensation from United States, state, etc., for artistic or cultural exhibitions, performances, or programs.

In computing tax there may be deducted from the measure of tax amounts received from the United States or any instrumentality thereof or from the state of Washington or any municipal corporation or subdivision thereof as compensation for, or to support, artistic or cultural exhibitions, performances, or programs provided by an artistic or cultural organization for attendance or viewing by the general public.

[1981 c 140 § 1.]

RCW 82.04.4324

Deductions — Artistic or cultural organization — Deduction for tax under RCW 82.04.240 — Value of articles for use in displaying art objects or presenting artistic or cultural exhibitions, performances, or programs.

In computing tax there may be deducted from the measure of tax by persons subject to payment of the tax on manufacturing under RCW 82.04.240, the value of articles to the extent manufacturing activities are undertaken by an artistic or cultural organization solely for the purpose of manufacturing articles for use by the organization in displaying art objects or presenting artistic or cultural exhibitions, performances, or programs for attendance or viewing by the general public.

[1981 c 140 § 2.]

RCW 82.04.4326

Deductions — Artistic or cultural organizations — Tuition charges for attending artistic or cultural education programs.

In computing tax there may be deducted from the measure of tax amounts received by artistic or cultural organizations as tuition charges collected for the privilege of attending artistic or cultural education programs.

[1981 c 140 § 3.]

RCW 82.04.4327

Deductions — Artistic and cultural organizations — Income from business activities.

In computing tax there may be deducted from the measure of tax those amounts received by artistic or cultural organizations which represent income derived from business activities conducted by the organization.

[1985 c 471 § 6.]

RCW 82.08.031

Exemptions — Sales to artistic or cultural organizations of certain objects acquired for exhibition or presentation.

The tax levied by RCW 82.08.020 shall not apply to sales to artistic or cultural organizations of objects which are acquired for the purpose of exhibition or presentation to the general public if the objects are:

(1) Objects of art;

(2) Objects of cultural value;

(3) Objects to be used in the creation of a work of art, other than tools; or

(4) Objects to be used in displaying art objects or presenting artistic or cultural exhibitions or performances.

[1981 c 140 § 4.]

RCW 82.12.031

Exemptions — Use by artistic or cultural organizations of certain objects.

The provisions of this chapter shall not apply in respect to the use by artistic or cultural organizations of:

(1) Objects of art;

(2) Objects of cultural value;

(3) Objects to be used in the creation of a work of art, other than tools; or

(4) Objects to be used in displaying art objects or presenting artistic or cultural exhibitions or performances.

[1981 c 140 § 5.]

RCW 82.04.4328

"Artistic or cultural organization" defined.

(1) For the purposes of RCW 82.04.4322, 82.04.4324, 82.04.4326, 82.04.4327, 82.08.031, and 82.12.031, the term "artistic or cultural organization" means an organization which is organized and operated exclusively for the purpose of providing artistic or cultural exhibitions, presentations, or

performances or cultural or art education programs, as defined in subsection (2) of this section, for viewing or attendance by the general public. The organization must be a not-for-profit corporation under chapter 24.03 RCW and managed by a governing board of not less than eight individuals none of whom is a paid employee of the organization or by a corporation sole under chapter 24.12 RCW. In addition, to qualify for deduction or exemption from taxation under RCW 82.04.4322, 82.04.4324, 82.04.4326, 82.04.4327, 82.08.031, and 82.12.031, the corporation shall satisfy the following conditions:

(a) No part of its income may be paid directly or indirectly to its members, stockholders, officers, directors, or trustees except in the form of services rendered by the corporation in accordance with its purposes and bylaws;

(b) Salary or compensation paid to its officers and executives must be only for actual services rendered, and at levels comparable to the salary or compensation of like positions within the state;

(c) Assets of the corporation must be irrevocably dedicated to the activities for which the exemption is granted and, on the liquidation, dissolution, or abandonment by the corporation, may not inure directly or indirectly to the benefit of any member or individual except a nonprofit organization, association, or corporation which also would be entitled to the exemption;

(d) The corporation must be duly licensed or certified when licensing or certification is required by law or regulation;

(e) The amounts received that qualify for exemption must be used for the activities for which the exemption is granted;

(f) Services must be available regardless of race, color, national origin, or ancestry; and

(g) The director of revenue shall have access to its books in order to determine whether the corporation is exempt from taxes.

(2) The term "artistic or cultural exhibitions, presentations, or performances or cultural or art education programs" includes and is limited to:

(a) An exhibition or presentation of works of art or objects of cultural or historical significance, such as those commonly displayed in art or history museums;

(b) A musical or dramatic performance or series of performances; or

(c) An educational seminar or program, or series of such programs, offered by the organization to the general public on an artistic, cultural, or historical subject.

[1985 c 471 § 7; 1981 c 140 § 6.]

WAC 458-20-249

Artistic or cultural organizations.

For purposes of business and occupation tax deduction and certain retail sales tax and use tax exemptions, RCW 82.04.4328 expressly defines the term "artistic or cultural organizations" in pertinent part as follows:

". . . the term "artistic or cultural organization" means an organization which is organized and operated exclusively for the purpose of providing artistic or cultural exhibitions, presentations, or performances or cultural or art education programs, . . . for viewing or attendance by the general public. The organization must be a not-for-profit corporation under chapter 24.03 RCW and managed by a governing board of not less than eight individuals none of whom is a paid employee of the organization or by a corporation sole under chapter 24.12 RCW. In addition, to qualify for deduction or exemption from taxation . . . the corporation shall satisfy the following conditions:

(a) No part of its income may be paid directly or indirectly to its members, stockholders, officers, directors, or trustees except in the form of services rendered by the corporation in accordance with its purposes and bylaws;

(b) Salary or compensation paid to its officers and executives must be only for actual services rendered, and at levels comparable to the salary or compensation of like positions within the state;

(c) Assets of the corporation must be irrevocably dedicated to the activities for which the exemption is granted and, on the liquidation, dissolution, or abandonment by the corporation, may not inure directly or indirectly to the benefit of any member or individual except a nonprofit organization, association, or corporation which also would be entitled to the exemption;

(d) The corporation must be duly licensed or certified when licensing or certification is required by law or regulation;

(e) The amounts received that qualify for exemption must be used for the activities for which the exemption is granted;

(f) Services must be available regardless of race, color, national origin, or ancestry; and

(g) The director of revenue shall have access to its books in order to determine whether the corporation is exempt from taxes.

(2) The term "artistic or cultural exhibitions, presentations, or performances or cultural or art education programs" includes and is limited to:

(a) An exhibition or presentation of works of art or objects of cultural or historical significance, such as those commonly displayed in art or history museums;

(b) A musical or dramatic performance or series of performances; or

(c) An educational seminar or program, or series of such programs, offered by the organization to the general public on an artistic, cultural, or historical subject."

Effective July 1, 1985, artistic or cultural organizations, as defined herein, are not subject to business and occupation tax upon amounts derived from conducting any business activities whatever. Formerly, a business and occupation tax deduction was available only for amounts received by such organizations from the United States and its instrumentalities or the state and local government entities (RCW 82.04.4322); certain manufacturing activities (RCW 82.04.4324); and tuition fees for artistic or cultural education programs (RCW 82.04.4326). Under current law, however, the deduction is unrestricted and applies to all activities conducted by such qualifying organizations.

Retail Sales Tax

Artistic or cultural organizations which make any charges for goods or services which are included in the definition of "retail sale" under RCW 82.04.050, must collect and report the retail sales tax thereon. No sales tax exemption is available for sales by such organizations.

Such organizations are exempt of paying retail sales tax upon their purchases of certain "objects" for the purpose of exhibition or presentation to the general public if the objects are:

(1) Objects of art;

(2) Objects of cultural value;

(3) Objects to be used in the creation of a work of art, other than tools; or

(4) Objects to be used in displaying art objects or presenting artistic or cultural exhibitions or performances. (RCW 82.08.031)

The term "objects" is deemed to mean items of tangible personal property. It does not include professional or commercial services rendered by third parties. Where, however, certain services are performed which are merely incidental to sales of tangible personal property, e.g., designing playbills or altering stage curtains which are then sold to qualifying organizations, the total charge therefore will be exempt.

Charges for materials, equipment, and services related to repair, maintenance, or replacement of buildings or structures are not exempt. Thus, e.g., theater seats, aisle carpeting, air conditioning systems, painting of interior or exterior of buildings, and the like are not tax exempt "objects."

Under Washington law exempt sales include rentals of exempt objects.

Examples of objects which may be purchased by qualifying artistic or cultural organizations without payment of retail sales tax are:

a) Tickets, programs, signs, posters, fliers, and playbills printed for particular displays or performances; scenery, costumes, stage, props, scrims, and materials for their construction;

b) Stage lights, filters, control panels, color medium, stage drapes, sets, set paint, gallery exhibition materials, risers, display platforms, and materials for their construction;

c) Sheet music, recordings, musical instruments and musical supplies for the staging of displays and performances;

d) Movie projectors, films, sound systems, video and sound equipment and supplies and computer hardware and standard, prewritten software directly used exclusively in the staging of performances or actual display of art objects.

Examples of objects which may be purchased by qualifying artistic or cultural organizations, upon which the retail sales tax must be paid are:

a) Supplies and equipment for clerical support, including bulk tickets for general use, stationery, typewriters, copy machines, and general office supplies;

b) Theater seats, lobby furniture, carpeting, vending machines, and general supplies for audience or patrons' convenience and use;

c) Shipping and packing materials, crates, boxes, dunnage, labels, tags, and container-related items for transfer or storage of exempt objects;

d) Sewing machines and other durable equipment used to prepare, repair, and maintain exempt objects (such items are deemed to be "tools," rather than exempt objects);

e) Theater or building lighting and utility fixtures and systems, and computer hardware and software not directly and exclusively used in staging performances or actually displaying art objects.

Qualified artistic and cultural organizations may obtain the tax exemptions by providing their suppliers with a written statement in essentially the following form:

> I, (buyer's name) , hereby confirm that the items purchased on (date of purchase) , without payment of retail sales tax, from (seller's name) are all objects of art or cultural value or to be used in the creation of such objects or in displaying art objects or presenting artistic or cultural exhibitions or performances.
>
> (signature of authorized purchaser)
>
> for: (name of organization)
>
> (registration no. of organization)

Vendors who accept such certifications in good faith will be excused from the responsibility of collecting and remitting sales tax on such sales.

Use Tax

Under RCW 82.12.031, the use tax does not apply to the use of any objects for the purposes explained earlier in this rule, and upon which the retail sales tax would be exempt if the objects were purchased in this state. The use tax applies upon all other items of tangible personal property used by artistic or cultural organizations upon which retail sales tax has not been paid.

[Statutory Authority: RCW 82.32.300. 86-07-006 (Order ET 86-4), § 458-20-249, filed 3/6/86.]

Fishing Boat Fuel (Sales and Use Tax)

RCW 82.08.0298

Exemptions — sales of diesel fuel for use in operating watercraft in commercial deep sea fishing or commercial passenger fishing boat operations outside the state.

The tax levied by RCW 82.08.020 shall not apply to sales of diesel fuel for use in the operation of watercraft in commercial deep sea fishing operations or commercial passenger fishing boat operations by persons who are regularly engaged in the business of commercial deep sea fishing or commercial passenger fishing boat operations outside the territorial waters of this state.

For purposes of this section, a person is not regularly engaged in the business of commercial deep sea fishing or the operation of a commercial passenger fishing boat if the person has gross receipts from these operations of less than five thousand dollars a year.

[1987 c 494 § 1.]

RCW 82.12.0298

Exemptions — use of diesel fuel in operating watercraft in commercial deep sea fishing or commercial passenger fishing boat operations outside the state.

The provisions of this chapter shall not apply with respect to the use of diesel fuel in the operation of watercraft in commercial deep sea fishing operations or commercial passenger fishing boat operations by persons who are regularly engaged in the business of commercial deep sea fishing or commercial passenger fishing boat operations outside the territorial waters of this state.

For purposes of this section, a person is not regularly engaged in the business of commercial deep sea fishing or the operation of a commercial passenger fishing boat if the person has gross receipts from these operations of less than five thousand dollars a year.

[1987 c 494 § 2.]

Fuel Used in Commercial Vessels (B&O Tax)

RCW 82.04.433

Deductions — sales of fuel for consumption outside united states' waters by vessels in foreign commerce.

(1) In computing tax there may be deducted from the measure of tax imposed under RCW 82.04.250 and 82.04.270 amounts derived from sales of fuel for consumption outside the territorial waters of the United States, by vessels used primarily in foreign commerce.

(2) The deduction in subsection (1) of this section does not apply with respect to the tax imposed under RCW 82.04.240, whether the value of the fuel under that tax is measured by the gross proceeds derived from the sale thereof or otherwise under RCW 82.04.450.

[2009 c 494 § 2; 1985 c 471 § 16.]

Nonprofit Youth Recreation Services and Local Government Physical Fitness Classes (Sales and Use Tax)

RCW 82.08.0291

Exemptions — Sales of amusement and recreation services or personal services by nonprofit youth organization — Local government physical fitness classes.

The tax imposed by RCW 82.08.020 shall not apply to the sale of amusement and recreation services, or personal services specified in RCW 82.04.050(3)(g), by a nonprofit youth organization, as defined in RCW 82.04.4271, to members of the organization; nor shall the tax apply to physical fitness classes provided by a local government.

[2000 c 103 § 8; 1994 c 85 § 1; 1981 c 74 § 2.]

RCW 82.12.02917

Exemptions — Use of amusement and recreation services by nonprofit youth organization.

The provisions of this chapter shall not apply in respect to the use of amusement and recreation services by a nonprofit youth organization, as defined in RCW 82.04.4271, to members of the organization.

[1999 c 358 § 7.]

Retailing (B&O Tax)

RCW 82.04.250

Tax on retailers.

(1) Upon every person engaging within this state in the business of making sales at retail, except persons taxable as retailers under other provisions of this chapter, as to such persons, the amount of tax with respect to such business is equal to the gross proceeds of sales of the business, multiplied by the rate of 0.471 percent.

(2) Upon every person engaging within this state in the business of making sales at retail that are exempt from the tax imposed under chapter 82.08 RCW by reason of RCW 82.08.0261, 82.08.0262, or 82.08.0263, except persons taxable under *RCW 82.04.260(10) or subsection (3) of this section, as to such persons, the amount of tax with respect to such business is equal to the gross proceeds of sales of the business, multiplied by the rate of 0.484 percent.

(3) Until July 1, 2024, upon every person classified by the federal aviation administration as a federal aviation regulation part 145 certificated repair station and that is engaging within this state in the business of making sales at retail that are exempt from the tax imposed under chapter 82.08 RCW by reason of RCW 82.08.0261, 82.08.0262, or 82.08.0263, as to such persons, the amount of tax with respect to such business is equal to the gross proceeds of sales of the business, multiplied by the rate of .2904 percent.

[2010 1st sp.s. c 23 § 509; (2010 1st sp.s. c 23 § 508 expired July 1, 2011); (2010 1st sp.s. c 23 § 507 expired July 13, 2010); 2010 1st sp.s. c 11 § 1; (2010 c 114 § 106 expired July 1, 2011); 2008 c 81 § 5; (2007 c 54 § 5 repealed by 2010 1st sp.s. c 11 § 7); 2006 c 177 § 5; 2003 2nd sp.s. c 1 § 2; (2003 1st sp.s. c 2 § 1 expired July 1, 2006). Prior: 1998 c 343 § 5; 1998 c 312 § 4; 1993 sp.s. c 25 § 103; 1981 c 172 § 2; 1971 ex.s. c 281 § 4; 1971 ex.s. c 186 § 2; 1969 ex.s. c 262 § 35; 1967 ex.s. c 149 § 9; 1961 c 15 § 82.04.250; prior: 1955 c 389 § 45; prior: 1950 ex.s. c 5 § 1, part; 1949 c 228 § 1, part; 1943 c 156 § 1, part; 1941 c 178 § 1, part; 1939 c 225 § 1, part; 1937 c 227 § 1, part; 1935 c 180 § 4, part; Rem. Supp. 1949 § 8370-4, part.]

Rural County and CEZ New Jobs (B&O Tax)

RCW 82.62.030

Allowance of tax credits — Limitations.

(1)(a) A person shall be allowed a credit against the tax due under chapter 82.04 RCW as provided in this section. The credit shall equal: (i) Four thousand dollars for each qualified employment position with wages and benefits greater than forty thousand dollars annually that is directly created in an eligible business project and (ii) two thousand dollars for each qualified

employment position with wages and benefits less than or equal to forty thousand dollars annually that is directly created in an eligible business project.

(b) For purposes of calculating the amount of credit under (a) of this subsection with respect to qualified employment positions as defined in RCW 82.62.010(8)(a)(ii):

(i) In determining the number of qualified employment positions, a fractional amount is rounded down to the nearest whole number; and

(ii) Wages and benefits for each qualified employment position shall be equal to the quotient derived by dividing: (A) The sum of the wages and benefits earned for the four consecutive full calendar quarter period for which a credit under this chapter is earned by all of the person's new seasonal employees hired during that period; by (B) the number of qualified employment positions plus any fractional amount subject to rounding as provided under (b)(i) of this subsection. For purposes of this chapter, a credit is earned for the four consecutive full calendar quarters after the calendar quarter during which the first qualified employment position is filled.

(2) The department shall keep a running total of all credits allowed under this chapter during each fiscal year. The department shall not allow any credits which would cause the total to exceed seven million five hundred thousand dollars in any fiscal year. If all or part of an application for credit is disallowed under this subsection, the disallowed portion shall be carried over to the next fiscal year. However, the carryover into the next fiscal year is only permitted to the extent that the cap for the next fiscal year is not exceeded.

(3) No recipient may use the tax credits to decertify a union or to displace existing jobs in any community in the state.

(4) The credit may be used against any tax due under chapter 82.04 RCW, and may be carried over until used. No refunds may be granted for credits under this section.

[2007 c 485 § 3; 2001 c 320 § 13; 1999 c 164 § 306; 1997 c 366 § 5; 1996 c 1 § 3; 1986 c 116 § 17.]

RCW 82.62.045

Tax credits for eligible business projects in designated community empowerment zones.

(1) For the purposes of this section "eligible area" also means a designated community empowerment zone approved under RCW 43.31C.020.

(2) An eligible business project located within an eligible area as defined in this section qualifies for a credit under this chapter for those employees who at the time of hire are residents of the community empowerment zone in which the project is located, if the fifteen percent threshold is met. As used in this subsection, "resident" means the person makes his or her home in the community empowerment zone. A mailing address alone is insufficient to establish that a person is a resident for the purposes of this section.

(3) All other provisions and eligibility requirements of this chapter apply to applicants eligible under this section.

[2007 c 485 § 4; 1999 c 164 § 307.]

Tree Trimming Under Power Lines (Sales and Use Tax)

RCW 82.04.050

"Sale at retail," "retail sale."

(1)(a) "Sale at retail" or "retail sale" means every sale of tangible personal property (including articles produced, fabricated, or imprinted) to all persons irrespective of the nature of their business and including, among others, without limiting the scope hereof, persons who install, repair, clean, alter, improve, construct, or decorate real or personal property of or for consumers other than a sale to a person who:

(i) Purchases for the purpose of resale as tangible personal property in the regular course of business without intervening use by such person, but a purchase for the purpose of resale by a regional transit authority under RCW 81.112.300 is not a sale for resale; or

(ii) Installs, repairs, cleans, alters, imprints, improves, constructs, or decorates real or personal property of or for consumers, if such tangible personal property becomes an ingredient or component of such real or personal property without intervening use by such person; or

(iii) Purchases for the purpose of consuming the property purchased in producing for sale as a new article of tangible personal property or substance, of which such property becomes an ingredient or component or is a chemical used in processing, when the primary purpose of such chemical is to create a chemical reaction directly through contact with an ingredient of a new article being produced for sale; or

(iv) Purchases for the purpose of consuming the property purchased in producing ferrosilicon which is subsequently used in producing magnesium for sale, if the primary purpose of such property is to create a chemical reaction directly through contact with an ingredient of ferrosilicon; or

(v) Purchases for the purpose of providing the property to consumers as part of competitive telephone service, as defined in RCW 82.04.065; or

(vi) Purchases for the purpose of satisfying the person's obligations under an extended warranty as defined in subsection (7) of this section, if such tangible personal property replaces or becomes an ingredient or component of property covered by the extended warranty without intervening use by such person.

(b) The term includes every sale of tangible personal property that is used or consumed or to be used or consumed in the performance of any activity defined as a "sale at retail" or "retail sale" even though such property is resold or used as provided in (a)(i) through (vi) of this subsection following such use.

(c) The term also means every sale of tangible personal property to persons engaged in any business that is taxable under RCW 82.04.280(1) (a), (b), and (g), 82.04.290, and 82.04.2908.

(2) The term "sale at retail" or "retail sale" includes the sale of or charge made for tangible personal property consumed and/or for labor and services rendered in respect to the following:

(a) The installing, repairing, cleaning, altering, imprinting, or improving of tangible personal property of or for consumers, including charges made for the mere use of facilities in respect thereto, but excluding charges made for the use of self-service laundry facilities, and also excluding sales of laundry service to nonprofit health care facilities, and excluding services rendered in respect to live animals, birds and insects;

(b) The constructing, repairing, decorating, or improving of new or existing buildings or other structures under, upon, or above real property of or for consumers, including the installing or attaching of any article of tangible personal property therein or thereto, whether or not such personal property becomes a part of the realty by virtue of installation, and also includes the sale of services or charges made for the clearing of land and the moving of earth excepting the mere leveling of land used in commercial farming or agriculture;

(c) The constructing, repairing, or improving of any structure upon, above, or under any real property owned by an owner who conveys the property by title, possession, or any other means to the person performing such construction, repair, or improvement for the purpose of performing such construction, repair, or improvement and the property is then reconveyed by title, possession, or any other means to the original owner;

(d) The cleaning, fumigating, razing, or moving of existing buildings or structures, but does not include the charge made for janitorial services; and for purposes of this section the term "janitorial services" means those cleaning and caretaking services ordinarily performed by commercial janitor service businesses including, but not limited to, wall and window washing, floor cleaning and waxing, and the cleaning in place of rugs, drapes and upholstery. The term "janitorial services" does not include painting, papering, repairing, furnace or septic tank cleaning, snow removal or sandblasting;

(e) Automobile towing and similar automotive transportation services, but not in respect to those required to report and pay taxes under chapter 82.16 RCW;

(f) The furnishing of lodging and all other services by a hotel, rooming house, tourist court, motel, trailer camp, and the granting of any similar license to use real property, as distinguished from the renting or leasing of real property, and it is presumed that the occupancy of real property for a continuous period of one month or more constitutes a rental or lease of real property and not a mere license to use or enjoy the same. For the purposes of this subsection, it is presumed that the sale of and charge made for the furnishing of lodging for a continuous period of one month or more to a person is a rental or lease of real property and not a mere license to enjoy the same;

(g) The installing, repairing, altering, or improving of digital goods for consumers;

(h) Persons taxable under (a), (b), (c), (d), (e), (f), and (g) of this subsection when such sales or charges are for property, labor and services which are used or consumed in whole or in part by such persons in the performance of any activity defined as a "sale at retail" or "retail sale" even though such property, labor and services may be resold after such use or consumption. Nothing contained in this subsection may be construed to modify subsection (1) of this section and nothing contained in subsection (1) of this section may be construed to modify this subsection.

(3) The term "sale at retail" or "retail sale" includes the sale of or charge made for personal, business, or professional services including amounts designated as interest, rents, fees, admission, and other service emoluments however designated, received by persons engaging in the following business activities:

(a) Amusement and recreation services including but not limited to golf, pool, billiards, skating, bowling, ski lifts and tows, day trips for sightseeing purposes, and others, when provided to consumers;

(b) Abstract, title insurance, and escrow services;

(c) Credit bureau services;

(d) Automobile parking and storage garage services;

(e) Landscape maintenance and horticultural services but excluding (i) horticultural services provided to farmers and (ii) pruning, trimming, repairing, removing, and clearing of trees and brush near electric transmission or distribution lines or equipment, if performed by or at the direction of an electric utility;

(f) Service charges associated with tickets to professional sporting events; and

(g) The following personal services: Physical fitness services, tanning salon services, tattoo parlor services, steam bath services, turkish bath services, escort services, and dating services.

(4)(a) The term also includes the renting or leasing of tangible personal property to consumers.

(b) The term does not include the renting or leasing of tangible personal property where the lease or rental is for the purpose of sublease or subrent.

(5) The term also includes the providing of "competitive telephone service," "telecommunications service," or "ancillary services," as those terms are defined in RCW 82.04.065, to consumers.

(6)(a) The term also includes the sale of prewritten computer software to a consumer, regardless of the method of delivery to the end user. For purposes of this subsection (6)(a), the sale of prewritten computer software includes the sale of or charge made for a key or an enabling or activation code, where the key or code is required to activate prewritten computer software and put the software into use. There is no separate sale of the key or code from the prewritten computer software, regardless of how the sale may be characterized by the vendor or by the purchaser.

The term "retail sale" does not include the sale of or charge made for:

(i) Custom software; or

(ii) The customization of prewritten computer software.

(b)(i) The term also includes the charge made to consumers for the right to access and use prewritten computer software, where possession of the software is maintained by the seller or a third party, regardless of whether the charge for the service is on a per use, per user, per license, subscription, or some other basis.

(ii)(A) The service described in (b)(i) of this subsection (6) includes the right to access and use prewritten computer software to perform data processing.

(B) For purposes of this subsection (6)(b)(ii), "data processing" means the systematic performance of operations on data to extract the required information in an appropriate form or to convert the data to usable information. Data processing includes check processing, image processing, form processing, survey processing, payroll processing, claim processing, and similar activities.

(7) The term also includes the sale of or charge made for an extended warranty to a consumer. For purposes of this subsection, "extended warranty" means an agreement for a specified duration to perform the replacement or repair of tangible personal property at no additional charge or a reduced charge for tangible personal property, labor, or both, or to provide indemnification for the replacement or repair of tangible personal property, based on the occurrence of specified events. The term "extended warranty" does not include an agreement, otherwise meeting the definition of extended warranty in this subsection, if no separate charge is made for the agreement and the value of the agreement is included in the sales price of the tangible personal property covered by the agreement. For purposes of this subsection, "sales price" has the same meaning as in RCW 82.08.010.

(8)(a) The term also includes the following sales to consumers of digital goods, digital codes, and digital automated services:

(i) Sales in which the seller has granted the purchaser the right of permanent use;

(ii) Sales in which the seller has granted the purchaser a right of use that is less than permanent;

(iii) Sales in which the purchaser is not obligated to make continued payment as a condition of the sale; and

(iv) Sales in which the purchaser is obligated to make continued payment as a condition of the sale.

(b) A retail sale of digital goods, digital codes, or digital automated services under this subsection (8) includes any services provided by the seller exclusively in connection with the digital goods, digital codes, or digital automated services, whether or not a separate charge is made for such services.

(c) For purposes of this subsection, "permanent" means perpetual or for an indefinite or unspecified length of time. A right of permanent use is presumed to have been granted unless the agreement between the seller and the purchaser specifies or the circumstances surrounding the transaction suggest or indicate that the right to use terminates on the occurrence of a condition subsequent.

(9) The term also includes the charge made for providing tangible personal property along with an operator for a fixed or indeterminate period of time. A consideration of this is that the operator is necessary for the tangible personal property to perform as designed. For the purpose of this subsection (9), an operator must do more than maintain, inspect, or set up the tangible personal property.

(10) The term does not include the sale of or charge made for labor and services rendered in respect to the building, repairing, or improving of any street, place, road, highway, easement, right-of-way, mass public transportation terminal or parking facility, bridge, tunnel, or trestle which is

owned by a municipal corporation or political subdivision of the state or by the United States and which is used or to be used primarily for foot or vehicular traffic including mass transportation vehicles of any kind.

(11) The term also does not include sales of chemical sprays or washes to persons for the purpose of postharvest treatment of fruit for the prevention of scald, fungus, mold, or decay, nor does it include sales of feed, seed, seedlings, fertilizer, agents for enhanced pollination including insects such as bees, and spray materials to: (a) Persons who participate in the federal conservation reserve program, the environmental quality incentives program, the wetlands reserve program, and the wildlife habitat incentives program, or their successors administered by the United States department of agriculture; (b) farmers for the purpose of producing for sale any agricultural product; and (c) farmers acting under cooperative habitat development or access contracts with an organization exempt from federal income tax under 26 U.S.C. Sec. 501(c)(3) of the federal internal revenue code or the Washington state department of fish and wildlife to produce or improve wildlife habitat on land that the farmer owns or leases.

(12) The term does not include the sale of or charge made for labor and services rendered in respect to the constructing, repairing, decorating, or improving of new or existing buildings or other structures under, upon, or above real property of or for the United States, any instrumentality thereof, or a county or city housing authority created pursuant to chapter 35.82 RCW, including the installing, or attaching of any article of tangible personal property therein or thereto, whether or not such personal property becomes a part of the realty by virtue of installation. Nor does the term include the sale of services or charges made for the clearing of land and the moving of earth of or for the United States, any instrumentality thereof, or a county or city housing authority. Nor does the term include the sale of services or charges made for cleaning up for the United States, or its instrumentalities, radioactive waste and other by-products of weapons production and nuclear research and development.

(13) The term does not include the sale of or charge made for labor, services, or tangible personal property pursuant to agreements providing maintenance services for bus, rail, or rail fixed guideway equipment when a regional transit authority is the recipient of the labor, services, or tangible personal property, and a transit agency, as defined in RCW 81.104.015, performs the labor or services.

(14) The term does not include the sale for resale of any service described in this section if the sale would otherwise constitute a "sale at retail" and "retail sale" under this section.

[2011 c 174 § 202. Prior: 2010 c 112 § 14; 2010 c 111 § 201; 2010 c 106 § 202; prior: 2009 c 563 § 301; 2009 c 535 § 301; prior: 2007 c 54 § 4; 2007 c 6 § 1004; prior: 2005 c 515 § 2; 2005 c 514 § 101; prior: 2004 c 174 § 3; 2004 c 153 § 407; 2003 c 168 § 104; 2002 c 178 § 1; 2000 2nd sp.s. c 4 § 23; prior: 1998 c 332 § 2; 1998 c 315 § 1; 1998 c 308 § 1; 1998 c 275 § 1; 1997 c 127 § 1; prior: 1996 c 148 § 1; 1996 c 112 § 1; 1995 1st sp.s. c 12 § 2; 1995 c 39 § 2; 1993 sp.s. c 25 § 301; 1988 c 253 § 1; prior: 1987 c 285 § 1; 1987 c 23 § 2; 1986 c 231 § 1; 1983 2nd ex.s. c 3 § 25; 1981 c 144 § 3; 1975 1st ex.s. c 291 § 5; 1975 1st ex.s. c 90 § 1; 1973 1st ex.s. c 145 § 1; 1971 ex.s. c 299 § 3; 1971 ex.s. c 281 § 1; 1970 ex.s. c 8 § 1; prior: 1969 ex.s. c 262 § 30; 1969 ex.s. c 255 § 3; 1967 ex.s. c 149 § 4; 1965 ex.s. c 173 § 1; 1963 c 7 § 1; prior: 1961 ex.s. c 24 § 1; 1961 c 293 § 1; 1961 c 15 § 82.04.050; prior: 1959 ex.s. c 5 § 2; 1957 c 279 § 1; 1955 c 389 § 6; 1953 c 91 § 3; 1951 2nd ex.s. c 28 § 3; 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.]

Use Tax on Rental Value (Use Tax)

RCW 82.12.010

Definitions.

For the purposes of this chapter:

(7)(a) "Value of the article used" is the purchase price for the article of tangible personal property, the use of which is taxable under this chapter. The term also includes, in addition to the purchase price, the amount of any tariff or duty paid with respect to the importation of the article used. In case the article used is acquired by lease or by gift or is extracted, produced, or manufactured by the person using the same or is sold under conditions wherein the purchase price does not represent the true value thereof, the value of the article used is determined as nearly as possible according to the retail selling price at place of use of similar products of like quality and character under such rules as the department may prescribe.

(c) In the case of articles owned by a user engaged in business outside the state which are brought into the state for no more than one hundred eighty days in any period of three hundred sixty-five consecutive days and which are temporarily used for business purposes by the person in this state, the value of the article used must be an amount representing a reasonable rental for the use of the articles, unless the person has paid tax under this chapter or chapter 82.08 RCW upon the full value of the article used, as defined in (a) of this subsection.