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Sent: Friday, May 14, 2021 4:13 PM
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Subject: FW: [External] capital gains tax

From: CALEB D ALLEN <calebdallen@comcast.net>
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Subject: capital gains tax

By Joe Haberzetle, JD, LLM and Jorge Alegre

Senate Bill 5096, " Concerning an excise tax on gains from the sale or exchange of certain capital assets," was passed by the Washington Legislature on April 25, 2021 and signed into law by Governor Inslee on May 4, 2021. The law generally imposes a 7% tax on net long-term capital gains in excess of $250,000 recognized during each calendar year. Net long-term capital gain is defined by reference to U.S. federal income tax law. The tax is imposed on capital gains recognized on or after January 1, 2022. The first returns will be due in 2023 on capital gains recognized during calendar year 2022.

The following are some essential details on the tax. For ease of reading, references to "capital gains" in this article mean "long-term capital gains."

What is Subject to Tax?

The tax is imposed specifically on long-term gains from the sale or exchange of capital assets. Thus, ordinary income, short-term capital gains, dividends, and interest are all excluded from the tax. Certain categories of assets are also excluded, most notably real estate (whether held directly or through a privately owned entity). Other exclusions cover assets held in retirement accounts, tangible property that was used in a trade or business prior to its sale, interests in qualified family-owned small businesses, certain livestock, timber, and commercial fishing privileges.

An annual standard deduction of $250,000 is available to each individual and married couple (unlike under federal law, married couples are not allowed a higher shared amount). Spouses who file a joint return for federal income tax must also file jointly for purposes of the Washington capital gains tax. An additional deduction of up to $100,000 is allowed for charitable contributions in excess of $250,000 to Washington-based nonprofits made by the taxpayer during the year. The 7% tax rate is applied to capital gains exceeding the deductible amount, with a limited credit available to the extent income or capital gains taxes are paid by the taxpayer to other jurisdictions.

Who is Subject to Tax?

The tax is imposed on net long-term capital gains recognized by individuals and allocated to Washington by provisions of the law. The tax does not apply to legal entities (e.g., corporations), but individuals may be subject to the tax on gains recognized by passthrough entities in which a taxpayer has an ownership interest.

Capital gains from the sale of intangible property such as stocks, bonds, and other investment instruments are subject to tax if the individual is domiciled in Washington at the time of sale. Domicile, although not defined in the capital gains tax law, is generally understood as the place a person considers their permanent residence and home, and in which they have the majority of their legal, professional, and personal ties.

Gains from sales of tangible personal property are generally allocated to Washington if the property was located in Washington at the time of sale. However, gains from the sale of tangible property located outside Washington may be subject to tax if the seller is a resident of Washington at the time of the sale, and the property was present in Washington at any time during the year of sale or the preceding year. A person is considered a "resident" for purposes of the tax if they are domiciled in Washington or maintain a place of abode in the state and are physically present for more than 183 days during the calendar year.

It is curious that the allocation rule for gains from sales of intangibles refers to the taxpayer's domicile, while the rule for gains from sales of tangible property refers to residency (including statutory residency under the 183-day rule). It is unclear whether this disparity was intentional on the part of the Legislature, or if it will be revised by future legislation.

Comparison to Other State Income Taxes

Few other states impose taxes specifically on capital gains; however, many states impose personal income taxes on residents and on certain nonresidents. Such taxes typically encompass capital gains earned by residents, and in many cases also encompass gains earned by nonresidents on sales of tangible property located within the state.

Many states' personal income tax rates are graduated such that little or no tax is imposed at lower income levels and the highest rates are paid by only a fraction of the population. For example, California tax rates on married couples range from 1% on the first $17,864 of taxable income to 13.3% on taxable income over $1 million. Most states do not apply preferential rates to long-term capital gains, so such gains are taxed at the same state income tax rates as short-term gains and ordinary income.

The Washington tax appears to be unique among states in that it is imposed solely on long-term capital gains and has a very high standard deduction so that less than 0.1% of state residents will likely pay the tax in any given year.

Controversy Surrounding the Tax

Opponents of the capital gains tax have argued (both prior to and since its enactment) that the tax violates the Washington State Constitution. Specifically, the state constitution requires taxes on property to be uniform (i.e., a single tax rate on all property of the same class) and limits the tax rate to 1%. Income is considered a class of property under Washington case law.

A 7% tax on capital gains in excess of $250,000 would violate both provisions of the state constitution if it is a tax on income. However, according to the law, the tax is an excise imposed on the sale or exchange of capital assets. By characterizing the tax as an excise or privilege tax, rather than a tax on income, the legislature is attempting to avoid the constitutional issue. One lawsuit challenging the tax has been filed in Douglas County and others are expected to follow.

If you have questions regarding the capital gains tax, please reach out to a member of Clark Nuber's State and Local Tax team.

Jorge Alegre is a senior manager in Clark Nuber's State and Local Tax team.