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Policy Brief

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Grasping at Intangibles

In calendar year 1996, Washington's state and local governments levied $4.3 billion dollars in property taxes. The state's share of this was $1.1 billion, or 26%, while the local governments claimed $3.2 billion. Property taxes represented 13% of general fund-state revenues in fiscal year 1996. Property taxes represented 34 % of local government revenue in fiscal 1993, the most recent year for which comprehensive local data are available.

The state constitution defines property to be "everything, whether tangible or intangible, subject to ownership." Property can be divided into two broad classes *real property*, which represents land and those things permanently affixed to land, and *personal property*, all the rest. Personal property, in turn can be divided between property which has a physical existence, *tangible property*, and that which has no physical existence, *intangible property*.

A large and historically important class of intangible property consists of financial assets such as money, bank deposits, municipal bonds, corporate bonds, mortgage loans, and common stock. Another group of intangible properties include monopoly rights granted by government such as patents, copyrights, trademarks, and exclusive rights to broadcast on specific bands of the spectrum. A third broad grouping of intangible properties include various forms of ongoing business relationships including customer lists and assembled workforces. A fourth group includes reputations for quality, integrity, honesty and good value. A fifth group includes workforce knowledge and skills.

Property, Capital, and Wealth

"Property" is a word with specific meaning in law, "an aggregate of rights which are guaranteed and protected by the government." In popular usage, property is interchangeable with: "capital" and "wealth." To an economist, capital indicates assets with which goods or services are produced, while wealth represents the value of things that are owned.

On one level, of course, capital and wealth are the same thing since the basis of value is the goods or services. In an advanced market economy such as ours, however, where a complex web of institutions (corporations, banks, pension funds, and so forth) intermediate between productive assets and their ultimate owners, the distinction between capital and wealth is useful.

Economists have long recognized that a nation's capital stock includes more than just the physical assets belonging to its people. The other assets are difficult to quantify however. John Kendrick, in a widely cited study, estimated that intangible assets represented 37% of the capital stock in 1969. Kendrick's work remains the most comprehensive breakdown of our total capital stock. Education and training represents the bulk of intangible capital. A fraction of this investment is funded by the business sector and is job specific, with the returns captured mostly by the funding firms. Most of the stock of education and training, however, is general in nature with returns accruing to the worker in higher wages.

History

At the time of the American Revolution, state and local governments raised much of their funds through poll taxes and specific rather than uniform property taxes. This tax system was generally understood to favor the wealthy. In the nineteenth century the general property tax emerged as the primary source of revenue for state and local governments. Beliefs in limited government and political equality shaped much of the century's political history, and a uniform tax on wealth was the appropriate tax for the era.

Limited government required only limited revenue. Real estate and tangible personal property were the primary forms of wealth. As a rule, the tax applied to all property at the same rate. As one observer has noted, "'equal taxation of property' was a highly popular concept that needed little defense." And in the predominantly agricultural economy, production for consumption rather than for sale represented a substantial share of economic activity. Sales and income taxes do not work well in such a setting.

By the turn of the twentieth century, however, as the American economy industrialized and capital markets became more highly developed, pressures developed to reduce the reliance on the property tax. Government expanded, increasing the demand for revenue. Capital markets developed, and increasingly business property was held by corporations rather than by individuals. Correspondingly, individuals held increasing proportions of their wealth as financial assets. At the same time, knowledge was becoming an increasingly important part of the nation's stock of capital.

This growth in the importance of intangible property put stress on the property tax as a uniform tax on wealth. On the one hand, the growth of financial intermediation increased the chance of double taxation of business capital, while on the other hand, wealth in the form of knowledge and intellectual property might escape taxation. As a result, states introduced other broad based taxes, including the sales tax, the gross receipts tax, and the income tax. At the same time, the base to which the property tax applied was generally narrowed. Today, nationally, the property tax is predominantly a tax on real property.

In a paper published in 1990, John H. Bowman, George E Hoffer, and Michael D. Pratt survey the extent of the taxation of intangibles across the fifty states and the District of Columbia. They report that intangibles are specifically taxed in only twenty-two states. In only nine of these states does this occur under the general property tax. (It is possible, however, that in some of the states where intangibles are not specifically taxed, some intangible value is picked up in the taxation of associated tangible property.)

Washington followed a similar path. In the initial state constitution of 1889 the state tax was the property tax, and a strong uniformity provision required that all property be assessed and taxed equally.

Amendment 14 to the state constitution, which voters approved in November 1930, allowed for the specification of distinct classes of property. Taxes must be uniform within each class, but may differ between classes. All real estate must constitute a single class. In 1931 the Legislature passed and Governor Hartley signed a bill to exempt from the property tax intangible financial assets. The same Legislature passed bills to establish individual and business income taxes, but these bills were vetoed by the governor. In 1933 the Legislature passed and Governor Martin signed a bill establishing a temporary tax on business gross income. In 1935 this tax became permanent as the Business and Occupation Tax.

All other intangibles besides financial assets remained taxable in Washington state. However, as a practical matter most intangibles have been untaxed. For example, Bowman, Hoffer, and Pratt's survey found that computer software was the only intangible subject to taxation in Washington state in the late 1980s.

The Current Dispute

State law requires that property be assessed annually, and that the value placed on property be one hundred percent of true and fair value unless specifically provided otherwise by law.

Three different approaches are used to determine the value of real property. Under the *sales* approach the value of the property in question is based upon recent sales prices of the property itself or comparable properties. Under the *cost* approach the value is based on estimates of the cost of reconstructing the property in question, with allowances for depreciation or economic obsolesce. Under the *income* approach the value is based upon the capitalized income that could be generated from the use of the property.

In addition taxpayers are required to report annually to local assessors (or to the Department of Revenue) their taxable personal property holdings.

Although intangible property is taxable in the state, the revenue that has been collected on intangible property has been a very small share of the total property tax. Generally intangibles have not been separately listed as personal property. When business tangible property is valued using either the sales or income approach, the value of associated intangibles may also be captured. During 1995, the taxation of intangibles was the subject of discussions among a working group with representatives from the business community, the county assessors, and the Department of Revenue.

In January of 1996 the Property Tax Division of the Department of Revenue advised all county assessors that they should not separately list and value intangible personal property. The memo gave a number of reasons for this advice: It is difficult to determine the taxable location (situs) of intangible property, and it can be difficult to place a separate value upon it. Beyond this, in cases where the property owner does not report the intangibles existence to the assessor, it may be difficult for the assessor to be aware of its existence. In addition, when assessors value real property by the comparable sales or the income approaches, they will tend to pick up intangible values along with the value of the real property. Thus the Department of Revenue memo argued, the separate listing and valuation of intangibles presented the potential both for double taxation and for non-uniform and inconsistent treatment of taxpayers.

Discussion

Under Washington's Constitution, the Legislature is allowed to establish separate classes of property but taxes must be uniform upon all property within any given class. The taxation of intangible property presents a serious challenge to the operation of a uniform system of taxes.

Assessors rely on taxpayers to report the personal property they own, and underreporting is potentially a problem for many intangibles. The risk is that those taxpayers who correctly report their intangible holdings will be unfairly penalized for their honesty and that this will erode the system's fairness.

Several approaches to the problem of intangible taxation have been discussed in the Legislature. One approach is to prohibit the separate listing intangibles while keeping the property subject to taxation. This would codify the policy advocated by the DOR's January 1996 memo. The value of intangible property would be picked up while applying the income approach or the sales approach to appraising associated tangible property. This presents a uniformity problem. When the cost approach is employed, intangible values will be missed. And because many intangibles are idiosyncratic it will be hard to identify comparables when implementing the sales approach. Thus the extent to which intangibles are taxed may vary considerably from taxpayer to taxpayer.

The alternative approach would exempt all intangible personal property from the property tax. The presence of intangible assets would be considered when determining the value of tangible property. For example, a brand new machine constructed at the cost of $100, whose only use is to make a patented product, could be assessed at $100. The fact that the patent is intangible and nontaxable would not force the assessed value of the machine to zero.

Taken all together, fully exempting intangibles seems to be the cleaner solution to the problem. The amount of money involved is not large. The Office of Financial Management estimates that value of this exemption in terms of local property taxes would have been $16.2 million in 1996. Including the state property tax might raise the value of the exemption to $22 million. This represents one half of one percent of the property taxes levied in that year.