2007
Tax Preference
Performance Reviews

Report 07-14

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STATE OF WASHINGTON
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Report Summary

What Is a Tax Preference?

Tax preferences are exemptions, exclusions, or deductions from the base of a state tax; a credit against a state tax; a deferral of a state tax; or a preferential state tax rate. Washington has more than 500 tax preferences.

Why a JLARC Review of Tax Preferences?

Legislature Creates a Process to Review Tax Preferences

In 2006, the Legislature expressly stated that periodic reviews of tax preferences are needed to determine if their continued existence or modification serves the public interest. The Legislature enacted Engrossed House Bill 1069 to provide for an orderly process for the review of tax preferences. The legislation assigns specific roles in the process to two different entities. The Legislature assigns the job of scheduling tax preferences, holding public hearings, and commenting on the reviews to a new Citizen Commission for Performance Measurement of Tax Preferences. The Legislature assigns responsibility for conducting the reviews to the staff of the Joint Legislative Audit and Review Committee (JLARC).

Citizen Commission Sets the Schedule

EHB 1069 directs the Citizen Commission for Performance Measurement of Tax Preferences to develop a schedule to accomplish a review of tax preferences at least once every ten years. The legislation directs the Commission to omit certain tax preferences from the schedule such as those required by constitutional law.

The Legislature also directs the Commission to consider two additional factors in developing its schedule. First, the Commission is to schedule tax preferences for review in the order in which the preferences were enacted into law, except that the Commission must schedule tax preferences that have a statutory expiration date before the preference expires. This means that Washington's longest-standing tax preferences are evaluated first.

Second, the legislation gives the Commission the option to schedule an expedited review for any tax preference that has an estimated biennial fiscal impact of $10 million or less. Expedited reviews incorporate a less detailed analysis than the full reviews of tax preferences.

In January 2007, the Commission adopted its first ten-year schedule for the tax preference reviews. The schedule for 2007 included a total of 22 tax preferences with 14 property tax, four business and occupation tax, three fuel tax, and one sales tax deferral. Of these 22, six tax preferences were slated to undergo the full review process.

JLARC Staff Conduct the Tax Preference Reviews

JLARC's assignment from EHB 1069 is to conduct the reviews of tax preferences according to the schedule developed by the Commission and consistent with the guidelines set forth in statute. This report presents JLARC's reviews for the six tax preferences scheduled by the Commission for full review.

JLARC's Approach to the Tax Preference Reviews

Consistent with the Scope and Objectives for conducting the full tax preference reviews, JLARC has evaluated the answers to a set of ten questions for each tax preference:

Public Policy Objectives:

1. What are the public policy objectives that provide a justification for the tax preference? Is there any documentation on the purpose or intent of the tax preference?
2. What evidence exists to show that the tax preference has contributed to the achievement of any of these public policy objectives?
3. To what extent will continuation of the tax preference contribute to these public policy objectives?
4. If the public policy objectives are not being fulfilled, what is the feasibility of modifying the tax preference for adjustment of the tax benefits?

Beneficiaries:

5. Who are the entities whose state tax liabilities are directly affected by the tax preference?
6. To what extent is the tax preference providing unintended tax benefits to entities other than those the Legislature intended?

Revenue and Economic Impacts:

7. What are the past and future tax revenue and economic impacts of the tax preference to the taxpayer and to the government if it is continued?
8. If the tax preference were to be terminated, what would be the negative effects on the taxpayers who currently benefit from the tax preference and the extent to which the resulting higher taxes would have an effect on employment and the economy?
9. If the tax preference were to be terminated, what would be the effect on the distribution of liability for payment of state taxes?

Other States:

10. Do other states have a similar tax preference and what potential public policy benefits might be gained by incorporating a corresponding provision in Washington?

Methodology

JLARC staff analyzed the following evidence in conducting these full reviews: 1) legal and public policy history of the tax preferences; 2) public policy objectives of the tax preferences; 3) beneficiaries of the tax preferences; 4) government data pertaining to the utilization of these tax preferences and other relevant data; 5) economic and revenue impacts of the tax preferences; and 6) other states' laws to identify any similar tax preferences.

Staff placed particular emphasis on the legislative history of the tax preferences, researching the original enactments as well as any subsequent amendments. Staff reviewed State Supreme Court, lower court, or Board of Tax Appeals decisions relevant to each tax preference. JLARC staff conducted extensive research on other state practices using the Commerce Clearing House database of state laws and regulations.

Staff interviewed the agencies that administer the tax preferences (primarily the Department of Revenue and the Department of Licensing), as well as several county assessors. These parties provided data on the value and usage of the tax preference and the beneficiaries. Data was also obtained from other state and federal agencies to which the beneficiaries are required to report. In several cases, additional information was provided to JLARC staff from the beneficiaries of the tax preference or other agencies that had special knowledge of either the tax preference or the beneficiaries.

It is not within the purview of these reviews to resolve or draw definitive conclusions regarding any legal issues that are discussed within the reviews.

Summary of the Results from JLARC's Reviews

The table on page 5 provides a summary of the results from JLARC's analysis of the tax preferences scheduled for full review in 2007. Of the six tax preferences included in this volume, this report recommends that the Legislature continue four of the current tax preferences. The report raises issues for the Legislature's consideration for two of the current tax preferences.

Organization of This Report

This report includes a separate section for each of the six tax preferences. Each section begins with a summary of the findings and recommendations from JLARC's analysis of that individual tax preference. Then, each chapter provides additional detail on that tax preference, including additional information supporting the answers to the questions outlined in the approach. Appendices provide the text of current law for each preference as well as an explanation of JLARC's property tax estimation procedure.

Additional Background Information on Charitable and Nonprofit Organizations

At the Legislature's direction, many of Washington's oldest tax preferences are being reviewed first in this overall tax preference review process. Several of these date back to legislative actions in early statehood or even Territorial days. The majority of these earliest exemptions reviewed in 2007 involve charitable and nonprofit organizations. To provide context for the individual sections that follow, this report summary concludes with some general information about tax preferences for charitable and nonprofit organizations.

Some of the oldest tax preferences in Washington are property tax exemptions for charitable organizations such as churches, cemeteries, orphanages, hospitals, homes for the aged, and libraries. This is consistent with the general history of the United States and with the treatment of such institutions in the colonies under British law, with some exemptions dating as far back as 1601.

By 1904, the State of Washington had recorded 250 charitable organizations. Charitable organizations have grown and diversified over the ensuing years. In 2006, the Secretary of State registered 21,850 exempt public charities, as well as more than 50,000 nonprofit corporations. Nonprofit organizations cover a wide variety of institutions including entities that provide services in education, health care, credit unions, labor unions, chambers of commerce, and many others.

It is common to describe charitable organizations as nonprofit organizations. However, the term "nonprofit" comes with several specific qualifications. In state law, all regular nonprofit corporations have guidelines outlined in Chapter 24.03 RCW. There are various types of nonprofit organizations distinguished in federal law. Nonprofit organizations apply to the federal Internal Revenue Service (IRS) to establish their tax exempt status. A public benefit nonprofit organization is organized and eligible for tax exempt status under 26 U.S.C. 501(c)(3). These nonprofit organizations are common and are referred to as "public charities." Nonprofit organizations have a wide range of public charitable activities and purposes. According to federal law, the promotion of health for the benefit of the community is considered a charitable purpose.

Some of the primary requirements that all nonprofits must meet are organizational restrictions on what can be done with the organizations' profits. Essentially, a nonprofit may not lawfully pay its profits to owners or to anyone associated with the organization. In addition, upon dissolution of the nonprofit, its assets must be distributed exclusively for charitable purposes. Another requirement is that the organization must have only a small part of its activities which is not furthering its charitable purpose. In addition to a restriction on the distribution of profits, a "nonprofit" designation also requires limitations on lobbying efforts and in political activities or efforts to influence legislation.

For charitable health care providers, there is an additional requirement of demonstrating community benefits. The standard adopted in 1969, and still in place today, does not require health care organizations to provide a specific level of care to the poor in order to qualify for the tax exemption. Instead, the IRS has established a "community benefit" standard, allowing the IRS to weigh several factors regarding provision of services to the community as a whole.

In exchange for the constraints on distribution of profits and business activities, nonprofits receive a variety of tax and subsidy benefits. At the federal level, nonprofits do not pay corporate taxes. At the state and local level, many nonprofits are eligible for one of several property tax exemptions. Nonprofits also receive an exemption for the state business and occupation tax for their income from contributions and donations, membership dues and fees, and grants.

Summary of Recommendations – 2007 Tax Preference Reviews

Tax Preference	Year Enacted	RCW Citation	# of Claimants in 2006 ($ amount)	Summary of Recommendation
Churches, parsonages and convents (p. 31)	1854	RCW 84.36.020	5,137 ($66 million)	Legislature should continue the tax preference
Cemeteries (p. 59)	1854	RCW 84.36.020	196 ($7.4 million)	
Household goods (p. 71)	1935	RCW 84.36.110(1)	2.4 million ($341 million)	
Refund of fuel tax for exported fuel (p. 83)	1923	RCW 82.36.300 RCW 82.38.180(2)	89 ($1.3 million)	
Nonprofit hospitals (p. 7)	1886	RCW 84.36.040(1)(e)	45 ($47 million)	Legislature should re-examine or clarify the intent of the tax preference*
Nonsectarian organizations (p. 43)	1915	RCW 84.36.030(1)	651 ($17 million)	

* See specific sections for detail on the issues recommended for the Legislature's consideration.