Washington State Tax Structure Study

Summaries of Incremental Tax Alternatives

User Fees and Dedicated Taxes

1. Replace taxes on private goods with user fees.

Description: Taxes and user fees are different. Taxes are compulsory payments to fund public services, and by definition there is not any necessary connection between those who pay taxes and those who receive services. User fees are charges paid directly by those who receive specific goods or services from government or by those whose activities burden the public.

User fees often make sense, given the public's increased concern about the level of taxes and the feeling that it is more fair to allocate costs to consumers when users can be readily identified. At the same time, the most important public goods, like schools and libraries, should remain as public goods financed by taxes.

The state should consider shifting a greater share—perhaps the entire share—of all highway and roads costs to motor vehicle users. This could be accomplished by higher gas taxes, tolls and congestion pricing, or by fees that have an even closer relationship to impacts on our roads, such as weight-and-mileage charges. It would permit a reduction in the property tax. If motor vehicle user fees and taxes covered more of the cost of city and county roads, local property taxes could be reduced and/or shifted to other purposes.

Estimated Collections: Revenue neutral

Advantages:

- Viewed as "fair" because use fees allocate costs to users of government services.
- Users have a choice as to whether to consume the service and incur the expense.
- Helps allocate scarce resources—fewer will use government services if they have to pay.
- Can lower reliance on taxes on public goods so that taxes can either be lowered.

Disadvantages:

- A shift to user fees will hurt low and moderate income Washingtonians.
- Some traditionally tax-backed "free" services could be subject to user fees.
- Some user fees are paid for goods and services that have a general public benefit, so it is appropriate to pay for those things with taxes, at least in part.
- There's no guarantee that if user fees go up, taxes will stay at the same level.

Principles Most Advanced:

- Equity (benefits principle)

Principles Most Eroded:

2. Avoid or reduce dedicated taxes, except "user fees."

Description: Dedicated taxes are taxes where a portion or all of the future receipts are dedicated for a specific purpose defined by law. Dedicated taxes in Washington fall into three groups:

(1) Small taxes that fund regulatory programs and which are paid by those regulated;
(2) Taxes that closely resemble user fees because the taxes pay for services used by those who pay the tax (i.e. gas tax); and
(3) Taxes that are earmarked to make them more acceptable to the public. For example, in November 2001 the voters passed Initiative 773 which added a 60 cent tax on each pack of cigarettes to fund additional health care responsibilities.

Dedicating taxes restricts the Legislature's ability to meet changes in the public needs for services. Programs funded by dedicated taxes are exposed when those taxes are repealed or when the source diminishes.

The Committee recommends that, as a general practice, dedicated taxes should be avoided. Taxes should not be dedicated to make them more acceptable. Dedicated taxes are appropriately used when they are, in effect, user fees paid by those who are being regulated or paid by those who directly benefit from the programs or facilities funded.

Estimated Collections: Revenue neutral

Advantages:

- The Legislature will have greater flexibility to meet changes in public needs for services.
- Improved compliance
- Fewer legal challenges
- Less complex

Disadvantages:

Principles Most Advanced:

- Stability
- Long-term adequacy
- Simplicity
- Equity (benefits principle)

Principles Most Eroded:

Business Taxes and Incentives

3. Exempt construction labor from sales tax.

Description: Washington is one of only a few states that impose sales tax on the labor portion of a construction contract. Currently retail sales tax is imposed on the entire contract price for a custom-built home, including labor, materials, and other overhead.

This proposal would provide an exemption for that portion of the contract attributable to labor. Contractors would separately account for labor and overhead by separate invoices or some other mechanism. Sales tax would only apply to the overhead and materials portion of each contract.

Proposed Tax Base: Sales tax would only apply to overhead, materials, and other non-labor costs for construction contracts.

Proposed Tax Rate: 6.5% state sales tax, appropriate local sales taxes

Estimated Collections: $400 million reduction in revenue.

Advantages:
- Encourages capital investments by businesses
- Encourages home ownership

Disadvantages:
- Complex for contractors to maintain separate accounting of contracts
- Tax issues will arise regarding documentation of labor versus other cost components.

Principles Most Advanced:
- Competitiveness

Principles Most Eroded:
- Long-term adequacy

4. Exempt start-ups from the B&O tax.

Additional information is still being determined.

5. *Increase small business credit.*

Description: Currently, small businesses are entitled to a credit against their B&O tax. The maximum credit available is $35 per month. The credit is phased out for larger businesses; as a business' tax liability increases beyond $35 per month, the available tax credit is reduced in $5 increments until it is phased out completely. Taxpayers in all business classifications are entitled to this credit. Businesses that have gross receipts below $28,000 per year and that do not report sales tax must register with the Department of Revenue but are not required to file tax returns. The $28,000 threshold is the amount of gross income at which a small business has no B&O tax liability because of the small business credit.

This proposal has two parts: (1) increase the credit amount currently available to small businesses, and (2) raise the threshold of income at which businesses are required to file with the Department.

The small business tax credit could be increased to $70 per month. The threshold for requiring filing of tax returns with the Department could be increased correspondingly, to $54,000. This proposal would require a statutory change.

Proposed Tax Base: The B&O tax base would remain the same.

Proposed Tax Rate: The B&O tax rates would remain the same.

Estimated Collections: $28 million reduction in revenue.

Advantages:

- Reduces the burden of the B&O tax on smaller, less profitable businesses.

Disadvantages:

- New and expanding firms may be unprofitable but have gross receipts that are too large to receive benefit of the credit.

Principles Most Advanced:

- Competitiveness
- Equity

Principles Most Eroded:

- Long-term adequacy
- Stability
- Neutrality

6. Review and retarget business incentives and exemptions.

Description: A large portion of the existing tax exemptions is "non-discretionary," meaning that they are necessary to comply with our federal and state constitutions and federal law. The other exemptions have been enacted by the Legislature or by voter initiative to define the tax base, encourage public service activities, improve the business climate, and improve tax administration. Once an exemption is enacted it is rarely repealed by legislative action, even though the reasoning or circumstances for original enactment may no longer be present.

Exemptions narrow the tax base and tend to make the structure more volatile. Property tax exemptions in particular result in increased taxes to the remaining taxable property. Excise tax exemptions can also result in tax shifts, to the extent taxing districts are able to increase rates.

It is recommended that the Legislature consider establishing a schedule for a periodic review of all tax exemptions, grouped by purpose or function, to ensure that these exemptions continue to serve the public purposes for which they were enacted. The Legislature should also require a sunset review of all new tax exemptions prior to permanent enactment. Typically, a sunset review period is between six and ten years.

Proposed Tax Base: **N/A**

Proposed Tax Rate: **N/A**

Estimated Collections:

Advantages:

- Exemptions that outlive their purpose are rarely repealed.

Disadvantages:

- Uncertainty

Principles Most Advanced:

- Neutrality
- Simplicity

Principles Most Eroded:

7. Revisit B&O rate structure and apportionment.

Additional information is still being determined.

Taxes on Property and Assets

8. *Property tax homestead credit against state levy*

Description: Property taxes apply to the assessed value of all taxable property, which includes all real and personal property owned within the state, unless specifically exempted. Various exemptions exist for certain types of property or for property owned by certain types of taxpayers.

This proposal would provide property tax relief to homeowners only, by providing a tax credit against the state levy for owner-occupied homes. A homestead credit would provide the same amount of relief to each homeowner irrespective of the value of their home.

The proposal would provide a $20,000 credit against the assessed value of residential property. Thus, rather than being assessed on a $100,000 home, the assessment would be based on $100,000 minus $20,000, equaling a taxable value of $80,000. This proposal will likely require a constitutional amendment to implement.

Proposed Tax Base: This proposal would reduce the tax base for the state property tax levy by providing a credit against the assessed value of residential property.

Proposed Tax Rate: The state levy is calculated annually.

Estimated Collections: $43 million reduction in state levy

Advantages:
- Makes an unpopular tax more palatable

Disadvantages:
- Not targeted to low income

Principles Most Advanced:
- Equity

Principles Most Eroded:
- Long-term adequacy

9. *Property tax relief or deferral targeted by income*

Description: Currently, senior citizens and disabled persons with incomes under $30,000 are entitled to property tax relief. They are exempt from special levies, and if their income is less than $24,000, they also receive a partial exemption from regular levies.

This proposal would provide property tax relief to homeowners based on their income or ability to pay. This is often called a "circuit breaker." Circuit breakers typically provide the most relief to those with the lowest income or those whose property taxes consume a lager proportion of their income. Circuit breakers tend to shift taxes to homeowners with higher incomes and, depending on how they are designed, to businesses.

Under this proposal, the age restriction (age 61) and disability qualification from the existing program could be eliminated so that all homeowners meeting the income requirements could qualify. All homeowners with incomes under $28,000 would be exempt from special levies and, if their income is less than $18,000, they would also receive a partial exemption from regular levies. This proposal would probably require a constitutional amendment to implement. An existing constitutional amendment already provides greater flexibility in providing property tax relief to seniors and the disabled, but additional targeted relief would require further constitutional changes.

Proposed Tax Base: This proposal would shift the property tax to homeowners with higher incomes and to businesses.

Proposed Tax Rate: Not applicable.

Estimated Collections: This proposal would shift the property tax to homeowners with higher incomes and to commercial property.

Advantages:
- Targeted low income tax relief.

Disadvantages:
- No means for county assessors to determine income for the number of homeowners who would qualify for this proposal.

Principles Most Advanced:
- Equity

Principles Most Eroded:
- Simplicity
- Long-term adequacy

10. Estate Tax

Description: Washington's estate tax system is not conforming to the federal changes made by the Economic Growth and Tax Reform and Reconciliation Act of 2001 (EGTRRA) to the federal estate and generation skipping transfer tax programs. (During the 2002 session, Washington's Legislature voted not to conform to the changes made by Congress.)

Proposed Tax Base: Washington's filing threshold for estate tax returns would be $700,000 and Washington would collect 100 percent of the state death tax credit. The federal estate tax filing threshold is currently $1,000,000 and will only allow a credit of 75 percent of the state death tax. This results in some estates having to file a Washington return but not having to file a federal estate tax return. All estates will have to pay the additional 25 percent of the state estate tax credit to Washington. (Washington's threshold will top out at $1,000,000 in 2006; the federal threshold will be $3,500,000 by 2009.)

Proposed Tax Rate: Washington's maximum tax rate will be 55%. The federal maximum rate is currently 50% (reduced to 45% by 2007).

Estimated Collections:

FY 2002	$102,833,400
FY 2003	$105,699,100
FY 2004	$105,558,000
FY 2005	$109,827,300
FY 2006	$113,881,800
FY 2007	$122,370,900

Advantages:

- Taxes the accumulation of wealth.
- Maintains revenue source.

Disadvantages:

- Out of sync with the federal Internal Revenue Code.
- Will cause estate-planning difficulties.

Principles Addressed:

- Equity
- Transparency

11. Tax on the market value of motor vehicles

Description: Under this proposal, motor vehicles would be taxed in a similar manner to personal property in which the Department of Revenue provides schedules for valuing vehicles at 100 percent of market value. Details on how tax is to be assessed and collected are yet to be determined.

Before 2000, the state levied an annual excise tax of 2.2 percent on each motor vehicle based on the manufacturer's suggested retail price. The depreciation schedule reduced the taxable value down to 10 percent of the original price in the 13th year. A voter initiative to repeal the tax was subsequently declared unconstitutional, but the Legislature eliminated the state tax effective January 2000.

Proposed Tax Base: Market value of motor vehicles designed for highway use

Proposed Tax Rate: 1%

Estimated Collections: $400 million annually

Advantages:

- Would expand the tax base to more broadly tax property.
- Most states impose an annual value-based tax on vehicles. Delaware, New Hampshire, North Dakota, South Dakota, Tennessee, Vermont, and West Virginia are among states that do not tax vehicles in such a manner. There are other states that tax on the basis of market value. Washington would not be unique.

Disadvantages:

- Already proven to be an unpopular tax.

Principles Most Advanced by Tax:

- The tax is stable relative to other taxes.
- The tax is paid in one lump sum and is very transparent.

Principles Most Eroded by Tax:

- Yet to be determined.

12. Extend sales tax to consumer services.

Description: Originally retail sales tax applied only to purchases of tangible personal property. Over the years certain services, mainly relating to recreational activities and long-distance telephone service, have been added to the tax base. However, the bulk of personal and professional services used by individuals and businesses remain not subject to the sales tax.

There are hundreds of service activities that are not subject to sales tax. These services fall into the general categories of business services, financial services, medical services and consumer services. A selected set of services such as consumer services (beauty shops, cable TV, residential telephone service) could be subjected to the retail sales tax. This proposal would add selected consumer services to the definition of retail sale, thus changing the business classification from service to retail and lowering the B&O tax rate from 1.5 percent to 0.471 percent. However, overall revenues would increase with the addition of 6.5 percent state sales tax and local sales taxes on selected services. This proposal would require a statutory change.

Proposed Tax Base: Consumer services would be added to the retail sales tax base and to the retail B&O category.

Proposed Tax Rate: 6.5% state sales tax, appropriate local sales taxes.
Retailing B&O at 0.471%.

Estimated Collections: $334 million for all consumer services
$379 million for all consumer services plus residential phone service.

Advantages:
- Captures the shift from a goods-based economy to a service-based economy.
- Only consumer services are included; taxing business inputs creates a disadvantage for non-vertically integrated firms.

Disadvantages:
- Few states tax services.
- Recent attempts to tax services in other states have failed.

Principles Most Advanced:
- Long-term adequacy
- Stability
- Equity

Principles Most Eroded:
- Competitiveness
- Economic neutrality

13. Streamlined sales tax

Description: Washington, along with 37 other states, has been working in recent years to develop a simpler, more uniform, and technologically advanced system for the administration of sales taxes. The Streamlined Sales Tax Project is a multistate effort to accomplish these goals. Twenty-seven of these states, including Washington, have enacted legislation allowing for participation in this development of a modernized sales tax system. Changes in the retail economy and technology advancements have made modernization of the sales tax system a priority for both retailers and tax administrators.

The recommendation is that Washington joins with other states in enacting uniform legislation that will modernize the sales tax system for the 21st century. Achieving this goal will substantially reduce the burden on sellers of complying with sales tax collection, particularly those operating on a multistate basis. The Project is attempting to reach agreement on some initial streamlining details by July 2002 in order to allow states to submit the first round of implementing legislation during their next legislative sessions.

Uniform legislation would include common definitions and simplified administration provisions.

Proposed Tax Base: The new definitions will result in some changes to the tax base although it is expected that overall collections will remain substantially the same.

Proposed Tax Rate: Not applicable.

Estimated Collections: Not applicable.

Advantages:
- Washington's state and local governments rely more heavily on sales tax than most other states, and streamlining will provide stability to the tax system.
- Provides simplicity for multistate retailers.

Disadvantages:
- May be some loss of flexibility by state and local authorities over sales tax system.

Principles Most Advanced:
- Long-term adequacy
- Simplicity

Principles Most Eroded:

14. Compensate retailers for collecting the sales tax.

Additional information is still being determined.

15. Give state property tax levy to local government.

Description: Washington currently imposes taxes on real property both at the state and local level. The Washington constitution requires that any statewide property tax revenues be used for public schools. Local jurisdictions do not have any restrictions on the use of property tax revenues, except in the cases of special levies where the revenues must be directed towards the purpose specified in the levy request.

In most states the property tax is strictly a matter for local governments. In Washington, the state levy for public schools amounts to nearly 25 percent of all property taxes paid statewide. Property tax levy rates are expressed in terms of dollars per $1,000 of assessed value. The state levy is set by statute at $3.60 per $1,000 of assessed value.

This proposal would transfer the state property taxing authority, in whole or in part, to local jurisdictions, without restrictions on the use of revenues.

Proposed Tax Base: Not applicable.

Proposed Tax Rate: Not applicable.

Estimated Collections: $1.4 billion loss in revenue to the state; corresponding gain to local governments.

Advantages:
- Property tax is more appropriate as a local funding source because expenditure of local funds generally benefit local residents, as opposed to being used to fund state-wide programs.

Disadvantages:
- Need to find an alternative source for school funding at the state level.

Principles Most Advanced:
- Long-term adequacy (local governments only)
- Stability
- Simplicity

Principles Most Eroded:
- Long-term adequacy (state government)

16. Simplify local B&O tax.

Description: Cities (but not counties) are authorized to impose a variety of fees and taxes on the privilege of doing business. Cities have also been given a considerable degree of latitude (local control) to define the nature of the activities subject to the tax. Some cities employ a gross receipts form of business tax, which is conceptually the same as the state B&O tax. However, there is no requirement that the definition of a given activity be the same as or bear any relationship to the definition used for state B&O tax purposes. Another area that lacks uniform treatment is the apportionment of income from activities that are performed in more than one jurisdiction.

The business community has in recent years been increasingly vocal about the negative effect of local B&O tax laws on the business climate. For businesses that operate in more than one city the task of keeping up with varying definitions for the same or like activities can be difficult. The effective lack of any apportionment for business income means that cities may tax such income out of proportion to the activity taking place in their jurisdiction. Non-uniform definitions combined with the lack of apportionment can result in the same income being taxed by more than one city.

Simplifying the local B&O tax system would increase the uniformity of locally imposed gross receipts business taxes and make it easier for businesses to conduct business throughout the state. This proposal would also eliminate the prospect of being taxed on more than 100 percent of a business' income. There are two primary proposals that have been discussed in recent legislative sessions: to require local B&O taxes to be uniform with the state B&O, or to require local B&O taxes to be uniform between all cities imposing such a tax. There is currently no agreement on which proposal, if any, to implement.

Proposed Tax Base: Depending on which proposal is implemented, there could be substantial changes in local B&O tax bases for cities that currently impose a B&O tax.

Proposed Tax Rate: Not applicable.

Estimated Collections: Cities currently collect $200 million in tax. Depending on which proposal is implemented, there could be substantial revenue shifts or losses for cities that currently impose B&O taxes.

Advantages:

- Easier for businesses to comply.

Disadvantages:

- May be some loss of flexible local authority over B&O tax.

Principles Most Advanced:

- Simplicity
- Economic neutrality
- Equity

Principles Most Eroded:

- Long-term adequacy (local governments)
- Stability

17. Rainy Day Fund

Additional information is still being determined.