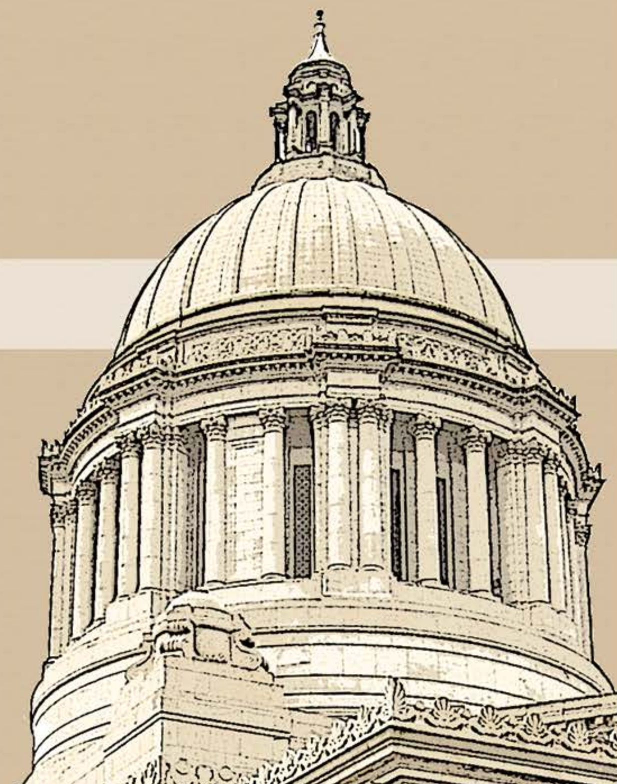
Washington State

Citizen Commission *for* Performance Measurement *of* Tax Preferences

Summary of

2013 Tax Preference Performance Reviews

with Commission Comments



This document provides a summary of the preferences reviewed by JLARC staff in 2013. Preferences related to medical items and services are followed by uncategorized preferences. A descriptive summary is first provided, followed by the public policy objective, estimated beneficiary savings, and the Legislative Auditor's recommendation. This is followed by any comments on the Legislative Auditor's recommendation by the Citizen Commission, adopted at the October 18th meeting.

Summary of 2013 Tax Preference Performance Reviews with Commission Comments from October 18, 2013

<table>
<tr><th>What the Preference Does</th><th>Public Policy Objective</th><th>Est. Beneficiary Savings</th><th>Legislative Auditor Recommendation</th></tr>
<tr><td colspan="4">Preferences Related to Medical Items and Services</td></tr>
<tr><td colspan="4">Government Payments to Public and Nonprofit Hospitals (B&O Tax) / RCW 82.04.4311</td></tr>
<tr><td>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.</td><td>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.</td><td>$162.7 million in the 2015-17 Biennium</td><td>Review and clarify: Because it is unclear why for-profit hospitals that provide government-subsidized health care are excluded from the preference.</td></tr>
<tr><td colspan="4">Commission Comment: The Commission endorses the Legislative Auditor's recommendation but notes that the Legislature has consistently excluded for-profit hospitals from this preference since 1937 and explicitly omitted for-profit hospitals in its statement of purpose when it amended the preference in 2005.

Rationale: The Legislative Auditor observes that although exclusion of for-profit hospitals from this preference has been long-standing, no rationale for their exclusion is included in the legislative record. Only 5 percent of government subsidized payments in 2011 went to for-profit hospitals. Thus, if the preference were extended to for-profit hospitals, the reduction in B&O tax receipts would be small. If the Legislature decides to review this preference, it will need to determine whether extending this preference to for-profit hospitals would result in a public benefit. The Commission received no testimony in support of the Legislative Auditor's recommendation.</td></tr>
<tr><td colspan="4">Health Maintenance Organizations (B&O Tax) / RCW 82.04.322</td></tr>
<tr><td>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.</td><td>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.</td><td>$53.1 million in the 2015-17 Biennium</td><td>Continue: Because it is fulfilling the inferred public policy objective of avoiding double taxation of this income.</td></tr>
<tr><td colspan="4">Commission Comment: Endorse without comment.</td></tr>
</table>

What the Preference Does	Public Policy Objective	Est. Beneficiary Savings	Legislative Auditor Recommendation
Medicare and Basic Health Plan Receipts (Insurance Premium Tax) / RCWs 48.14.0201(6)(a), 48.14.0201(6)(b)			
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.
Endorse without comment.			
Dentistry Prepayments (Insurance Premium Tax) / RCWs 48.14.0201(6)(c)			
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.
Commission Comment: The Commission does not endorse the recommendation of the Legislative Auditor to terminate the exemption from the insurance premium tax for health care service contractors on prepayments received for dentistry services. The Commission recommends that the Legislature review and clarify whether this exemption is serving a broad-based public policy objective. **Rationale:** Based upon its review the Legislature could determine to terminate the dentistry insurance premium tax exemption, continue it, or establish a preferential insurance premium tax rate. While the 1993 law established a temporary exemption, the exemption became permanent when the part of the 1993 law pertaining to Certified Health Plans was repealed in 1995. There is no public record that the Legislature explicitly intended the temporary exemption to become permanent or whether this was simply the outcome of repealing parts of the 1993 law. The Commission received public testimony that argued that this was an intentional, not an accidental, outcome at the time the Legislature revised the law in 1995. While the Legislature did not expressly provide a permanent exemption for all health care service contractors providing prepaid dental services in the Health Care Reform Act originally adopted in 1993, the Legislature clearly intended that the tax preference apply for Limited Certified Health Plans for Dental Services. These original intended beneficiaries of the preference continue to enjoy the benefits of this preference along with health care service contractors that would not have had the benefit of this preference for dentistry services under the original 1993 legislation. The 1995 legislation adopted changes to the statute in its current			

What the Preference Does	Public Policy Objective	Est. Beneficiary Savings	Legislative Auditor Recommendation
form that extended the tax preference to all health care service contractors. The Legislative Auditor inferred that the absence of any specific reference in the 1995 legislation or in the legislative history of an intent to extend the preference to all health care service contractors was, in effect, an oversight and that the Legislature did not intend to provide the tax preference to all health care service contractors. However, the Commission believes the record is inconclusive as to whether the Legislature simply overlooked the fact that the 1995 legislation converted a temporary exemption into a permanent one or whether the Legislature intended to make the exemption permanent. The Affordable Care Act (ACA) and its impact may raise a new issue specific to this tax preference. According to public testimony, the industry is facing a 2% tax (instead of 1.5%) on insurance obtained in the new ACA-mandated insurance exchange. For pediatric dentistry, the higher tax rate is intended to help pay the costs of running the exchange. The industry argued that increasing the tax from 1.5% to 2% (by terminating the tax preference) would lower the amount of dental services provided to vulnerable populations. If this assertion is true, it raises the question of whether the 2% tax on exchange-obtained insurance would result in a similar outcome. The industry did not comment on this possibility. Furthermore, if the Legislature intended this tax preference to be temporary when enacted in 1993, it is possible the tax preference may have had the unintended consequence of increasing the supply of dental services to vulnerable populations. If so, this may have some social-welfare benefits. The Legislature should request the industry to clarify the specific programs that are at risk if the tax preference is terminated. In response to a commission question during public testimony, the industry was either unable or unwilling to comment on specifics about programs at risk. Finally, there is a question of whether program cuts, if they occur, would be mitigated by increased health insurance coverage generated by the ACA exchanges. The Legislature may also wish to consider the disparity of tax treatment between the different types of insurance carriers for dental services. The Commission also received public testimony which indicated that most providers of dentistry services are not-for-profit organizations which engage in substantial public service initiatives. Thus, it is possible that some of the benefits of the tax preference, perhaps a significant portion, are passed on to the public through various educational programs to reduce oral disease and improve overall health.			
Prescription Drug Administration (B&O Tax) / RCW 82.04.620			
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.

<table>
<tr><th>What the Preference Does</th><th>Public Policy Objective</th><th>Est. Beneficiary Savings</th><th>Legislative Auditor Recommendation</th></tr>
<tr><td colspan="4">Commission Comment: The Commission endorses the Legislative Auditor’s recommendation that the Legislature may want to consider adding reporting or other accountability requirements and suggests the Legislature consider how the Affordable Care Act (ACA) impacts incentives to provide services covered by this preference.
Rationale: In light of the Affordable Care Act (ACA), the Legislature may want to track how the ACA impacts incentives to provide the services covered by this preference. Depending on the results of this tracking, alterations in the preference may be appropriate.</td></tr>
<tr><td colspan="4">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</td></tr>
<tr><td>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.</td><td>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.</td><td>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</td><td>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.</td></tr>
<tr><td colspan="4">Commission Comment: Endorse without Comment.</td></tr>
<tr><td colspan="4">Nonprofit Blood and Tissue Banks (B&O Tax, Sales and Use Tax) / RCWs 82.04.324, 82.08.02805, 82.12.02747</td></tr>
<tr><td>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.</td><td>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.</td><td>B&O Tax: $4.7 million in the 2015-17 Biennium
Sales and Use Tax: $17.9 million in the 2015-17 Biennium</td><td>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.</td></tr>
<tr><td colspan="4">Commission Comment: Endorse without comment.</td></tr>
</table>

What the Preference Does	Public Policy Objective	Est. Beneficiary Savings	Legislative Auditor Recommendation
Prescription Drug Resellers (B&O Tax) / RCW 82.04.272			
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.
Commission Comment: The Commission endorses the Legislative Auditor's recommendation to continue the prescription drug resellers preference, but in light of public testimony, the Legislature could consider whether to review this preference. **Rationale:** The Legislative Auditor believes the Legislature's inferred public policy objective for the prescription drug resellers B&O preferential tax rate is 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. But, the preference is also available to drug resellers operating out-of-state warehouses that have nexus. The Commission received testimony questioning the necessity of this preference, but also received testimony indicating that drug reseller employment in the state has grown 182% since the preference was enacted in 1998.			

Summary of 2013 Tax Preference Performance Reviews with Commission Comments from October 18, 2013

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			
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.
Commission Comment: Endorse without comment.			

Summary of 2013 Tax Preference Performance Reviews with Commission Comments from October 18, 2013

What the Preference Does	Public Policy Objective	Est. Beneficiary Savings	Legislative Auditor Recommendation
Fishing Boat Fuel (Sales and Use Tax) / RCWs 82.08.0298, 82.12.0298			
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 vessels engaged in interstate and foreign commerce. In addition, the $5,000 minimum gross receipts level has not been reviewed since 1987.
Commission Comment: The Commission endorses the Legislative Auditor's recommendation and encourages the Legislature to state an explicit public policy objective for this preference and to structure this preference to be consistent with the stated public policy objective. **Rationale:** The Legislative Auditor determined that although the preference removes a possible disincentive for fishing boats to purchase fuel in Washington, 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 boats when compared to tax treatment on fuel for commercial vessels engaged in interstate and foreign commerce. The Legislature should determine whether this preference serves a public policy objective and, if so, structure the preference to align with an explicitly stated objective.			
Fuel Used in Commercial Vessels (B&O Tax) / RCW 82.04.433			
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.
Commission Comment: Endorse without comment.			

What the Preference Does	Public Policy Objective	Est. Beneficiary Savings	Legislative Auditor Recommendation
Nonprofit Youth Recreation Services and Local Government Physical Fitness Classes (Sales and Use Tax) / RCWs 82.08.0291, 82.12.02917			
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.
Commission Comment: Endorse without comment.			
Retailing (B&O Tax) / RCW 82.04.250(1)			
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.
Commission Comment: The Commission endorses the recommendation of the Legislative Auditor for the Legislature to review and clarify the retailing preferential B&O tax rate and encourages the Legislature to examine whether the preferential B&O tax rate should be eliminated or be changed to some other amount. **Rationale:** The Legislative Auditor believes that the inferred public policy objective of establishing a preferential retailing B&O tax rate was to lessen the impact of a sales tax increase in 1983. Currently, this preferential rate is 0.471%, which is not significantly different from the 0.484% B&O tax rate that applies to manufacturing and wholesaling. Thus, elimination of the preferential rate would likely have minimal effect. However, public testimony received by the Commission suggested that the B&O tax rate places a competitive disadvantage on retailers who compete with on-line providers who are not subject to comparable sales tax rates. In its review the Legislature could examine whether there would be broad-based public benefits by revising, rather than eliminating, the preferential B&O tax rate.			

What the Preference Does	Public Policy Objective	Est. Beneficiary Savings	Legislative Auditor Recommendation
Rural County and CEZ New Jobs (B&O Tax) / RCWs 82.62.030, 82.62.045			
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.
Commission Comment: The Commission endorses the Legislative Auditor's recommendation to determine if new jobs are located where the Legislature intended and if the number of new jobs is what the Legislature intended. In its review the Commission recommends that the Legislature consider whether "rural" rather than "distressed" is the appropriate determinant of eligibility and whether the 15% increase in employment requirement is the most appropriate standard for retaining preference benefits. **Rationale:** Shifting this preference's emphasis from "distressed" to "rural" has opened the preference to rural counties with relatively healthy economies. As a result, this may be creating an unnecessary loss of tax revenue. Population density is not a direct measure of economic distress. The Legislature should consider returning to economic measures (as opposed to demographic measures) for defining eligibility. Additionally, under current law, existing firms need to show a 15% increase in employment to retain the tax benefits. It is unclear why a 15% rate is more appropriate than some other rate, such as 10%.			
Tree Trimming Under Power Lines (Sales and Use Tax) / RCW 82.04.050(3)(e)			
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.
Commission Comment: Endorse without comment.			

Summary of 2013 Tax Preference Performance Reviews with Commission Comments from October 18, 2013

What the Preference Does	Public Policy Objective	Est. Beneficiary Savings	Legislative Auditor Recommendation
Use Tax on Rental Value (Use Tax) / RCW 82.12.010(7)(c)			
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.
Commission Comment: Endorse without comment.			