

Analysis of the Property Tax Deferral Bill

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Introduction

As legislators meet in special session to debate whether to limit the yearly rise in the property tax burden the state and local governments place on citizens, Governor Christine Gregoire has announced a second measure intended to bring partial property tax relief to some Washington families.

The proposal would allow homeowners earning up to the state median income, \$57,000 a year, to defer up to 50% of their annual property tax bill on a primary residence, subject to certain restrictions. Copies of the legislation have not been released. What follows is an analysis based on news reports and information released by the governor's office. The main conclusions of the analysis are:

- Some homeowners would be burdened with back taxes and interest charges.
- The tax debt would function as a lien against the home, and against the estates of deceased homeowners.
- Heirs may be forced to sell the home to pay back taxes; home-based family businesses could be lost.
- For families that fell further into debt, the state would assume a role similar to a credit card company or payday lender, seeking to collect despite the debtor's declining ability to pay.
- A policy of tax deferral does not protect homeowners through permanent tax relief.

Policy Analysis

The policy intent of the tax deferral proposal is to provide temporary tax relief to modest-income taxpayers. At the same time the policy seeks to protect revenue increases to the state by requiring that deferred taxes be paid at some point in the future. The state would reimburse local governments for any revenue losses they sustain under the tax deferral program.

Taxpayers who opted for the deferral would pay interest when the taxes are repaid. The annual interest rate the state would charge would be based on the federal short-term rate plus 2%. In 2008 this rate would be 7%.

The tax deferral would function as a lien against the taxed property. If the property is sold or otherwise transferred, the new owner would become responsible for paying the back taxes plus accrued interest charges. If the new owner's income were above the state median, these taxes and interest charges could become payable immediately, since the new owner would not be eligible under the deferral policy.

Similarly, if the property owner who received the tax deferral dies, the tax deferral would function as a lien against the decedent's estate. The unpaid taxes, plus accrued interest, would become the responsibility of the owner's heirs, particularly if these heirs did not meet the eligibility requirements of the deferral law.

As often happens when estates are entailed by debt, the heirs may have to sell the home in order to pay the back taxes and interest charges. If the home is used to support a small business, the family may lose the business as well.

Benefits and Risks of Tax Deferral

Proponents of the tax deferral proposal make it clear that the back taxes and interest charges would eventually be paid to the state: "When the house is sold, the state will be reimbursed."¹

Unlike a tax cut, a tax deferral policy does not provide permanent tax relief. The primary benefit of a tax deferral policy is it provides certain taxpayers more time to meet their tax obligations, even as those obligations grow over the intervening period.

For many families with modest incomes, the deferral policy would provide welcome temporary relief. They would have more time to pay off other debts, which would put these families in a stronger financial position to pay property taxes when they come due. Similarly, the temporary relief would give some families time to improve their financial position, through higher income, a new job, or a successful business, before taxes and interest charges come due.

Another benefit of the tax deferral policy is that many families would have time to accrue equity in their homes as real estate values rise. Some or all of the accrued equity could then be used to pay the back taxes and interest charges, by either taking a second mortgage on the home, or by selling the home and paying the taxes out of the proceeds of the sale.

As with any other kinds of debt, providing tax debtors more time allows them to develop a financial plan which, if successful, would ultimately permit them to meet their payment obligations.

Losing the Home

Families whose financial situation does not improve, however, could find themselves worse off under a tax deferral policy than they were before.

¹ Governor Christine Gregoire, quoted in "25% property-tax deferral proposed," by Andrew Garber, *The Seattle Times*, November 27, 2007, page B1.

Because the tax relief is temporary, and it adds interest charges on top of the original tax debt, the policy may result in outcomes that are the opposite of what its authors intended. In these cases, a tax deferral policy would make it *more* likely a modest-income family would lose their home.

As back taxes and interest charges mount, some low-income families may find they are falling farther and farther behind, until they reach a point where they can never catch up. The state would then assume the role similar to that of a credit care company or a payday lender, seeking to collect as much of the debt as possible, even as the debtor's ability to pay diminishes.

Using home equity to pay debt would only work if the taxpayer's equity increases faster than the rising amount of deferred taxes plus interest. If values rise more slowly than the increase in the tax obligation, or if property values fall, a modest-income family may find itself deeper in debt than before.

In Washington state, not paying property taxes is a punishable offense. The state has a number of enforcement actions it takes when taxes are not paid, up to and including seizing the property or other assets and selling them to meet the tax obligation. Violating Washington's tax laws can result in collection actions, added penalties, court appearances and possible jail time.

Linking Property Taxes to Income

The eligibility requirement of the tax deferral proposal links a citizen's tax obligation to his income. This idea has already been broached at the state level. A June 2007 statement released by the governor's office measures Washington residents' property tax burden in relation to personal income, not to property values.² The figures given show that the average property tax was equal to an annual state income tax rate of 3.06%. The result of this approach is to explicitly link property taxes owed to the taxpayer's income, even though income was not the legal basis for calculating the tax in the first place.

The tax deferral proposal moves state tax policy in the same direction, linking property taxes owed to personal income, rather than to valuation only. Should state policymakers continue to move toward determining taxes owed based on personal income instead of market value, the property tax would become, in effect, a type of state income tax.

Another effect of linking property taxes to income is it creates a disincentive for taxpayers to increase their level of reported income.

Once a family's income rises above the median level, they would no longer be eligible for a continued tax deferral, and it is possible that all the back taxes accrued over the years would become due. Depending on the size of the tax debt, this could provide a strong incentive to avoid incremental increases in income, or at least defer increases until the family acquired the financial ability to pay the back taxes.

Protecting Homeowners through Permanent Tax Relief

² "Washington's Tax Ranking Drops to 37th in Nation," in "Governor Gregoire Delivers on Promise to Reduce Middle Management," Office of Governor Chris Gregoire, June 18, 2007.

This analysis examines the strengths and weaknesses of a policy of tax relief based on deferring some homeowners' tax obligation to a future date. The main disadvantages of this approach are that the relief provided is temporary, and that lawmakers would be conferring financial benefits on some homeowners but not others.

These weaknesses can be remedied by making all property owners equally eligible for tax relief and by making the relief permanent, so that citizens are not made debtors to the state. These policy goals can be accomplished in two ways:

1. **Enact a permanent cut in the state property tax** – The state tax makes up about 25% of most people's yearly property tax bill. Lowering the amount of money the state takes from citizens would bring real and long-lasting financial relief to homeowners and business owners across the state. This policy works. In 1997 the legislature enacted a permanent 4.7% reduction in the state property tax.³ The result was more take-home pay for families and millions of dollars of stimulus to the economy, with no reduction in public services.

2. **Phase out the state property tax over five years** – Tax money flowing into the treasury is increasing at a yearly rate well beyond population growth plus inflation. In fact, state spending is up 30% over four years. Phasing out the state property tax would protect taxpayers while maintaining ample revenue to pay for public services.

Paul Guppy is Vice President for Research at Washington Policy Center, a non-partisan public policy research organization in Seattle. Nothing here should be construed as an attempt to aid or hinder the passage of any legislation before any legislative body. For more information contact Washington Policy Center at 206-937-9691 or online at www.washingtonpolicy.org.

³ See "Property Tax Relief: Is Referendum 47 Working?" by Paul Guppy, Washington Policy Center Policy Brief, July 1998, at www.washingtonpolicy.org.