SENATE BILL REPORT
SB 5961

As of April 8, 2019

Title: An act relating to improving the equity and sustainability of Washington's tax structure.

Brief Description: Improving the equity and sustainability of Washington's tax structure.

Sponsors: Senators Saldaña, Kuderer, Dhingra, Hunt, Lovelett, Nguyen and Wilson, C.

Brief History:
Committee Activity: Ways & Means: 4/08/19.

Brief Summary of Bill

- Imposes a capital gains tax at a rate of 8.9 percent beginning January 1, 2020.
- Increases and funds the Working Families Tax Exemption Program.
- Increases the small business business and occupation tax credit to an amount equivalent to a $200,000 exclusion for all businesses with a taxable annual income below $2.5 million.
- Provides sales and use tax exemptions for feminine hygiene products, diapers, durable medical and mobility enhancing equipment, and over-the-counter drugs.
- Expands the property tax relief program for senior citizens, individuals with disabilities, and veterans.
- Establishes a committee to research and evaluate options to modernize and rebalance Washington State's tax structure.

SENATE COMMITTEE ON WAYS & MEANS

Staff: Jeffrey Mitchell (786-7438)

Background: Capital Gains. A capital gains tax (CGT) is a tax on the profit realized on the sale of non-inventory assets that are purchased at a lower price than the sales price. Common examples would be capital gains realized from the sale of stocks, bonds, mutual funds, boats, and real estate.

This analysis was prepared by non-partisan legislative staff for the use of legislative members in their deliberations. This analysis is not a part of the legislation nor does it constitute a statement of legislative intent.

Under the federal tax code, individuals and corporations pay income tax on the net total of all their capital gains just as they do on other sorts of income. For individuals, the amount of federal CGT depends on both the tax bracket of the individual and the amount of time the capital asset was held before being sold. Short-term capital gains are taxed at the individual's ordinary income tax rate, and are defined as capital assets held for a year or less before being sold. Currently, long-term capital gains are generally taxed at a preferential rate in comparison to ordinary income for federal income tax purposes. In 2019, the top marginal rate on ordinary income is 37 percent compared with a top marginal rate of 20 percent for long-term capital gains.

In addition to the federal tax, capital gains are often subject to state income taxes. Most states do not have separate capital gains tax rates. Instead, most states tax capital gains as ordinary income subject to the state's income tax rates.

<u>Earned Income Tax Credit & Working Families Tax Exemption.</u> The Earned Income Tax Credit (EITC) is a federal refundable tax credit for individuals with low to moderate income. Qualified individuals receive a credit on their federal tax return. The size of an individual's benefit from the EITC depends on the recipient's income, marital status, and number of children. The credit amount is a fixed percentage of earnings that increases with each dollar earned until it reaches a maximum level and then begins to phase out at higher income levels. The EITC is refundable, meaning it can exceed an individual's income tax liability.

To be eligible for the federal EITC, an individual must have at least one qualifying child or be between the ages of twenty-five to sixty-four with no qualifying children. Claimants must be either a United States citizen or a resident alien and have a valid social security number. For the purposes of the EITC, earned income includes wages, salaries, tips, and other employee compensation, plus net earnings from self-employment for the taxable year. A person is not eligible for the EITC if their aggregate amount of disqualified income such as interest, dividends, or capital gain income exceeds $3,500 in the taxable year.

For tax year 2018, a qualifying individual's adjusted gross income (AGI) must be less than:

- $49,194—$54,884 for married filing jointly—with three or more qualifying children;
- $45,802—$51,492 for married filing jointly—with have two qualifying children;
- $40,320—$46,010 for married filing jointly—with have one qualifying child; or
- $15,270—$20,950 for married filing jointly—with no qualifying children.

For tax year 2018, the maximum credit available is as follows, for both single individuals and those married filing jointly:

- $6,431 with three or more qualifying children;
- $5,716 with two qualifying children;
- $3,461 with one qualifying child; or
- $519 with no qualifying children.

In 2008, the Legislature enacted a state-level benefit program called the Working Families Tax Exemption that was based in part off of the federal EITC program. The state exemption is modeled as a sales and use tax remittance program. To be eligible, a person must have paid Washington state and local sales and use taxes, received a federal EITC benefit, have been a resident of Washington for more than 180 days for the year in which the exemption is claimed, and apply to the Department of Revenue (DOR) for the remittance. The program has never been implemented or funded; however, if it were so, the remittance would be equal to the greater of 10 percent of the person's federal EITC credit or $50.

The exemption program is under the administrative purview of DOR, and is required to be approved in the state operating budget act before any exemption benefits may be paid. As previously mentioned, the program has never been fully funded or authorized in an enacted state operating budget.

Business and Occupation Tax. Washington's major business tax is the business and occupation (B&O) tax. The B&O tax is imposed on the gross receipts of business activities conducted within the state, without any deduction for the costs of doing business. Businesses must pay the B&O tax even though they may not have any profits or may be operating at a loss. A business may have more than one B&O tax rate, depending on the types of activities conducted. Major tax rates are 0.471 percent for retailing; 0.484 percent for manufacturing, wholesaling, and extracting; and 1.5 percent for services, and activities not classified elsewhere. Several lower rates also apply to specific business activities. A B&O tax credit is provided for businesses whose B&O tax liability is below a certain level. The credit varies depending on the amount of B&O tax due—the total of all classifications—after all other B&O tax credits have been taken. The amount of the small business B&O tax credit for service-related business is $840 per year, which completely exempts a service business with annual B&O income below $56,000 and provides a partial reduction in B&O tax liability for a service business with income at or below $112,000. For all other taxpayers, the amount of the small business B&O credit is $420 per year, which for taxpayers subject to the 0.484 percent B&O tax rate, completely exempts a business with an annual B&O income below $86,777 and provides a partial reduction in B&O tax liability for a business with an income below $173,554.

Sales and Use Tax. Retail sales taxes are imposed on retail sales of most articles of tangible personal property, digital products, and some services. A retail sale is a sale to the final consumer or end user of the property, digital product, or service. If retail sales taxes were not collected when the user acquired the property, digital products, or services, then use taxes apply to the value of property, digital products, or services when used in this state. The state, most cities, and all counties levy retail sales and use taxes. The state sales and use tax rate is 6.5 percent. Local sales and use tax rates vary from 0.5 percent to 3.5 percent, depending on the location.

Property Tax Relief Program for Senior Citizens, Individuals with Disabilities, and Veterans. Authorized by a constitutional amendment, qualifying senior citizens, persons retired due to disability, and veterans receiving compensation from the United States Department of Veterans Affairs at total disability rating for a service-connected disability are entitled to property tax relief on their principal residence. To qualify, a person must be sixty-one years old in the year of the application or retired from employment because of disability, own their principal residence, and have a combined disposable income of less than $40,000 a year. Eligible individuals may qualify for a partial property tax exemption and a valuation freeze. If the owner is confined to a hospital, nursing home, assisted living facility, or adult family home, the claim for exemption may still be made as long as the residence is temporarily unoccupied, the residence is occupied by a spouse or domestic partner, or the residence is rented out in order to pay for the alternative living arrangement.

Partial tax exemptions for senior citizens and persons retired due to disability are provided as follows:
- if disposable income is $35,001 to $40,000, all excess levies and the additional state levy are exempted.
- if disposable income is $30,001 to $35,000, all excess levies, the additional state levy, and regular levies on the greater of $50,000 or 35 percent of AV—$70,000 maximum —are exempted.
- if disposable income is $30,000 or less, all excess levies, the additional state levy, and regular levies on the greater of $60,000 or 60 percent of AV of the principal residence are exempted.

In addition to the partial exemptions listed above, the valuation of the residence of an eligible individual is frozen, for the purpose of calculating property tax liability, at the AV of the residence on the later of January 1, 1995, or January 1st of the assessment year in which the person first qualifies for the program. To be eligible, the person must have a disposable income of less than $40,000.

In addition to the exemption program, individuals who meet the requirements for the senior citizen and individuals with disabilities exemption program, except for the income and age requirements, are permitted to defer their property taxes if their combined disposable income is $45,000 or less and they are sixty years or older. Taxes that are deferred become a lien against the property and accrue interest at 5 percent per year. If deferred taxes are not repaid within three years after the eligible person ceases to own and live in the residence, the lien will be foreclosed and the residence sold to recover taxes.

For property tax relief programs, combined disposable income is defined as the sum of federally defined adjusted gross income and the following, if not already included: capital gains; deductions for losses; depreciation; pensions and annuities; military pay and benefits; veterans benefits except attendant-care and medical-aid payments; Social Security and federal railroad retirement benefits; dividends; and interest income on state and municipal bonds. Payments for the care of either spouse received in the home, in a boarding home, in an adult family home, or in a nursing home; prescription drugs; and Medicare health care insurance premiums are deducted when determining combined disposable income

<u>Washington State Tax Structure Study Committee and Tax Structure Work Group.</u> The Washington State Tax Structure Study Committee (committee) was created in the 2001-03 Operating Budget. The committee was directed to study the elasticity, equity, and adequacy of the state's tax system and develop multiple alternatives to the existing tax system.

The committee membership was required to consist of 11 members:
- six academic scholars appointed by DOR from relevant disciplines, after consulting with leadership in the largest caucuses in each chamber of the Legislature; and
- one member appointed by each the Governor and the chairs of the largest caucuses in each chamber of the Legislature.

Additionally, DOR was directed to create an advisory group to provide advice and assistance to the committee. The Legislature directed the committee to submit a final report including the results of and conclusions from the analysis and recommended tax structure alternatives. The committee's recommendations included, but were not limited to, replacing the business and occupation tax with a business value added tax, establishing a rainy day fund, and streamline the sales tax.

The Tax Structure Work Group (work group) was created in the 2017-19 operating budget. The work group was directed to facilitate public discussions throughout the state regarding Washington's tax structure and report the results to the fiscal committees of the Legislature, upon request.

The work group consisted of a member from each of the major caucuses in the House of Representatives, appointed by the speaker of the House of Representatives, who also served as co-chairs of the work group.

During the 2018 interim, the work group held public meetings in Spokane, Yakima, Vancouver, and Seattle. The public meetings included a staff briefing on the general revenue structure, discussions among attending participants about the state of the current tax structure and ideas about how to change the structure, and individual oral testimony. The discussions, public testimony, and results of a follow-up survey of attending participants were summarized in a final report, adopted by the co-chairs in December 2018. The final report also included recommendations from the work group, including reauthorizing the work group and expanding the membership to include multiple members from each chamber of the Legislature and various stakeholder groups, and to increase the scope of work to include analysis, policy development, and continued public meetings.

<u>Tax Preferences.</u> State law provides for a range of tax preferences that confer reduced tax liability upon a designated class of taxpayer. Tax preferences include tax exclusions, deductions, exemptions, preferential tax rates, deferrals, and credits. Currently, Washington has over 650 tax preferences, including a variety of sales and use tax exemptions. Legislation that establishes or expands a tax preference must include a Tax Preference Performance Statement (TPPS) that identifies the public policy objective of the preference, as well as specific metrics that the Joint Legislative Audit and Review Committee (JLARC) can use to evaluate the effectiveness of the preference. All new tax preferences automatically expire after ten years unless an alternative expiration date is provided.

Summary of Bill: The bill as referred to committee not considered.

Summary of Bill (Proposed Substitute): <u>Capital Gains Tax.</u> Beginning January 1, 2020, an annual state net CGT is imposed on the sale or other voluntary exchange of long-term capital assets by individuals. The tax rate is 8.9 percent. Generally, the tax rate is applied to the capital gains amount reported on the individual's federal income tax return. For resident individuals, all capital gains from the sale or exchange of intangible personal property, such as stock, are allocated to Washington. Capital gains from real estate transactions are allocated to Washington if the real property is located in Washington. Generally, capital gains from the sale or exchange of tangible personal property are allocated to Washington if the property was located in Washington at the time of the transaction.

All taxpayers must file with the state DOR, a CGT return for each taxable year; however, a person with no tax liability is not required to file a tax return. The due date of the state CGT return is the due date for the federal income tax return, unless otherwise required by DOR. The first state CGT returns are due in 2021.

For all taxpayers, the first $250,000 in long-term capital gains is excluded from the state CGT.

Sales or exchanges of some capital assets are explicitly excluded from the state CGT, including:

- residential dwellings along with the land upon which the dwelling is located;
- assets held in a retirement accounts;
- assets transferred as part of a condemnation proceeding;
- livestock related to farming or ranching;
- agricultural land that meets certain requirements;
- certain types of property used in a trade or business such as machinery and equipment that have been immediately expensed;
- timber and timberlands; and
- affordable rental housing sold to a nonprofit corporation or housing authority.

In addition to the exemptions described above, certain transfers of a taxpayer's interest in a qualified family-owned small business are exempt. Generally speaking, a qualified family-owned small business is one in which:

- the taxpayer held an ownership interest in the business for at least the eight years preceding the sale or transfer of the business;
- the taxpayer or his or her family member materially participated in the business in at least five of the eight years preceding the sale or transfer of the business;
- the business did not have more than 50 full-time employees at any time during the twelve month period preceding the sale or transfer of the business; and
- the business had worldwide gross revenues of $5 million or less in the 12-month period preceding the sale or transfer of the business.

All state CGT revenues are deposited into the state general fund.

<u>Working Families Tax Exemption.</u> Beginning in calendar year 2020, the Working Families Tax Exemption is implemented. The payout is increased from 10 percent of the federal EITC to 20 percent.

The administration of the program is moved from DOR to the Employment Security Department.

<u>Business and Occupation Tax Credit for Small Businesses.</u> The B&O tax credit for small businesses is expanded. For businesses primarily engaged in service-related activities, the credit is increased from an annualized amount of $840 to $3,000 if the taxpayer's annualized tax obligation, prior to the credit, is less than $37,500. For all other taxpayers, the credit is increased from an annualized amount of $420 to $972 if the taxpayer's annualized tax obligation, prior to the credit, is less than $12,100.

These increased B&O credits roughly correspond to a $200,000 exclusion for all taxpayers with taxable incomes below $2.5 million who are subject to the primary B&O tax rates.

Sales and Use Tax Exemptions. Sales and use tax exemptions are provided for:
- feminine hygiene products;
- diapers;
- durable medical equipment used in the home and prescribed mobility enhancing equipment; and
- over-the-counter drugs.

The exemptions are exempted from TPPS requirements, the ten year expiration of tax preferences, and JLARC review.

Property Tax Relief Program for Senior Citizens, Individuals with Disabilities, and Veterans. Income thresholds for the senior citizen, individuals with disabilities, and veterans property tax exemption are modified. Income ceilings based on a percentage of county median household income are added to each threshold category as follows beginning with property tax collection year 2021:
1. Income threshold one replaces the $30,000 income threshold. "Income threshold one" is defined as equal to the greater of income threshold one for the previous year or 45 percent of county median household income.
2. Income threshold two replaces the $35,000 income threshold. "Income threshold two" is defined as equal to the greater of income threshold two for the previous year or 55 percent of county median household income.
3. Income threshold three replaces the $40,000 income threshold. "Income threshold three" is defined as equal to the greater of income threshold three for the previous year or 65 percent of county median household income.

The income threshold for the valuation freeze is modified to be based off of income threshold three—a combined disposable income of up to 65 percent of county median household income. The income threshold for the deferral program is updated to up to 75 percent of county median household income. The property tax deferral program is altered such that heirs and devisees may maintain the deferral, subject to certain conditions. Confinement in the home of a relative for the purposes of long-term care is added to the list of conditions under which the exemption may be maintained.

"County median household income" is defined as the median income estimates for the state of Washington, by county, of the legal address of the principal place of residence, as published by the Office of Financial Management. DOR is directed to publish updated income thresholds every five years beginning March 1, 2021. DOR must authorize an option for electronic filing of applications for the exemption program. DOR is required to submit a report to the Legislature every five years beginning December 1, 2021. The report must include the number of additional properties that qualify for the exemption as the result of the changes in the bill.

The bill applies to taxes levied for collection in 2021 and thereafter.

The bill contains a TPPS identifying the public policy objective of provide tax relief to senior citizens, disabled persons, and veterans. The bill is exempt from the automatic ten-year tax preference expiration date.

<u>Tax Structure Work Group.</u> The work group is reauthorized and expanded, in membership and in scope.

The membership of the work group includes nine voting members, appointed as follows:

- two members of the two largest caucuses in each chamber of the Legislature, appointed by the president of the Senate and the speaker of the House of Representatives, respectively; and
- one member who represents the Office of the Governor.

The membership must also include one nonvoting member representing each of the following organizations: DOR, the Association of Washington Cities and the Washington State Association of Counties. All work group members must submit a letter of interest and statement of understanding that the commitment to serve on the work group is through December 31, 2024. Elected officers not reelected to their respective offices may be relieved of their responsibilities. Vacancies must be filled within 60 days of notice of vacancy.

The work group must choose a chair or co-chairs from among its legislative membership.

Decisions are made by a simple majority vote of the membership. Voting by proxy is not permitted.

DOR must create one or more technical advisory groups to assist the work group with its duties. The advisory groups may include academic scholars and other recognized experts in relevant fields. The Legislature intends to include both economic theory experts and tax practitioners in an advisory group.

DOR must provide staff support, subject to the degree such support is funded through appropriation. DOR may engage one or more consultants to provide work group support.

The duties of the work group are to:

- update the final report of the committee and investigate other matters that may be material to changing the state tax structure;
- facilitate a series of public meetings in geographically dispersed locations to present the updated report and other findings, collect feedback from taxpayers about the tax structure, and summarize the feedback in a report; and
- make recommendations to the Legislature for changes to the state tax structure, based on the updated report and other findings—recommendations may not result in an estimated loss in state revenue.

It is the intent of the Legislature to consider the recommended changes to the state tax structure during the 2023 legislative session. If the proposal is not adopted, the work group is directed to facilitate public meetings to collect feedback about the legislative proposal and modify the proposal to address the feedback. During the 2024 legislative session, it is the intent of the Legislature to consider the modified proposal.

By December 31, 2024, the work group is directed to submit a final report, compiling of all other reports previously submitted since July 1, 2019.

The work group expenses must be jointly paid by each house of the Legislature. Members of the work group must serve without compensation, but may be reimbursed for travel expenses.

Appropriation: None.

Fiscal Note: Available.

Creates Committee/Commission/Task Force that includes Legislative members: Yes.

Effective Date: The bill contains several effective dates. Please refer to the bill.