

WASHINGTON'S CAPITAL GAINS TAX UPHELD

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U.S. Corporate Alert

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On Friday, 24 March 2023, the Washington Supreme Court upheld the state's capital gains tax (the WA CGT) in a 7–2 decision, bringing an end to months of uncertainty as a suit to challenge the new tax worked its way through the state's court system. This decision from Washington's highest court reverses earlier trial court rulings and leaves the tax's opponents with no further avenues through which to challenge the WA CGT under the Washington State Constitution. Potential challenges under the U.S. Constitution are unlikely to change the application of the WA CGT to most taxpayers.

The Washington Supreme Court held that the WA CGT is an excise tax, not a property tax, meaning that the tax is not subject to the state's constitutional limitations on property taxes. The court declined to revisit its precedents holding that income taxes are property taxes and therefore subject to the uniformity requirement and 1% limitation in Article VII of the Washington State Constitution. This means that the ruling does not necessarily open the door for a broad-based net income tax to be upheld.

Initial returns for the WA CGT will now be due on 18 April 2023 (for the 2022 tax year). Some Washington taxpayers potentially subject to the tax already have compliance plans in place due to the Washington Supreme Court's 30 November 2022 order allowing the Department of Revenue to collect the new tax while the tax was being litigated. Nonetheless, a brief review of the tax is worthwhile now that we know the tax is here to stay.

TAX RATE AND BASE

The WA CGT is assessed at a rate of 7% on an individual's Washington capital gains, which are defined as an individual's net long-term capital gains for federal income tax purposes, subject to adjustments for certain long-term capital gains and losses and certain federal loss carryforwards, as described below. Transactions that are not subject to federal income tax, such as tax-free mergers, transfers to partnerships, and gains from sales of qualified small business stock, are not subject to the WA CGT. Dividends, which are typically taxed at long-term capital gains rates for federal income tax purposes, are also not subject to the WA CGT.

ALLOCATION OF PROPERTY, RESIDENCY, AND ATTRIBUTION OF OWNERSHIP

Gains from the sale or exchange of tangible and intangible personal property allocated to Washington are taxable. Generally speaking, gains from the sale of tangible property are allocated to the state of Washington based on the location of the property sold or exchanged, whereas gains from the sale of intangible property (including stock and partnership interests) are allocated to the state of Washington if the seller is domiciled in Washington.

For purposes of allocating gains based on a taxpayer's domicile, the WA CGT generally follows Washington's existing domicile rules, although individuals domiciled in Washington are considered to be the beneficial owners of their proportionate share of long-term capital assets held by pass-through entities (including partnerships, S

corporations, and disregarded entities). Trusts are not subject to the WA CGT (except with respect to sales of tangible property located in this state), unless (i) the trust's grantor both is a Washington resident and is taxed on the trust's income for federal income tax purposes under the so-called "grantor trust rules," or (ii) the trust constitutes an incomplete gift of the trust assets because the Washington resident grantor holds the power to revoke the trust or retains other powers over the trust that would cause the trust assets to be included in the grantor's estate for estate tax purposes.

EXEMPTIONS

The following are exempt from the newly upheld tax:

- All sales or transfers of real estate (specially defined in the WA CGT) by deed, real estate contract, judgment, or other lawful instruments that transfer title and are filed as public record with the county in which the real property is located.
- Gains from the sale of any interest in a privately held entity, but only to the extent that any long-term capital gain or loss from such sale or exchange is directly attributable to real estate owned directly by such entity.
- Gains on certain eligible assets, including assets held in retirement accounts, assets transferred in connection with condemnation proceedings, certain breeding livestock, certain depreciable property used in a trade or business, timber and timberlands, commercial fishing privileges, and goodwill received from the sale of an auto dealership.

DEDUCTIONS AND CREDITS

Certain deductions are taken into account in determining Washington capital gains subject to the WA CGT, including the following:

- US\$250,000 standard deduction per individual. Note: Married couples are considered a single individual for purposes of determining this deduction regardless of whether filing singly or jointly.
- The amount of Washington capital gains resulting from the sale of "substantially all" (defined as at least 90%) 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, provided that certain qualifications (including, among others, annual gross receipts of less than US\$10,000,000) are met.
- Certain qualified charitable contributions to the extent that such contributions exceed US\$250,000, limited to a maximum charitable contribution deduction of US\$100,000.

Credits are available against the WA CGT for the following:

- Any state of Washington business and occupation tax.
- Any non-Washington excise taxes paid on a transaction that is also subject to the WA CGT.

FILING REQUIREMENTS

Only individuals who owe WA CGT are statutorily required to file returns. The Department of Revenue is not authorized to expand filing requirements to include informational returns from nonowing taxpayers. Taxpayers must file under the same status as their federal income tax returns (e.g., taxpayers who filed federal income tax returns as “married filing jointly” must file a joint WA CGT return if owing WA CGT).

FINAL THOUGHTS

With the long-term presence of this tax now appearing almost certain, we encourage anyone who may be subject to the WA CGT to consult with their tax advisors. The tax practitioners at K&L Gates are available to assist in determining how these provisions may affect your personal tax planning. This includes negotiation of merger and acquisition transactions involving companies with owners domiciled in Washington.

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