

INTRODUCTION AND SUMMARY OF FINDINGS

This report presents a detailed analysis of tax exemptions for major Washington state and local taxes. The term "exemption" is used broadly to include a wide variety of tax preference items which confer reduced tax liability upon a certain class of taxpayers. It includes exclusions, deductions, preferential tax rates, deferrals and credits. The exemption study is updated every four years pursuant to RCW 43.06.400 (see Appendix 1). The report does not include a discussion of the theoretical considerations of tax exemptions, nor does it contain any recommendations as to the retention or removal of existing exemptions. It is intended only to fulfill the statutory requirement of providing a "listing" of current exemptions.

The current study analyzes 567 different exemptions found principally in Titles 82 and 84 of the Revised Code of Washington. In some instances, similar statutes are considered together as a single exemption, e.g., retail sales and use tax exemptions for the same product or activity. In other cases, a single statute may be divided into separate exemptions to better illustrate the impacts, e.g., the property tax exemption for public property is discussed separately for the various governmental jurisdictions (federal, state, city, county, etc.).

It must be emphasized that the revenue impacts presented herein reflect the estimated savings to taxpayers and do not necessarily indicate the potential revenue which might accrue to governmental jurisdictions in the absence of the exemptions. Constitutional prohibitions against taxing certain activities, property tax rate limits, the overall state limitation on spending (Initiative 601), issues of tax administration, and even the likelihood of changes in

taxpayer behavior combine to limit the potential revenue. Further, the estimates are in terms of accrued tax liability and the actual cash receipts during a particular biennium might be lower as a result of initial compliance factors. A later section of this introduction discusses the degree to which revenue might be realized in the absence of these exemption statutes.

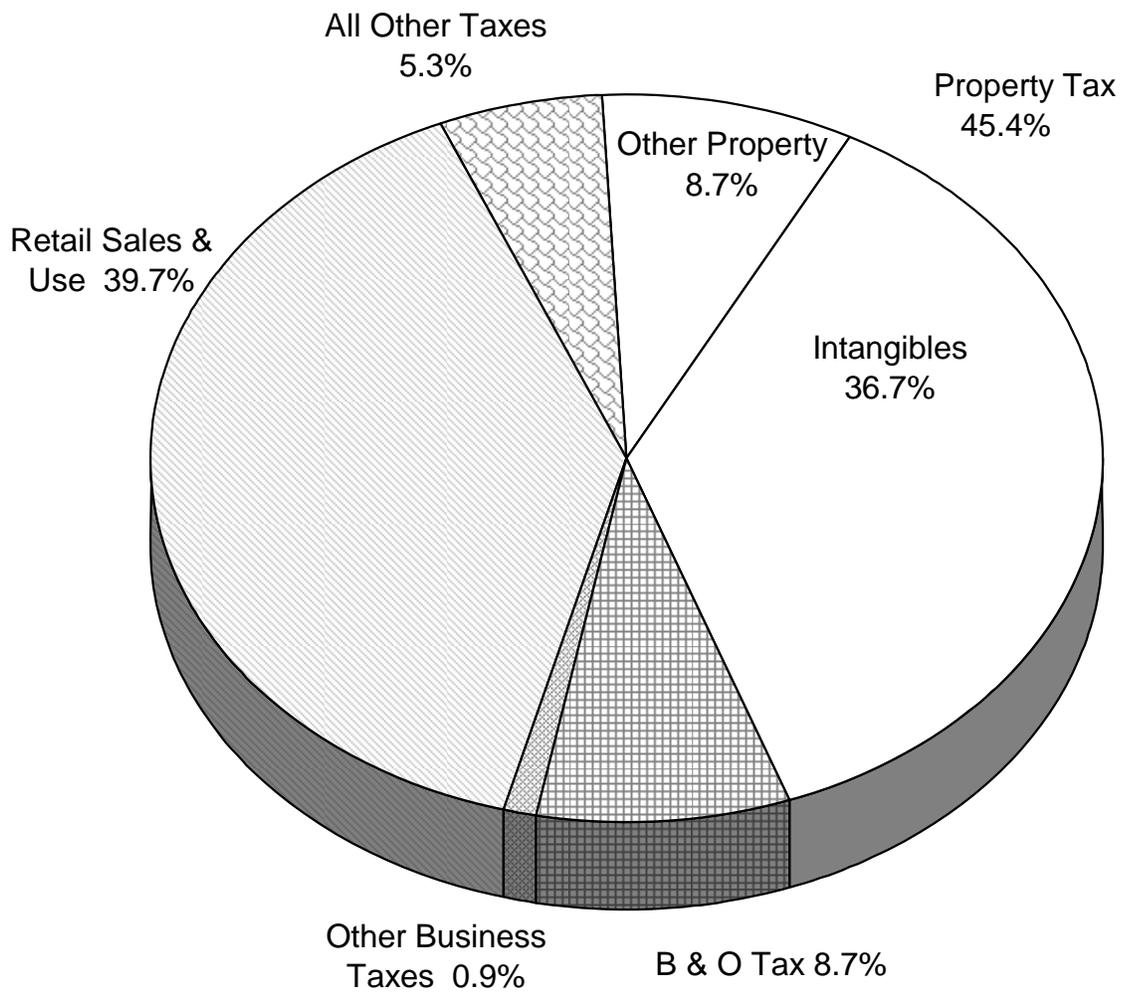
Table 1
SUMMARY OF TAX EXEMPTIONS BY TAX SOURCE

Estimated Savings to Taxpayers
2007-09 Biennium (\$000,000)

Tax Source	Number of Exemptions	State Taxes	Local Taxes	TOTAL
Property Tax	103	\$ 9,056.2	\$35,653.2	\$44,709.4
In Lieu Excise Taxes	39	50.6	29.4	80.0
Business & Occupation Tax	161	8,609.9	---	8,609.9
Public Utility Tax	32	593.3	---	593.3
Other Business Taxes	41	267.0	---	267.0
Retail Sales & Use Tax	158	29,987.2	9,138.3	39,125.5
All Other Taxes	33	4,961.3	137.9	5,099.2
TOTAL	567	\$53,525.5	\$44,958.8	\$98,484.3

Chart 1
DISTRIBUTION OF TAX EXEMPTIONS BY TAX SOURCE

Estimated Taxpayer Savings for 2007-09 Biennium
Percentage of \$98.5 Billion Total State /Local Tax Savings



As seen in Table 1, the aggregate state and local impact of the 567 exemptions amounts to an estimated savings for taxpayers of \$98.5 billion for the 2007-09 Biennium. About 54 percent of the total or \$53.5 billion is represented by exemptions from state taxes; exemptions from local government taxes amount to \$45 billion. Well over one-half of the state impact is associated with retail sales/use tax exemptions. Property and business and occupation (B&O) tax exemptions also account for a large share of the state impact. By far the largest share of local exemptions impacts relates to the property tax; nearly all of the remainder is attributable to local sale tax exemptions.

In terms of tax sources, the property tax is attributable for the largest savings for taxpayers - \$44.7 billion or 45 percent of the total for all taxes. Within the property tax category, the exemption of intangibles amounts to \$36 billion in tax savings; such a large impact dominates the remainder of the tax exemption impacts. The retail sales and its companion use tax total \$39.1 billion in tax savings. Among the larger sales/use tax exemptions are constitutionally required exemptions for interstate sales, the exclusion of personal and professional services, personal property brought into the state by nonresidents, and the exemption of food for off-premises consumption. The third largest group of exemptions is for the state B&O tax; exemptions for employee wages and salaries, income related directly to interstate commerce, and the investment income of nonfinancial businesses represent the largest B&O tax exemptions.

Exemptions vs. Revenues

Table 2 and Chart 2 compare the estimated taxpayer savings resulting from exemptions for major state tax sources with the forecasted revenues for those same sources. (Local taxes are excluded

due to the lack of revenue projections.) In the aggregate, these state exemptions amount to \$48.6 billion for the 2007-09 Biennium, while the projected revenues for these state sources total only \$28 billion. For most of these state taxes, the amount exempted exceeds the actual amount of expected revenue. The estimated amount of taxpayer savings equals 172 percent of the amount of revenue derived from these state taxes. Stated another way, the amount of taxpayer savings is over 60 percent of the potential tax base, if all of these exemptions were eliminated.

Table 2
COMPARISON BETWEEN EXEMPTIONS AND REVENUES
Selected Major State Tax Sources
2007-09 Biennium (\$000,000)

State Tax Source	Total Taxpayer Savings Resulting from Exemptions	Projected Tax Revenues ¹	Exemptions as a Percent of Revenue	Exemptions as a Percent of Potential Tax Base ²
State Property Tax Levy	\$9,056.2	\$ 3,007.4	301.2%	75.1%
State B&O Tax	8,609.9	5,718.5	150.6	60.1
Public Utility Tax	593.3	764.4	77.6	43.7
Retail Sales/Use Tax	29,987.2	16,999.8	176.4	63.8
Real Estate Excise Tax	383.3	1,750.3	21.9	18.0
TOTAL	\$48,629.9	\$28,240.4	172.2%	63.3%

¹ Revenue Forecast, Office of the Forecast Council, November, 2007. Forecast for retail sales/use, B&O, public utility, and real estate excise taxes includes nongeneral fund components of these taxes.

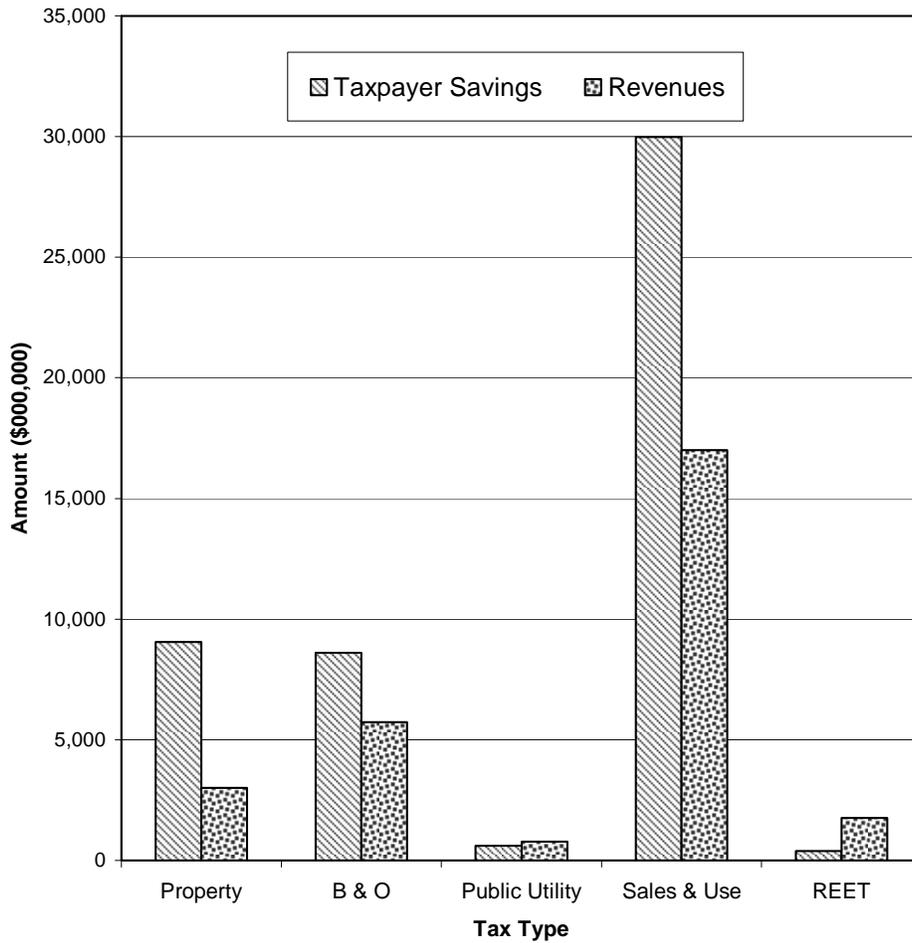
² The total taxpayer savings from exemptions compared with the total exempt amount plus the projected revenue, i.e., exemptions compared with the total potential revenue if the exemptions did not exist.

Chart 2

COMPARISON BETWEEN EXEMPTIONS AND REVENUES

Taxpayer Savings and Projected Revenue Collections
For Major State Taxes (Does Not Include Local)

2007-09 Biennium (\$000,000)



Categorical Analysis

Tax exemptions are established for a variety of reasons. In an attempt to present more meaningful data for the various types of exemptions, 14 categories were developed and each of the exemptions was assigned to the category which most closely represents its general purpose or type of beneficiary (recognizing that many exemptions serve multiple purposes). A brief description of the exemption categories appears below:

Tax Base

This category includes activities which were not intended by the Legislature to be included in the original tax base. For example, the state B&O tax is intended to tax the privilege of engaging in business. Working for an employer as an employee is not considered as engaging in business, because employees typically do not have the same degree of responsibility for, or benefit from the success of, a firm as does the owner of the business. Thus, there is a specific statutory exemption (RCW 82.04.360) to assure that employees are not subject to B&O tax, even though it was never the intention that the tax apply to salaries and wages.

Government

Governmental jurisdictions include the federal government, the state of Washington, local governments and foreign countries. In some instances these entities may be taxed, e.g., state and local jurisdictions pay retail sales tax on the acquisition of tangible personal property. Even the federal government is indirectly taxed through the use tax liability of contractors who install tangible personal property pursuant to federal construction contracts. However, for some other taxes, subjecting publicly owned property and governmental activities to tax would simply amount to a transfer of funds among jurisdictions. Particularly in the case of property taxation, valuation of public property would significantly increase the cost of administering the tax.

Commerce

The U.S. Constitution prohibits direct taxation of interstate commerce. As a result, certain exemptions have been enacted to assure that Washington does not violate this requirement.

Intangibles

Wealth that is represented by intangible assets, such as money, stock and bonds, bank deposits and other securities, is exempt from property taxation. Because of its unique nature and the difficulty of distinguishing between intangibles that are owned by individuals and businesses, a separate category has been assigned to this major exemption which dominates the fiscal impact totals.

Services

A major exclusion from the base of the retail sales tax is represented by services. Initially, the sales tax applied only to tangible personal property (i.e., goods). But over the years the base has been extended to certain other activities such as construction and repair services. If the sales tax is considered as a broad-based tax upon consumption, then purchases of personal and professional services consumed by individuals and businesses could logically be subject to tax. However, this would represent a major new direction in state tax policy.

Nonprofit Organizations

There are a variety of property, B&O and sales tax exemptions allowed for nonprofit organizations. This report further categorizes these exemptions according to the specific type or function of the organization:

- "H" - Health or social welfare organization
- "C" - Charitable or religious organization
- "A" - Arts or cultural organization
- "O" - All other nonprofit groups.

Individuals

These exemptions generally benefit people, as opposed to businesses or other entities. Some exemptions in this category are directed toward a certain group of people such as senior citizens.

Business Incentives

Some exemptions are "targeted" to encourage particular activities by businesses. Most often, these are intended to attract or retain a specific industry to Washington and create employment opportunities in this state. Other exemptions seek to encourage businesses to behave in a certain fashion, e.g., locate or expand in rural counties, invest in pollution control equipment, etc.

Other Exemptions for Businesses

Many other exemptions are provided for firms without specifically expecting a particular behavior, e.g., deductions for cash discounts and credit losses. These are generally enjoyed by most business entities. Broadly speaking, exemptions for businesses can be assumed to benefit individuals in the long run, since firms typically pass on their tax liability to customers, employees, or owners of the business.

Agriculture

Many exemptions have been adopted to assist the agricultural industry. The bulk of Washington's current excise taxes were adopted in the 1930s when the Great Depression was adversely impacting many industries, in particular the farming community.

Other Exemptions

Some exemptions do not fit conveniently into another grouping, so these are considered together in the "Other" category.

Table 3 summarizes the results of the categorical analysis. The largest single exemption is the property tax exemption for intangibles, amounting to \$36.2 billion in taxpayer savings which accounts for over one-third of the total. Exemptions for individuals are also close to one-third of taxpayer savings. Among the larger items in this category are the property tax exemption for household goods; use tax exemption for imported personal property of nonresidents; and sales tax exemptions for food, prescription drugs, motor vehicle fuel (recognizing that businesses also purchase gasoline), trade-ins and local residential telephone service. The share of total exemptions for individuals would be much greater if it included their portion of the taxpayer savings for intangibles and services.

Table 3
TAX EXEMPTIONS BY CATEGORY
2007-09 Biennium (\$000,000)

Category	Number of Exemptions	State and Local Taxpayer Savings	Percent of Total
Tax base	66	\$ 8,252.5	8.4%
Government	74	4,988.3	5.1
Commerce	23	5,210.0	5.3
Intangibles	1	36,185.9	36.7
Services	3	5,436.6	5.5
Nonprofit organizations:			
Health or social welfare	34	522.6	0.5
Charitable or religious	12	198.9	0.2
Arts or cultural	7	33.7	--
Other organizations	25	176.3	0.2
Individuals	47	32,049.4	32.6
Business incentive	103	1,288.5	1.3
Other business	89	1,956.9	2.0
Agriculture	54	693.2	0.7
Other	29	1,491.4	1.5
TOTAL	567	\$98,484.3	100.0%

Exemption categories over which the Legislature has the least discretion are Tax Base and Commerce. Exemptions in these categories are either required for constitutional reasons or

would involve a significant departure from current tax policy to eliminate them. Those in the Government category, likewise, have little potential for repeal. Taken together, the exemptions in these three categories represent nearly 20 percent of the total taxpayer savings.

Two classes of exemptions reflect long-standing and fundamental tax policy: the property tax exemption for intangibles and the sales tax exemption for services. Significant revision in either category would involve a major tax policy change.

Exemptions for businesses are assigned to one of three groupings: Business Incentives, Other Business, or Agriculture. There are 103 exemptions in the first category, 89 in the second, and 54 in the third. Together, these account for 4 percent of the total taxpayer savings. Dominating the business tax exemptions are the property tax exemption for inventories and the sales tax exemption for manufacturing machinery.

The 78 exemptions provided for nonprofit organizations account for a very small portion, less than 1.0 percent, of the total taxpayer savings. Finally, the 29 exemptions assigned to the Other category represent about 1.5 percent of the taxpayer savings.

Table 4**TAX EXEMPTIONS BY YEAR OF ENACTMENT
State/Local Tax Savings for 2007-09 Biennium (\$000,000)**

Year Adopted	Number	Current Savings	Year Adopted	Number	Current Savings
1854	4	\$ 942.2	1941	1	\$ 0.1
1871	1	701.8	1943	3	383.4
1886	1	110.6	1945	5	38.9
1889	5	3,148.1	1947	4	24.5
1890	3	4.8	1949	9	519.2
1891	2	7.3	1951	1	519.3
1911	1	142.6	1955	4	1.1
1915	3	42.1	1957	2	1.7
1923	3	4.1	1959	4	32.6
1925	2	124.7	1961	5	23.9
1929	1	1.3	1963	3	6.7
1931	4	36,368.8	1965	7	195.4
1933	5	2,060.2	1967	15	682.4
1935	38	39,160.9	1970	12	295.0
1937	3	130.0	1971	12	1,552.0
1939	1	0.0	1972	1	1.3
1940	2	32.9	1973	4	172.4

Table 4 - Continued

**TAX EXEMPTIONS BY YEAR OF ENACTMENT
State/Local Tax Savings for 2007-09 Biennium (\$000,000)**

Year Adopted	Number	Current Savings	Year Adopted	Number	Current Savings
1974	4	\$1,633.0	1993	10	\$400.1
1975	10	273.6	1994	6	236.0
1976	11	39.5	1995	17	763.0
1977	6	2,257.9	1996	11	111.6
1979	14	390.8	1997	18	14.9
1980	12	27.7	1998	20	349.5
1981	6	33.3	1999	6	47.2
1982	3	98.0	2000	7	1,402.2
1983	16	236.8	2001	21	180.6
1984	7	515.4	2002	5	144.3
1985	8	137.4	2003	35	283.2
1986	6	7.6	2004	20	32.4
1987	14	29.8	2005	26	690.5
1988	3	0.7	2006	23	111.8
1989	21	384.0	2007	17	161.3
1991	9	51.0			
1992	4	6.6			

Chart 3

NUMBER OF EXEMPTION STATUTES BY YEAR OF ADOPTION
Current Total of 567 by Year of Original Adoption

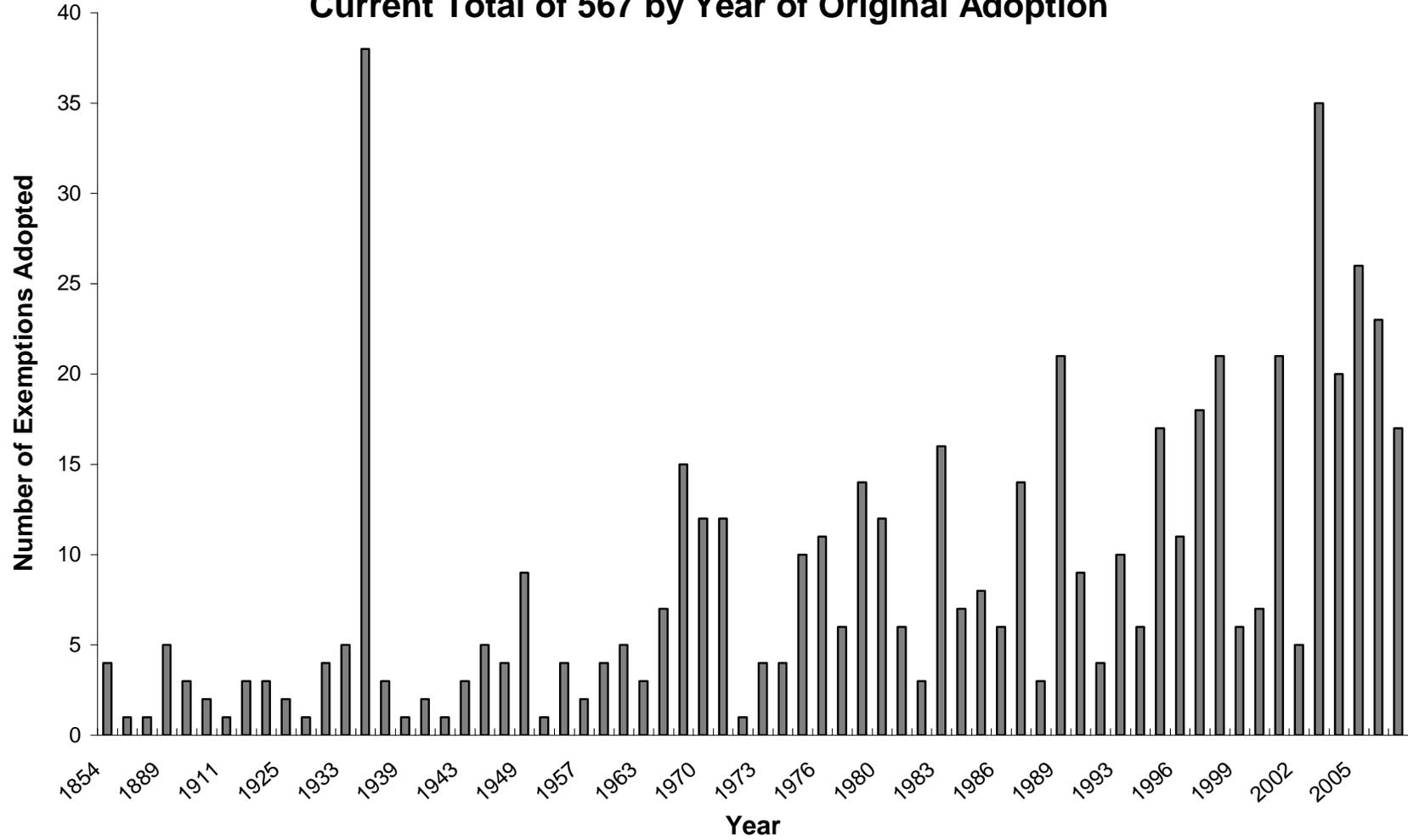
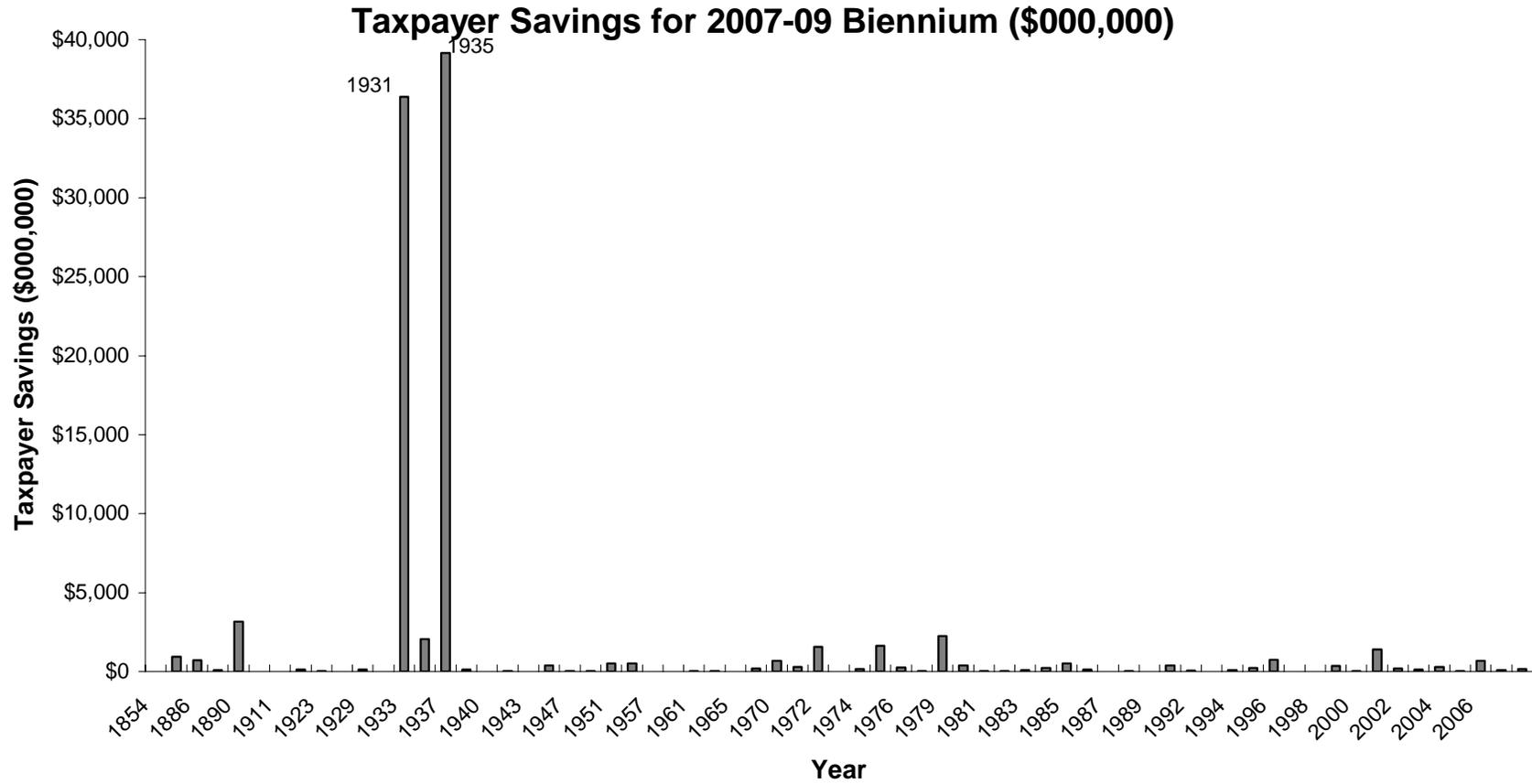


Chart 4

CURRENT VALUE OF TAX EXEMPTIONS BY YEAR OF ORIGINAL ADOPTION



Exemption History

Table 4 and Charts 3 and 4 trace the evolution of tax exemption statutes starting in Washington's territorial days. The current dollar value of exemptions in terms of taxpayer savings is largely attributable to exemptions enacted in the 1930s, when the present tax structure was formulated. Over 70 percent of the current taxpayer savings is represented by exemptions which date from the 1930s. The property tax exemption for intangibles was initially adopted in 1931 (with clarifications added in 1997). The 38 exemptions which define major excise tax bases contained in the Revenue Act of 1935 represent the most new exemption statutes in a specific year.

Relatively little took place in the field of tax exemptions during the three decades from the mid-1930s to the mid-1960s. Then activity increased as major new tax policies were instituted, including constitutional amendments allowing exemptions for senior citizens, current use assessment of farm and open space lands, limitation on the growth rate of property tax levies (not really an exemption), and the exemption of food for off-premises consumption - the first major exemption enacted by initiative of the voters.

Since the turn of the century there have been many new exemptions, averaging 21 new statutes every year, culminating in the 35 new exemptions added in 2003 - the second most new exemption statutes established in any one year. The dollar value of most newly enacted exemption statutes is comparatively small.

Some of the exemptions enacted during the 1990s can be attributed to the state expenditure limitation, Initiative 601, enacted by the voters in 1993. Under this limit on overall state spending, there was more incentive to return "excess" revenues to the taxpayers, since they could not be directly spent on current programs. One convenient method for returning such revenue to taxpayers was via new exemption programs.

Would Revenue Be Realized?

Readers will notice that following the taxpayer savings estimates presented for each of the 567 tax exemptions discussed in the body of this report there appears a question: "If the exemption were repealed, would the taxpayer savings be realized as increased revenues?" The responses are intended to help readers understand the degree to which the figures represent foregone state or local government revenues. Certainly, for many of the excise taxes there is a one-to-one relationship between the amount that taxpayers save and the amount that government gives up in potential revenues. Other exemptions might elicit a behavioral response by taxpayers which could restrict the potential revenue that might be realized. Some exemptions might require a considerable administrative effort and expense on the part of tax collection agencies (e.g., any attempt to tax intangibles, either as a property tax or under an income tax, would necessitate a

**Table 5
WOULD REVENUE BE REALIZED?**

**Potential Amount of State/Local Revenue
If Exemptions Were to be Repealed
2007-09 Biennium (\$000,000)**

Tax Source	Number of Exemptions	Current Taxpayer Savings	<u>Degree to Which Revenue Might be Realized if Exemptions were Repealed</u>			
			No	Unlikely	Possibly	Yes
Property Tax	103	\$44,709.4	\$ 8,515.9	\$36,185.9	\$ 0	\$ 7.5
In Lieu Excises	39	80.0	1.4	48.6	0	29.9
B&O Tax	161	8,609.9	5,367.3	1,070.8	24.6	2,147.2
Other Business Taxes	73	860.3	543.5	157.0	10.3	149.5
Retail Sales/Use Tax	158	39,125.5	1,127.0	25,943.6	186.8	11,868.1
All Other Taxes	33	5,099.2	3,926.0	13.8	521.2	638.2
TOTAL	567	\$98,484.3	\$19,481.1	\$63,419.7	\$742.9	\$14,840.4

major budgetary commitment). The entire property tax exemption field presents a special case of exemption impacts, the result of which is to rule out these exemptions as a source of potential new revenue, as long as limitations exist on the amount of regular levy receipts for taxing districts. While removal of a property tax exemption would broaden the tax base, it would also produce a commensurate reduction in tax rates, so that taxing district revenues remain at the level required by the limitations. (To be sure, this would reduce property taxes for existing taxpayers, but it would not generate additional receipts for most taxing districts.) Finally, as indicated above, many exemptions exist because of constitutional reasons or simply to help define the intended tax base. Neither of these categories can be relied upon as the source of potential new governmental revenue.

The discussion of the potential revenue associated with the exemptions has been summarized in Table 5. Only \$7.5 million in property taxes would be anticipated if these exemptions were eliminated. The potential receipts associated with taxes in lieu of property tax totals almost \$30 million. The state B&O tax exemptions represent over \$2.1 billion in additional revenues, while the public utility tax and other business taxes imply about \$150 million in new revenue. By far the source with the largest revenue potential is the retail sales/use tax. In total, approximately \$11.9 billion might be produced if these exemptions were repealed. **Overall for all taxes considered in this study, the total taxpayer savings of \$98.5 billion for the 567 exemptions represents about \$14.8 billion of potential state or local government revenue.**