

HOUSE BILL REPORT

ESSB 5096

As Passed House:

April 21, 2021

Title: An act relating to enacting an excise tax on gains from the sale or exchange of certain capital assets.

Brief Description: Investing in Washington families and creating a more progressive tax system in Washington by enacting an excise tax on the sale or exchange of certain capital assets.

Sponsors: Senate Committee on Ways & Means (originally sponsored by Senators Robinson, Hunt, Nguyen and Wilson, C.; by request of Office of Financial Management).

Brief History:

Committee Activity:

Finance: 3/15/21, 4/16/21 [DPA].

Floor Activity:

Passed House: 4/21/21, 52-46.

Brief Summary of Engrossed Substitute Bill

- Imposes a 7 percent tax on Washington capital gains realized from the sale of long-term assets.

HOUSE COMMITTEE ON FINANCE

Majority Report: Do pass as amended. Signed by 11 members: Representatives Frame, Chair; Berg, Vice Chair; Walen, Vice Chair; Chopp, Harris-Talley, Morgan, Orwall, Ramel, Springer, Thai and Wylie.

Minority Report: Do not pass. Signed by 6 members: Representatives Orcutt, Ranking Minority Member; Dufault, Assistant Ranking Minority Member; Chase, Stokesbary, Vick and Young.

This analysis was prepared by non-partisan legislative staff for the use of legislative members in their deliberations. This analysis is not part of the legislation nor does it constitute a statement of legislative intent.

Staff: Tracey O'Brien (786-7152).

Background:

Capital Gains.

Most property owned by an individual for personal purposes is considered a capital asset, including houses, furniture, cars, stocks, and bonds. The sale of these items may result in a capital loss or a capital gain. Short-term capital gains or losses are gains or losses from assets held for one year or less. Long-term capital gains or losses are gains or losses from assets held for more than one year.

At the federal level, the gains on some of these capital assets may be subject to taxation, and the losses may be deducted, when computing an individual's net capital gain for tax liability purposes.

Some property is exempted from federal capital gains tax. This includes: stock in trade and other inventory; accounts or notes receivable; depreciable property; real estate used in a trade or business; and certain hedging transactions. In addition, an individual may not need to report the sale or exchange of a main home.

An individual filing a 1040 federal tax return calculates any capital gains or losses on Form 8949 and reports the gain or loss on Schedule D. Capital gains are generally taxed at a lower rate than other income. The rates are determined by the source of the net capital gain and the taxpayer's regular income tax rate. For tax year 2019, the five maximum capital gains rates are 0 percent, 15 percent, 20 percent, 25 percent, and 28 percent. For example, if the net capital gain resulted from the sale of collectibles, the 28 percent rate applies; however, if the gain is not from the sale of collectibles, small business stock, or an unrecaptured section 1250 gain, and the regular tax rate that would apply is 10 or 15 percent, then the capital gains tax rate is 0 percent.

2019 Federal Capital Gains Tax Rates (Internal Revenue Service Publication 550):

Source of net capital gain	Maximum capital gain rate
Collectibles	28%
Eligible gain on qualified small business stock minus the section 1202 exclusion	28%
Unrecaptured section 1250 gain	25%
Other gain and the regular tax that would apply is 37%	20%
Other gain and the regular tax rate that would apply is 22%, 24%, 32%, or 35%	15%
Other gain and regular tax rate that would apply is 10% or 12%	0%

"Other gain" means any gain that is not a collectibles gain, gain on small business stock, or unrecaptured section 1250 gain.

Tax Preference Performance Statement.

State law provides for a range of tax preferences that confer reduced tax liability upon a designated class of taxpayer. Tax preferences include tax exclusions, deductions, exemptions, preferential tax rates, deferrals, and credits. Currently, Washington has over 650 tax preferences, including a variety of sales and use tax exemptions. Legislation that establishes or expands a tax preference must include a Tax Preference Performance Statement (TPPS) that identifies the public policy objective of the preference, as well as specific metrics that the Joint Legislative Audit and Review Committee (JLARC) can use to evaluate the effectiveness of the preference. All new tax preferences automatically expire after 10 years unless an alternative expiration date is provided.

Summary of Bill:

Beginning January 1, 2022, a tax is imposed on the adjusted capital gains of an individual for the privilege of selling or exchanging long-term capital assets or receiving Washington capital gains. The tax is equal to 7 percent of an individual's capital gain on long-term capital assets. The tax imposed is necessary for the support of state government and its existing institutions.

This tax is in addition to any other taxes imposed by state and local governments.

This tax also applies to natural persons and to individuals who are beneficial owners of long-term capital assets held by a pass-through or other disregarded entity, to the extent the individual's ownership interest in the entity is reported for federal tax purposes. This includes a grantor of a nongrantor trust when the grantor's transfer of assets to the trust is treated as an incomplete gift for federal gift tax purposes.

"Washington capital gains" are defined as an individual's adjusted capital gains allocated to Washington state less a standard deduction of \$250,000 for all filers, whether filing as an individual or jointly. The standard deduction will be annually adjusted for inflation.

"Adjusted capital gain" is defined as the federal net long-term capital gain plus any loss from a sale or exchange that is exempt from the tax imposed in this chapter, and less any gain from a sale or exchange that is exempt from the tax imposed in this chapter, to the extent that such gain or loss was included in calculating federal net long-term capital gain.

Long-term assets include intangible or tangible personal property:

- For intangible personal property, the capital gains tax will apply if the taxpayer was domiciled in Washington at the time of sale or exchange.
- For tangible personal property, the capital gains tax will apply if the property was located in Washington at the time of the sale or exchange. The sale of tangible personal property will also be subject to the state's capital gains tax if: (1) the property was located in Washington at any time during the current or immediately

preceding taxable year; (2) the taxpayer was a Washington resident at the time of the sale or exchange; and (3) the sale was not subject to income or excise tax on the adjusted capital gain by another taxing jurisdiction.

A "resident" is an individual domiciled in Washington during the entire taxable year. A resident also includes a person who is not domiciled in Washington during the taxable year but maintained a place of abode and was physically present in Washington for more than 183 days during the taxable year. Such a person will be a resident for that portion of the year in which they were domiciled or maintained a place of abode. If an individual maintained no permanent place of abode in this state during the entire taxable year, maintained a permanent place of abode outside of Washington for an entire taxable year, and spent an aggregate of no more than 30 days in Washington, the person is considered a nonresident.

Exemptions, Deductions and Credits.

The following assets are exempt from the capital gains tax:

- all real estate, meaning land and fixtures affixed to the land, plus used mobile homes, used park model trailers, used floating homes, and improvements constructed upon leased land;
- sale of an interest in an entity owning real property, but only to the extent that any long-term capital gain or loss from such sale or exchange is directly attributable to the real estate owned directly by such entity;
- retirement assets, including 401(k), a tax-sheltered annuity and custodial account, deferred compensation plans, individual retirement accounts (IRAs), Roth IRAs, employee defined contribution programs, employee defined benefit programs, or similar retirement saving vehicles;
- assets condemned by the government;
- cattle, horses, or breeding livestock, if 50 percent of the taxpayer's gross income for the year is from farming or ranching;
- commercial fishing privileges;
- certain depreciable property used in a trade or business;
- goodwill received from the sale of an automobile dealership; and
- timber, timberlands, or receipts from a Real Estate Investment Trust.

A credit for Washington capital gains tax paid is available for the business and occupation tax. Credits are also allowed equal to the amount of any legally imposed income or excise tax paid by the taxpayer to another jurisdiction. Deductions are allowed for taxes prohibited by the United States or Washington constitutions or laws.

A deduction from the amount of adjusted capital gain is allowed for qualified charitable donations. During the tax year for which the deduction is sought, the taxpayer must have donated at least \$250,000 to qualified charitable organizations. The amount of the deduction is the amount of qualified donations in excess of \$250,000, with an annual maximum deduction of \$100,000. The threshold donation of \$250,000 and the maximum

donation amount of \$100,000 will be adjusted annually for inflation. A qualified donation is a donation to a nonprofit organization that is eligible to receive a charitable deduction pursuant to IRC Section 170(c) and the organization is principally directed or managed within the state of Washington.

A deduction from the amount of adjusted capital gain is authorized for the sale of a qualified family-owned small business. The deduction is the amount of adjusted capital gain derived from the sale of at least 90 percent of all of the fair market value of the assets of, or transfer of at least 90 percent of the taxpayer's interest in, a qualified family-owned small business.

A "qualified family owned small business" is defined as a business:

- in which the taxpayer held a qualifying interest for at least 5 years immediately preceding the sale or transfer;
- in which the taxpayer or a family member materially participated in the operation of the business for at least five of the 10 years immediately preceding the sale or transfer, unless the sale or transfer was to a family member; and
- that had a worldwide gross revenue of \$10 million or less during the 12-month period immediately preceding the sale or transfer. The amount of the world-wide gross revenue limit must be adjusted annually for inflation.

"Material participation" means an individual was involved in the operation of the business on a regular, continuous, and substantial basis.

"Qualifying interest" means an interest as a proprietor in a business carried on as a sole-proprietor. It can also mean an interest in a business if at least:

- 50 percent of the business is owned, directly or indirectly, by the taxpayer and members of the taxpayer's family;
- 30 percent of the business is owned, directly or indirectly, by the taxpayer and members of the taxpayer's family, and: (1) at least 70 percent of the business is owned, directly or indirectly, by members of two families; or (2) at least 90 percent of the business is owned, directly or indirectly, by members of three families.

Tax Proceeds.

The first \$500 million in taxes, penalties and interest collected pursuant to this act each year must be deposited into the Education Legacy Trust Account (ELTA). The uses of the ELTA funds are expanded to permanently include early learning and child care. Any remaining proceeds will be deposited into the Common School Construction Account. The amount deposited in ELTA will be adjusted annually for inflation.

Adjustments.

Each year beginning with calendar year 2024, the Department of Revenue (DOR) must adjust the standard deduction, the worldwide gross revenues of a qualifying family owned business, charitable deduction threshold and cap, and the amount of the tax proceeds

deposited in ELTA. The amounts will be adjusted by the current Consumer Price Index for all urban consumers for the Seattle metropolitan area as calculated by the United States Bureau of Labor Statistics for the proceeding 12 months plus one.

Other Provisions.

The administrative provisions for the DOR apply to this new tax, and additional provisions for the filing, payment, and applicable penalties are included.

It is a class C felony to knowingly attempt to evade payment of the capital gains tax. It is a gross misdemeanor to knowingly fail to pay tax, make returns, keep records, or supply information required.

This act is exempt from the requirements of a TPPS, a JLARC review, and the exemptions do not expire.

Appropriation: None.

Fiscal Note: Available.

Effective Date: The bill takes effect 90 days after adjournment of the session in which the bill is passed.

Staff Summary of Public Testimony:

(In support) Systemic inequities existed in our tax system prior to the COVID-19 pandemic. While it is important to acknowledge the need for personal responsibility for one's own success and to acknowledge the needs of businesses, one must realize that income and wealth inequality is the biggest challenge we are facing as a society. We need to foster healthy communities by providing shelter, food, and education, creating stability in citizens' lives. This legislation begins to address the centuries of systemic racism by investing in Washingtonians.

In Washington, the higher your income, the lower your tax burden is. This tax applies to transactions conducted exclusively by those who can afford the tax. Most family assets, including retirement funds, are exempt.

The bulk of money funding startup businesses come from out-of-state investors. This tax would only apply to those jackpot investors who have made successful investments. It is a modest tax on extraordinary profits. It is a privilege to make such profits.

This bill is crucial to recovery of Washington's small businesses. There is a constant lack of access to child care that has been exacerbated by the pandemic. This will assist in helping the child care industry to meet the needs of Washingtonians and enable workers to return to work. It is an important step to combat financial insecurity that resulted from the pandemic.

Charitable organizations are outmatched to deal with today's unprecedented challenges. It is time for state government to play an important role in meeting the needs of our citizens. Therefore, it is time for those of us who can afford it to contribute more towards the services needed by our neighbors.

(Opposed) Shares and stock options are the method for funding the startup ecosystem. Due to limited funds for operating, many startups include employee stock option plans as a significant part of their employees' compensation. Startups are the engine of our economic growth. The COVID-19 pandemic is shifting how and where businesses operate. Many businesses are eliminating headquarters and looking at relocating and condensing business as the result of the increase in remote work options. As a result of this proposed tax, many startups and employees will leave Washington and move their work to other states.

This would be the only standalone capital gains tax in the United States. No state considers it an "excise tax." The states that impose a capital gains tax consider it an income tax and it is filed with a 1040 tax form. With an increase in state revenues from actual collections and forecasted growth as well as federal pandemic stimulus money, Washington does not need to impose this tax. There is plenty of money to fund state government. Washington's best competitive advantage to attract and retain business is the lack of an income tax. Indeed, this proposal would fundamentally and unfairly burden small businesses.

The Internal Revenue Service has declared that a capital gains tax is an income tax. Over 80 years ago, the Washington Supreme Court ruled that a graduated income tax like this one was unconstitutional. It shows great disdain for the voters to push this agenda when the courts and voters have previously rejected attempts to impose an income tax. Indeed, this is only going to lead to a costly lawsuit and referendum.

This is not the time to impose a new tax. Businesses are struggling to overcome the pandemic and a historic increase to Unemployment Insurance taxes. Many business owners are selling substantial assets in order to stave off bankruptcy. This penalizes the retirement of small business owners by levying a tax on the sale of their business.

Persons Testifying: (In support) Dylan Grundman O'Neill, Institute on Taxation and Economic Policy; Sakara Remmu, Washington Black Lives Matter Alliance; Pauli Owens, Service Employees International Union 925; Kevin Litwack; Dennis Eagle, Washington Federation of State Employees; Scarlett To, MomsRising; Dan Price; Shomya Tripathy, Asian Counseling and Referral Service; Drayton Jackson, Statewide Poverty Action Network; Shaula Massena, Northwest Sustainable and Responsible Insights; Dan Olmstead, Poverty Bay Coffee Company; Stephan Blandford, Children's Alliance; Ryan Pricco, Child Care Aware of Washington; Ruth Lipscomb; Rhonda Gray; and David Goldstein, Civic Ventures.

(Opposed) Molly Jones, Washington Technology Industry Association; Randa Minkarah,

Resonance AI; Claudius Mbemba, Neu; Dann Mead Smith, Washington Policy Center; Dan Newhouse, Office of Congressman Dan Newhouse; Tommy Gantz, Association of Washington Business; Jeff Pack, Washington Citizens Against Unfair Taxes; C Davis, Washingtonians to Recall Inslee; Tim Eyman, Permanent Offense; Maxford Nelsen, Freedom Foundation; Christie Biesold, Merlino Fine Foods; and Tim Schauer, MacKay Sposito.

Persons Signed In To Testify But Not Testifying: Cynthia Stewart, League of Women Voters of Washington; Andrew Villeneuve, Northwest Progressive Institute; Drayton Jackson, Statewide Poverty Action Network; Summer Stinson; Emily Parzybok, Balance Our Tax Code; Sonya Campion, Campion Advocacy Fund; Andy Nicholas, Washington State Budget and Policy Center; Jacob Vigdor, University of Washington; Aaron Czyzewski, Food Lifeline; Patricia Flores; Emily Carmichael, Washington's Paramount Duty; Maggie Humphreys, MomsRising; Eli Goss, OneAmerica; Mindi Lee, Puget Sound Advocates for Retirement Action; Maria Shiekh; Leigh Sims, Life on Mars; Karla Esquivel, Andaluz Gift Shop; Nick Pitsilionis, Black Cypress Restaurant; Aaron Verzosa, Archipelago; Autumn Barnett; Brian Duncan; Inna Rator; Treasure Mackley, Invest in Washington Now; Adrienne Stuart, Washington State Developmental Disabilities Council; Elinor Graham, University of Washington and Washington Chapter of the American Academy of Pediatrics; Charles Mayer, Washington Physicians for Social Responsibility; Sarah Reyneveld, Washington's Paramount Duty; Megan Pirie; Rachael Myers, Washington Low Income Housing Alliance; Kosta Alexandropoulos, Yamas Greek Eatery; Emily Murphy, Retired Public Employees Council; Jessa Lewis, Alliance for a Healthy Washington; Lorrell Noahr, Washington Education Association; Noah Martin, Quaker Voice on Washington Public Policy; Matthew Lang; Tess Foy, Child Care Resources; Mike Smyth; Chester Baldwin, Washington Business Properties Association; Joseph Kerr; Kristin Keyes-Halterman; Mark Johnson, Washington Retail Association; Stephanie Swanberg, Tri-City Regional Chamber of Commerce; James O'Hagan; Jerry VanderWood, Associated General Contractors of Washington; Yasha Carpentier and Pam Manley, Washingtonians to Recall Inslee; Greg Hanon, National Association of Industrial and Office Properties; Tom Davis, Washington Farm Bureau; James Moyer, Washington Association of Wheat Growers; Carolyn Logue, Washington Food Industry Association; Mark Streuli, Washington Potato and Onion Association and Washington Cattlemen's Association; Bill Stauffacher, Building Industry Association of Washington and Independent Insurance Agents & Brokers of Washington; Nathan Gorton, Washington REALTORS; Julia Gorton, Washington Hospitality Association; Gary Smith, Independent Business Association; Marty Goodman, Holland Partner Group; Sharon Hanek; Laurie Layne; Heather Hansen, Washington State Grange; Byoung Moon, Joeun Insurance Corporation; Greg Seifert, Washington Association of Health Underwriters; Chad See, Freezer Longline Coalition; Paul Clampitt; Nate Stone, The Fury Group; Lance Farr, Farr Fisheries Incorporated; Laurie Layne; Gary Smith, Independent Business Association; Joseph Bishop-Henchman, National Taxpayers Union Foundation; and Reni Storm.