AGENDA

Tax Structure Work Group Meeting – September 21, 2022, 9:00 a.m. – 12:00 p.m.

Virtual meeting via Zoom Webinar

1. **Work Group Members and Presenters**:
    - Only **WORK GROUP MEMBERS** and **PRESENTERS** will be able to enter the event as panelists. All others must enter the event as attendees.
    - Work group members and presenters will be able to enter the Webinar starting at 8:30 a.m.
    - **Panelists via Web:** https://us06web.zoom.us/j/86854270900
    - **Webinar ID:** 868 5427 0900

2. **Meeting Attendees:**
    - **Attendees via Web:** https://us06web.zoom.us/j/86854270900
    - **Webinar ID:** 868 5427 0900

3. **To join by audio or if there are technical computer issues**:
    - Attendees or Panelists via Phone: Dial (253) 215-8782, then enter: 868 5427 0900#

4. **Experiencing Technical Problems?** If you experience technical difficulties on the day of the Zoom Webinar, please contact Pauline Mogilevsky at pmogilevsky@triangleassociates.com or (206) 981-2217.

5. **Other Notes about Zoom Webinar Meeting:** *We encourage you to enter the Zoom Webinar room* ***at least 15 minutes prior to the start of the meeting*** *so we can address any technical issues.* ***To make sure you can connect to the webinar****, please test your system and connections online ASAP at:* *https://zoom.us/test*

6. Tax Structure Work Group Web Page: https://taxworkgroup.org/

7. TVW Recording: The meeting is being recorded and streamed live on TVW: https://www.tvw.org/schedule-main/ and can be viewed at a later time.

How can you participate?

We have allotted a limited amount of time at the end of the agenda for public comment. If you would like to provide a public comment, please send us your name and organization via the email: info@taxworkgroup.org

	Tax Structure Work Group Members
☐	Representative Noel Frame, Co-Chair
☐	Senator Keith Wagoner, Co-Chair
☐	Senator Joe Nguyen
☐	Senator Lisa Wellman
☐	Senator Phil Fortunato
☐	Representative Ed Orcutt
☐	Representative Pat Sullivan
☐	Representative Jesse Young
☐	Derek Young, Councilmember, Pierce County
☐	Scott Merriman, Legislative Liaison, Office of Financial Management
☐	Dean Carlson, Senior Tax Policy Coordinator, Department of Revenue
☐	Anne McEnerny-Ogle, Mayor, City of Vancouver

No	Agenda Item	Time	Lead	Meeting Instructions
Pre	Optional Technology Practice Session	8:30 – 8:50 a.m. (20 minutes)	Sophie Glass, Triangle Associates	• TSWG members and presenters are encouraged to sign on as early as 8:30 a.m. to make sure they can join the Zoom Webinar, test audio and video, etc. • TSWG members can drop in to ensure they are comfortable with Mentimeter polling technology.
1	Introductions and Meeting Overview	9:00 – 9:10 a.m. (10 minutes)	Rep. Frame and Sen. Wagoner Facilitator Sophie Glass, Triangle Associates	• Co-Chairs to call the meeting to order. • Facilitator conducts a roll call of work group members. (Please unmute when your name is called to acknowledge you are on the line and then re-mute yourself.) • Overview of technical ground rules. • Overview of meeting agenda. • Any member of the public who wants to provide public comment should email info@taxworkgroup.org your name and organization by 11:15 a.m. The public may also send any questions or comments regarding any of the topics covered during today's meeting to the above email. • Overview of meeting purpose and timeline.

No	Agenda Item	Time	Lead	Meeting Instructions
2	Engagement Updates	9:10 – 9:20 a.m. (10 minutes)	Riham Hashi, Triangle Associates	• Update on approach and next steps for circling back with community members who participated in the engagement process.

3	Provide Guidance to DOR on Policy Proposal Development	9:20 – 10:20 a.m.
		(60 minutes)
			Facilitator Sophie Glass and Morgan Shook, ECONorthwest
			
			Kathy Oline, DOR
				• DOR provides an overview of questions for TSWG consideration related to the:
				  ○ Margins tax (page)
				  ○ Working Families Tax Credit
				• TSWG discusses and voting members provide direction/responses to DOR via anonymous Mentimeter polling.

4	Break	10:20 – 10:30 a.m. (10 minutes)		

5	Provide Guidance to DOR on Policy Proposal Development (continued)	10:30 – 11:30 a.m.
		(60 minutes)
			Facilitator Sophie Glass and Morgan Shook, ECONorthwest
			
			Kathy Oline, DOR
				• DOR provides an overview of questions for TSWG consideration related to the:
				  • Primary residence property tax exemption/renters' credit (page)
				  • Wealth tax
				  • Property tax limit factor (page)
				• TSWG discusses and voting members provide direction/responses to DOR via anonymous Mentimeter polling.

7	Public Comment / Testimony	11:30 – 11:50 a.m. (20 minutes)	Attendees Facilitator Sophie Glass	• Any member of the public who wants to provide public comment should email info@taxworkgroup.org with your name and organization by 11:15 a.m. • Commenters will have up to three minutes to provide comments and may only be extended at the discretion of the Co-Chairs.
8	Wrap Up and Summary of Action Items	11:50 a.m. – 12:00 p.m. (10 minutes)	Rep. Frame and Sen. Wagoner Facilitator Sophie Glass	• Co-Chairs provide closing remarks. • Summary of action items and next steps.

Replace the B&O Tax with a Margin Tax

Draft v. 9-16-22

Under a margin tax, businesses are taxed on their margin, which is generally calculated as gross receipts minus the greater of the following:

- Compensation paid,
- Cost of goods sold,
- A fixed percentage of gross receipts, or
- A flat amount (i.e., $1 million).

The Department's model

The margin tax model created by the Department of Revenue uses data from the IRS and the Department to estimate the revenue expected to be generated (under the assumption of revenue neutrality) if Washington State were to replace the business and occupation (B&O) Tax with a margin tax.

The model assumes that each taxpayer will select the largest of the four standard deductions (i.e., compensation paid, cost of goods sold, 30% of gross receipts, or $1 million) to determine its pre-apportioned taxable margin.

Possible approaches

The Department has determined that there are two potential approaches to developing a proposal for the compensation paid and cost of goods sold deductions. We could:

1. Use the IRS's method of calculating the compensation and cost of goods sold deductions as a guide, or
2. Use Texas's method in developing custom definitions for the compensation and cost of goods sold deductions.

We outline and compare the two methods for each deduction below.

Compensation paid deduction

IRS method background

For Federal income tax withholding purposes, the term "wages" is defined in IRC section 3401(a) as all remuneration for services performed by an employee for his employer, with certain specific exceptions.

Employers use Form W-2 to report:

- Wages, tips, and other compensation paid to an employee, including some but not all stock-based compensation.
- Income and social security taxes withheld.
- Information regarding deductible benefits, etc.

Partners or other owners of pass-through entities are not employees and do not receive a Form W-2. The pass-through entity must furnish copies of Schedule K-1 for Forms 1065 or 1120-S to each partner. Each partner reports their share of the partnership's income or loss on their personal tax return.

Form 1099-MISC and Form 1099-NEC are used to report payments to independent contractors and other non-employees, including corporate directors.

Considerations

- Taxpayers will already be familiar with W-2 wages.
- Using the IRS forms would be easier to administer and audit for the Department.
- Not allowing wages outside of W-2 wages might make the compensation deduction less attractive.

Texas method background

The Texas compensation deduction includes:

- W-2 wages and cash compensation paid to officers, directors, owners, partners, and employees.
- Benefits provided to all personnel to the extent deductible for federal income tax purposes, including workers' compensation, health care and retirement benefits.
- The net distributive income from entities treated as partnerships for federal tax purposes and LLCs treated as either S-Corps or sole proprietors for federal income tax purposes. Such income is not included on Form W-2, nor is it considered wages under IRC 3401. Generally, such distributions would be included on Schedule K-1 for Forms 1065 or 1120-S.
- Fees paid to directors of the business. These fees are not generally included on Form W-2. They would normally be included in Form 1099.
- Stock awards and stock options deducted for IRS purposes, to the extent not included in W-2 wages.

Texas imposes a wage limitation on W-2 wages and cash compensation paid to officers, directors, owners, partners, and employees. The wage limitation is adjusted each even-numbered year using the consumer price index. The limitation is $400,000 per person for reports due in 2022 and 2023.

Considerations

- Allowing wages outside of W-2 wages makes the compensation deduction more attractive.
- Including wages outside of W-2 wages increases complexity.
- Capping the deduction keeps businesses from claiming higher than expected compensation deductions.
- Capping the compensation deduction might make the deduction less attractive.

The Department's model

With respect to compensation, the model assumes salaries and wages as reported on the underlying IRS forms (i.e., 1120, 1120-S, and 1065) along with an option to include benefits (i.e., pensions, profit sharing plans, and employee benefit programs). This model does not assume that businesses would be allowed to deduct compensation paid to contractors, which would be reported on IRS Form 1099. Additionally, the model does not assume the definition of compensation used under the Texas franchise tax and therefore does not cap compensation to an inflation-adjusted amount of $400,000 per employee.

Decisions requested

The table below includes items we need a decision on for proposal development.

Decision	Options	Department Recommendation
How should Washington calculate the compensation paid deduction?	• Limit the deduction to IRS W-2 wages • Create a Washington definition of compensation	**The Department recommends using the IRS W-2 wages.** Limiting the compensation deduction will help keep rates low and reduce the complexity.
Should Washington allow contractor compensation to qualify for the compensation deduction?	• Allow contractor compensation • Do not allow contractor compensation	**The Department recommends not allowing a deduction for contractor compensation.** This might incentivize businesses to use more contractors rather than employees earning W-2 wages.
Should Washington cap the per employee compensation deduction?	• Cap the deduction to a set amount (i.e., $400,000) • Do not cap the deduction	**The Department does not have a recommendation.** Limiting the compensation deduction with a per employee cap will help keep rates lower.
Should Washington limit the compensation deduction to a certain percentage of possible compensation costs?	• Cap the deduction at a certain percentage (i.e., 35%) of compensation costs • Do not cap the deduction at a certain percentage of compensation costs	**The Department does not have a recommendation.** Limiting the compensation deduction with a percentage cap will help keep rates lower.

Cost of goods sold deduction

IRS method background

The IRS allows businesses that manufacture products or purchase them for resale, to deduct cost of goods sold. If an expense is included in the cost of goods sold, it cannot be deducted again as a business expense. Corporations and partnerships use Form 1125A to calculate their cost of goods sold. Sole proprietors calculate cost of goods sold on Schedule C.

Generally, the IRS calculates cost of goods sold as follows:

Inventory at the beginning of the year.
+ Add purchases.
+ Add labor costs that are a necessary part of the manufacturing process.
+ Add other costs incurred in the manufacturing process, such as packaging, freight-in and overhead expenses allocable to the manufacturing operation.
− Subtract inventory at the end of the year.

Considerations

- Taxpayers will already be familiar with how they calculate cost of goods sold for IRS purposes.
- The IRS calculation is easier to administer and audit for the Department and reduces complexity for businesses.
- Taxpayers may be able to manipulate what is included in the cost of goods sold amount reported on the IRS return. For IRS reporting purposes, taxpayers are simply trying to arrive at net income. Therefore, the IRS does not appear to strictly regulate which expenses are included in cost of goods sold.
- The calculation is narrower than Texas's definition and may exclude many businesses from being able to claim a cost of goods sold deduction.
- Does not allow businesses to deduct labor costs related to acquiring goods, only the labor costs related to the production of goods.

Texas method background

Texas allows entities that sell real property, tangible personal property and digital products in the ordinary course of business to claim a cost of goods sold deduction. Texas has also expanded its definition of cost of goods sold to allow certain service providers to claim a cost of goods sold deduction, including construction contractors, movie theaters, restaurants, oil change service providers, and others. Texas does not use the IRS cost of goods sold calculation. Texas created its own definition but generally allows expenses that are capitalized for federal tax purposes.

Unlike the IRS, Texas details all allowable costs under Texas's definition of cost of goods sold. Texas's definition of cost of goods sold is broader than the IRS' because it allows businesses to deduct costs for both producing and acquiring goods. Specifically, Texas includes the following costs to the extent they are allocable to acquiring or producing goods:

- Labor costs including W-2 wages, contractor compensation, temporary labor, payroll taxes and benefits.
- Costs attributable to processing, assembling, repackaging, storing, warehousing and inbound transportation.
- Indirect costs subject to IRS capitalization rules.

Considerations

- Using Texas's approach gives Washington more flexibility to specifically define which costs qualify.
- Allows retailers and wholesalers, in addition to manufacturers, to deduct qualifying labor costs, because businesses can deduct the costs of producing or acquiring goods.

- Allows service businesses who sell or provide tangible personal property while performing their services to claim a cost of goods sold deduction.
- Texas has found their definition of cost of goods sold to be difficult to administer.
- A broader definition increases complexity and makes it more difficult for both taxpayers and the Department to determine which labor costs qualify.
- Determining allowable costs for digital products increases complexity as technology changes rapidly.

The Department's model

With respect to cost of goods sold, the model uses the cost of goods sold reported on the underlying IRS forms (i.e., 1120, 1120S, and 1065). This does not assume the Texas definition of cost of goods sold which includes certain adjustments based on the nature of the business activity (e.g., the cost incurred for production versus acquisition).

Decisions requested

The table below includes items we need a decision on for proposal development.

Decision	Options	Department Recommendation
How will Washington calculate cost of goods sold?	• Start with the IRS cost of goods sold calculation • Create a Washington definition of cost of goods sold	**The Department recommends starting with the IRS cost of goods sold calculation.** Limiting the cost of goods sold deduction will help keep rates lower and reduce the complexity.
Should Washington limit the cost of goods sold deduction to a certain percentage of possible cost of goods sold?	• Cap the deduction at a certain percentage (i.e., 35%) of cost of goods sold • Do not cap the deduction at a certain percentage of cost of goods sold	**The Department does not have a recommendation.** Limiting the cost of goods sold deduction with a percentage cap would help keep rates lower.

Department of Revenue Washington State

Possible Options

September 16, 2022

Primary Residence Property Tax Exemption & Renters' Refund Programs

Introduction

This document summarizes possible options and considerations for property tax relief in the form of:

- A primary residence property tax exemption.
- A corresponding renters' credit or refund.

Note: The exemption and credit/refund only apply to the state school levies' portions of the property taxes.

Primary Residence Property Tax Exemption (PRPTE)

PRPTE—Option 1 ("No-shift" PT exemption local application, state administration)

Option 1: Locally administered $250,000 assessed value PRPTE

A "no-shift" PRPTE up to the first $250,000 of assessed value to be administered locally by county assessors and treasurers.

Under a "no-shift" PRPTE, the assessed value remains within the state's total assessed value for purposes of calculating levy rates. However, the tax rate does not apply to the exempted value.

Administration

- Requires property owners to apply to their local county assessor.
- Applicants sign an attestation that the property is their primary residence and they have not applied for the exemption on another property in Washington.
- Counties provide the state agency responsible for administration (state) a list of all applicants. The state will verify eligibility and conduct audits.

Benefits

- Reduces the implementation time by avoiding the need to create a new stand-alone computer system that would be necessary to administer a refund program.
- Provides county assessors and treasurers with the ability to show the tax savings on each property owner's annual property tax statement which is an administrative capability they previously requested.
- Places the responsibility of verifying eligibility and conducting audits on the state, not the local county assessors.
- Allows counties to request additional staff needed to accept applications and calculate exemptions.

Challenges

- Enacting a constitutional amendment to avoid uniformity issues.
- Providing funding for the county assessors to increase the staffing they will need to process the applications.
  - If a PRPTE were to pass, there could be approximately 1.8 million applications statewide, based on 2021 legislation (HB 1494).
- Gathering the data necessary to verify primary residency requirements. There is no statewide use code for primary residence.
- Calculating the state school levies in a timely manner.
- Adding an additional layer of complexity to an already complex levy calculation process.
- Increasing appeals for assessors at the county board of equalization due to denied applications.

PRPTE—Option 2 (Refund of property tax paid administered by state)

Option 2: PRPTE in the form of a refund equivalent to $250,000 of assessed value

Create a program in the form of a refund equivalent to PRPTE up to $250,000 of assessed value to be administered by the state.

Benefits

- Centralizes the entire PRPTE benefit amount.
- Reduces the risk of participants claiming more than one refund or refunds on nonowner-occupied residences (rental property and vacation homes).
- Alleviates the need to revise the existing levy process at the county or state level, since any property valuation and rate setting processes are unaffected.
- Increases transparency regarding the amount of the property tax savings to individual property owners by administering the exemption in the form of a refund.
- Assists with fiscal note requests and studies to the Legislature by providing the state direct access to county assessment data with the addition of the new centralized computer system needed for the state to verify ownership and assessment data at the county level in order to verify eligibility for a refund.

Challenges

- Enacting a constitutional amendment to avoid a gift of public funds.
- Funding additional employees and the development of a new computer system to process approximately 1.8 million applications each year.
- Funding and contracting for a new separate centralized property tax system for the state to obtain county assessors' data necessary to calculate the exemption and ensure an applicant has not claimed the exemption in more than one county.
- Gathering the data needed to verify the primary residency requirement.
- Requiring property owners to pay their property tax in full in order to receive a refund may be perceived by them and other as bureaucratic.

- Increasing workload for staff from the additional appeals filed by property owners protesting the denial of their refund, likely to be heard as either administrative appeals or appeals before Boards of Tax Appeals.

PRPTE—Option 3 (PT exemption for all residential property administered by locals)

Option 3: $250,000 PRPTE for all residential property

Create a locally administered "no-shift" property tax exemption up to the first $250,000 of assessed value for all residential property in each county – no primary residence requirement.

Benefits

- Reduces significantly the administrative burden on county assessors by eliminating the need to approve applications or verify primary residency, as compared to other options.
- Eases the implementation time needed by county assessors and treasurers by including it in the current levy process, rather than a refund or rebate.
- Provides county assessors and treasurers the information needed to show the amount of tax savings on each property owner's annual property tax statement, which is a capability they previously requested.

Challenges

- Enacting a constitutional amendment to avoid uniformity issues.
- Responding to criticisms that it also benefits owners of second homes (e.g., owners of vacation homes) who are perceived to have more income than many others.
- Responding to criticisms that it also benefits rental property owners, including out of state investors of rental homes, without requiring the tax savings be passed onto tenants.
- Funding to county assessors for additional staffing if needed to administer the exemption program.

Renters' Refund Program

Renters' Refund—Option (Specified dollar amount)

Option: State administered renters' refund – a specified dollar amount

Create a state administered renters' refund program with a specified refund amount equal to the taxes due on up to $250,000 of assessed value. Requires an application to the state. Refund amount could be in tiers, based on ranges in rental amounts paid.

Include a corresponding requirement that landlords annually provide each tenant a Certificate of Rent Paid for the previous calendar year and that renters applying for the refund provide this documentation to the state along with their application.

Benefits

- Centralizes the refund program with the state, rather than local jurisdictions.
- Provides transparent tax benefit for individuals receiving refunds.

Challenges

- Requires enactment of a constitutional amendment to avoid a gift of public funds.
- Requires the implementation of a significant computer system for processing applications and paying refund amounts.
- Requires extensive staffing to approve approximately 800,000 – 1 million applications each year.
- Requires that landlords provide each tenant a Certificate of Rent Paid, which the landlords may say is too burdensome.
- Increases workload for staff from the appeals filed by renters protesting the denial of their refund, likely to be heard as administrative appeals.

Property Tax Limit Factor

Draft v. 9-16-22

Background:

Washington law limits levy increases to the levy growth limits, often referred to as the "101% levy limit" or the "1% growth limit," plus an increase in levy capacity by additional amounts for the following add-ons:

- New construction;
- Construction of wind turbine, solar, biomass, and geothermal facilities;
- Improvements to property; and
- Increased value of state-assessed property.

The inflation rate is calculated as the percentage change in the implicit price deflator (IPD) for personal consumption expenditures as published by the Bureau of Economic Analysis.

The limit factor is calculated as:

- For lower-population taxing districts (fewer than 10,000 residents), 101%;
- For higher-population districts, the lesser of 101% or 100% plus inflation; or
- For taxing districts who adopt a substantial need resolution (authorized under RCW 84.55.0101), up to 101% if the IPD is less than 1%.

"Prorationing" means the process of determining which taxing districts must reduce levies and by how much. This occurs because in addition to the limit factor, state and local levies are subject to a constitutional 1% limit on the total property tax levied on a particular property. Total local levies on a property also cannot exceed $5.90 per $1,000 of value. Whenever one of these limits is reached some junior taxing districts may be required to reduce or eliminate their property tax levies.

Concept modeled in 2020:

Changes the "limit factor" for the state levy to 100% plus the change in state population and inflation. If population decreases, then the population change is set to zero when calculating the limit factor. The modeling assumes increases in levy capacity for add-ons such as new construction will continue.

What we need from you:
The table below includes the item we need a **decision** on for proposal development.

Decision	Options	Considerations/Recommendation
Should we set a minimum limit? ***Decision needed by September***	• Yes, negative growth stays at zero • No	Setting limits could avoid large revenue swings. **Recommend setting minimum limit.**
Should we set a maximum limit? ***Decision needed by September***	• Yes, cap growth • No	Setting limits could avoid large revenue swings. **Recommend setting maximum limit.**