Washington State Tax Structure Study

Alternatives Subcommittee Paper
4/18/02

Tax Exemptions

What are Tax Exemptions?

The Department of Revenue is required to prepare a report for the Legislature every four years comprised of a listing of the reduction in revenues from tax exemptions. This requirement, first enacted in 1983, was one of the first of its kind in the country. The statute calling for the report defines "tax exemption" to mean "an exemption, exclusion, or deduction from the base of a tax, a credit against a tax, a deferral of a tax, or a preferential tax rate". Inherent in this definition is treatment of individual activities or industries that is different from the general provisions of a tax, and/or treatment that is different from similar activities/taxpayers.

A tax exemption is different from a tax "loophole". An exemption is an intended benefit. A loophole is an unintended benefit. The two terms should not be used interchangeably.

Tax Exemptions Viewed as Tax Expenditures

A number of states use the term "tax expenditure" rather than "tax exemption". The idea of tax expenditure is that, like direct expenditure programs, exceptions to the basic tax structure constitute a commitment of government resources. They are "spent" through the tax system by a reduction in revenue rather than through a direct appropriation. Both convey benefits to individuals and business. Unlike direct appropriations, however, tax expenditures are not typically subject to an annual programmatic or spending review process.

Why are Tax Exemptions Enacted?

Tax exemptions, or preferential treatment, are enacted for a number of reasons. The most common are as follows.

- To define the tax base, establish what is the norm, especially for new taxes. Examples include: defining the B&O tax base to exclude the income of employees as "being in business"; casual and isolated sales (selling your neighbor a lawnmower) have never been part of the sales tax base because it is not a regular activity and is not considered engaging in business.

- To encourage public service activities which government couldn't realistically perform. An example is the property tax exemptions for nonprofit organizations (orphanages, blood banks, youth organizations, homes for the aged, nonprofit hospitals, etc.).

- To improve the business climate, encourage economic development, level the playing field and allow Washington to compete on fundamental marketing grounds. Examples include: the distressed area sales tax deferral programs, taxing authority and benefits for public facilities districts, sales tax exemption for manufacturing machinery and equipment, and the property tax exemption for business inventories.

- To recognize unique circumstances. Examples include: the preferential B&O rates to recognize low profit margins, and the B&O tax exemption for agriculture because they can't affect the price of their product and have essentially no ability to pass the tax along to their customers.

- Because the state has little, or no, choice. Examples include: the sales tax exemption for interstate commerce required by federal law and the sales tax exemption for all items that are purchased with food stamps. If we didn't provide this sales tax exemption Washington could not participate in the federal food stamp program.

- For administrative convenience. Examples include: the sales tax exemption for newspapers (impractical to collect sales tax on a 5 cent newspaper when the exemption was enacted in 1935), the property tax exemption for household goods and personal effects (appliances, jewelry, furniture).

- To keep our taxes constitutional. An example is the multiple activities B&O tax credit, and the credit for manufacturers for like taxes paid in other states in response to a U.S. Supreme Court decision in 1987 declaring our tax on manufacturers unconstitutional.

- Because the voters enact them through the initiative process. Examples include: the sales tax exemption for food for home consumption, the sales tax exemption for trade-ins, repeal of the motor vehicle excise tax, and repeal of the inheritance tax.

Are Exemptions Ever Repealed?

Experience has shown that 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. At least one exemption, and in most cases many more, have been enacted in each legislative session since our modern excise tax system was put in place in 1935. In it's Tax Exemptions 2000 report the Department listed 430 exemptions, with an impact for the 1999-2001 biennium of $27.2 billion for state government and $18.7

billion for local government. It is important to note that a significant portion of these impacts, about 50 percent in total, represent exemptions that either cannot be repealed because of federal law (interstate commerce) or are unlikely to be seriously considered for repeal by the Legislature (government property, intangible property). For comparison purposes actual state revenue collections for the 1999-2001 biennium were in the order of $19 billion.

As of the start of the 2002 session, only six exemptions have been repealed by legislative action and less than half a dozen had been allowed to expire. Most of the repeals have been fairly small in terms of impact, with the notable exception of the temporary repeal of the sales tax exemption for food in 1982 (lasting 14 months).

There have been a few reports and other efforts to evaluate exemptions over the years. There was a proposed constitutional amendment on the ballot in 1972 that would have mandated review of each exemption within five years, and every 10 years thereafter. If the exemption were not specifically re-enacted it would terminate. The measure failed at the ballot 45% to 55%; primary opposition came from a coalition of business, agriculture, and nonprofit interests.

The last serious effort to comprehensively examine a significant number of exemptions was in 1983. A bill was introduced that would have terminated (sunset) 94 exemptions. The bill was amended to require the Department to prepare the Exemption Study, starting in 1984.

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 that increases in revenue are derived from general tax increases rather than repeal of exemptions.

How Should Exemptions be Evaluated?

The Department of Revenue has suggested to the Legislature from time to time that it use the following criteria, in the form of questions, for consideration of proposals for tax exemption, special rates, or other preferential treatment.

- Does the exemption promote a desirable public policy?
- Does it set a precedent, such that others in similar circumstances will be encouraged to seek similar treatment?
- Will enactment significantly narrow the tax base?
- Is the activity, or the problem to be solved, unique, such that the language in the bill or law cannot be interpreted to extend the benefit to persons other than those intended?
- Would enactment improve equity by providing equal treatment with others in similar circumstances?

- Is the problem to be solved, or circumstances prompting the request for special treatment, temporary, such that relief should be extended only for a specific period of time?
- Does it have a clear statement of purpose, so that the results can be effectively evaluated?
- Is the nature of the special treatment complex and costly to administer?
- Does it increase the fairness of the tax system by removing or lessening one of its regressive features?
- If the estimated revenue impact were in the form of a request for a continuing appropriation, would you support it?