

Washington's New Capital Gains Excise Tax: An Income Tax by Another Name

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The Washington State Supreme Court recently upheld an excise tax on the privilege of selling capital assets within the State of Washington. The Court upheld the new tax over concerns that the tax violated both the state and federal constitutions. The purpose of this article is not to debate the wisdom espoused by the majority in its decision. Rather, we explore practical, probable, and possible (are we tired of PPP as an acronym yet?) outcomes of this case.

Mechanics of the Capital Gains Excise Tax

The new tax applies to Washington residents and non-residents who are present in the state for at least 183 days during a calendar year. For individuals with properties in multiple states, it is important to work with competent tax counsel to determine your primary tax home and consider whether you spend a majority of your time in Washington. Additional caution should be given when an individual may reside in a neighboring state but work in Washington. The 183-day test includes any day where part of the day was spent within Washington. In certain circumstances, taxpayers may inadvertently become subject to the new tax.

The tax is calculated as seven percent of Washington capital gains exceeding \$250,000 during a calendar year. Washington capital gains are generally the individual's federal long-term capital gains, with adjustments for carryforward items and items not subject to the Washington tax. In addition, capital gains attributable to the sale of real property within Washington are excluded from the capital gains tax, but generally subject to the Washington real estate excise tax.

Taxpayers are generally required to file electronic returns with the Department of Revenue and pay the associated tax liability on or before the federal tax deadline. A federal extension of time to file automatically extends the taxpayers' filing due date but not the payment due date. Penalties and interest may apply for failure to timely file or pay.

Practical Outcomes

- **File and Pay:** The capital asset excise tax is effective for tax years beginning on January 1, 2022. Taxpayers who had Washington capital gains sufficient to trigger excise tax should be prepared to file and pay taxes by April 18, 2023. A federal extension of your individual tax return automatically extends the time to file the Washington excise tax return but does not extend the time to file. Taxpayers may need to register with the Washington Department of Revenue in order to file returns and make payments.

- **Planning Opportunities**

- **New Domicile:** Washington, with its lack of an income tax, has previously been the recipient of many Oregonians seeking to minimize their state tax liabilities, especially upon retirement. The new capital gains excise (income) tax will inevitably cause residents to consider redomiciling prior to significant capital gain events. Taxpayers should consult with tax counsel to ensure they understand the relevant factors when considering redomiciling to another state. Business owners looking to transition ownership (exit planning) may find redomiciling particularly effective at minimizing their tax liabilities upon exiting their business.
- **Trust Planning:** RCW 82.87.040(b) creates a look-through rule for federal pass-through and disregarded entities (partnerships, S corporations, and grantor trusts). Additionally, non-grantor trusts are treated as grantor trusts whenever the grantor has made an incomplete gift under federal tax law. Washington residents who might be subject to the new tax should consult with estate planning counsel to consider potential planning strategies involving gift transfers to nonresidents and transfers to non-grantor trusts not subject to the look-through rule.

Probable Outcomes

- **Legislative Revisions:** With the Washington Supreme Court upholding the capital gains tax, legislators will inevitably propose tweaks in the coming years. While the current tax focuses on taxpayers with significant capital gains, opponents of the tax anticipate legislators will reduce the \$250,000 standard deduction and/or increase the seven percent rate.
- **Disputes with the Department:** Tax planners will likely create a playbook of options to mitigate the new tax. Taxpayers should anticipate the Department of Revenue will challenge aggressive tax positions and seek out non-filers.

Possible Outcomes

- **Additional “Excise” Taxes:** The analysis in the Washington Supreme Court case suggests it is permissible to create an excise tax for the privilege of engaging in specified activities within Washington while the measure of the tax is calculated on the basis of net income from such activity. It is not outside the realm of possibility to envision an excise tax on the privilege of providing services (wages) within the state whereby the measure of the tax is net income from such tax.
- **Constitutional Amendments/Voter Initiatives:** A rose by any other name would smell as sweet. An income tax by any other name is still an income tax. As someone around long enough to remember the promise of \$30 vehicle registration fees on the ballot, one possible outcome is taxpayers will galvanize behind anti-tax provisions limiting the legislature’s ability to enact new income-based excise taxes by repealing the existing law or proposing amendments to the Washington Constitution.

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About the Author

Justin Hobson has 15 years of experience helping clients on corporate and tax matters. Justin assists businesses, from startups to large international corporations, on tax issues and business transactions. He also has experience with corporate matters, including mergers and acquisitions, financing transactions, securities offerings, and corporate governance. Justin began his career at PricewaterhouseCoopers LLP where his practice primarily focused on international tax matters. His experience includes tax return compliance, tax controversy matters, tax advice and structuring, and auditing tax provisions in accordance with Accounting Standards Codification (ASC) 740.