Washington Tax Incentives: Development Tool or Bait-and-Switch Tactic?

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In this edition of Skookum Tax News, DeLappe examines reporting requirements tied to Washington tax incentives, traps they can pose to the intended beneficiaries, and current legislative efforts to address the requirements' flaws.

Washington enacted "the largest single tax break ever given to a single company by a state"[1] in 2013 to persuade Boeing Co. to build its 777X jet in the state. And in line with a national movement to evaluate incentives' economic development objectives,[2] the aerospace breaks have sparked debate about disclosure of tax savings and tying incentives to the company's in-state workforce.[3] But comparatively little has been said about another side of tax incentives: incentives in which tax savings end up being illusory. In Washington, the two subjects converge on the reporting requirement for many tax incentives.

The reporting requirements are obviously intended to evaluate an incentive's success — a laudable goal that no one questions. But Washington's requirements do not accomplish that objective very well. Moreover, many fail to realize that reporting requirements can eliminate the intended tax savings for otherwise eligible taxpayers. The 2016 legislative session has included proposals to address shortcomings in the current reporting requirements. Efforts to collect more meaningful data to evaluate incentives while reducing the reporting burdens on taxpayers motivates one proposal, while another springs from the recognition that incentives are not a place for bait-and-switch tactics.

I. Background and Shortcomings of Two Reporting Requirements

Over the past dozen years, the Washington State Legislature has imposed a reporting requirement on 32 incentives enacted or extended to promote economic development.[4] Lawmakers first established an annual report requirement (RCW 82.32.534) as part of an aerospace preference package in 2003.[5] They established a different annual survey requirement (RCW 82.32.585) in extending a high-technology preference package in 2004.[6]

Later tax incentives mandated either a report or a survey. Both forms require taxpayers to report job information and data on the incentive, but they differ on most of the data required.[7] Taxpayers have long expressed concerns about the burdens of the two forms, which require significant input from various departments in the company.[8]

One might wonder what the government is doing with all the data taxpayers spend time and money to collect and submit. From a policy perspective, no one suggests giving taxpayers busywork to promote economic development. Unfortunately, some requested data are merely busywork. Even the Joint Legislative Audit and Review Committee (JLARC) — the agency charged with compiling the data in the annual reports and surveys, and reporting it to the Legislature — views some data as unnecessary.[9] Even worse, the Legislature added the survey requirement for incentives

[1]Billy Hamilton, "Big Deal: Shedding More Light on Washington State Tax Breaks," *State Tax Notes*, Feb. 1, 2016, p. 357.

[2]*See, e.g.*, Jennifer A. Zimmerman, "Answering the Critics: A Movement Towards Transparency and Accountability," *IPT Insider*, Feb. 2016, at 5.

[3]*See, e.g.*, *id.*; Paul Jones, "Effort to Link Boeing Incentives to Job Levels Fails Again," *State Tax Notes*, Feb. 15, 2016, p. 474; David Brunori, "Transparency Victory in Washington," *State Tax Notes*, Jan. 18, 2016, p. 215; and Dave Wasson, "Extension of Tax Breaks for Boeing Enacted in Special Session," *State Tax Notes*, Nov. 18, 2013, p. 416.

[4]Washington House Bill Report ESHB 2540, Feb. 16, 2016, p. 2 (*available at* http://app.leg.wa.gov/billinfo/summary.aspx?bill=2540&year=2015).

[5]Washington State Department of Revenue, Report to the Legislature: Recommendations to Update and Improve Annual Surveys and Reports (Dec. 31, 2013) at 1 (*available at* http://dor.wa.gov/docs/reports/annual_survey_and_report.pdf).

[6]*Id.* at 2.

[7]*Id.* at App. B (comparing the contents of the annual report and annual survey).

[8]*Id.* at 2.

[9]*Id.* at 3.

expanded or extended after August 1, 2013, so some taxpayers now have to file both forms.[10] These taxpayers have the unenviable task of collecting and submitting even more data, some of which are unnecessary to the incentive's evaluation.

At the end of 2013, the Department of Revenue recommended that the Legislature simplify the reporting requirements into one form tailored to collect more meaningful data.[11] JLARC similarly submitted recommendations to help lawmakers align reporting requirements with the data needed to measure tax incentives' effectiveness.[12] JLARC Deputy Legislative Auditor John Woolley says that lawmakers now use JLARC's recommendations in drafting new incentives.

The Legislature has yet to implement the DOR's recommendations. But some lawmakers have been trying — most notably Rep. Terry Nealey (R), the House Finance Committee's ranking minority member. This year he introduced HB 2879 to streamline reporting into a single, simpler form and implement the DOR's other 2013 recommendations (one of which is discussed in Trap #1 below). He also introduced HB 2540 to reduce the penalty for missing the reporting requirement (discussed in Trap #2 below).

II. What Happens to Reports and Surveys Taxpayers File?

Here is a behind-the-scenes look at what happens to the data taxpayers report on the incentives, thanks to Woolley and Kristine Rompus, tax policy specialist — legislation and policy at the DOR.

It all begins when the DOR receives the surveys and reports. Absent a timely extension request, taxpayers must file the report or survey by April 30 of the year following the year for which the corresponding incentive was claimed. Approximately 25-30 taxpayers each year request extensions, which extends the deadline 30-90 days.

As soon as the DOR receives the data, its Research and Fiscal Analysis Division starts "scrubbing the data." Many taxpayers complete surveys or reports without needing to, so the department has to weed them out. Other taxpayers complete the information incorrectly when compared with, for example, employee data that the DOR receives from the Employment Security Department (ESD), the state-regulated unemployment insurance system. The DOR sometimes contacts the taxpayer directly to verify the data. The process culminates by December 1 with publication of annual public disclosure reports.[13]

At this time the DOR also sends JLARC a complete set of the scrubbed data. JLARC's task is to determine whether incentives meet their public policy objectives. Woolley emphasizes that tax return data and data reported to ESD lack the granularity necessary for this analysis because only the reports focus on data regarding the incentive instead of companywide data. JLARC focuses on trends over time. But with approximately 180 incentives to evaluate, JLARC's legislative mandate is to evaluate most incentives only once every 10 years.[14] A Citizen Commission for Performance Measurement of Tax Preferences also reviews other incentives — usually smaller ones.[15]

III. Lawmakers Should Address Shortcomings

The information in the public disclosure reports differs depending on whether the taxpayer is filing a survey or report. For surveys, the DOR publishes only the taxpayer, the specific incentive, and the amount of tax incentive received. For reports, the DOR publishes much more, including site and job details, but not the amount of tax incentive received.[16]

The discrepancy on what is public or confidential is illogical. The DOR points out that "similar or identical information is treated inconsistently in the two filings."[17] That is yet another basis for its 2013 recommendation to consolidate the two. Also, scrubbing data for two different filings places another burden on the department, just as reporting on two forms burdens taxpayers. According to Rompus, consolidating the filings into a single form would ease the burden on the DOR and taxpayers alike.

Despite agreement between taxpayers and tax authorities on that, lawmakers have yet to pass a law streamlining the filings. Nealey, who said his goal is to reduce regulatory burdens on business, proposed HB 2879 this session to do precisely that. Despite support from the Association of Washington Business (AWB), many apparently did not understand the bill and failed to provide adequate support. Last year HB 2134, a similar effort by Rep. Reuven Carlyle (D), met the same fate. Both political parties agree on this measure, yet it has still failed to pass.

IV. Proposals to Fix Traps in Reporting Requirements

When a taxpayer cannot realize any tax savings from an incentive despite qualifying in its business activities, bait-and-switch tactics may be at work. Because of two traps in 32 Washington incentives, businesses whose activities in the

[10] *Id.*

[11] *Id.*

[12] JLARC, "Legislative Auditor's Guidance for Drafting Performance Statements in Tax Preference Legislation" (Jan. 2, 2014), *available at* http://leg.wa.gov/JLARC/AuditAndStudyReports/documents/LegAudGuidanc e-DraftingTaxPrefLeg.pdf).

[13] All reports since 2004 are at https://fortress.wa.gov/dor/efile/MyAccount/TaxIncentivePublicDisclosure/.

[14] *Supra* note 12 at 1, 9.

[15] *Id.*

[16] *Id.* at 26.

[17] DOR, *supra* note 5, at 3.

state qualify for the same incentive can end up paying different taxes. Both traps involve the strict deadline for filing the annual report or survey. Nealey's bills would remedy both traps, but each remedy has a cost, which has posed a challenge for passing the legislation — especially given the current climate following rulings by the state's highest court on inadequate state funding of education.[18]

A. Trap #1

Normally, a taxpayer that catches its mistake can amend a tax return within a statute of limitations of up to five years. But a taxpayer that learns late of an incentive that requires a survey or report cannot amend returns to claim the incentive that far back because of the deadline for the reporting requirements. As the DOR noted in its 2013 recommendations (note that Washington tax incentives are called preferences): "Under current law, a taxpayer cannot claim the preference for a prior tax period if it has not already filed the required Annual Report or Annual Survey."[19] The DOR proposed a good solution:

> Allow taxpayers to qualify for a preference under an amended return even after the accountability document filing due date.
>
> The strict filing deadlines for the Annual Report and Annual Survey can prevent taxpayers from fully utilizing tax preferences. However, there is no substantive reason beyond the current statutory language for this to be the case. The information necessary to evaluate a preference could still be captured if the taxpayer submits accountability information when it files an amended return. Analysis of the preference is not unduly impacted if the necessary information is filed along with the amended return within the four-plus-current-year non-claim period. This is an important issue to the business community.[20]

HB 2879 would have implemented that recommendation. But in late February, Nealey said that the bill "is not going very far this year." The fiscal analysis concluding that the bill would reduce state revenue by nearly $500,000 annually surely did not help.[21] For now, businesses with activities in Washington should try to stay attuned to incentives to claim them at the earliest opportunity. They should also support the legislative effort in 2017.

B. Trap #2

Things sometimes go awry with reporting when a taxpayer claims an incentive. Taxpayer unawareness of an incentive's reporting requirement, employee turnover, or an employee not following through may result in a failure to file or a tardy filing. For various reasons beyond the taxpayer's control, the report may not be filed on time. Then what happens?

Under current law, Washington imposes a steep penalty on the failure to file the annual survey or report: 100 percent of the tax that would otherwise have been due had it not been for the incentive plus interest becomes immediately due and payable.[22] Aside from a very narrow exception, that punishment applies even to innocent errors and taxpayers that voluntarily step forward to remedy the problem. In fact, voluntarily coming forward opens the taxpayer up to an audit and assessment for any failure to file the survey or report for up to five years in the past. That can quickly add up to a very large assessment. The DOR must retroactively treat the incentive as though it did not exist for all periods not barred by the statute of limitations. For example, the department recently published a determination involving a taxpayer that missed the deadline by less than six months because of an employee's mistake — yet had to pay the full tax savings on a credit it had taken on its research and development spending, plus interest.[23]

A business may fall victim to that trap after expanding into Washington or making decisions based on the incentive's availability. That is an absurdly heavy penalty for a taxpayer performing activities that lawmakers otherwise want to incentivize. It is particularly painful given the busywork nature of some data required in the surveys and reports. HB 2540 aims to remedy that situation by reducing the amount of the penalty. Drew Shirk, the DOR's senior assistant director of tax policy and legislative liaison, testified that the department supports the bill and favors reducing the penalty. The House and Senate have both unanimously approved HB 2540, but the fiscal impact of reducing the penalty very nearly stymied the bill in committee. As of writing, the only step remaining is Democratic Gov. Jay Inslee's signature. If enacted, the bill will become effective in July, with a narrow provision for retroactive relief for appeals pending before 2016.

V. Conclusion

Nationally, credits and incentives are "probably the number 1 hot topic in transparency and disclosure," Mark Sommer of Frost Brown Todd LLC said at the American Bar Association Midyear Meeting in January. And possibly one solution, favored by *State Tax Notes* deputy publisher David Brunori, would be to eliminate all tax incentives. (His colleague, Cara Griffith, on the same ABA panel, memorably noted, "David Brunori hates all tax credits. Passionately.") But if tax incentives are going to exist, the overarching concerns of taxpayers must be heeded: Taxpayers need

[18] *McCleary v. State of Washington*, 173 Wash. 2d 477, 269 P.3d 227 (2012), and subsequent orders in the same case.

[19] DOR, *supra* note 5, at 2.

[20] *Id.* at 5.

[21] DOR Fiscal Note for HB 2879 (*available at* https://fortress.wa.gov/binaryDisplay.aspx?package=43167).

[22] RCW 82.32.534(4), 82.32.585(6).

[23] Washington State DOR Appeals Division Det. No. 15-0153, 34 WTD 583 (Dec. 31, 2015).

information in advance on how to comply with the incentives, and individual businesses should not be treated worse than their competitors in the same state.

Unfortunately, in Washington, some have grown to see bait-and-switch tactics as a means to generate revenue. Even with unanimous support once a bill hits the floor, fiscal notes somehow bog the bills down in committee so that they struggle to even come up for a floor vote. So the problem continues: With one hand lawmakers grant the tax incentive based on a reasoned decision to forgo tax revenue in favor of economic development; with the other they take the incentive away in the name of a missed reporting deadline. That is a particularly harsh result when some of the data collected is not meaningful in evaluating the incentives' effectiveness and the evaluation of the reported data occurs only once a decade. For now, taxpayers need to do all they can to claim incentives at the earliest opportunity and very carefully comply with the reporting requirements. Washington law leaves no room for error. ☆