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When It Rains, It Pours in Washington State – The Washington Supreme Court Upholds the 2021 Enacted Capital Gains Tax

By Larry Brant on 3.24.23 | Posted in Legislation, State and Local Tax, Tax Laws

It is a rainy day in the Pacific Northwest with chances of snow showers. For those taxpayers that reside in the state of Washington or own highly appreciated capital assets located in the state, their day just got a bit gloomier.

Earlier today, the Washington Supreme Court, in a 7-2 opinion, overturned the Douglas County Superior Court decision that had ruled the state capital gains tax enacted by the legislature in 2021 violates the Washington State Constitution.

Majority Opinion

In its 50-plus page opinion written by Justice Debra L. Stevens, the majority of the court concludes:

"The court below [the Douglas County Superior Court] concluded the tax is a property tax that violates article VII's uniformity requirement. In light of this ruling, the court did not address Plaintiffs' additional constitutional challenges. We accepted direct review and now reverse. The capital gains tax is appropriately characterized as an excise because it is levied on the sale or exchange of capital assets, not on capital assets or gains themselves. This understanding of the tax is consistent with a long line of precedent recognizing excise taxes as those levied on the exercise of rights associated with property ownership, such as the power to sell or exchange property, in contrast to property taxes levied on property itself. Because the capital gains tax is an excise tax under Washington law, it is not subject to the uniformity and levy requirements of article VII. We further hold the capital gains tax is consistent with our state constitution's privileges and immunities clause and the federal dormant commerce clause. We therefore reject Plaintiffs' facial challenge to the capital gains tax and remand to the trial court for further proceedings consistent with this opinion."

The court succinctly summarized the parties' positions as follows:

Opponents Position

"Plaintiffs seek to facially invalidate the capital gains tax on three separate grounds. They first argue that the tax is a property tax on income pursuant to *Culliton* and that it violates the uniformity and levy limitations on property taxes set forth in article VII, sections 1 and 2 of the Washington Constitution. They also argue the tax violates our state constitution's privileges and immunities clause and the federal constitution's dormant commerce clause."

Government's Position

"The State maintains that the capital gains tax is an excise tax, not a property tax, and that each of Plaintiffs' constitutional challenges fails. Separately, Intervenors challenge the wisdom of *Culliton*. If the court were to hold the capital gains tax comes within the purview of *Culliton's* holding that an income tax is a property tax subject to article VII, sections 1 and 2, Intervenors urge the court to overturn *Culliton* as incorrect and harmful or because its legal underpinnings have eroded."

Justice Stephens, joined by Justices Gonzalez, Madsen, Owens, Yu, Montoya-Lewis and Whitener, ultimately concluded that the new tax is an excise tax. She states:

"We hold the capital gains tax is an excise tax under Washington law. We decline to reexamine *Culliton* because article VII's uniformity and levy limitations on property taxes do not apply. We further conclude the capital gains tax survives constitutional scrutiny under our state privileges and immunities clause and the federal dormant commerce clause. We therefore reverse the superior court's grant of summary judgment to Plaintiffs and remand to the superior court for further proceedings consistent with this opinion."

Dissenting Opinion

Justice McCloud (joined by Justice Johnson) wrote a 20-plus page dissenting opinion. She succinctly points out, noting the broad state constitutional definition of property:

"'Capital gains' are income. In Washington, income is property. A Washington 'capital gains tax' is therefore a property tax.

The problem is that in Washington, our constitution limits any such property tax to one percent annually. The Washington Legislature nevertheless enacted a new law, Engrossed Substitute Senate Bill (ESSB) 5096, 67th Leg., Reg. Sess. (Wash. 2021), codified at ch. 82.87 RCW, which taxes 'capital gains'; at seven percent annually. That's more than one percent. This new 'capital gains' tax therefore constitutes a property tax that violates the Washington Constitution's 'one percent' annual limit on such a 'property' tax. In a contest between a Washington statute and the plain language of the Washington Constitution, the judicial branch has the duty to uphold the constitution.

I therefore respectfully dissent."

Justice McCloud goes on to state:

"The plain language of the statute shows that taxable incident is not the sale or transfer of the capital asset itself. Rather, the taxable incident is the realization of income derived from the sale of qualifying capital assets. Because the taxable incident or event is the realization of income—not the mere transfer of the asset—the tax is an income tax, regardless of the label placed on it by the legislature. *Jensen v. Henneford*, 185 Wash. 209, 217, 53 P.2d 607 (1936) (plurality opinion). The measure of the tax is indisputably the amount of income gained from the transaction. The fact that the tax is measured by the amount of net income only reinforces the conclusion that the taxable incident is receipt of income and that the capital gains tax is an income tax.

.....

A tax is determined by its incidents, not by its legislative label. The structure of the capital gains tax shows that it is a tax on income resulting from certain transactions—not a tax on a transaction per se. Therefore, the tax is an income tax, not an excise tax. Under our constitution and case law, an income tax is a property tax. As enacted, this income tax or 'capital gains tax' violates the one percent levy limitation of article VII, section 2."

Impact on Taxpayers

As reported in prior blog posts on November 30, 2022, April 12, 2022, May 7, 2021 and April 29, 2021, Senate Bill 5096 created a capital gains tax regime in Washington state. The purpose of the tax is to fund K-12 education.

The tax went into effect on January 1, 2022. Because the Washington Supreme Court did not strike down the new tax, most taxpayers subject to the tax are required by April 17, 2023 to file their first Washington Capital Gains Tax Return (for the 2022 taxable year) and pay any tax owing.

The tax is seven (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 result from the sale or exchange of a long-term capital asset (a capital asset held more than one year).

The new law contains numerous notable 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.
- 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.

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 also **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.

- "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 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 on a sale or exchange of a capital asset 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 capital gains tax. In such cases, the credit is the amount of B&O tax incurred from the sale or exchange of the capital asset.

The 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.

Conclusion

Unless the Washington state legislature repeals the law, it appears the recently enacted state capital gains tax regime is here to stay. Taxpayers need to familiarize themselves with the new tax, its exclusions, its thresholds and the reporting requirements. The penalties for noncompliance, just like other tax regimes, can be substantial.

Tags: capital gains tax, legislation, State and Local Tax, Washington state capital gains tax, Washington State Tax