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New Seattle Income Tax: Answers to Your FAQs

The City of Seattle adopted Ordinance 125339 on July 14, 2017, which imposes an income tax on Seattle residents and certain irrevocable trusts. The Seattle income tax is imposed at a rate of 2.25% of a resident taxpayer's "total income" in excess of \$250,000 for taxpayers filing single or married filing separately, or \$500,000 for taxpayers filing jointly. "Total income" is defined as the amount reported as income on line 22 of IRS Form 1040 or, in the case of trusts, line 9 of IRS Form 1041.

Q: When is Seattle's income tax effective?

The tax applies to income received after January 1, 2018. Unless enjoined or invalidated by a court, the first income tax returns and payments would be due on April 15, 2019.

Q: Who is a resident?

A resident is a natural person (individual) who either (a) has his or her "domicile" in Seattle for the entire tax year or (b) has his or her domicile outside Seattle, but maintains a "permanent place of abode" in Seattle, spends all or part of 184 days or more in Seattle during the tax year, and is present in Seattle for other than "temporary or transitory purposes."

Q: Are nonresidents subject to tax?

No. Nonresidents do not pay Seattle tax even if they earn income within Seattle. For example, a resident of Bellevue would not be subject to Seattle income tax on wages from employment in Seattle, rental income from real property owned in Seattle, or pass through income from a business entity conducting business in Seattle.

Q: Are residents subject to tax on income from sources outside Seattle?

Yes. Residents pay Seattle tax on their total income without regard to source. For example, a resident of Seattle would be subject to Seattle income tax on wages from employment in Bellevue, rental income from real property owned in Florida, or pass-through income from a business entity conducting business entirely outside Seattle.

However, residents are entitled to a credit against Seattle income tax for any income tax paid to another state or local government with respect to income attributable to sources outside Seattle.

Q: Can I move to a suburb and avoid the tax?

Yes. You will need to navigate Seattle's residency rules, but nonresidents do not pay Seattle income tax regardless of their sources of income.

Q: Are corporations, LLCs, partnerships, or other entities subject to tax?

With the exception of certain irrevocable trusts, entities are not subject to Seattle income tax. However, residents of Seattle that own pass-through entities (e.g., partnerships, LLCs, and S corporations) will be subject to tax on their share of pass-through entity income regardless of whether the income is actually distributed to or received by the owner.

Q: My business is already paying Seattle B&O tax, isn't this a double tax?

Technically, no (except for sole proprietors), but practically, yes. The proposed Seattle income tax would be in addition to Seattle B&O tax currently paid by the business entity. Business entities would continue to pay Seattle B&O tax on gross income. In the case of pass-through or disregarded entities (e.g., partnerships, LLCs, and S corporations), that same income would then be taxed again as part of business owner's total income. Sole proprietors would be subjected to a double city tax—Seattle B&O tax on "gross income" and Seattle income tax on "total income."

For example, Jane owns a retail business (Jane LLC) in Seattle with \$4,000,000 in annual gross receipts and \$1,000,000 in net income. Jane LLC would pay \$8,760 in Seattle B&O tax ($0.219\% \times \$4,000,000$). If Jane is a Seattle resident, she would also pay \$16,875 in income tax ($2.25\% \times (\$1,000,000 - \$250,000)$).

Q: What is "total income"?

"Total income" is defined as the amount reported as total income before any adjustments, deductions or credits on line 22 of IRS Form 1040 or, in the case of trusts, line 9 of IRS Form 1041. Total income generally includes:

- Wages, salaries, and tips
- Interest
- Dividends
- Capital gains
- Net income from sole proprietorships or disregarded entities (from IRS Schedule C)
- Net income from pass-through entities (whether or not received) (from IRS Schedule E)
- Net rental or royalty income (from IRS Schedule E)
- IRA distributions
- Pension and annuity payments
- Alimony and maintenance

Q: Does Seattle require withholding or estimated tax payments?

No. The ordinance provides that payments are due on April 15 of the year following the tax year or by any extended due date. There are no provisions requiring withholding or estimated tax payments.

Q: How are trusts taxed?

Trusts are the only entities subject to Seattle income tax. The tax applies to a trust or portion of a trust that (a) is not taxable to the grantor (i.e., a "nongrantor trust") and (b) consists of property that was transferred to (i) an irrevocable trust by a Seattle resident or (ii) a revocable trust by a trustor who was a Seattle resident at the time the trust or portion of the trust becomes irrevocable. Thus, irrevocable trusts will be subject to Seattle income tax without regard to the location of the trustee(s) or beneficiaries if the trustor was a Seattle resident at the time of transfer to an irrevocable trust or at the time the trust became irrevocable. The income from a grantor trust of which the grantor is a Seattle resident, or distributions of net income from a nongrantor trust to a Seattle resident, would be subject to tax as part of the Seattle resident's total income.

Q: Is the Seattle income tax deductible for federal income tax purposes?

Potentially. However, under current law, individuals who itemize their deductions may deduct either state and local income taxes *or* sales taxes. Thus, the potential federal tax benefit of deducting Seattle income tax may be offset by a loss of the deduction for state and local sales taxes. In addition, the federal alternative minimum tax (AMT) limits or eliminates the benefit of the deduction for many high-income earners.

Q: Is the Seattle income tax legal?

Seattle's income tax raises significant legal issues and, in our view, is likely illegal under current Washington law.

1. **State Preemption—Net Income Tax.** State law expressly prohibits a city tax on "net income." RCW 36.65.030. The city is likely to argue that the Seattle income tax is a tax on "total income" rather than "net income." However, "total income" includes items that are net income (e.g., net income from pass-through entities, sole proprietorships, and disregarded entities; net rental income; and net royalty income).
2. **State Preemption—Business and Occupation (B&O) Tax.** State law requires that city B&O taxes (i.e., a tax imposed on or measured by gross income) conform to certain legislative requirements. If Seattle's income tax is characterized as a tax on "gross income," the income tax would be an invalid B&O tax because it is inconsistent with many of the state law B&O tax requirements. See RCW Ch. 35.102. Seattle's income tax also jeopardizes the city's authority to impose its current B&O tax.
3. **City Taxing Power.** Washington cities have no inherent taxing power. Seattle's taxing power is limited to the power delegated to it by the legislature. For example, the Washington Supreme Court has previously held that cities do not have the right to levy a tax on gross income from wages. *Cary v. Bellingham*, 41 Wn.2d 468 (1952). Because the legislature has clearly not delegated the power to impose an income tax, the city will likely assert its power to license for revenue or another general grant of authority.
4. **State Constitution.** The Seattle income tax is likely unconstitutional under controlling Washington Supreme Court precedent. In a series of cases in the 1930s, the Washington Supreme Court held that various forms of income tax were unconstitutional property taxes. *Culliton v. Chase*, 174 Wash. 363 (1933) (holding that a state tax "on ... net income" violated the uniformity requirements of the state constitution); *Jensen v. Henneford*, 185 Wash. 209 (1936) (holding that a state tax "on the privilege of receiving income" violated state uniformity requirements); *Petroleum Nav. Co. v. Henneford*, 185 Wash. 495 (1936) (holding that a state corporate net income tax violated state uniformity requirements). The city intends to use the Seattle income tax as a vehicle to get the Washington Supreme Court to reconsider and potentially overrule its precedent. See City of Seattle Resolution No. 31747 (stating that "the City of Seattle can pioneer a legal pathway and build political momentum to enable the State of Washington and other local municipalities to put in place progressive tax systems [i.e., income taxes].").

If you have additional questions on the new tax ordinance and on how it may affect your trust tax obligations, please contact experienced counsel.

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