

Chapter 5: Principal Constraints

Introduction

The purpose of this chapter is to outline certain constraints that may affect the state's ability to make substantial changes to the tax structure. These constraints fall into several categories: legal considerations contained in the state and federal constitutions; issues dealing with local government funding restrictions; and practical considerations related to the administration of new taxes for both the administering agency and taxpayers.

Legal Considerations

In considering changes to Washington's tax structure, certain overarching principles embodied in the Constitutions of the United States and the state of Washington must be kept in mind. The purpose of this section is to summarize the major principles that could limit changes to the current tax structure.

- **Taxes shall be uniform upon the same class of property.**

Article VII, Section 1 of the Washington Constitution provides that all taxes shall be uniform upon the same class of property. Real estate is one class of property, and it must be taxed uniformly within any particular taxing district in Washington.

In a 1933 case, *Culliton v. Chase*, the Washington State Supreme Court declared that income is property. The court ruled that a graduated net income tax is unconstitutional because it does not uniformly tax a class of property: income. Although the case is almost 70 years old and its legal underpinnings have been weakened over the years, the case has not been overruled. Washington is now only one of two states that deem income to be property (Pennsylvania is the other).

- **There must be a connection, or nexus, between the government imposing the tax and the activity sought to be taxed.**

United States Supreme Court tax cases interpreting the Due Process and Commerce clauses of the United States Constitution require that there be a connection, or nexus, between the government imposing the tax and the activity sought to be taxed. Without nexus, the state has no authority to tax. A business has nexus under the Due Process clause if it systematically exploits a market by doing such things as directing advertising at potential customers in a state. A business has nexus under the

Commerce clause if it conducts activities in a state that enable it to establish and maintain a market for its sales.

A 1992 United States Supreme Court case, *Quill v. North Dakota*, held that a business with no physical presence in North Dakota and selling through the mail did not have nexus under the Commerce clause and could not be obligated to collect sales or use tax from its customers. Its application to other kinds of taxes is unclear.

- **A tax on interstate commerce is valid if it meets certain conditions.**

The Commerce clause of the United States Constitution vests authority in the Congress to regulate commerce with foreign nations and among the states. In the 1977 case of *Complete Auto Transit v. Brady*, the United States Supreme Court held that in the absence of Congressional action a state may impose a tax on interstate commerce, provided that the tax (i) is applied to an activity with a substantial nexus with the taxing state, (ii) is fairly apportioned, (iii) does not discriminate against interstate commerce, and (iv) is fairly related to the services provided by the state.

- **A state may not impose a net income tax on a business whose only contact with the state is to solicit sales of tangible personal property through employees or contractors.**

Although not a constitutional provision, one federal law should be mentioned. Public Law 86-272 prohibits a state from imposing a net income tax on a business whose only contact with the state is to solicit sales of tangible personal property through employees or contractors. This law does not apply to the business and occupation (B&O) tax, which is measured by gross receipts.

- **The Legislature has very broad discretion in the area of taxation. One class may be taxed and another may be exempted from tax.**

The Equal Protection clause of the United States Constitution and the Privileges and Immunities clauses of the United States and Washington Constitutions each require that persons be treated equally under similar circumstances. In the area of taxation, however, the Legislature has very broad discretion. One class may be taxed and another may be exempted from tax. As long as the distinction between classes is reasonable and not arbitrary or capricious, the differential treatment is valid.

- **The state may not impose a tax within a local jurisdiction for local government purposes.**

Article XI, Section 12 of the Washington State Constitution prohibits the state from imposing a tax within a local jurisdiction for local government purposes. Instead, the state may grant municipalities the authority to impose specified taxes for local purposes.

- **The Washington State Constitution mandates that state taxes not be released or commuted.**

Article XI, Section 9 of the Washington Constitution mandates that state taxes not be released or commuted. In a 1984 case, *Bond v. Burrows*, the Washington State Supreme Court held that a mechanism to allow residents of border counties to pay a lower rate of state sales tax than residents of other counties violated this provision. Taxes must be applied uniformly, including uniformity as to rates, within a jurisdiction and within a class of taxpayers. However, the Legislature has considerably more latitude in making distinctions between excise taxpayer groupings than between groups of property taxpayers.

- **The United States and Washington Constitutions both prohibit the state from passing any law impairing existing contracts.**

Article I, Section 10 of the United States Constitution and Article I, Section 23 of the Washington Constitution both prohibit the state from passing any law impairing existing contracts. Bonds and other evidences of indebtedness are contracts between the borrowing government and the lending bond owner. Accordingly, the state may not repeal a tax expressly pledged to outstanding bonds, such as the motor vehicle fuel tax, which is frequently pledged to repay highway bonds. These constitutional provisions constrain the time period within which an existing tax can be replaced. At the state level, none of the three major taxes (B&O tax, state property tax, and the retail sales tax) have been expressly committed to bond debt service. But the Legislature has permitted a number of special local excise taxes to be promised to bond debt service, including local real estate excise taxes, various local sales and use taxes, and local option motor vehicle excise taxes.

Practical Considerations

In addition to constitutional limitations, there are significant practical considerations related to the administration and collection of taxes.

Successful tax administration is based on a system of voluntary compliance. Washington's existing tax system is structured to allow taxpayers to identify taxable activities, calculate tax liability and remit tax payments with a tax return summarizing the taxable period. The role of the Department of Revenue is to provide the education and infrastructure to assist taxpayers in this endeavor. Taxes that are too difficult for taxpayers to measure and remit voluntarily or taxes that are too complex or costly to enforce will detract from a system of voluntary compliance.

The principles listed below identify certain areas of tax administration that will affect the burden on both taxpayers and the Department of Revenue. However, there may be circumstances where the Legislature and Governor apply policy goals for a particular tax or program that override these guidelines.

- Taxpayers should be easily identifiable. They should be defined as a separate group using simple, easy to apply, and verifiable criteria.
- The tax rate should be simple and direct so taxpayers can easily calculate how much tax they owe.
- The tax should be based on an easily understood and identifiable activity or business event so potential taxpayers can self assess and pay the tax correctly.
- The taxable activity should be objective and easily measured by both the taxpayer and the Department of Revenue. For example, the retail sales tax is applied to the selling price of an item. The amount paid in the retail transaction is easy to measure and not subject to debate. A tax base that is difficult to measure is subject to dispute by both the taxpayer and the administering agency. For example, a tax on intangible goods would be extremely complex to implement due to the difficulties of measuring value for both taxpayers and the Department.
- Tax rates should be predictable. They should not commence or terminate according to the balance in a given fund; neither should the rate increase or decrease according to the fund balance. Such changes confuse taxpayers and result in either underpayments or overpayments and higher administrative costs to manage these mistakes.
- Taxpayers should be able to determine how much tax is owed rather than relying on the state to determine each taxpayer's liability. Individual treatment drives administrative costs higher, whereas generalized administrative practices keep costs low. This is a fundamental principle of a voluntary tax system. The existing enforcement difficulties surrounding the use tax on tangible personal property owned by individuals is related to this principle. The Department has no direct contact with individuals or transactions to enforce this tax, except in the cases of motor vehicles and other purchases that are subject to licensing requirements. These enforcement difficulties arise for other potential taxes as well, such as a personal property tax on property owned by individuals.