

## Responses to Questions Raised Regarding Incremental Alternatives

### **Remove sales tax from construction services**

This proposal would take sales tax off of the total amount charged by construction contractors and put it onto the purchase by contractors of materials incorporated into the structure.

- Currently, custom home contractors (and other contractors working for the landowner) do not pay sales tax at the time of purchase of materials, such as lumber, nails, and sheetrock, which are incorporated into the home.
- Contractors now charge sales tax to the customer on the total selling price (the contract price) of the completed home.
- Speculative contractors building on their own land now pay sales tax on materials.
- This proposal would require that all contractors pay sales tax on materials at the time they purchase them.
- Sales tax would be removed from the final contract price of the completed home.
- This would make the taxation of construction more consistent with the practices of other states.
- The removal of sales tax on the labor component of construction would make homes less expensive to purchase.
- This proposal would increase compliance with sales tax liability by requiring all sales tax to be paid "up front." The Department of Revenue's 1996 Tax Compliance Study showed sales tax compliance to be more troublesome for construction contractors than for any other industry. It is complex for contractors performing both custom and speculative work to differentiate from taxable and exempt purchases and remit the appropriate sales tax after purchases are made. Many small construction companies have unsophisticated record-keeping procedures which make this particularly difficult.

The Committee raised questions about the effects of this proposal on manufactured housing and remodeling.

- This proposal would not affect the tax liability of persons who manufacture homes. These persons would still be considered manufacturers for both B&O and sales tax liability.
- Persons who manufacture housing pay manufacturing B&O and are not required to pay sales tax at the time of purchase on any materials purchased that are incorporated into the manufactured home.
- Persons buying new manufactured housing pay sales tax on the total purchase price.
- All construction, whether an entire custom home or a remodel job, is currently subject to the sales tax. Under this proposal, persons who remodel or perform other limited construction jobs would pay sales tax on all materials at the time of purchase.

#### *Note:*

This proposal does not affect the manufacturing machinery and equipment (M&E) exemption. Manufacturers are not required to pay the sales or use tax on machinery and equipment used directly in the manufacturing operation. This sales and use tax exemption was enacted in the

mid-1990's to bring Washington into alignment with other states' treatment of M&E. It does not apply to construction activities.

The proposal has an impact on the distressed area and high technology sales and use tax deferrals. Manufacturers in economically distressed areas and high technology businesses engaged in research and development are not required to pay the sales and use tax on certain construction and equipment costs. If construction costs were no longer subject to sales tax, there would be no need to defer tax on the facilities. However, contractors would be paying sales tax on the materials incorporated into the structures so the programs would have to be adjusted to take this into account if the same level of benefit to manufacturers and high technology businesses were to be provided.

It is a policy call for the Legislature and Governor as to which exemptions should be kept and which repealed or allowed to lapse. The Governor has stated he fully supports retention of the M&E exemption.

### **Reform B&O apportionment methods**

This proposal would reform apportionment methods for businesses taxed under the service B&O classification. It is important to note here that this proposal only addresses issues of complexity in the state B&O tax system in regards to apportionment. The Tax Structure Study has also heard concerns from business representatives and local governments regarding the existing discussions over local B&O apportionment issues. This proposal does not affect these issues. The Governor recently said that he would support legislation, developed last year, addressing local B&O issues, including apportionment.

### **Reduce number of B&O tax rates and classifications**

At the request of the committee, the Department of Revenue previously put forward a list of possible incremental adjustments to the current tax structure. One of these was to reduce the number of business and occupation tax rates and classifications.

The Department wishes to withdraw this particular adjustment and replace it with a concept statement. The Department believes in the concept of business and occupation tax simplification, but the specifics need a great deal more development before a concrete proposal can be put forward.

The Department hopes that the committee will support the general idea of a simplified business and occupation tax structure. Such a structure would have many fewer classifications and rates than the current structure. It would have clear definitions of taxable activities with bright line demarcations between the various activities. It would be simpler for businesses to comply and for the Department of Revenue to administer.

### **Eliminate the PUT**

This proposal would shift PUT taxpayers into either the B&O service class @ 1.5% or a newly created B&O utility classification @ 3.8%.

Currently the following tax rates apply to public utilities:

- Water distribution - 5.029%
- Sewer collection - 3.852%
- Power - 3.873%
- Gas distribution - 3.852%
- Telegraph - 3.852%
- Motor transportation - 1.926%
- Railroad / railroad car - 1.926%
- Urban transportation - 0.642%
- Vessels under 65 feet - 0.642%
- Other public service businesses - 1.926%

The Revenue Act of 1935 established the B&O and PUT as separate systems of taxation. At that time, private business and public utilities operated under separate systems of regulation. Utilities were subject to both state and federal regulation of rates and operations. Because these businesses were monopolies, competition was not an issue, allowing for higher rates of tax. Regulators set the rates charged for service and both protected the interests of customers and allowed for a fair return on investment for the utilities. Regulated utilities had their PUT obligation built into the rates charged their customers. State law requires that, for companies serving more than 20,000 customers, the portion of electricity and gas bills attributable to the PUT be separately stated.

Currently, most utilities are no longer regulated by either state or federal agencies. Most utilities operate in a similar manner as private industry. There is no longer the same justification for two separate systems of taxation.

The proposal to eliminate the PUT and to shift utility taxpayers into the B&O system would consolidate these into the existing B&O system. This has already happened with respect to two formerly regulated businesses—telephone service and warehousing.

**Streamlined sales tax**

The value of including a proposal regarding the Streamlined Sales Tax Project would be to provide a statement of support for the principles of administrative simplicity and harmony with other states that are a central goal of this project.

The efforts of the Streamlined project are directly related to the fundamental charge of the Committee: "...to determine how well the current tax structure functions and how it might be changed to better serve the citizens of the state in the 21st century..."

It is necessary to move in this direction if the long-term sustainability of the sales tax system is an established goal. In aid of the existing efforts already under way in the state of Washington for the Streamlined project, this proposal suggests that the Tax Structure Study include an endorsement of the principles and goals of the Streamlined group. As Washington continues with the complex and often difficult process of implementing Streamlined legislation, support from the Tax Structure Study would be helpful.