A Citizen's Guide to the REET –

Washington State's Real Estate Excise Tax

Presented by:

Washington REALTORS®

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I. Overview

Washington State government together with its cities and counties are authorized to levy taxes on the transfers of real property. This tax, known as the Real Estate Excise Tax (REET), is levied on the total selling price of the property and is generally paid by the seller.

Washington's Real Estate Excise Tax is the second highest in the nation and negatively affects housing affordability, housing mobility and home ownership.

The tax is frequently passed on to the buyer by way of a price increase. This increases the required down payment or income required to qualify for a mortgage shutting many low and moderate would-be home-buyers out of the market. Increased closing costs may force buyers to purchase mortgage insurance, increasing monthly payments, which can put home ownership out of reach for those buying at the top of their ability.

The tax reduces the amount of equity earned from a home investment. Seniors count on this equity to help fund retirement as they downsize to smaller, less expensive homes.

Move-up buyers lose valuable equity needed to re-invest in a newer or larger home affecting the decision and/or ability to change housing status. A decision not to move-up results in reduced inventory of older, smaller, more affordable homes available for first time buyers. Reduced inventory drives up price of the existing housing stock causing the housing stock to be used less efficiently.

The tax is regressive, placing a higher burden on people with lower incomes and disproportionately burdening those who move frequently.

Real estate excise taxes place a heavy burden on the small portion of the population who pay the tax which funds public benefits enjoyed by a larger population.

It is an unreliable source of revenue as it fluctuates with the cyclical housing market.

How local REET revenues can be used is appropriately restricted. Tax receipts and obligations have a strong nexus to economic and population growth making revenue expenditures most suitable for critical infrastructure projects needed to strategically support, accommodate and encourage this growth.

II. Legislative History

The REET has a long history in Washington state, starting as a conveyance tax in 1935. In 1951 local governments were authorized to levy a real estate excise tax of up to 1 percent on the sale of real property as a revenue source for local schools. In 1980, the state legislature changed the local real estate excise tax from a local option to a state tax to help implement the Basic Education Act which placed the responsibility for funding basic education on state government.

From 1982 to 1987, the rate of the state REET underwent a number of temporary increases in response to economic recession and repeal of the conveyance tax in 1987. A two-year surtax was added in 1987 for purchase of natural resource conservation areas. This surcharge expired in 1989 leaving the state REET rate at its current level of 1.28%.

Washington Real Estate Excise Tax Levy Rates

State REET	**1.28%**
REET 1	**.25%**
REET 2	**.25%**
In Lieu of Sales Tax	**.50%**
Conservation Areas	**1.0%**
Affordable Housing (San Juan Co. only)	**.50%**
Total Levy Authorized	**3.78%**

In 1982, cities and counties were given the option of levying a local REET to pay for capital improvements listed under the local improvement district authorization. The tax was authorized in lieu of the authority to tax or charge impact fees for land development and does not require voter approval. They were also given the option of imposing an additional REET in lieu of an optional sales and use tax. An optional REET imposed on buyers for purchase and maintenance of conservation lands was authorized in 1990.

In 1992, after passing the Growth Management Act (GMA), cities and counties required or choosing to plan under the Act were given greater flexibility to impose impact fees along with the REET and were authorized to charge a second REET to pay for capital projects needed to accommodate population and economic growth and maintain infrastructure concurrency required by the GMA.

An affordable housing REET was authorized in 2002 but due to a qualifying clause, only San Juan County is eligible to impose this REET.

Combining the statewide REET with all local options available make the total allowed tax rate 3.78% on the value of real estate transactions, the second highest real estate transfer tax rate in the nation. The most common rate home owners face across the state is 1.78%.

III. The State's Portion of the REET

The rate of the state portion of the Real Estate Excise Tax is 1.28% of the total sales price of real property and is paid by the seller. The majority of the revenues, 92.3%, are deposited into the State General Fund making those funds eligible for general operating and/or capital expenses of state government. The remainder is used for funding assistance to local governments including 6.1% to the Public Works Trust Fund and 1.6% to the City County Assistance Fund.

State REET collections are the fourth largest contributor to the General Fund after the sales and use, business and occupation and property taxes. REET collections accounted for 18.7 percent of total General fund revenues in the 2005-07 bi-ennium up from 5.7 percent in 2003-2005 and 4.1 percent in 2001-03.

State REET revenues provide an important source of infrastructure funding assistance to local governments. Six and one tenth of one percent of total REET revenues are deposited into the State Public Works Assistance Account and is used to fund the Public Works Trust Fund, a revolving, low interest (.5%-2%) loan program available to local governments to assist in financing local public infrastructure projects including: water, sewer and stormwater systems, roads and bridges.

Local governments access these funds through a yearly competitive application process. Applications are scored and ranked by the Public Works Board, a body appointed by the Governor to administer the fund. The ranked list is forwarded to the legislature for final approval.

The Public Works Assistance Account (PWAA) is the most significant source of infrastructure financing assistance available to local governments. Loan repayments are re-circulated into the account and now provide over half of the available funds distributed totaling over $150 million in fiscal year 2006-07. The REET is the second largest contributor at $77.4 million during the same time period. Other sources include water, sewer and solid waste tax revenues.

More than 2,000 local infrastructure projects have received loans from the program since its inception in 1986. Total loan distributions have grown from $34.5 million in the program’s first year to a high of $391 million in 2004-05. Loans are capped at $10 million and serve to augment local contributions and/or leverage other grants and loans. In 2005-06, $325 million in loans leveraged $308 million in additional funds.

IV. Local Option Real Estate Excise Taxes

State law authorizes cities and counties to impose several optional real estate excise taxes each for prescribed purposes. The side bar provides a quick overview of each option.

Local REET 1 and REET 2 are the most widely implemented local options. These taxes represent the primary source of local taxing authority strictly dedicated for critical infrastructure needed to accommodate growing communities.

This is due in large part by efforts of the development community to pass legislation that tightened authorized uses of the tax. In 1992, the legislature revised the local REET statute outlining the projects for which the funds could be used. Table 1 outlines authorized uses for both REET 1 and REET 2.

Local Option Real Estate Excise Taxes

Capital Improvements (REET 1): All cities and counties may levy up to .25% tax to fund general capital programs listed in the capital facilities element of the jurisdiction's comprehensive plan. Most cities and counties have implemented this tax.

GMA REET (REET 2): Cities and counties mandated to plan or choosing to plan under the Growth Management Act (GMA) may impose a second tax up to .25%. Proceeds are exclusively limited to fund growth related capital projects.

Buyer's REET for the Acquisition and Maintenance of Conservation Areas: Subject to voter approval, counties may levy up to 1% tax for acquisition and maintenance of conservation areas. This is the only REET option imposed on the buyer. San Juan is the only county imposing this tax.

Additional REET in Lieu of Optional Sales Tax: Any city or county may impose an additional REET not to exceed .5% if they opt not to levy a second optional .5% local retail sales tax. Clarkston and Asotin are the only jurisdictions imposing this tax.

Affordable Housing REET: Subject to voter approval, counties who imposed the Conservation REET by 2003 may impose up to .5% to fund affordable housing construction and maintenance. San Juan County is the only county eligible to impose this tax. All ballot initiatives attempting to impose this REET in that county have failed.

REET 1 - Counties and cities with populations fewer than 5,000 and cities and counties of any size who are not planning under the state's Growth Management Act (GMA) may use REET 1 funds for virtually any capital and local improvement project.[1] Counties and cities with populations over 5,000 who are required or choose to plan under the GMA may only use the funds for financing the planning, acquisition, re-construction, repair, replacement, rehabilitation or improvement of specific capital facilities listed in the table.

Projects funded by the tax must be specified in a capital facilities plan element of that jurisdiction's comprehensive plan, a growth management planning document whose contents are outlined in state law.

REET 2 - REET 2 is authorized only for counties and cities either mandated or choosing to plan for growth under GMA. Jurisdictions who were not mandated but choose to plan under GMA must seek voter approval to impose the tax.

Authorized in 1990 and simultaneous to passing GMA, this optional tax was intended by the legislature as a tool to help local governments meet concurrency requirements in the Act. "Concurrency" refers to a requirement that cities and counties have infrastructure necessary to serve new development in place at the time the development is ready for occupancy. Failure to meet concurrency requirements forces building moratoria and denied development applications. Failure by cities and counties to accommodate the growth allocated to them stifles economic vitality and results in an inadequate supply of housing driving up demand and prices.

Reviewing the allowed uses in Table 1, it is clear the legislature understood that roads, water, sewer and parks provide the essential framework that builds communities and encourages development in certain locations over others. This understanding is the crucial element to making growth management plans a reality. To encourage and incentivize development into urban areas it is critical that adequate infrastructure is already in place.

Table 1: Authorized uses of REET 1 and REET 2 Revenues

Planning, acquisition, re-construction, repair, replacement, rehabilitation or improvement of the following public facilities listed in the jurisdiction's capital facilities plan	**1st Quarter Percent: REET 1** (0.25%) all cities/counties	**2nd Quarter Percent: REET 2** (0.25%) GMA counties and cities only
Streets, Roads, Highways	Yes	Yes
Sidewalks	Yes	Yes
Street Lighting	Yes	Yes
Traffic Signals	Yes	Yes
Bridges	Yes	Yes
Domestic Water Systems	Yes	Yes
Storm and Sanitary Sewer	Yes	Yes
Parks	Yes	Yes (not land acquisition)
Recreational Facilities	Yes	**No**
Law Enforcement Facilities	Yes	**No**
Fire Protection Facilities	Yes	**No**
Trails	Yes	**No**
Libraries	Yes	**No**
Administrative or Judicial Facilities	Yes	**No**
River and/or Waterway Flood Control	Yes, if funds were expended for such purposes prior to 6/92	**No**
Housing Projects	Debt payment only for debt incurred between 6/92 and 12/31/95	**No**

As with REET 1, funds may only be used to finance projects listed in the capital facilities plan of a comprehensive plan. This requirement ensures cities and counties are using their REET revenues in a strategic manner and planning to meet their future infrastructure needs with available revenues. Comprehensive planning documents are long term, twenty year plans for how a community will accommodate their forecasted population growth over that same time frame. Yearly updates of a capital facilities plan are allowed to address changes or unplanned emergencies, however these occurrences should be minimal and excessive re-allocation of funds or redirecting funds to projects not previously outlined in the plan indicate a problem with utilizing the planning process in the most effective and strategic manner.

Requiring funds be used only for projects listed in the capital facilities plan helps maintain consistency of priorities for infrastructure construction. This is important for a twenty year planning horizon which will outlive the revolving door of local elected officials, each coming to office with varying priorities. Infrastructure is a long term investment in a community and planning for and funding infrastructure investments with a lifespan of fifty years or more should be shielded from the temptation to use these funds for the immediate need or shifting policy priority.[1]

The adopted city or county budget must identify which projects are funded "in whole or in part" from the proceeds of REET 1 and 2 and must show that the tax is intended to be in addition to other funds available for such capital purposes.[2] The law does not clarify how a jurisdiction should indicate the tax is intended to be in addition to other funds. If budget documents do not clearly show compliance with this requirement, staff should be asked to show compliance.

REET 1 and 2 proceeds must be kept in separate dedicated accounts which helps ensure the funds are only used for purposes authorized by state law.[3] (See section titled Accountability)

Any city or county that has received an order of non-compliance with the Growth Management Act, shoreline master planning requirements or adoption of appropriate development regulations to implement the Growth Management Act, may have their authority to collect REET 2 revenues temporarily rescinded by the Governor until the order has been lifted.

[1] For a more thorough discussion of the role of capital facilities planning in growth management see Washington REALTORS® Policy Guide "Infrastructure Funding: Investing in Your Community Through the Capital Budget".

[2] RCW 82.46.010(1) states "The legislative authority of any county or city shall identify in the adopted budget the capital projects funded in whole or in part from the proceeds of the tax authorized in this section, and shall indicate that such tax is intended to be in addition to other funds that may be reasonably available for such capital purposes."

[3] RCW 82.46.030 (2) states in part "The… proceeds from the county tax…shall be placed in a county capital improvements fund. The … proceeds from city or town taxes shall be … placed by the city treasurer in a municipal capital improvements fund.

Buyers' REET for the Acquisition and Maintenance of Conservation Areas - Another optional REET authorizes county governments to impose up to 1% tax on the value of real estate transactions to pay for the acquisition and maintenance of lands and water, that have "environmental, agricultural, aesthetic, cultural, scientific, historic, scenic, or low-intensity recreational value for existing and future generations, and includes, but is not limited to: open spaces, wetlands, marshes, aquifer recharge areas, shoreline areas, natural areas, and other lands and waters that are important to preserve flora and fauna".[4]

The tax must be approved by voters and may be placed on the ballot either by adoption of a resolution by the county legislative authority or by request by petition signed by at least 10% of the total number of voters who voted in the last general election. A ballot proposition must state a specified period the tax will be imposed and must state the tax rate.

At least 60 days before the election a plan for how the proceeds will be expended must be prepared by the county if the proposition is the result of a resolution by the county. If the proposition was initiated by a petition, the plan must be in place at least 60 days after the election. Cities must be consulted and a public hearing held prior to adoption of a plan.

This is the only REET that is imposed on a buyer of property making it a more direct contributor to unaffordable housing in an area imposing the tax. San Juan County is the only county currently imposing this tax.

Additional REET in Lieu of Second Option Sales Tax - In 1982 the legislature authorized local governments to levy an additional .5% REET if they chose not to impose an optional local sales and use tax. Jurisdictions that use this "REET in lieu of sales tax" option are therefore authorized to levy up to .25% REET 1 and up to .5% on this REET for a combined total rate of .75%. If that jurisdication is planning under the Growth Management Act, they may levy REET 2 making a total local REET of 1% possible.

The purpose of the REET in lieu of sales tax option was to accommodate jurisdictions located on state borders who wanted to keep their sales tax rate competitive with cities across the border. The intent of the option is to lessen the temptation of residents to shop across the border to avoid the higher sales tax while allowing the jurisdiction to maintain effective tax revenues. To date, two Washington cities, Asotin and Clarkston, use this option.

In 2006, the city of Sultan and Snohomish County attempted to take advantage of a loophole in this statute. To generate more revenue for the City the two jurisdictions considered an agreement in which the City would levy the REET in lieu of sales tax option and the County would continue to collect the optional sales tax on sales within city limits and reimburse those revenues back to the City.

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[4] RCW 36.32.570

In an Attorney General Opinion, this scheme was determined illegal unless a government service agreement was in place authorizing the transfer of these funds for payment of specified services by the City to the County. Efforts by the real estate community to stop this agreement were successful.

V. Challenges and Opportunities of the REET

Accountability - When tax revenues are restricted to specific uses by law, it is tempting for local governments to stretch the definition of those specified uses to fill budget gaps. Lack of familiarity with statutory restrictions can also cause misappropriation of funds. Over the years some examples of improper use of REET funds have surfaced making it important to hold governments accountable for how they use these funds. Examples of improper use include using REET 2 funds to purchase park lands, using interest income from REET revenues for non-authorized uses and purchasing computer equipment.

The Washington State Auditor's Office conducts financial and performance audits on local governments. They look especially close at how restricted funds are used. When the Office finds restricted funds were used improperly, they report this finding, however they are not charged with ensuring compliance. Ensuring compliance is dependent on taxpayer awareness and diligence.

State statute outlines processes for ensuring compliance. These processes include requiring revenues be deposited in separate designated accounts and identifying projects funded by the revenues in the jurisdiction's annual or biannual budget. Despite these requirements, activists have found cases where local governments did not follow these requirements and in one case, a local government was not able to differentiate REET receipts from other receipts when asked.

REET is a Regressive and Discriminatory Tax - A tax is regressive when its burden relative to income is greater on lower income people compared to people with higher incomes. The REET is a flat rate tax causing lower income people to spend a disproportionately higher amount of income to pay the tax. Some states concerned with the regressive nature of the tax have addressed this by assessing the tax on homes above a certain price or on a portion of the equity realized. Many other states only charge a small fee to cover the administrative cost of transferring the property.

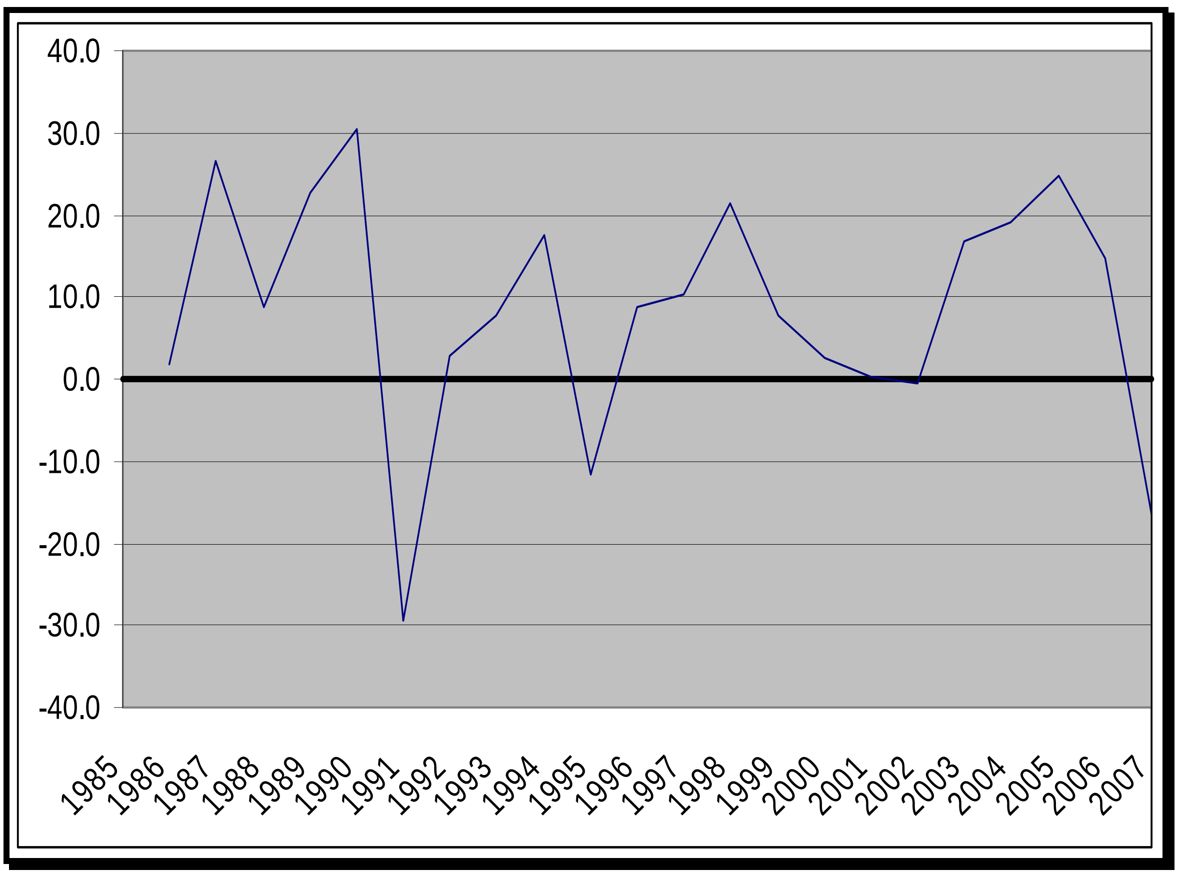
The REET draws from a very narrow tax base. Approximately 8% of the state's housing stock is transferred each year. Therefore, the burden of paying the tax falls on the small percentage of people who are involved in a transaction and those who move more frequently. The amount of people who benefit from tax receipts is disproportionate to the number of people who pay the tax.

A Volatile Revenue Source Directly Related to Housing Market Cycles - Historic trends of REET revenue collections show tremendous volatility. Figure 1 illustrates upward spikes are followed by sharp reductions as the revenue stream correlates to the cyclical booms and busts of housing markets, an indicator of the health of the overall economy.

The number of transactions and the value of properties sold directly affect the amount of revenue generated by the REET. Figure 2 shows the correlation between number of sales and tax receipts. The number of new housing permits approved is another factor influencing revenue collections. Typically, the number of permit approvals equals about 15% of the number of real estate transactions.

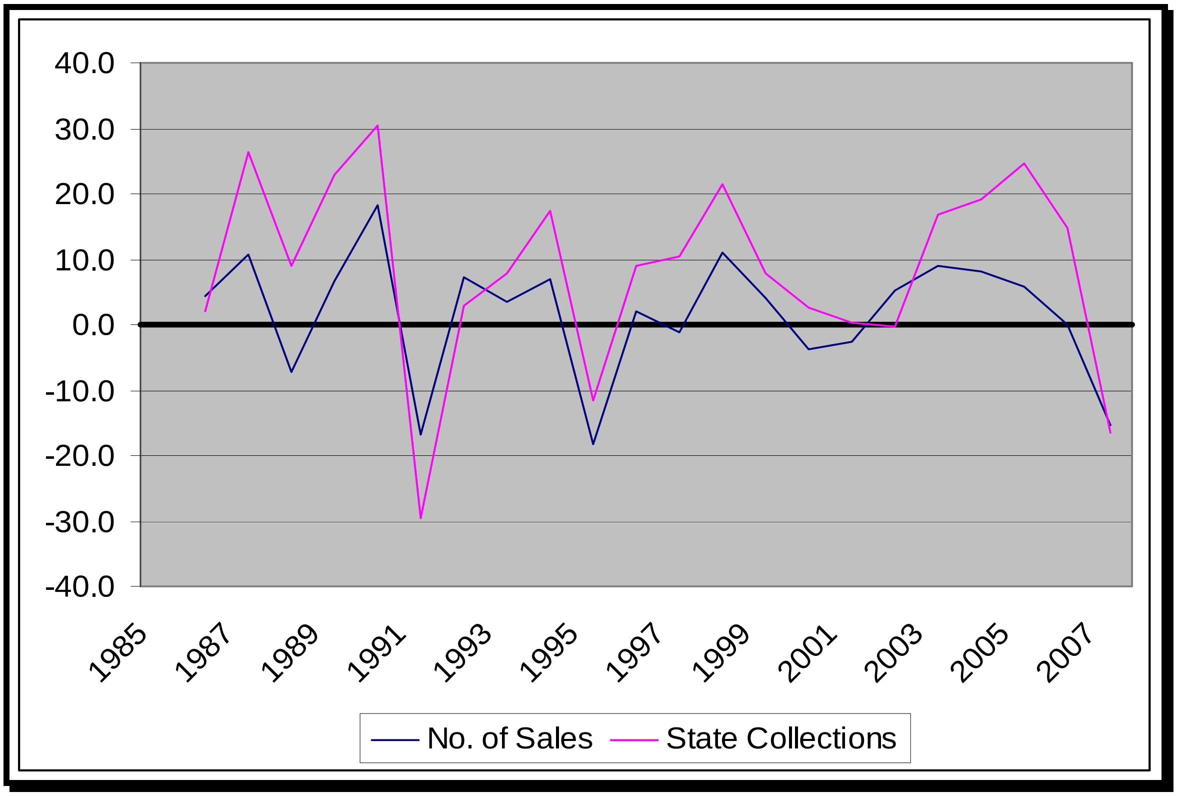
The volatility of REET collections make this revenue source a poor candidate for financing on-going programs, especially programs dependent on fiscal growth. Because collections reflect the economic growth of the state, this revenue source is ideal for one-time capital expenditures such as infrastructure and other essential capital facilities. For this reason, the development community have advocated that an increasing portion of state REET collections be earmarked for growth-related infrastructure and that there be decreased dependency on the tax to fund ongoing programs.

Figure 1: State REET Collections
Percent Change Year to Year
1985-2007



Source: Washington State Department of Revenue

Figure 2: **State REET Collections and Number of Transactions Percent Change Year to Year 1985-2007**



Source: Washington State Department of Revenue

Impacts of REET on Housing Affordability, Mobility and Homeownership - Homeowners and would-be homeowners are generally unaware of the tax's existence until they engage in the process of buying or selling a home. This "hidden tax" and especially the rate of the tax can have significant impacts on the price of housing as the tax is added to the selling price of the home. It also can affect mobility, because it reduces the amount of equity available to reinvest in a new home. The loss of mobility reduces the number of older, less expensive homes available for first time homebuyers, reducing the opportunity for homeownership. Loss of mobility can also contribute to important quality of life factors such as traffic congestion, pollution and increasing commute times.

Homeowners considering "moving up" to newer or larger homes consider all transaction costs in their decision. The equity available to reinvest in a new home, along with income and interest rates all play important factors in this decision. When faced with the reduction in equity the tax causes, most real estate professionals have found that sellers will increase the price of the home to make up for this reduction. The typical combined state and local tax rate of 1.78% equates to a tax of $5,340 on a $300,000 home.

If the transaction costs are too high, making a move-up purchase unfeasible, people whose purchase is discretionary may opt-out failing to free up more affordable, older homes for first time home-buyers.

This scenario can also affect those who experience a job change. If it is not affordable to move closer to a new job, that family may choose instead to endure longer commutes further straining our transportation systems, increasing pollution and frustrating recent statewide goals to reduce the number of vehicle miles traveled.

REET especially harms first time home buyers and “would-be” buyers, people typically at the low and moderate range of the income scale. When the tax is added to the price of a home, a larger down payment is needed requiring more cash at closing. The higher price is reflected in higher mortgage payments shutting potential home buyers out of the market if they are buying at the top of their ability. Finally, increasing closing costs may force first time buyers to purchase mortgage insurance which can add .5% to their monthly payments.

Using REET Revenues Strategically and Effectively - Expanding infrastructure capacity is essential in order to accommodate population growth. New homes need new sewer and water lines. New housing developments increase traffic requiring new or wider roads, sidewalks, traffic signals and lights. Paying for projects that increase infrastructure capacity competes for local tax revenues with general government operating expenses as well as costs of maintaining existing roads, water and sewer systems. Local government operating expenses are consistently strained as criminal justice services, health care costs, pension contributions and contract wage increases push against voter approved property tax limits. All these competing needs make it necessary to restrict a funding stream to pay for the infrastructure expansions necessary to accommodate population growth.

REET revenues are one of the most significant sources of funding available to local governments for increasing infrastructure capacity. By accommodating the housing needs of a growing population, local governments ready themselves to benefit from an increased property tax base as formerly vacant or underused land is developed. The sales and business tax base is expanded as those new households purchase necessary goods and services.

Expanding the property, sales and business tax base is essential in order for local governments to maintain adequate funding for schools, public safety and operations and maintenance of streets, parks and other public facilities.

For these reasons, local governments should prioritize REET revenues for the critical infrastructure necessary to attract and serve new development. Roads, water and sewer systems are the supporting framework of a community. The majority of Washington’s cities and counties are planning for growth under the mandates of the Growth

Management Act. This dynamic planning process provides the information needed to forecast and plan to construct and fund expanded capacities of this critical framework.

It is no accident that local REET revenues must be spent on projects listed in a capital facilities element of a local government. A well written capital facilities element will outline the increased capacities needed for all infrastructure necessary to accommodate 20 years worth of population growth. Most capital facilities plans outline improvements needed to upgrade outdated or failing infrastructure but fail to adequately enumerate increased capacities needed for growth. Addressing this failure is the start to prioritizing REET revenues for growth. The plan should address timing of capacity increases and expressly obligate REET revenues to fund these projects.

VI. Conclusion

Although the Real Estate Excise Tax has a negative effect on housing markets and homeownership there is little chance that the tax will go away. State and local governments are increasingly dependent on these revenues, especially as rising home values increase receipts.

The negative aspects of the tax provide the impetus to resist efforts to further increase the already high rate. Governments should instead acknowledge the nexus between economic growth and tax receipts by strategically using the revenues to support that growth.

By prioritizing revenues to fund the critical infrastructure investments necessary to support and accommodate population and economic growth (roads, water and sewer systems) government will utilize this volatile revenue stream efficiently and in a sustainable fashion.

Sources

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