POLICY BRIEF

An Unearned Income Tax in Washington:

Building Resources for the Greater Good

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Economic Opportunity Institute

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About the Economic Opportunity Institute

The Economic Opportunity Institute is a public policy institute that offers practical solutions to some of the most pressing problems facing individuals and children in Washington—solutions that result in long-term economic security for families and communities.

EOI staff research issues, evaluate programs, and build coalitions to move policy forward. State and national legislators, community leaders, locally elected officials, and leaders in communities throughout the United States rely on EOI for analyses and policy development.

The Economic Opportunity Institute is currently developing pragmatic policies to address the following issues: state taxation policies, family leave insurance, Social Security and retirement security, early childhood education, and health care.

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Executive Summary

Washington's current state tax system is inadequate to support the public services necessary to a vital economy. According to a national report on state taxation, "CEOs in Washington worry about whether the state is willing to provide the services they need."[1] Well-funded public education, health care, and other public services are essential if the state's residents and businesses are to thrive.

Washington is one of only seven states with no broad-based personal income tax. Existing taxes fall disproportionately on the state's lower-income residents. Reforming the state's tax system could bring in desperately needed additional revenue and could make the state's tax system more equitable.

One possibility is the adoption of a tax on unearned dividend and interest income. A tax on unearned income would be paid almost exclusively by the state's highest income residents and could produce revenues that grow with the state's economy and need for services. The additional revenue could total between $100 million and $500 million a biennium depending on the tax rate and exemption level.

Introduction

Washington is one of only seven states with no broad-based personal income tax. The absence of an income tax has some troubling implications. Most states fund services through a combination of income, property, sales, and corporate taxes. Washington relies heavily on sales, business, and targeted taxes. As a consequence, Washington has a very regressive state tax system. It also has a tax system that has become inadequate to fund state services, because the tax base has not grown as fast as the state's economy. The sales tax and targeted tax rates have been pushed upwards to meet revenue needs, but can only be stretched so far. The state's Office of Financial Management predicts that future state tax revenue under the current tax system will grow at only about 85 percent of the rate of personal income and the overall economy.[2]

National and local studies of state taxation have recommended that Washington expand its tax base to balance its tax structure.[3] By broadening its tax base, Washington could create a fairer tax system that provides solid support for state government. Without broadening its tax base, Washington will continue to struggle with inadequate tax revenues to fund essential public services.

The adoption of an income tax is one possibility for expanding the tax base. Beginning in the 1920s, state tax commissions have recommended the adoption of a state income tax eight times, most recently in 2001.[4] Washington voters approved a graduated income tax in 1932, but in 1933 the state Supreme Court, equating income with property, ruled five-to-four against a graduated taxation of income. Since the 1930s, Washington voters have rejected the income tax as persistently as state commissions have praised it, most recently in 1973.

A more incremental approach to expanding the tax base could be the introduction of a tax on two components of unearned income: dividends and interest. Most states with an income tax include all income, but two states, New Hampshire and Tennessee, tax only unearned income. Dividend and interest income is taxed at a rate of five percent in New Hampshire and six percent in Tennessee. In Washington, an unearned income tax has the potential to reduce the regressivity of state taxes and provide a new stream of revenue for state government.

The Unearned Income Tax Proposal for Washington State

The unearned income tax is primarily a tax on the unearned dividend and interest income received by individuals. In this proposal, dividend and interest income in excess of a fixed exemption level is taxed at a flat rate.

Definitions

Taxpayers:

- Individuals living or residing in Washington for any part of the taxable period.
- Fiduciaries (administrators, guardians, trustees, or persons acting in a similar capacity) who receive interest or dividend income for the benefit of Washington inhabitants or residents.
- Sole proprietorships, partnerships, or S-corporations that report interest and dividend income on their personal income tax form 1040.

Tax base: Unearned income, defined as the sum of taxable interest income as reported on line 8a of form 1040 or 1040A (2004) and dividend income as reported on line 9 of form 1040 or 1040A (2004).

Exemptions: Three options for an exemption level are considered in this brief.

- *Option A:* $2,000 for individual, business, and fiduciary; $4,000 for joint filers.
- *Option B:* $2,000 for individual, business, and fiduciary; $4,000 for joint filers with an additional $1,000 per person exemption for individuals aged 65 or older.
- *Option C:* $3,000 for individual, business, and fiduciary; $6,000 for joint filers.

Tax rates:

- *Option 1:* 1% on unearned income in excess of the exemption level.
- *Option 2:* 5% on unearned income in excess of the exemption level.

Revenue Estimates

Introducing an unearned income tax in Washington state would help raise the revenue necessary to support vital public services and improve Washington's tax structure. The amount of revenue generated by an unearned income tax depends on the exemption level and tax rate that are adopted. Table 1 shows revenue estimates for six possible versions of the unearned income tax. The revenue brought in ranges from a low of $49 million, with the higher exemption and lower tax rate, to $275 million, with the lower exemption and higher tax rate. Relative to state tax revenues in 2003, this represents a 0.4% to 2% increase.

Only a small fraction of Washington taxpayers would be required to pay any unearned income tax whatsoever. With the exemption level set at $2,000, only 16% of Washington residents would be required to pay the unearned income tax. With the exemption set at $3,000, the percent of residents paying the tax would be even smaller, 11%. The bulk of the revenue generated by the unearned income tax comes from a small share of residents that receives large amounts of income from financial assets.

Table 1: Unearned Income Tax Revenue Projections for 2005

Tax rates and exemptions levels	Annual revenue in 2005	% of Washington households taxed
1% tax $2,000 single/$4,000 joint exemption	$55 million	16%
5% tax $2,000 single/$4,000 joint exemption	$275 million	16%
1% tax $2,000 single/$4,000 joint exemption plus $1,000 more for seniors	$52 million	14%
5% tax $2,000 single/$4,000 joint exemptions plus $1,000 more for seniors	$260 million	14%
1% tax $3,000 single/$6,000 joint exemption	$49 million	11%
5% tax $3,000 single/$6,000 joint exemption	$245 million	11%

Source: Revenue projections from the Institute for Taxation and Economic Policy.
Note: Interest and dividends earned by retirement accounts are not taxed in this proposal.

Table 2 shows the effect of the unearned income tax on individuals at different income levels. The estimates show that low-income Washington residents would pay no or very little unearned income tax. Only 3 to 5 percent of individuals in the lowest fifth of the income distribution would pay any unearned income tax at all, and their average tax bill would be at most $10. Looking at individuals in the

Table 2: Projected Impact of the State Unearned Income Tax and 2003 Federal Tax Cuts by Income Level

		Individual income level, by quintile				
	Total	**First (lowest 20%)**	**Second**	**Third**	**Fourth**	**Fifth (top 20%)**
Average income in group		$11,000	$25,000	$40,000	$63,000	$183,000
Impact of 2003 federal tax cuts on dividends and capital gains						
Average federal tax change	($266)	($1)	($16)	($51)	($88)	($1,173)
Impact of 1% rate, $2,000 individual/$4,000 joint exemption:						
Percent paying tax	16%	5%	12%	15%	19%	30%
Average WA tax change	$20	$2	$5	$8	$13	$72
Net WA and fed. tax change	($246)	$1	($11)	($43)	($75)	($1,101)
Impact of 5% rate, $2,000 individual/$4,000 joint exemption						
Percent paying tax	16%	5%	12%	15%	19%	30%
Average WA tax change	$100	$10	$25	$40	$65	$359
Net WA and fed. tax change	($166)	$9	$9	($11)	($23)	($814)
Impact of 1% rate, $2,000 individual/$4,000 joint exemption, $1,000 more for seniors						
Percent paying tax	14%	4%	10%	12%	17%	27%
Average WA tax change	$19	$2	$4	$7	$12	$70
Net WA and fed. tax change	($247)	$1	$12	($44)	($76)	($1103)
Impact of 5% rate, $2,000 individual/$4,000 joint exemption, $1,000 more for seniors						
Percent paying tax	14%	4%	10%	12%	17%	27%
Average WA tax change	$95	$10	$20	$35	$60	$352
Net WA and fed. tax change	($171)	$9	$4	($16)	($28)	($821)
Impact of 1% rate, $3,000 individual/$6,000 joint exemption						
Percent paying tax	11%	3%	9%	10%	13%	22%
Average WA tax change	$18	$2	$4	$6	$10	$67
Net WA and fed. tax change	($248)	$1	($12)	($45)	($78)	($1106)
Impact of 5% rate, $3,000 individual/$6,000 joint exemption						
Percent paying tax	11%	3%	9%	10%	13%	22%
Average WA tax change	$89	$10	$20	$30	$50	$336
Net WA and fed. tax change	($177)	$9	$4	($21)	($38)	($837)

Source: Based on estimates from the Ins titute on Taxation and Economic Policy.
Note: Net tax change does not include the federal taxes saved by itemizers who deduct the WA unearned income tax when filing federal income taxes.

middle of the income distribution, 10 to 15 percent of individuals would pay an average of $4 to $25 yearly in unearned income taxes.

For high-income taxpayers, total federal and state taxes on unearned income would still be lower than they were five years ago. Federal taxes on unearned income were cut substantially in 2003, as shown in the first line of Table 2. For individuals in the top 20% of the income distribution, for example, the average state unearned income tax bill would be $67 to $359. The 2003 federal tax cuts reduced taxes on unearned income for these individuals by an average of $1,173. The net effect of the 2003 tax cuts and the proposed unearned income tax would be an average *reduction* in taxes on unearned income of $814 to $1,106 for high-income taxpayers.

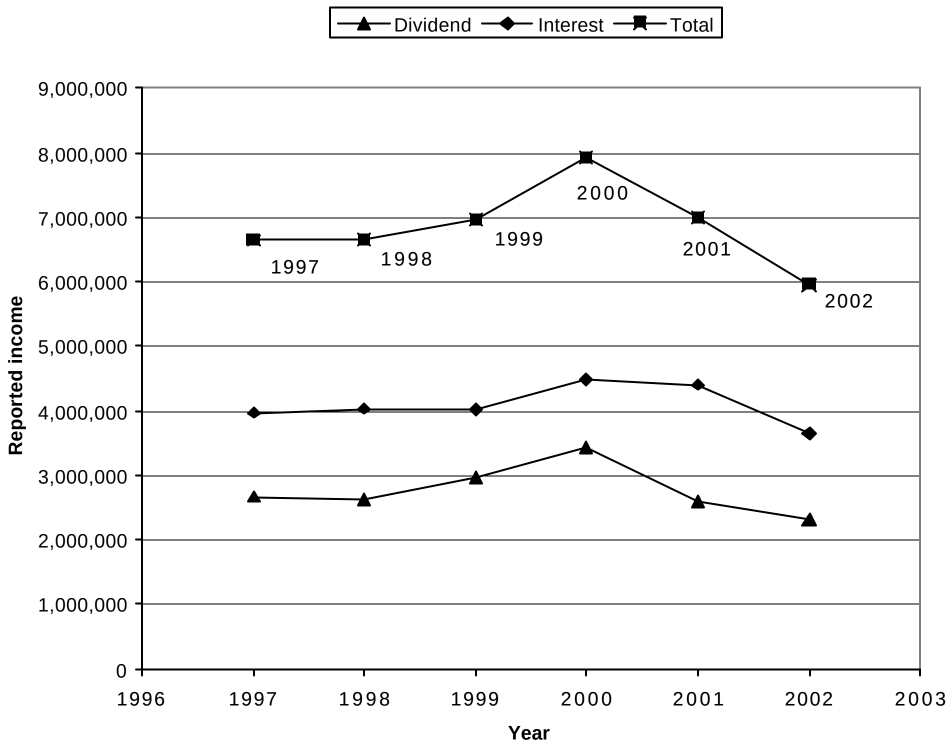
The unearned income tax would introduce a substantial transfer of resources from federal to state government. Washington residents who itemize their taxes could deduct the unearned income taxes paid to Washington in calculating their federal income tax. This means that about 15% of the tax revenue generated by the proposed unearned income tax would represent a transfer of tax dollars from federal to state government rather than an increase in taxes paid by Washington residents.[7]

Volatility and a Rainy Day Fund

One concern regarding the unearned income tax is potential revenue volatility. Unearned income varies more from year to year than do wages and salaries, and a tax on unearned income would also exhibit this volatility. Figure 1 tracks the dividend and interest income reported by Washington residents between 1997 and 2002 (a particularly volatile period encompassing the dotcom boom and bust). Combined dividend and interest at the high in 2000 is 33% greater than at the low in 2002. The revenue generated by an unearned income tax would display a similar level of volatility.

One way to smooth out the revenue generated by the unearned income tax would be to establish a rainy day fund in conjunction with the tax. The rainy day fund would be maintained by setting a target amount of unearned income tax to be collected each year. In “boom” years, when tax revenue exceeds the target, the excess revenue would be placed in the rainy day fund. In “bust” years, when tax revenue falls short of the target, funds would be drawn from the rainy day fund to bring tax revenue up to the target level.

Figure 1: Dividend and Interest Income, 1997-2002



Source: IRS Tax Statistics Website, Individual Tax Statistics by State, http://www.irs.gov/taxstats/article/0,,id=103106,00.html.

The Unearned Income Tax in New Hampshire and Tennessee

The unearned income taxes of New Hampshire and Tennessee provide working models of how a tax on unearned income could be structured in Washington. In both New Hampshire and Tennessee, revenue from the unearned income tax makes up about five percent of total state taxes collected. Table 3 summarizes the major features of the unearned income tax in the two states.

Table 3: The Unearned Income Tax in New Hampshire and Tennessee

	New Hampshire	Tennessee
Taxpayers	Resident individuals Fiduciaries (executors, trustees) Partnerships, LLCs, associations	Resident individuals Fiduciaries (executors, trustees) Partnerships
Tax base	Interest and dividend income *Interest:* form 1040, 1040A line 8a *Dividends:* form 1040, 1040A line 9	Interest and dividend income *Interest:* form 1040, 1040A line 8a *Dividends:* form 1040, 1040A line 9
Tax rate	5%	6%
Exemptions	$2,400 individual $4,800 married filing jointly *Additional exemptions:* *$1,200 if blind* *$1,200 if spouse is blind* *$1,200 if aged 65 or older or disabled* *$1,200 if spouse is 65 or older or disabled*	$1,250 individual $2,500 married filing jointly *Additional exemptions:* *Blind persons are completely exempt.* *Persons 65 or older are exempt if total income from all sources is less than $16,200 for individuals or less than $27,000 for joint filers.*
Distribution	State government	62.5% state government; 37.5% local government

Sources: New Hampshire and Tennessee tax documents and revenue departments.

Constitutional Issues in Washington

Any new state tax must pass a test of constitutionality. The Washington State Supreme Court in the past has interpreted income as a form of property. As such, the taxation of income is subject to the same limits that apply to the taxation of personal property. Currently, this implies that any income tax adopted without a constitutional amendment must be a flat tax at a maximum rate of 1%, with a maximum of $3,000 of income exempted. Were the unearned income tax to be considered a property tax, it would be subject to the 1% limit on the tax rate and the $3,000 limit on the exemption.

Recent legal analysis suggests that there may be grounds to reconsider Washington's interpretation of income as property. According to legal scholar Hugh Spitzer, there remain only two states, Pennsylvania and Washington, whose courts have not reversed earlier decisions treating income as property. Spitzer's analysis finds a "reasonable likelihood" that were an income tax approved in Washington today, the courts would reconsider the interpretation of income as property.[8] If Washington courts ruled in a manner more consistent with the dominant view in other states, the property tax limits ($3,000 exemption, 1% rate) would not be found to apply to the unearned income tax. In this case, the tax rate on dividend and interest income could be set at the higher level of five or six percent used in New Hampshire and Tennessee.

The history of the unearned income tax provides another argument for a tax rate exceeding the 1% limit on property tax. In New Hampshire, the unearned income tax evolved from a tax on intangible property, such as securities. Until 1995, New Hampshire did not tax dividend and interest income per se. Instead, the state imposed a tax on the intangible property that generated the income (e.g., securities, bank accounts). Because of the difficulty of assigning a fixed value to some intangible assets, such as stocks, New Hampshire's intangible property tax was replaced in 1995 by its unearned income tax. Unearned dividend and interest income thus came under taxation not as income but as a proxy for the value of the underlying intangible property. Along this line, it could be argued that limits on property taxation apply to the value of the intangible property generating the income rather than the income itself. Were this argument to be accepted in Washington, the tax rate on unearned income could be set much higher than the 1% specified in the constitutional limit.

Effect on Retirees

One question regarding the adoption of an unearned tax is its effect on retirees. For working individuals, unearned income generally makes up a small share of total income, while this share is higher for retirees.[9]

National data on the income of retirees provides reassurance on this count (Table 4). Asset income (dividend, interest, and rents) ranks behind Social

Table 4: Income Source as a Percent of Total Income by Family Income Level for Persons Aged 65 or Older in 2001

		Family income level, by quintiles				
Income source	**Total**	**First (lowest 20%)**	**Second**	**Third**	**Fourth**	**Fifth (highest 20%)**
Social Security	41.1	83.6	72.1	56.9	41.7	20.5
Earnings	19.5	1.6	4.7	8.5	15.2	32.3
Pensions	20.4	5.0	13.6	20.5	27.3	21.3
Assets	16.6	4.1	7.2	11.4	13.0	24.3
SSI, other gov't	2.1	5.4	2.1	2.3	2.4	1.3
Other	0.3	0.3	0.3	0.4	0.4	0.3

Source: AARP Public Policy Institute, "Income and Poverty of Older Americans in 2001."

Security benefits, pension income, and earnings as an income source for the elderly. For elderly households at the low end of the income distribution, asset income constitutes less than ten percent of total income. Research on poverty among the elderly has shown that a reduction or even elimination of asset income would have almost no effect on the share of elderly persons whose incomes fall below the poverty line.[10]

Further information regarding the impact of an unearned income tax on older persons is provided in Table 5. The data show that dividend and interest income does not constitute a major source of income for the typical (median) older person. While the majority (53 percent) of persons aged 65 and older received some interest income, most people received very little, as reflected in the median of only $600 for those having interest income. Only 23 percent of aged persons received dividend income; for these seniors, the median amount was $780.

Table 5: Income of Persons Aged 65 and Older, 2002

Sources of income	Recipients as percent of those 65 and older	Median income from source
All seniors		***$14,148***
Social Security	88.8%	$9,864
Interest income	53%	$600
Pension income	30.6%	$8,400
Dividend income	22.8%	$780
Earnings income	16.3%	$15,000
Rents, royalties, estates, or trusts	7.8%	$3,000
Survivor benefits	4.9%	$5,508
Supplemental Security Income	3.5%	$3,396
Veterans benefits	3.3%	$4,799
Disability benefits	0.6%	$6,000
Unemployment compensation	0.6	$2,520
Worker's compensation	0.3%	$8,640
Public assistance	0.3%	$2,000

Source: AARP Public Policy Institute, "Sources of Income for Older Persons in 2002."

The conclusion to be drawn from these numbers is that were Washington to enact an unearned income tax with an exemption level of $2,000 to $3,000, most older persons would pay no tax whatsoever on unearned income. In 2002, almost half (47 percent) of older persons received no interest income and 77 percent of seniors received no dividend income. Even among those with some dividend and interest income, the median amounts fell below the proposed $2,000 or $3,000 exemption threshold of the unearned income tax.

A final point regarding retirees is that a 1% tax on unearned income is low by national standards, even for retirees. Most of the nation's retirees pay a tax on unearned income when they pay their state's personal income tax. The state personal income tax rate, at the lowest income bracket, ranges from 1% to 6% in the 41 states with a personal income tax. With a 1% tax on unearned income, Washington seniors would still pay comparably low state taxes on their unearned income relative to seniors in most other states.

Implementing an Unearned Income Tax

The introduction of a state tax raises the issue of how the new tax will be implemented. For most Washington residents, total dividend and interest income is less than the personal exemption of the proposed unearned income tax. These individuals and couples would not be required to file unearned income tax forms.

For taxpayers whose dividend and interest income surpasses the $2,000 or $3,000 exemption limit, the determination of the unearned income tax is straightforward. Both dividend and interest income are reported on federal tax forms 1040 and 1040A; the taxpayer reports the same amounts on the unearned income tax form. From there, the individual filers would deduct $2,000, joint filers $4,000.[11] The tax on the remaining dividend and interest income is calculated at a flat rate.

From a tax collection standpoint, the unearned income tax is designed to keep administrative and enforcement costs low. It minimizes collection costs by taxing forms of income already subject to federal taxation and reporting requirements. According to New Hampshire's tax commissioner, G. Philip Blastos, "This is not a very difficult tax to administer."[12]

Nonetheless, the cost of administering a new tax must be weighed against the benefits of the tax. The case of New Hampshire can be used to estimate the cost of administering and enforcing the unearned income tax. In New Hampshire, state taxes, including the unearned income tax, are collected at a cost of about 1.5 percent of tax revenue. In Washington, taxes have historically been collected at a lower cost. For example, the average cost of tax collection in fiscal years 1999 to 2003 was 0.714 percent of tax revenue.[13] A conservative estimate would put the cost of collecting the unearned income tax at the higher New Hampshire level of 1.5 percent. Initially, there would also be short-term costs involved in putting the unearned income tax into place.

Conclusion

The unearned income tax could bring in desperately needed new revenue for public services, such as education and health care. The unearned income tax would reduce the regressivity of Washington's state tax system. It could also set a precedent for broadening the state's tax system to include other sources of income, further reducing regressivity and increasing revenue. It has an insignificant effect on seniors, given that only those seniors with exceptionally high levels of interest and/or dividend income would pay the tax. Finally, it may be more politically palatable in Washington than a general income tax.

A disadvantage of the unearned income tax in Washington is its limited ability to generate revenue if imposed at the one percent property tax rate limit specified by the state constitution. Whether the one percent limit would be found to apply to an unearned income tax enacted in Washington is an open question. A higher tax rate, for example five percent, would result in revenues of close to half a billion dollars each biennium. The Legislature could enact such an unearned income tax at this higher rate. It would then be legally challenged. This would enable the state Supreme Court to reconsider its 1933 five-to-four ruling against a graduated income tax.

Notes

[1] *The Government Performance Project: The Way We Tax* February, 2003. http://www.governing.com/gpp/2003/gp3wa.htm.
[2] Marilyn Watkins and Jason Smith, "It's not Just the Recession: The Budget Crisis and Washington State's Structural Deficit," Economic Opportunity Institute Blueprint, p. 7. http://www.EOIonline.org.
[3] See Katherine Barrett, Richard Greene, Michele Mariani, and Anya Sostek, "The Government Performance Project: The Way We Tax. A 50-State Report." *Governing*, February 2003. Available at /gpp/2003/gp3intro.htm. See also the *Washington State Tax Structure Study*, November 2002, available at http://dor.wa.gov/content/statistics/WAtaxstudy/wataxstudy.htm.
[4] *The Government Performance Project: The Way We Tax* February, 2003. http://www.governing.com/gpp/2003/gp3wa.htm.
[5] Effective May 7, 2003, the maximum federal tax rate on capital gains and dividend income was cut from 35% to 15%. See http://www.ctj.org/html/publist.htm#congress for a summary of recent federal tax changes.
[6] The Center for Tax Justice estimates the offset to federal taxes of the unearned income tax at 15% to 16%, depending on the exemption level and tax rate chosen.
[7] The Center for Tax Justice estimates the offset to federal taxes of the unearned income tax at 15% to 16%, depending on the exemption level and tax rate chosen.
[8] Hugh Spitzer, Gates commission report, Appendix B, p. 4.
[9] In 1998, for example, asset income (dividends, interest, and rent) made up 11.4 percent of the income of those aged 65 or older as compared to 2.9 percent of the income of those under 65 (Wentworth and Pattison, Social Security Bulletin, Volume 64, No. 3, 2001/2002).
[10] See Wentworth and Pattison, "Income Growth and Future Poverty Rates of the Aged," *Social Security Bulliten*, Volume 64, Number 3, 2001/2002.
[11] Washington might also choose to exempt certain forms of interest or dividends from taxation. New Hampshire and Tennessee, for example, allow taxpayers to deduct the interest earned on government bonds.
[12] G. Philip Blastos, New Hampshire Tax Commissioner, conversation with the author, January 27, 2005.
[13] *Tax Statistics 2003.* Washington State Department of Revenue, February, 2004.