

INTRODUCTION AND SUMMARY OF FINDINGS

Introduction

This report presents a detailed listing of tax exemptions for the major Washington state and local taxes. The term "exemption" is used broadly to include a variety of tax preference items which confer reduced tax liability upon a certain class of taxpayers; it includes exclusions, deductions, preferential tax rates, deferrals, credits, as well as exemptions. The Exemption Study is updated every four years pursuant to RCW 43.06.400 (see Appendix I). 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 2012 edition of the Exemption Study lists 640 different exemptions found principally in Titles 82 and 84 of the Revised Code of Washington. However, the Department focuses only on the 452 tax exemptions that would likely increase state revenues if eliminated. This was a result of an amendment to the authorizing statute adopted in 2011 as a part of ESHB 1346 (Chapter 20, 1st Special Session, Section 201). The remaining exemptions are not likely to increase state revenues due to constitutional prohibitions against taxing certain activities, property tax rate limitations which result in tax shifts among remaining property owners, or possible changes in taxpayer reporting behavior.

In some instances, similar statutes are considered together as a single estimate, 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 estimates to better illustrate the impacts.

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. The estimates are provided 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.

INTRODUCTION AND SUMMARY OF FINDINGS

Summary of Findings

In aggregate, the state and local impacts of the 452 tax exemptions combine for an estimated taxpayer savings of \$29.3 billion for the 2011-13 Biennium. A large majority of the impact for these exemptions - \$24 billion or 82 percent - is represented by exemptions from state taxes; exemptions from local government taxes amount to only \$5.3 billion. The reduced impact for local taxes is due to the almost total exclusion of property tax exemptions from the 2012 study.

Table 1 summarizes the number of exemptions and the distribution of state and local impacts for the various types of taxes considered in this report.

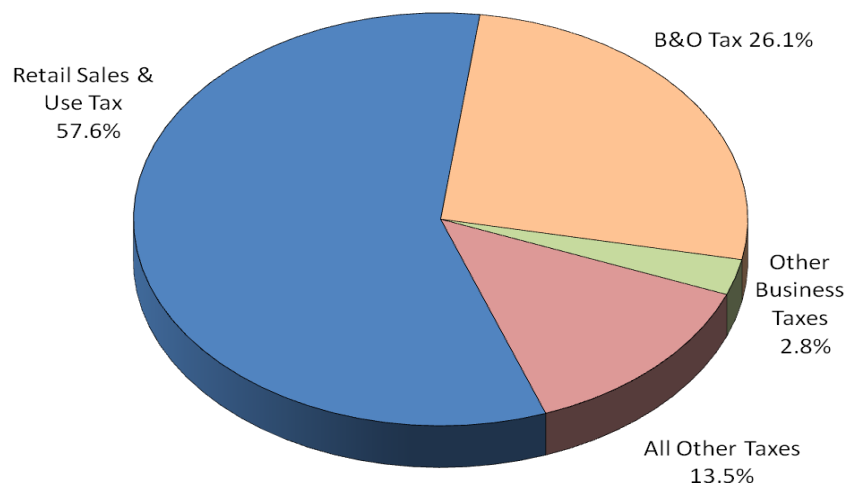
Table 1
SUMMARY OF TAX EXEMPTION IMPACTS BY TAX SOURCE
Estimated Taxpayer Savings
2011-13 Biennium (\$ millions)

| Tax Source | 2012 Report # of Exemptions | Estimated Biennial Taxpayer Savings | | |
|---------------------------|-----------------------------------|-------------------------------------|-------------------|--------------------|
| | | State Taxes | Local Taxes | TOTAL |
| Property Tax | 6 | \$ 4.83 | \$ 4.54 | \$ 9.37 |
| In Lieu Excise Taxes | 35 | 58.56 | 46.66 | 105.22 |
| Business & Occupation Tax | 176 | 7,654.52 | --- | 7,654.52 |
| Other Business Taxes | 63 | 819.22 | --- | 819.22 |
| Retail Sales & Use Tax | 151 | 12,098.98 | 4,777.95 | 16,876.93 |
| All Other Taxes | 21 | 3,423.03 | 427.06 | 3,850.09 |
| TOTAL | 452 | \$24,059.14 | \$5,256.21 | \$29,315.35 |

INTRODUCTION AND SUMMARY OF FINDINGS

Chart 1 shows the distribution of taxpayer savings by tax source, with the majority of the savings coming from sales/use tax exemptions. Business and occupation (B&O) tax exemptions also account for a large share of the state impact.

Chart 1
DISTRIBUTION OF TAX EXEMPTIONS BY TAX SOURCE
Estimated Taxpayer Savings for 2011-13 Biennium
Percentage of \$29.3 Billion Total State /Local Tax Savings



Nearly all of the local exemption impacts relate to local sales taxes. It should be noted that this study does not consider certain local taxes, such as the municipal business taxes, since they are locally administered.

Normally, the property tax is attributable for the largest tax exemption savings for taxpayers, especially the exemption of intangibles (money, stocks, bonds, etc). However, as noted above, the 2012 study considers only those statutes which would likely increase state revenues if eliminated. Because of the limits on taxing district revenues, nearly all of the property tax exemptions represent a shift in tax burdens, rather than actual revenue reductions. Repeal of property tax exemptions would result in a broader tax base, thereby lowering the levy rates for all taxpayers. Thus, the property tax plays a very small role in the impact of tax exemptions for this report.

INTRODUCTION AND SUMMARY OF FINDINGS

Among the larger sales/use tax exemptions are the exclusion of personal and professional services, personal property brought into the state by nonresidents, vehicles used in interstate commerce, food for off-premises consumption, motor vehicle fuel, manufacturing machinery, and prescription drugs. By far the largest state B&O tax exemption is the exclusion of employee salaries/wages; this helps define the intended tax base by restricting the tax to business income.

Exemptions vs. Revenues

Table 2 and Chart 2 on the following page compare the estimated taxpayer savings resulting from exemptions for selected state tax sources with the forecasted revenues for those same sources. In the aggregate, these state exemptions amount to \$21.2 billion for the 2011-13 Biennium, while the projected revenues for these state sources total \$22.8 billion. For the state B&O tax and the real estate excise tax, the amount exempted exceeds the actual amount of expected revenue. For the retail sales/use tax and the public utility tax, the actual revenues exceed the impact of the exemptions. For the four state tax sources, the amount of taxpayer savings is nearly 50 percent of the potential tax base, if all exemptions were eliminated.

Table 2

COMPARISON BETWEEN IMPACTS OF TAX EXEMPTIONS AND TAX REVENUES

Selected Major State Tax Sources 2011-13 Biennium (\$ millions)

| State Tax Source | Estimated State Revenue Impact of Exemptions | Projected State Tax Revenues ¹ | Exemptions as a Percent of Revenue | Exemptions as a Percent of Potential Tax Base ² |
|------------------------|--|---|------------------------------------|--|
| State B&O Tax | \$7,654.5 | \$6,540.9 | 117.0% | 53.9% |
| Public Utility Tax | 270.3 | 805.1 | 33.6 | 25.1 |
| Retail Sales/Use Tax | 12,099.0 | 14,735.6 | 82.1 | 45.1 |
| Real Estate Excise Tax | 1,136.2 | 703.9 | 161.4 | 61.7 |
| TOTAL | \$21,160.0 | \$22,785.5 | 92.9% | 48.2% |

¹ Economic and Revenue Forecast, Office of the Forecast Council, November, 2011.

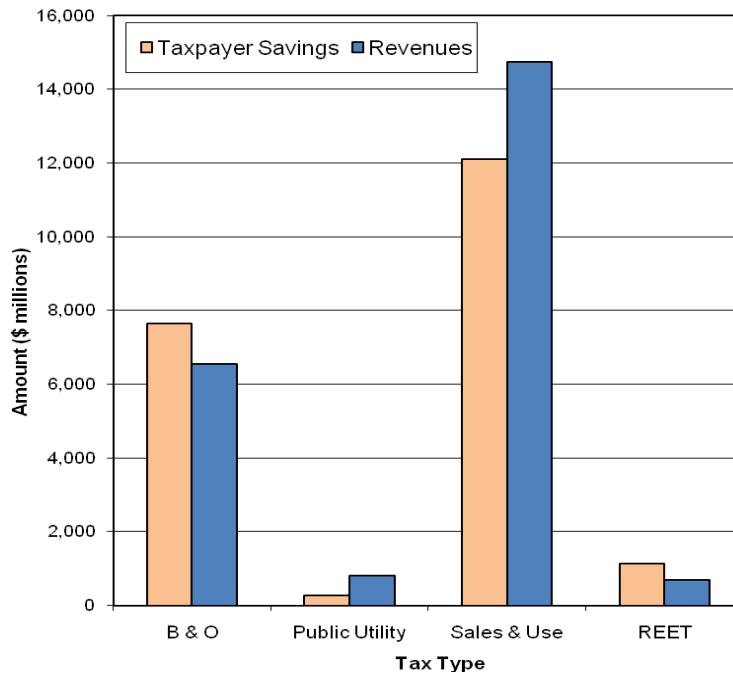
² The total taxpayer savings from exemptions compared with the total exempt amount plus the projected revenue, i.e., exemptions compared with the total potential revenue if the exemptions did not exist.

INTRODUCTION AND SUMMARY OF FINDINGS

Chart 2
COMPARISON BETWEEN EXEMPTIONS AND REVENUES

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

2011-13 Biennium (\$ millions)



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 primary purpose or type of beneficiary. 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. 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.

INTRODUCTION AND SUMMARY OF FINDINGS

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.

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.

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.

Nonprofit Organizations: There are a variety of property, B&O and sales tax exemptions provided 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.

INTRODUCTION AND SUMMARY OF FINDINGS

Individuals: These exemptions generally benefit people, as opposed to businesses or other entities. The obvious example for this category is the sales tax exemption of food products for human consumption. 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.

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. Exemptions for individuals are the leading category, representing 30 percent of the total 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, 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.

INTRODUCTION AND SUMMARY OF FINDINGS

Table 3
TAX EXEMPTIONS BY CATEGORY
2011-13 Biennium (\$ millions)

| Category | Number of Exemptions | | Taxpayer Savings | |
|--------------------------|----------------------|------------|-------------------|---------------|
| | Current Law | 2012 Study | Amount | % of Total |
| Tax base | 78 | 51 | \$ 7,883.8 | 26.9% |
| Government | 80 | 41 | 391.7 | 1.3 |
| Commerce | 23 | 9 | 2,204.2 | 7.5 |
| Intangibles | 1 | 0 | -- | -- |
| Services | 3 | 3 | 4,933.6 | 16.8 |
| Nonprofit organizations: | | | | |
| Health or social welfare | 39 | 22 | 492.0 | 1.7 |
| Charitable or religious | 12 | 6 | 23.4 | 0.1 |
| Arts or cultural | 10 | 5 | 15.0 | 0.1 |
| Other organizations | 28 | 15 | 51.7 | 0.2 |
| Individuals | 53 | 35 | 8,869.0 | 30.2 |
| Business incentive | 113 | 94 | 1,739.6 | 5.9 |
| Other business | 108 | 96 | 1,021.4 | 3.5 |
| Agriculture | 60 | 53 | 588.2 | 2.0 |
| Other | 32 | 22 | 1,101.8 | 3.8 |
| TOTAL | 640 | 452 | \$29,315.4 | 100.0% |

INTRODUCTION AND SUMMARY OF FINDINGS

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 over one-third 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. The latter category represents nearly \$5 billion in foregone sales tax revenue. 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. These categories account for 243 out of the 452 exemptions considered in the 2012 report – well over one-half of the total exemptions. However, the aggregate impact for business-related exemptions is relatively small – barely 11 percent of the total taxpayer savings. Dominating the business tax exemptions are the sales tax exemption for manufacturing machinery and equipment, the reduced B&O tax rates and tax credits for aerospace-related activities, and agricultural exemptions, including the B&O tax exemption for farmers, and the sales tax exemptions for feed, seed, and fertilizers.

The 45 exemptions provided for nonprofit organizations account for a very small portion – approximately 2 percent - of the total taxpayer savings. Finally, the 22 exemptions assigned to the "Other" category represent 3.8 percent of the foregone revenues.

INTRODUCTION AND SUMMARY OF FINDINGS

Exemption History

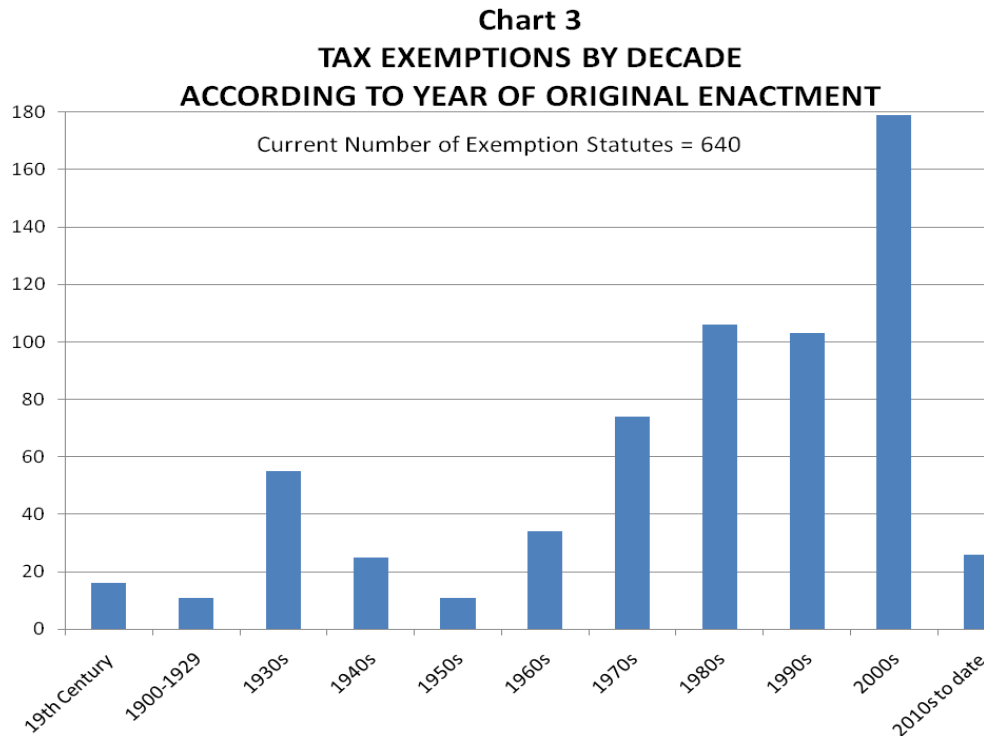
Table 4 and Chart 3 trace the evolution of tax exemption statutes over time, starting in Washington's territorial days.

Until 1935, no more than half a dozen new exemptions appeared in any single year. With the adoption of the Revenue Act of 1935 came 42 new exemption statutes. These were associated with the retail sales/use tax, business and occupation tax, and various other new state excise taxes.

Table 4
CURRENT TAX EXEMPTIONS BY YEAR OF ENACTMENT

| <u>Year</u> | <u>Number</u> | <u>Year</u> | <u>Number</u> | <u>Year</u> | <u>Number</u> |
|-------------|---------------|-------------|---------------|-------------|---------------|
| Adopted | | Adopted | | Adopted | |
| 1854 | 4 | 1959 | 4 | 1992 | 4 |
| 1871 | 1 | 1961 | 5 | 1993 | 11 |
| 1886 | 1 | 1963 | 4 | 1994 | 6 |
| 1889 | 5 | 1965 | 9 | 1995 | 17 |
| 1890 | 3 | 1967 | 16 | 1996 | 11 |
| 1891 | 2 | 1970 | 12 | 1997 | 18 |
| 1911 | 1 | 1971 | 13 | 1998 | 20 |
| 1915 | 3 | 1972 | 1 | 1999 | 7 |
| 1923 | 4 | 1973 | 5 | 2000 | 7 |
| 1925 | 2 | 1974 | 5 | 2001 | 21 |
| 1929 | 1 | 1975 | 10 | 2002 | 5 |
| 1931 | 4 | 1976 | 11 | 2003 | 34 |
| 1933 | 5 | 1977 | 4 | 2004 | 18 |
| 1935 | 42 | 1979 | 13 | 2005 | 25 |
| 1937 | 3 | 1980 | 12 | 2006 | 19 |
| 1939 | 1 | 1981 | 9 | 2007 | 19 |
| 1940 | 2 | 1982 | 4 | 2008 | 15 |
| 1941 | 1 | 1983 | 15 | 2009 | 15 |
| 1943 | 3 | 1984 | 6 | 2010 | 12 |
| 1945 | 5 | 1985 | 9 | 2011 | 11 |
| 1947 | 4 | 1986 | 6 | 2012 | 3 |
| 1949 | 10 | 1987 | 14 | | |
| 1951 | 2 | 1988 | 3 | | |
| 1955 | 4 | 1989 | 29 | TOTAL | 640 |
| 1957 | 1 | 1991 | 9 | | |

INTRODUCTION AND SUMMARY OF FINDINGS



Relatively little took place in the field of tax exemptions during the three decades following the Revenue Act. Then activity increased in the late 1960s, as new tax policies were instituted, including new constitutional amendments allowing property tax exemptions for senior citizens and current use assessment of farm and open space lands. The first major exemption enacted by initiative of the voters occurred in 1977 with the adoption of Initiative 345 exempting food for off-premises consumption from the retail sales tax. This study dates the current food exemption statute from 1982, when the exemption was re-imposed after a temporary repeal during the recession of the early 1980s.

In recent decades there have been many new exemptions, as state policy-makers have attempted to encourage economic development through various tax incentive programs. Over the past 25 years there have been an average of 14 new exemption statutes adopted annually, culminating in the 34 new exemptions added in 2003 - the second largest number of new exemption statutes established in any one year.