

Larry's Tax Law

The State of Washington May No Longer Be a Tax Haven – A New Capital Gains Tax May Be on the Horizon

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On April 25, 2021, the Washington State Legislature passed Senate Bill 5096 (SB 5096). The bill was immediately sent to Governor's Inslee's desk for signature. It brings a new tax regime to the state of Washington.

Before we go into the details surrounding the new tax, I have to mention that it was challenged even before the governor had the opportunity to sign it into law. A group of potentially affected taxpayers filed a lawsuit in Douglas County, Washington, to strike down the new law as being unconstitutional. So, it is possible that SB 5096 will never breathe life.

Knowing that the new tax regime is under attack, it is still important to have a good understanding of it in the event it survives the battle.

Purpose: The purpose of the tax is to fund K-12 education in Washington.

Revenue: It is expected that the new law will raise \$415 million or more in annual tax revenue.

Tax: The tax is 7 percent on the long-term capital gains derived from the voluntary sale or exchange of stocks, bonds and other capital assets in excess of \$250,000 per year (subject to an inflationary adjustment). For this purpose, the new law defines "capital assets" by adopting the definition contained in Section 1221 of the Internal Revenue Code of 1986, as amended. Long-term capital gains means the sale or exchange of a long-term capital asset (a capital asset held more than one year).

Commencement Date: The new tax is to be effective on January 1, 2022.

Exceptions: The new law contains numerous exceptions. The tax does **not** apply to:

- Any real estate transferred by deed, contract, judgment or other lawful instrument.
- Any interest in a privately held entity but only to the extent that the long-term capital gain or loss from the sale or exchange is directly attributable to real estate directly owned by the entity.

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- Retirement Accounts.
- Condemnations or transfers under the imminent threat of condemnation.
- Cattle, horses or breeding livestock provided more than 1/2 of the taxpayer's gross income during the taxable year is derived from farming or ranching.
- Depreciable property (i.e., property qualifying for expensing under Code Section 179 or depreciation under Code Section 167(a)(1)) used in a trade or business.
- Timber, timberland, dividends and distributions from REITs derived from the sale or exchange of timber or timberland.
- Commercial fishing privileges.
- Goodwill from the sale of an automobile dealership.

Obviously, several industries had good lobbyists. Real estate, farming, ranching, fishing and automobile dealerships will receive favorable treatment under the new law. Unfortunately, other industries are not so privileged.

Not so fast, buried in Section 8 of SB 5096 is an important carve-out. The "adjusted capital gain derived in the taxable year from the sale of substantially all of the fair market value of the assets of, or the transfer of substantially all of the taxpayer's interest in, a qualified family-owned small business" are **not** subject to the new tax. There are several components to this carve-out:

- The business must be a "qualified family-owned business."
- A "qualified family-owned business" is a business: (i) in which the taxpayer held a "qualifying interest" for at least five years immediately preceding the sale or exchange; (ii) the taxpayer or members of his/her family materially participated (or both) in the business for at least five of the ten years immediately preceding the sale or exchange (unless the sale or exchange was to a qualified heir); and (iii) the worldwide gross revenue of the business is \$10 million or less (subject to an inflationary adjustment) for the 12-month period immediately preceding the sale or change.
- "Qualifying interest" means (i) an interest as a sole proprietor; (ii) an interest of at least 50 percent of a business that is owned (directly or indirectly) by the taxpayer and/or members of his/her family; or (iii) an interest of at least 30 percent of a business that is owned (directly or indirectly) by the taxpayer and/or members of his/her family and at least 70 percent is owned (directly or indirectly) by two families or 90 percent is owned (directly or indirectly) by three families.
- For purposes of these requirements, "material participation" has the meaning prescribed by Code Section 469. In general, it means being involved in the business on a regular, continuous and substantial basis.

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- "Qualified heir" means a member of the taxpayer's family. In turn, "family" includes ancestors of the taxpayer, the spouse or state registered domestic partner of the taxpayer; lineal descendants of the taxpayer, of the taxpayer's spouse or state registered domestic partner, or of a parent of the taxpayer; or the spouse or state registered domestic partner of any lineal descendant of these individuals.
- "Substantially all" means 90 percent (applied in terms of value).

The new law provides a deduction of up to \$100,000 from the taxpayer's capital gains if the taxpayer made \$250,000 or more in contributions to a charity directed or managed in Washington during the same tax year as the sale or exchange giving rise to the tax.

To avoid double taxation of a sale or exchange under the Washington Business and Occupation ("B&O") tax regime, a credit is allowed against taxes due under the B&O tax regime if such sale or exchange is also subject to the new tax. In such cases, the credit is the amount of B&O tax on the sale or exchange.

The new law comes with some compliance teeth. In addition to civil penalties and interest for noncompliance, it is a Class C felony to knowingly attempt to evade the tax. Also, it is a gross misdemeanor for knowingly failing to pay the tax, file returns or keep records or supply the taxing authority with information requested relative to the tax.

It is expected that Governor Inslee will sign the new tax regime into law. Whether it will survive the pending lawsuit is anyone's guess at this point in time.

One thing is for certain, Washington state lawmakers are eyeing opportunities to increase tax revenues to fund budgetary needs. For taxpayers considering moving to Washington to reduce their state and local tax burden arising from the sale or exchange of capital assets, they need to proceed with caution. Unless a planned taxable event will occur before 2022 (the anticipated effective date of the new law), these taxpayers may be moving into harm's way. Washington, the tax haven for Oregonians (and others) anticipating a significant capital gains event, may be no longer.

We will keep you advised as the controversy surrounding the new Washington capital gains tax regime evolves.

Tags: capital gains tax, Carve-outs, compliance, deductions, Governor Jay Inslee, SB 5096, Washington Business & Occupations Tax, Washington legislature, Washington state, Washington state capital gains tax