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Washington Legislature Enacts Capital Gains Tax and Trial Court Rules Unconstitutional; Questions Answered



Update: *This article was updated on March 14, 2022, to answer questions about new developments on the Washington capital gains tax.*

The Washington Legislature passed [Senate Bill 5096](#) on April 25, 2021. SB 5096 is a state capital gains tax on individual residents of the State of Washington. The state House approved the bill 52-46; the state Senate approved the bill by a single vote margin, 25-24. Governor Inslee promptly signed the bill into law. On March 1, 2022, the Douglas County Superior Court ruled that the tax is an unconstitutional tax on income, and appeals on that decision could take more than a year to resolve. Meanwhile, statewide voter initiatives to override the tax may appear on the November 2022 ballot. We provide answers to a few of the most pressing questions about the Washington capital gains tax.

If upheld, when would the tax commence?

If ultimately upheld on appeal and not overridden by voter initiative or subsequent legislative action, the tax would apply to capital gains recognized on or after January 1, 2022.

What is the tax rate?

A flat tax rate of 7% would apply to Washington residents' net federal long-term capital gain per calendar year in excess of the standard deduction and exemptions.

What exemptions and deductions apply to the tax?

The tax applies only to long-term capital gain; ordinary income, short-term capital gains, qualified dividends, tax-exempt interest, and other categories of income are excluded.

A standard deduction of \$250,000 is available for each individual and married couple (a married couple shares a single \$250,000 standard deduction, or \$125,000 for each spouse). Spouses who file joint returns for federal purposes must also file jointly for purposes of the Washington capital gains tax, effectively sharing and dividing equally all gains and losses for the year, while spouses who file separate federal returns must also file separate Washington returns and will have their Washington capital gains tax liability determined separately.

Several categories of assets, some broad and some narrow, are also expressly exempt from the tax. These include real estate, interests in privately held entities to the extent the value is attributable to directly owned real estate, assets held in retirement accounts, assets subject to condemnation proceedings, certain livestock, certain business assets subject to depreciation or expensing, timber, commercial fishing privileges, and goodwill from the sale of certain auto dealerships.

Gains from the sale of certain family-owned small businesses (with less than \$10,000,000 in annual revenue) are deductible as well. A modest charitable deduction is available for contributions to Washington charities in excess of \$250,000 and is limited to a maximum deduction of \$100,000 per taxpayer per year.

Who would be subject to the tax?

Individuals who are legally domiciled in Washington are generally subject to the tax, and individuals who are not legally domiciled in Washington are generally not subject to the tax (unless they recognize gain on the sale of tangible personal property located in Washington).

The tax does not apply to corporations or other entities, but individuals to whom capital gains are allocated from pass-through entities such as partnerships and LLCs would be subject to tax on those allocated gains.

How would the tax apply to trusts?

Trusts that are taxed as nongrantor trusts would not be subject to the Washington capital gains tax, but Washington beneficiaries of nongrantor trusts who receive allocations of long-term capital gain may be subject to the tax on those allocations. Capital gains recognized by grantor trusts, of which the trust assets are treated as owned by the grantor for federal income tax purposes, and by nongrantor trusts that would be includible in the grantor's estate (sometimes called incomplete gift nongrantor trusts), would be allocated and taxable to the grantor.

Can voters override the tax by initiative?

The legislature included a provision in the capital gains tax bill to make it exempt from the referendum process, but the voter initiative process remains available, and at least one voter initiative to override the tax is expected to appear on the November 2022 ballot.

Is the capital gains tax constitutional?

The Washington State Constitution, Article VII, provides that all taxes on property, defined as "everything, whether tangible or intangible, subject to ownership," must be uniformly applied and cannot exceed an annual rate of 1%.

In applying these limitations to previously adopted taxes, the Washington Supreme Court has ruled that taxes on gross income or net income are taxes on property subject to the constitutional uniformity and rate limitations. The court has characterized previous efforts to tax the receipt of income as taxes on property that are subject to these constitutional limitations.

In other cases, the court has held that taxes on a particular use or enjoyment of property, or on a voluntary act or privilege as distinct from mere ownership, are characterized as excise taxes not subject to constitutional uniformity and rate limitations.

The Douglas County Superior Court ruled on March 1, 2022 that the capital gains tax is a tax on the receipt of income subject to the uniformity and 1% limits on property taxes under prior Washington Supreme Court precedent. The court held the tax violated both provisions of the constitution. According to the court, "[the tax] violates the uniformity requirement by imposing a 7% tax on an individual's long-term capital gains exceeding \$250,000 but imposing zero tax on capital gains below that \$250,000 threshold. It violates the limitation requirement because the 7% tax exceeds the maximum annual property tax rate of 1%."

The superior court ruling may be appealed either to the court of appeals or to the Washington Supreme Court, which may accept review or may instead require the court of appeals to hear the case first. In any case, the appeals process may take more than a year. By way of comparison, 20 months passed between the superior court and court of appeals decisions in litigation to overturn the city of Seattle income tax, and another nine months passed before the supreme court declined to review the court of appeals decision. If the supreme court had agreed to review the court of appeals decision in that case, even more time may have passed before final resolution. Of course, the capital gains tax appeals could be resolved much more quickly.

If the tax is ultimately upheld, would the tax apply to gains recognized during the appeals process?

Unless the tax is modified by the legislature or by initiative, or unless the courts grant a special reprieve, the tax would apply to gains as of January 1, 2022 even if the constitutionality of the tax is not resolved for several years. In conjunction with the appeals process, the courts may order the Department of Revenue not to collect the tax pending resolution of the appeals, in which case back taxes could be due, or the courts may allow the department to collect the tax pending resolution and then order the tax to be refunded if ultimately determined to be unconstitutional.

How might Washington residents begin to plan for the tax?

There are several planning considerations that taxpayers might consider in anticipation of the possibility that the Washington capital gains tax is not determined to be unconstitutional or overturned by initiative. Taxpayers might consider changing their residency status; establishing legal domicile in a different state would avoid capital gains tax on intangible assets. Taxpayers may also smooth out their capital gains income stream over several years to utilize the full annual \$250,000 deduction each year when feasible, including through the use of charitable remainder unitrusts. Taxpayers may also choose to give assets with built-in gains to lower-income beneficiaries or to nongrantor trusts to minimize or avoid the tax.

Note: This update was originally published on April 30, 2021, with the title "Washington's New 7% Capital Gains Tax Questions Answered."

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