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SUPREME COURT OF THE STATE OF WASHINGTON

CHRIS QUINN, an individual; CRAIG LEUTHOLD, an individual; SUZIE BURKE, an individual; LEWIS and MARTHA RANDALL, as individuals and the marital community comprised thereof; RICK GLENN, an individual; NEIL MULLER, and individual; LARRY and MARGARET KING, as individuals and the marital community comprised thereof; and KERRY COX, an individual,

Respondents,

vs.

STATE OF WASHINGTON, DEPARTMENT OF REVENUE an agency of the State of Washington, and VIKKI SMITH, in her official capacity as Director of the Department of Revenue,

Appellants.

EDMONDS SCHOOL DISTRICT, TAMARA GRUBB, MARY CURRY, and WASHINGTON EDUCATION ASSOCIATION,

Intervenors

———

APRIL CLAYTON, an individual; KEVIN BOUCHEY, an individual; RENEE BOUCHEY, an individual; JOANNA CABLE, an individual; ROSELLA MOSBY, and individual; BURR MOSBY, an individual; CHRISTOPHER SENSKE, an individual; CATHERIN SENSKE, an individual; MATTHEW SONDEREN, an individual; JOHN MCKENNA, an individual;

WASHINGTON FARM BUREAU; WASHINGTON STATE TREE FRUIT ASSOCIATION; WASHINGTON STATE DAIRY FEDERATION,

Respondents,

vs.

STATE OF WASHINGTON, DEPARTMENT OF REVENUE an agency of the State of Washington, and VIKKI SMITH, in her official capacity as Director of the Department of Revenue,

Appellants.

EDMONDS SCHOOL DISTRICT, TAMARA GRUBB, MARY CURRY, and WASHINGTON EDUCATION ASSOCIATION,

Intervenors

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I. INTRODUCTION

The State opens its brief to this Court not with a defense of the capital gains tax, but an appeal of its policy. The State also attempts to deflect by recasting the actual nature of the capital gains tax and mischaracterizing the decision of the court below. However, scrutiny of the statute adopted by the Legislature and the governing authority confirms that the superior court was correct when it found the capital gains tax unconstitutional. The capital gains tax is a tax on income that violates both the state and federal constitutions.

First, the capital gains tax violates Article VII of the Washington Constitution because it is a tax on property that does not satisfy the constitutional requirements of uniformity and rate limitations.[1] The capital gains tax does not meet the definition of an excise tax, despite the State's arguments otherwise. The capital gains tax is imposed by reason of an individual's legal or

[1] The Quinn Plaintiffs join the arguments made by the Clayton Plaintiffs in response to the brief filed by Intervenors.

beneficial ownership of property; applies when long-term capital gains attributed to "Washington" are recognized by the owner for federal income tax purposes; and is not imposed on individual transactions or any privilege conferred by Washington but is imposed on an aggregate amount measured by the total "Washington" capital gains recognized by the individual over a given calendar year after netting deductions and exclusions. In other words, the capital gains tax is an "absolute and unavoidable" demand on an individual's property—income—a quintessential property tax.

Second, the capital gains tax violates the Privileges and Immunities Clause of the Washington Constitution because the Legislature impermissibly taxed certain persons while exempting others within the same class with no stated, reasonable ground for granting an immunity from the tax.

Finally, the capital gains tax structured by the Legislature violates the dormant Commerce Clause of the United States Constitution regardless of whether it is deemed a property tax,

excise tax, or something other. The State impermissibly taxes activity occurring outside the state as to which it lacks any nexus, imposes a tax that is not fairly apportioned to activities occurring within the state, and discriminates against interstate commerce by exposing gains derived across state lines to the risk of multiple state taxation. The State tries to save the capital gains tax by relying on an inapt principle applied to facial challenges in other contexts which requires proof that no set of circumstances exists in which the law could be constitutionally applied. But a state tax that violates the Commerce Clause must be stricken in toto—even if there are some circumstances in which imposition of the tax may be permissible.

In sum, the capital gains tax cannot survive constitutional scrutiny. This Court should affirm the superior court's order declaring the tax unconstitutional and invalid, and therefore void and inoperable as a matter of law.

II. ISSUES ON APPEAL

1. Does the capital gains tax violate Article VII of the Washington Constitution when it imposes a tax on individuals based on their ownership of property, lacks uniformity, and exceeds the permissible tax rate?

2. Does the capital gains tax violate the Privileges and Immunities Clause of the Washington Constitution when the Legislature granted a privilege of exemption from the tax to certain persons while subjecting other persons to the tax that fall within the same class and the Legislature did not provide any reasonable ground for granting that privilege?

3. Does the capital gains tax violate the Commerce Clause of the United States Constitution when it (1) impermissibly taxes gains derived from out-of-state activity, (2) imposes a tax that is not fairly apportioned to activities occurring within the state, and (3) discriminates against interstate commerce by exposing gains derived from out-of-state transactions to multiple state taxation?

III. STATEMENT OF THE CASE

A. The Legislature Imposed a Capital Gains Tax on Individuals.

In 2021, the Legislature levied for the first time a tax on the annual long-term capital gains of individuals. Laws of 2021, 67th Leg., Ch. 196 (Engrossed Substitute Senate Bill ("ESSB") 5096) § 5.[2] Beginning January 1, 2022, the tax is imposed on an individual's annual "Washington capital gains." *Id.* § 5 (imposing the tax on individuals); § 4(13) (defining "Washington capital gains" as "adjusted capital gain") and (4(1) defining "adjusted capital gain" as "federal net long-term capital gain").

Capital gains incurred by pass-through entities (e.g., partnerships, limited liability companies, S corporations, or grantor trusts) are taxed against the entity's "legal or beneficial owner" to the extent of the individual's ownership interest in the entity "as reported for federal income tax purposes." *Id.* § 5(1),

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[2] ESSB 5096 is codified at Chapter 82.87 RCW. This brief cites to the session law as adopted by the Legislature. A copy of ESSB 5096 is attached as Appendix A.

(4). In other words, an individual need not voluntarily act to sell or exchange any long-term capital asset to be subject to the capital gains tax—mere legal or beneficial ownership of the capital asset and recognition of the gains is sufficient

The starting point for determining an individual's tax liability begins with identifying the taxpayer's "Washington capital gains," which are derived directly from the individual's "federal net long-term capital gain" reported for "federal income tax purposes" on the taxpayer's IRS tax return with some exceptions for losses carried forward or back. §§ 4(1), (3), 5(3). Next, long-term capital gains that are excluded from Washington's capital gains tax are subtracted from that amount. *Id.* § 4(a). Then, amounts of long-term capital gains that are not allocated to Washington under the statute are subtracted. *Id.* § 4(1)(a). Long-term capital gains derived from tangible personal property (e.g., physical capital assets) are allocated to Washington if *either* (1) the property was located in this state at the time of sale or exchange; *or* (2) the property was located in

Washington at some time during the taxable year, the taxpayer was a resident of Washington at the time of the sale or exchange, and the taxpayer is not otherwise subject to the payment of an income or excise tax on the long-term capital gains by another state. *Id.* § 11(1)(a). Long-term capital gains derived from intangible personal property (e.g., stocks, bonds, goodwill) will be taxed by Washington if the taxpayer was domiciled in Washington at the time the sale or exchange occurred, regardless of whether the assets can be allocated to a state other than Washington or the transaction that creates the gain occurs in a jurisdiction other than Washington. *Id.* § 11(1)(b). A credit is allowed against the tax equal to the amount of any income or excise tax paid to another taxing jurisdiction but only if the gains are derived from assets "within" the other jurisdiction. *Id.* § 11(2)(a).

After the initial "Washington capital gains" are calculated, the taxpayer may deduct from the amount (1) a standard deduction of $250,000, or a total of $250,000 for spouses and

domestic partners; (2) an adjusted deduction for gains derived from the sale or transfer of certain family-owned small business; and (3) a $100,000 deduction for charitable donations over $250,000 made to certain Washington-based nonprofit organizations. *Id.* §§ 7-9. The sum total of the final "Washington capital gains" is then multiplied by seven percent to determine the ultimate tax liability. *Id.* § 5.

The tax, as structured by the Legislature, will require all individuals both inside and outside the State who incur Washington capital gains to go through this calculation each year to determine if they are liable for the tax. *Id.* §§ 5, 12. Individuals owing the capital gains tax to Washington must report and pay the amount due on or before the date that their federal income tax return must be filed. *Id.* § 12(1). In addition to filing a Washington return, taxpayers must file a copy of their federal income tax return along with all schedules and supporting documentation for the federal return. *Id.* § 12(2). Failure to

comply subjects the taxpayer to civil and criminal penalties. *Id.* § 15.

B. The Superior Court Found ESSB 5096 Unconstitutional.

Individual and associational plaintiffs filed separate lawsuits in Douglas County Superior Court to obtain declaratory judgment that ESSB 5096 is constitutionally invalid under both the federal and state constitutions. CP Vol. I 1-9 (Quinn Compl.); CP Vol. II 1-17 (Clayton Compl.). Each asserted that ESSB 5096 (1) violates Article VII, Sections 1 and 2, of the Washington Constitution because it imposes a non-uniform tax on income and exceeds the one percent limit on taxes upon personal property; (2) violates Article I, Section 12, of the Washington Constitution by imposing a tax on certain persons while exempting others; and (3) violates the Commerce Clause of the United States Constitution because it allocates taxable gain to Washington based on the taxpayer's location instead of the location of the activity, discriminates against interstate

commerce, and is not fairly apportioned. *See id*.[3] The cases were consolidated. CP Vol. I 107-111. Both sets of Plaintiffs later amended to add more parties challenging the constitutionality of the tax. *See* CP Vol. I 16-24; CP Vol. I 607-25.

A school district and individuals involved in education were allowed to intervene as party defendants in the case after the State entered its appearance in the case. CP Vol. I 136-40. The State unsuccessfully sought to dismiss the lawsuits and to transfer venue. *See* CP Vol. I 189-97. Thereafter, the parties cross-moved for summary judgment. CP Vol. I 227-31.

After considering the "wealth of material" filed by both sides, CP Vol. I 866, the Superior Court granted summary judgment for the Plaintiffs. CP Vol. I 872, 876. The court first noted that it had disregarded the policy considerations put forth by the State and Intervenors as being inapplicable to determining

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[3] The Quinn Plaintiffs did not move for a ruling on their privacy claim under Article I, Section 7, of the Washington Constitution so that claim is not at issue on appeal.

the legality of the tax. CP Vol. I 866 (citing *State ex rel Namer Inv. Corp. v. Williams*, 73 Wn.2d 1, 7, 435 P.3d 975 (1968)). The court next summarized "nearly a century of case law" setting forth how tax statutes should be analyzed to determine their proper nature and incidents. CP Vol. I 867-69. It then described multiple aspects of ESSB 5096 which establish that the capital gains tax is not an excise tax, but an "absolute and unavoidable" tax meeting the definition of a property tax under the case law. *See* CP Vol. I 871-72. The Superior Court concluded that ESSB 5096 violates Article VII, Sections 1 and 2, of the Washington Constitution because the tax lacks uniformity and exceeds the one percent rate limit for property taxes. CP Vol. I 872. The Superior Court did not reach the Plaintiffs' other constitutional arguments for the invalidity of ESSB 5096, having found the law invalid under Article VII. *Id*.

The State and Intervenors appealed directly to this Court.

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IV. ARGUMENT

The capital gains tax enacted by the Washington Legislature does not withstand constitutional scrutiny. The State attempts to save the capital gains tax by recasting the nature and structure of the tax and appealing to policy interests. However, as long ago recognized by this Court, "[i]t is not the function of this court in cases like this to consider the propriety of the tax, or to seek for the motives or to criticize the public policy which may have prompted adoption of the legislation." *State ex rel. Namer Inv. Corp. v. Williams*, 73 Wn.2d 1, 7, 435 P.2d 975 (1968) (citing *State Board of Tax Comm'rs of Indiana v. Jackson*, 283 U.S. 527, 51 S. Ct. 540, 75 L. Ed. 1248 (1931)). The Court determines whether the law adheres to constitutional strictures placed on the State's authority to impose a specific tax in dispute. *See id.*

Here, regardless of the policy reasons advocated by the State for the capital gains tax, the tax enacted by the Legislature cannot survive constitutional scrutiny. The plain text of ESSB

5096 belies the State's arguments about its true incident and measure and confirms the law's invalidity. The superior court correctly found ESSB 5096 to be unconstitutional. This Court in its *de novo* review should conclude the same. *See Lee v. State*, 185 Wn.2d 608, 614, 374 P.3d 157 (2016).

A. ESSB 5096 Violates Article VII Of The Washington Constitution.

ESSB 5096 violates the Washington Constitution because it is a tax on property that fails to comply with the constitutional restrictions of uniformity and rate limitations set forth in Article VII. The State tries to recast the capital gains tax into an excise tax to avoid this conclusion. *See* State's Br. at 31-47. However, "[t]he character of a tax is determined by its incidents, not by its name." *Harbour Vill. Apartments v. City of Mukilteo*, 139 Wn.2d 604, 607, 989 P.2d 542 (1999) (quoting *Jensen v. Henneford*, 185 Wash. 209, 217, 53 P.2d 607 (1936)). Analyzing ESSB 5096's true subject matter and its incidents, "i.e., the manner in which it is assessed and the measure of the tax," *id.* at 607 n.1 (citation omitted), confirms that that the capital gains tax is a property tax

on income. *See, e.g., Wash. Pub. Ports Ass'n v. Dep't of Revenue*, 148 Wn.2d 637, 650 & n. 12, 62 P.3d 462 (2003) (collecting cases recognizing that income is property and taxes *on* the receipt of income are property taxes).[4]

1. The Capital Gains Tax Is Assessed Based on Individual Ownership of Long-Term Capital Assets, Not Voluntary Activity.

The State spends over ten pages of its brief walking through a history of cases describing excise taxes and property taxes. *See* State's Br. at 19-29. Yet the principles this Court applies to assess whether the subject matter of a particular tax is one of property or one of excise are not in dispute. This Court has held a tax on property is one that is "an absolute and unavoidable demand," *Black v. State*, 67 Wn.2d 97, 99, 406 P.2d 761 (1965), that "falls upon the owner merely because he is

[4] In a different context, this Court recently held that a security deposit—which is money held in deposit under contractual lease terms—is the " personal property" of the tenant and subject to the three-year statute of limitations for recovery of personal property. *See Silver v. Rudeen Mgmt. Co., Inc.*, 197 Wn.2d 535, 538, 484 P.3d 1251 (2021).

owner [of property].” *Morrow v. Henneford*, 182 Wash. 625, 631, 47 P.2d 1016 (1935) (quoting *Bromley v. McCaughn*, 280 U.S. 124, 137, 50 S. Ct. 46, 74 L. Ed. 226 (1929). In contrast, an excise tax is “imposed upon a voluntary act *of the taxpayer*, which affords the taxpayer the benefits of the occupation, business, or activity that triggers the taxable event” and which is “based upon the extent to which the taxpayer enjoys the taxable privilege.” *Sheehan v. Cent. Puget Sound Reg'l Transit Auth.*, 155 Wn.2d 790, 800, 123 P.3d 88 (2005) (emphasis added); *see also Black*, 67 Wn.2d at 99 (“the obligation to pay an excise is based upon the voluntary action *of the person taxed* in performing the act, enjoying the privilege or engaging in the occupation which is the subject of the excise, and the element of absolute and unavoidable demand, as in the case of a property tax, is lacking”) (emphasis added).

The State contends that ESSB 5096 imposes an excise tax on the privilege of selling or exchanging long-term capital assets. State’s Br. at 31. Examination of the text of ESSB 5096

demonstrates that the State mischaracterizes the true object of the tax. The express language of the statute provides that only individuals are subject to payment of the tax:

> (4)(a) The tax imposed in this section applies to the sale or exchange of long-term capital assets owned by the taxpayer, whether the taxpayer was the legal or beneficial owner of such assets at the time of the sale or exchange. *The tax applies when the Washington capital gains are recognized by the taxpayer* in accordance with this chapter.
>
> (b) For purposes of this chapter:
>
> (i) *An individual is considered to be a beneficial owner of long-term capital assets held by an entity that is a pass-through or disregarded entity for federal tax purposes*, such as a partnership, limited liability company, S corporation, or grantor trust, *to the extent of the individual's ownership interest in the entity* as reported for federal income tax purposes.
>
> (ii) . . . *A grantor of [incomplete gift non-grantor trusts] is considered the beneficial owner of the capital assets* of the trust for purposes of the tax imposed in this section and *must include any long-term capital gain or loss from the sale or exchange of a capital asset by the trust* in the calculation [of their Washington capital gains.]

ESSB 5096 § 5(4) (emphasis added). The capital gains tax is thus imposed when three conditions are met: (1) an individual owns or possesses a legal or beneficial interest in capital assets for a period of at least 12 months; (2) the assets are sold or exchanged for gain without regard to whether the individual had any involvement in the sale or exchange; and (3) the individual recognizes the capital gains on their federal income tax returns. *Id.*; *see also* § 4(1), (3), (13) (defining "adjusted capital gains," "federal net long-term capital gain," and "Washington capital gains"). The tax is not imposed *on* the activity of selling or exchanging long-term capital assets, as the State contends. It is imposed *on* the recognition of capital gains, i.e. income, for which the State confers no right or privilege.

Further, the fact that the capital gains tax does not apply to every sale or transfer of capital assets belies the State's arguments that ESSB 5096 imposes a valid excise tax on activities. Unlike excise taxes on specific activity (e.g., the real estate excise tax on sales of Washington real estate, or the sales

tax on retail sales in Washington), the capital gains tax does not apply to every capital asset transaction occurring in the state. And unlike both the real estate excise tax and the sales tax, the capital gains tax is not imposed on the *legal* owner that is the party to the taxed sale or exchange.

Indeed, an individual need not engage in any voluntary act to be subject to the capital gains tax. *See Sheenhan*, 155 Wn.2d at 800. For example, an individual residing in Washington who is the beneficiary of a grantor trust domiciled elsewhere will be subject to the capital gains tax when the trustee sells or exchanges long-term capital assets held by the trust because the income is passed through to the beneficiary under both federal income tax law and ESSB 5096. Likewise, a Washington resident who owns shares in an S corporation domiciled outside Washington will be subject to the capital gains tax when the Board of Directors or manager of the entity sells or exchanges long-term capital assets held by the entity because the income is passed through to shareholders to the extent of their interest in

the entity. *See, e.g.,* CP Vol. I 697-99. So too with a Washington citizen who happens to own stock in a foreign corporation that is acquired in a merger or acquisition or which engages in a stock redemption, neither requiring a nexus to Washington or any action from the individual. *See, e.g.,* CP Vol. I 693-95. Any of these individuals will be subject to the capital gains tax even if they do not deliberately, intentionally, or voluntarily take any action to cause the sale or exchange of long-term capital assets held by the related entities. So long as the individual reports non-exempt long-term capital gains on their federal income tax returns, they will be subject to the state capital gains tax. The State is simply wrong when it asserts that the capital gains tax applies "only to those that sell or transfer" capital assets. State's Br. at 31. The tax is triggered by the ownership of income in the form of capital gains, not by an individual's voluntary action to transfer long-term capital assets.

The State also wrongly asserts that the capital gains tax is an excise tax because it is imposed based on "the exercise of one

of the rights to use property, i.e. to sell or transfer ownership." State's Br. at 32. As the examples above demonstrate, the assertion is wrong. And the State cites no authority for the proposition that an excise tax can be imposed on an individual based on a third-party's voluntary exercise of rights to sell or exchange the property. *Cf. Arborwood Idaho, L.L.C. v. City of Kennewick*, 151 Wn.2d 359, 367, 89 P.3d 217 (2004) (holding "a valid excise tax" is one where "the obligation to pay" is "based upon the voluntary action *of the person taxed*") (emphasis added). Moreover, to the extent the State is suggesting that the taxpayer's "exercise of one of the right's to use property" is the voluntary receipt of gains, this Court has already rejected the notion that such a tax is an excise in *Jensen v. Henneford*, 185 Wash. 209, 219, 53 P.2d 607 (1936).

In *Jensen*, this Court rejected the State's argument that a 1935 tax was a valid excise on the "privilege of receiving income," instead of a direct tax on the income itself. 185 Wash. at 218. Having previously concluded that a tax on income was

subject to the constitutional requirements for property tax in *Cullitan v. Chase*, 174 Wash. 363, 25 P.2d 81 (1933), the Court in *Jensen* further concluded that:

> The right to receive, the reception, and the right to hold are progressive incidents of ownership and indispensable thereto. To tax any one of these elements is to tax their sum total, namely, ownership, and therefore the property (income) itself. Despite its change of designation, we are convinced that the 1935 act imposes a tax on net income, and is therefore a property tax.

185 Wash. at 219. The Court expressly rejected the notion advocated again here by the State that the beneficial receipt of income from property's use can be subject to an excise tax because "to tax by reason of ownership of property is to tax the property itself." *Id*.

Here, like the net income tax in *Jensen*, the subject matter of the capital gains tax is not the privilege of using or transferring a class of property within the state. Rather, the subject of the tax is the income that individuals receive simply because of their direct or beneficial ownership of property, regardless of whether

the transactions from which the gains are derived are undertaken voluntarily or entirely passively. These characteristics make the capital gains tax an "absolute and unavoidable" demand on property, i.e. income, which cannot be an excise tax under this Court's precedents.

2. The Measure of the Capital Gains Tax Is the Amount of Gains Reported on Federal Income Tax Returns, Not the Amount of the Transaction Purportedly Being Taxed.

In every excise case highlighted by the State, the measure of the excise is based on the total value of the privilege being taxed. *See Sheehan*, 155 Wn.2d at 800 ("[E]xcise taxes are directly imposed based upon the extent to which the taxpayer enjoys the taxable privilege."). For example, the business and occupation ("B&O") tax upheld in *Morrow v. Henneford*, was imposed on the privilege of engaging in business activity in the state and measured by the total gross income earned from business activity in Washington. 182 Wash. at 631. The real estate excise tax upheld in *Mahler v. Tremper*, 40 Wn.2d 405, 243 P.2d 627 (1952), was imposed on the selling price of the

property located in the state and transferred under state law. In *Black v. State*, the measure of the sales tax was the total cost of the in-state lease. 67 Wn.2d at 98. So too with the leasehold excise tax in *Washington Public Ports*, which was measured by the total taxable rent for in-state facilities. 148 Wn.2d at 642–43. In *High Tide Seafoods v. State*, the measure of the tax on enhanced fish food was the total value of the fish at transfer. 106 Wn.2d 695, 700, 725 P.2d 411 (1986) (citing RCW 82.27.020). In *Sheehan*, 155 Wn.2d at 800, the measure of the motor vehicle excise tax was the value of the vehicle at registration. And the estate tax upheld in *In re Estate of Hambleton*, 181 Wn.2d 802, 335 P.3d 398 (2014), was measured by the total value of the property at the time of the decedent's death and is apportioned to the extent any of the property was located outside of Washington. *See* RCW 83.100.040.

Unlike in each of those cases, the measure of the capital gains tax at issue here is not measured by the extent to which the taxpayer engages in any privilege conferred by or an activity

regulated by Washington. This makes it markedly unlike the B&O tax highlighted by the State, *see* State's Br. at 34, which is measured by the value of the taxable privilege—business—engaged in by the taxpayer. The State in fact never identifies the "taxable privilege" that only individuals allegedly engage in to be subject to the capital gains tax—other than to suggest that capital gains are income for the wealthy. *See id*. But, as the United States Supreme Court has said in another context, "[a] tax on sleeping measured by the number of pairs of shoes you have in your closet is a tax on shoes." *Trinova Corp. v. Mich. Dep't of Treasury*, 498 U.S. 358, 374, 111 S. Ct. 818, 829, 112 L. Ed. 2d 884 (1991).

Here, the capital gains tax is measured by an individual's total, annual long-term Washington capital gains for the federal taxable year. ESSB 5096 §§ 4(1), (13), 5. ESSB 5096 defines Washington capital gains as the aggregate sum of the individual's federal net long-term capital gains adjusted by the amounts of long-term capital losses and gains that are either

exempt or not allocated to Washington, less the amounts of standard and itemized deductions set forth in the statute. *See* ESSB 5096 §§4(1), (4)(13), 7, 8, 9. In other words, the capital gains tax is imposed on the value of the individual's annual net income. The capital gains tax is a property tax on annual income. *See High Tide Seafoods*, 106 Wn.2d at 699 (a property tax is imposed on the value of property); *Black*, 67 Wn.2d at 99 (same).

3. The Superior Court Correctly Analyzed ESSB 5096 to Determine its Proper Nature and Measure.

The State also misses its mark when it complains about the superior court's letter ruling and the "hallmarks" of the capital gains tax described there. *See* State's Br. at 33-47. The "hallmarks" identified by the superior court do not delineate a new test for what constitutes a property tax versus an excise tax under this Court's precedents, as the State contends. *See* State's Br. at 33-47. The superior court correctly reviewed these factors to determine "who is being taxed [under ESSB 5096], what is being taxed, and how the tax is measured." *See* CP Vol. I 869 (quoting *Kunath v. City of Seattle*, 10 Wn. App. 2d 205 (2019)).

The superior court's conclusion was correct. Analysis of ESSB 5096's relevant attributes make clear that the capital gains tax is a tax on property (income), not an excise tax. *See* CP Vol. I 869.

The superior first court noted that ESSB 5096 is expressly connected to federal *income* taxes. CP Vol. I 869. ESSB 5096 tethers its definition of capital assets to Subtitle A of the Internal Revenue Code, which governs federal income taxes. *See* ESSB 5096 § 4(2) ("'Capital asset' has the same meaning as provided by Title 26 U.S.C. Sec. 1221"); *see also* § 4(3) ("'Federal net long-term capital gain' means the net long-term capital gain reportable for federal income tax purposes"). ESSB 5096 further relies on the amount of total gains reported on an individual's federal income tax returns as the starting bases for determining the amount of capital gains tax owed to Washington. While these federal attributes are not in and of themselves determinative of ESSB 5096's incident, they highlight that the object of the capital gains tax is to tax individual income.

The superior court also observed that the capital gains tax is directly imposed on the net total gain recognized by an individual on their federal income tax returns after adjustments are made based on Washington's designated allocations and exemptions. The superior court noted that these features make ESSB 5096 unlike each of the excise taxes described by the State in its briefing that are imposed on a transactional basis measured by the gross value of the transaction engaged in. *See* CP Vol. I. 869, n. 2 (listing cases cited by State). Nothing is remarkable about the superior court's observation or comparison in that regard.

The superior court also correctly ascertained that the capital gains tax is levied on all "Washington capital gains" regardless of whether the gains were derived from transactions within Washington. Setting aside that Washington lacks authority to impose such taxes without apportionment, as discussed later in this brief, the capital gains tax is not tethered to Washington-based activity, privileges, or rights. The superior

court correctly concluded that the State imposed the capital gains tax "without concern whether the State conferred any right or privilege to facilitate the underlying transfer," and thus entitling the State to charge an excise. CP Vol. I 870 (citing *Jensen*, 185 Wash. at 218). The State was concerned only with reaching acquired income. *Contrast* ESSB 5096 *with State ex rel Stiner v. Yelle*, 174 Wash. 402, 407, 25 P.2d 91 (1933) ("This act does not concern itself with income which has been acquired, but only with the privilege of acquiring").

The superior court finally observed, that unlike the excise taxes cited by the State, the capital gains tax is not imposed on every transfer of title or ownership of capital assets, or even necessarily assessed on the person engaging in the transfer. CP Vol. I 871. This too supports the superior court's conclusion that while the State has characterized the tax as a levy on the "sale or exchange" of capital assets, its extra-territorial reach shows it is in fact not. The capital gains tax set forth in ESSB 5096 is a tax on income.

4. The Capital Gains Tax Is a Non-Uniform Property Tax That Exceeds Constitutional Rate Limitations.

Because capital gains fall within the definition of "property" and the capital gains tax falls under the definition of "property tax" recognized by this Court, ESSB 5096 must comply with the Washington Constitution, Article VII, Sections 1 & 2. It does not.

The Uniformity Clause set forth in Article VII, Section 1 requires that "[a]ll taxes shall be uniform upon the same class of property within the territorial limits of the authority levying the tax . . . .The word 'property' as used herein shall mean and include everything, whether tangible or intangible, subject to ownership." "'[N]et income.' . . . under the Fourteenth Amendment, constitutes one class of property." *Jensen*, 185 Wn. at 222–23. If net income is a single class of property, it follows that net income in the form of gains derived from the sale of long-term capital assets is one class of property, and any tax on such gains must satisfy the constitutional principles of uniformity.

The capital gains tax is non-uniform in at least two ways. First, the State imposes the capital gains of individuals but not other residents, such as corporations, that sell or exchange capital assets. This is non-uniform taxation. *Power, Inc. v. Huntley,* 39 Wn.2d 191, 195, 235 P.2d 173 (1951) ("If the four per cent tax on corporate net incomes is a tax on property, it violates the principle of uniformity in that it levies no tax on the incomes of individuals and copartnerships which may be in competition with corporations required to pay the tax.") (citing authorities).

Second, taxpayers will pay a seven percent tax on their "Washington capital gains" ESSB 5096 §5. But after a standard deduction, the first $250,000 of Washington capital gains are subject to zero tax. ESSB 5096 § 7. Additional deductions for qualifying sales of small businesses and charitable deductions are also allowed. *Id*. As a result, ESSB 5096 imposes a graduated, non-uniform tax on a single class of capital gains. *See Culliton*, 174 Wn. at 382 ("The constitutional amendment speaks of the same class of property. One who pays a tax on a $2,000

taxable income pays a tax on precisely the same class of property as one who pays a tax on a $1,000 taxable income, and to tax the one at a progressively higher rate than the other positively violates the other clause of the amendment, that all taxes shall be uniform upon the same class of property.”).

ESSB 5096 must also comply with Article VII, Section 2, which places a ceiling on the aggregate taxes that can be imposed on property. Section 2 restricts the aggregate of all tax levies on property to a rate of one percent annually without a supermajority vote of the people. Seven percent is obviously more than one percent, so ESSB 5096 also violates the Washington Constitution by levying a tax that exceeds the maximum rate permitted under Section 2. The superior court was correct to invalidate the capital gains tax imposed under ESSB 5096 on these state constitutional grounds.

B. ESSB 5096 Violates the Privileges and Immunities Clause of the Washington Constitution.

Article I, Section 12 of the Washington Constitution provides that “No law shall be passed granting to any citizen,

class of citizens, or corporation other than municipal, privileges or immunities which upon the same terms shall not equally belong to all citizens, or corporations." Const. art. I, § 12. This provision, which is more protective than the federal equal protection clause, "protects . . . against laws serving the interest of special classes of citizens to the detriment of the interests of all citizens." *Grant Cnty. Fire Prot. Dist. No. 5 v. City of Moses Lake*, 150 Wn.2d 791, 806–07, 83 P.3d 419 (2004). Courts subject legislation implicating Article I, Section 12 to a two-part test. *Schroeder v. Weighall*, 179 Wn.2d 566, 572–73, 316 P.3d 482 (2014). First, the Court must ask whether the law grants a "privilege" or "immunity" within the meaning of the constitution. *Id*. If the answer is yes, then the Court must ask whether there is a "reasonable ground" for granting that privilege or immunity. *Id*.

In the case of ESSB 5096, the answer to the first question of whether the statute implicates a "fundamental right[] of state citizenship" is yes. *See Schroeder*, 179 Wn.2d at 573. This Court

has recognized that the term "privileges and immunities" "as used in the state constitution should receive a like definition and interpretation as that applied to them when interpreting the federal constitution." *Grant Cnty. Fire Prot. Dist. No. 5*, 150 Wn.2d at 812-13. The federal constitution's "privileges and immunities" clause includes the fundamental right "to be exempt, in property or persons, from taxes or burdens which the property or persons of citizens of some other state are exempt from." *Id*. Thus, "[b]y analogy," the Washington Constitution's "privileges and immunities" clause also includes the fundamental right to be exempt from taxes which other citizens or corporations are also exempt from. *See id.*

The State argues that there is no fundamental right to be exempt from a state tax that the state has granted to other persons. State's Br. at 50. The cases relied on by the State for this proposition, however, concerned citizens seeking *similar* exemptions as that granted to others engaged in *different* activity. For example in *Supply Laundry Co. v. Jenner*, the petitioners

challenged on equal protection grounds exemptions under the B&O tax for various businesses and professions. 178 Wash. 72, 78, 34 P.2d 363 (1934). The Court rejected the notion that the Legislature could not "draw fine distinctions *between* classifications." *Id.*; *accord Morrow*, 182 Wash. at 634; *Black*, 67 Wn.2d at 100. The Court in these cases did not endorse the notion advocated by the State here that the Legislature can draw distinctions within the *same* class.

ESSB 5096 imposes a capital gains tax on any sale or exchange of long-term capital assets. § 5(1). The tax thus generally applies to any person[5] who owns long-term capital

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[5] The tax code generally applies to any "person" meaning interchangeably "any individual, receiver, administrator, executor, assignee, trustee in bankruptcy, trust, estate, firm, copartnership, joint venture, club, company, joint stock company, business trust, municipal corporation, political subdivision of the state of Washington, corporation, limited liability company, association, society, or any group of individuals acting as a unit, whether mutual, cooperative, fraternal, nonprofit, or otherwise and the United States or any instrumentality thereof." RCW 82.04.020 (excise tax purposes); see also RCW 83.100.020(9) (estate and transfer tax; same); RCW 84.04.075 (property taxes; same).

assets and engages in the sale or exchange of those assets. The same provision also specifies however that "[o]nly individuals are subject to payment of the tax," meaning that any non-natural person that also derives capital gains is not subject to payment of the tax. *Id.* ESSB 5096 on its face subjects only certain persons owning and selling capital assets to the tax, while exempting any other person with the *exact same circumstances* from the tax.

The second question when applied to state taxes asks whether there is a "reasonable ground" for the legislature to have taxed one class and exempted other classes from the same tax. *Schroeder*, 179 Wn.2d at 573; *cf. Texas Co. v. Cohn*, 8 Wn.2d 360, 376, 112 P.2d 522 (1941) (applying federal equal protection analysis to tax law).[6] "Under the reasonable ground test a court will not hypothesize facts to justify a legislative distinction . . . .

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[6] This Court has since held that Article I, Section 12 provides greater constitutional protections than equal protection. *Grant Cty. Fire Protection Dist. No. 5*, 150 Wn.2d at 806–07. The test applied in *Texas Co*, which looked to "any conceivable basis" to uphold the classification, therefore no longer applies.

Rather, the court will scrutinize the legislative distinction to determine whether it in fact serves the legislature's stated goal." Id. at 574 (internal citations omitted). The Legislature's stated purpose for imposing the tax in ESSB 5096 purportedly is to "rebalance" the state's tax code so that its "wealthiest residents" pay more taxes on their share of income than those residents at the bottom of the income spectrum. ESSB 5096 § 1. This stated purpose, however, speaks only to the difference in levying the tax on individuals whose "profit is in excess of $250,000," *id*., it says nothing of a legislative basis for imposing the tax only on individuals as opposed to imposing the tax on any person owning the capital assets and selling those assets for gain.[7] And there is no discernable basis in the legislative text for the State to treat individuals incurring capital gains discriminatively from other "persons" incurring capital gains, when the purported reason is to raise revenue, except for the Legislature to reach individual

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[7] Such a distinction, of course, also violates Article VII, Section 1's uniformity provision for property taxes.

income. *Cf. Comptroller of Treasury of Md. v. Wynne*, 575 U.S. 542, 554, 135 S. Ct. 1787, 191 L. Ed. 2d 813 (2015) (disparate treatment of corporate and personal income cannot be justified based on the state services enjoyed by two groups of taxpayers). This arbitrary distinction does not in fact support the Legislature's stated purpose, and thus unconstitutionally burdens the tax against only a select set within the relevant class of taxpayers in violation of Article I, Section 12. ESSB 5096 should be invalidated on these state constitutional grounds as well.

C. ESSB 5096 Violates The Commerce Clause Of The United States Constitution.

The Supreme Court has long held that Article I, Section 8, clause 3 ("the Commerce Clause") of the United States Constitution contains a dormant prohibition against certain state taxation involving interstate commerce. *See Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 179–80, 115 S. Ct. 1331, 131 L. Ed. 2d 261 (1995) (analyzing history of the dormant Commerce Clause). To survive Commerce Clause scrutiny, a state tax must meet a four-part test that focuses on the

practical effect of the challenged tax. *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274, 279, 97 S. Ct. 1076, 51 L. Ed. 2d 326 (1977). The tax must (1) apply to an activity with a substantial nexus with the taxing state; (2) be fairly apportioned; (3) not discriminate against interstate commerce, and (4) be fairly related to the services that the state provides. *Id.* at 279. ESSB 5096 violates this inquiry because the statute (1) impermissibly imposes the tax based on the location of the taxpayer and not the location of the activity from which the income is derived; (2) imposes the tax without fairly apportioning it to activities occurring only within Washington; and (3) discriminates against interstate commerce by subjecting income derived outside the state to risk of multiple state taxation. The State's attempt to validate the capital gains tax in the face of these deficiencies must fail.

1. The Commerce Clause Analysis Requires The Court To Determine Whether Application Of The Tax Is Unconstitutional.

The State first asks this Court to apply a test for facial challenges that the United States Supreme Court has never applied when analyzing a state tax law under the Commerce Clause. Specifically, the State asserts—citing only non-tax, non-Commerce Clause cases—that Plaintiffs must establish that there are "no set of circumstances" in which the capital gains tax can constitutionally be imposed to invalidate the tax. *See* State's Br. at 15-17, 54-55, 58. Not so. As discussed below, the Supreme Court has not hesitated to find a state tax scheme invalid under the Commerce Clause even if there may be scenarios in which some imposition of the tax could be constitutionally permissible.

The State's facial argument derives from a principle applicable in other contexts that a challenge to a legislative act generally requires the challenger to "establish that no set of circumstances exists under which the Act would be valid." *United States v. Salerno*, 481 U.S. 739, 745, 107 S. Ct. 2095 (1987) (analyzing substantive due process challenge to federal bail legislation); *Washington State Republican Party*, 141 Wn.2d

245, 282, n. 14, 4 P.3d 808 (2000) (analyzing First Amendment challenge to state campaign finance law). Yet the State does not cite any case in which this "no set of circumstances" principle has been applied in a Commerce Clause challenge to a state tax law, nor are Plaintiffs aware of any such case.[8]

The State misleadingly references *Tyler Pipe Industries, Inc. v. Department of Revenue*, 483 U.S. 232, 248, 107 S. Ct. 2810, 97 L. Ed. 199 (1987), as purportedly supporting its position because the Supreme Court invalidated a specific business and

[8] Application of *Salerno* has been called into question by the Supreme Court and other courts, including in tax challenges. *See, e.g.*, *City of Chicago v. Morales*, 527 U.S. 41, 55 n. 22, 119 S. Ct. 1849, 144 L.Ed.2d 67 (1999) (questioning *Salerno*'s application); *Gordon v. Holder*, 721 F.3d 638, 654 (D.C. Cir. 2013) (rejecting *Salerno*'s application when a tax statute "erases the boundaries that define a sovereign's jurisdiction"); *Sierra Club v. Bosworth*, 510 F.3d 1016, 1023–24 & n.4 (9th Cir. 2007) (collecting cases in which Supreme Court has not applied *Salerno*, including *Kraft Gen. Foods Inc v. Iowa Dep't of Rev. & Finance*, 505 U.S. 71, 112 S. Ct 2365, 120 L. Ed. 2d 59 (1992), a state tax Commerce Clause challenge); *accord Robinson v. City of Seattle*, 102 Wn. App. 795, 806-08, 10 P.3d 452 (2000) (discussing *Salerno's* application and declining to apply the "no set of circumstances" test in a constitutional challenge to a city tax ordinance under the Washington Constitution).

occupation (B&O) tax exemption while leaving the B&O tax code intact. *See* State's Br. at 16. But, contrary to the State's suggestion, the petitioners in *Tyler Pipe* did not challenge the entirety of the B&O tax code or bring an as-applied challenge; instead they brought a facial challenge against a provision in the State's tax code that assessed the B&O tax "only on those goods manufactured in Washington that are sold outside the State." *Id.* at 240. The Supreme Court agreed with the challengers that the provision had "facially discriminatory consequences" because it treated transactions differently depending on whether they were in-state or out of it. *Id.* at 241. The Court thus found the challenged statute invalid under the Commerce Clause because it "unfairly burden[ed] commerce by exacting more than a just share from the interstate activity." *Id.* at 247 (quoting *Washington Dept. of Revenue v. Association of Washington Stevedoring Cos.*, 435 U.S. 734, 748, 98 S. Ct. 1388, 1393, 55 L.Ed.2d 682 (1978)).

The Supreme Court's analysis in *Tyler Pipe* is consistent with its Commerce Clause analysis in other tax cases in which the Court has applied a "practical" analysis that looks at whether application of the tax would violate the Commerce Clause. *See, e.g.*, *Wynne*, 575 U.S. at 552 (Commerce Clause requires a "practical approach" that looks to the economic impact of the tax); *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 616, 101 S. Ct. 2946, 69 L. Ed. 2d 884 (1981) (applying a "consistent and rational method of inquiry focusing on the practical effect of a challenged tax"); *Gwin, White & Prince v. Henneford*, 305 U.S. 434, 439–40, 59 S. Ct. 325, 83 L. Ed. 272 (1939) (looking at tax statute in its "practical operation" to find it discriminated against interstate commerce). Contrary to the State's argument, the Supreme Court has not saved state tax statutes by asking whether it could find any instance that the tax would not violate the Commerce Clause. The Supreme Court has instead consistently invalidated state tax laws when the "practical operation" of the

tax scheme exceeds a state's taxing authority or discriminates against interstate commerce.

For example, in *Gwin*, the fact that Washington's B&O tax applied equally to income earned from activities entirely in Washington and those earned both within and outside Washington did not save the tax from being struck down as facially invalid. Notwithstanding that the tax could constitutionally apply to the exclusively in-state activity, the Supreme Court held the entire tax scheme discriminated against interstate commerce because it involved "risk of a multiple burden to which local commerce is not exposed." *See Gwin*, 305 U.S. at 439.

Similarly in *Wynne*, the Supreme Court agreed that Maryland's personal income tax structure violated the Commerce Clause because the system allowed a credit for income tax paid to another jurisdiction for one portion of the state's income tax but not another. *Wynne*, 575 U.S. at 545. The Court noted that the tax could be separated into three categories

depending on who and where the income was earned. *See id.* at 566-67. Yet the fact that the tax could constitutionally apply to income earned solely in-state did not save the law because the scheme as a whole discriminated against interstate commerce. *Id.* at 567; *see also id.* at 565 n. 8 ("In applying the dormant Commerce Clause, [the categories] must be considered as one.")

As explained in detail in the next sections, ESSB 5096 suffers from similar structural defects under the Commerce Clause as the state taxes invalidated in *Gwin* and *Wynne*. Even the State tacitly acknowledges that there could be circumstances where application of the capital gains tax would violate the dormant Commerce Clause. *See* State's Br. at 57-58; *see also* CP Vol. I 663 (admitting "circumstances where the tax might not constitutionally apply). Those unconstitutional "circumstances" doom the capital gains tax when the well-established Commerce Clause analysis is applied.[9]

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[9] The State also notes that the legislature included a severability clause in ESSB 5096 and suggests that this aspect could save the

2. ESSB 5096 Impermissibly Allocates Capital Gains to Washington Based on Activities Occurring Outside its Borders.

The Commerce Clause limits Washington's power to tax to only those activities within its jurisdictional reach. See *Gwin*, 305 U.S. at 438-39. "State taxation, whatever its form, is precluded if it discriminates against interstate commerce or undertakes to lay a privilege tax measured by gross receipts derived from activities in such commerce which extend beyond the territorial limits of the taxing state." *Id.* (citations omitted). This extraterritoriality principle applies whether the tax imposed by the State is a tax on sales, a gross receipts tax on the privilege of engaging in activity, or a tax on income. *See Wynne*, 575 U.S. at 551–52 (Commerce Clause does not "distinguish[]" between taxes on gross receipts or net income); *Jefferson Lines, Inc.*, 514

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statute in an as-applied challenge. State's Br. at 17 n. 2. However, as discussed next, ESSB 5096's constitutional defects concern not only what is included in the text, but also what the text is missing. Attempting to sever only select provisions of the statute would not save its unconstitutionality under the Commerce Clause.

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U.S. at 184 (states may only tax sales or services occurring within its borders). The *Complete Auto* test thus requires that the tax only apply to activities connected to the State and that there be a fair relation between the tax and the activities of the taxpayer in the State. *See Jefferson Lines, Inc.*, 514 U.S. at 184, 199.

To determine whether a state tax impermissibly extends beyond the state's territorial limits, the court must ask "whether the tax applies to an activity with a substantial nexus with the taxing State." *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080, 2099, 201 L. Ed. 2d 403 (2018) (emphasis added). "Such a nexus is established when the taxpayer . . . 'avails itself of the substantial privilege of carrying on business' [i.e., the taxed activity] in that jurisdiction," *id*. (internal citation omitted), or there is "nexus between [the] tax and transactions within [the] state for which the tax is an exaction." *Mobil Oil Corp. v. Comm'r of Taxes of Vermont*, 445 U.S. 425, 437, 100 S. Ct. 1223, 63 L. Ed. 2d 510 (1980). Likewise, the measure of the tax, i.e., what is included in the calculation of the tax, must be reasonably

related to the taxpayer's presence or activities in the state. *Jefferson Lines, Inc.*, 514 U.S. at 199. "When the measure of a tax bears no relationship to the taxpayers' presence or activities in a State . . . the State is imposing an undue burden on interstate commerce." *Commonwealth Edison Co.*, 453 U.S. at 629. Both inquiries ensure "the taxing power . . . bears fiscal relation to protection, opportunities and benefits given by the state—that is whether the state has given anything for which it can ask return." *MeadWestvaco Corp. ex rel. Mead Corp. v. Ill. Dep't of Rev.*, 553 U.S. 16, 24–25, 128 S. Ct. 1498, 170 L. Ed. 2d 404 (2008) (citation omitted); *accord Allied-Signal, Inc. v. Dir., Div. of Tax'n*, 504 U.S. 768, 777, 112 S. Ct. 2251, 119 L. Ed. 2d 533 (1992) ("The principle that a State may not tax value earned outside its borders rests on the fundamental requirement of both the Due Process and Commerce Clauses that there be 'some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.'") (citation omitted).

ESSB 5096 overreaches the bounds of the Commerce Clause because it allocates gains to Washington that are not derived from activity with nexus to the State. Specifically, Washington allocates to itself *all* gains:

> (1) derived from sales or exchanges of tangible property located in the state at the time of the sale or exchange (§ 11(1)(a));
>
> (2) derived from sales or exchanges of tangible property previously located in the state if the taxpayer was a resident at the time of the sale/exchange and the taxpayer is not otherwise subject to the payment of another tax by another jurisdiction (§ 11(1)(a)(i)-(iii)); and
>
> (3) derived from sales or exchanges of intangible personal property if the taxpayer was domiciled in the state at the time of the sale or exchange. (§ 11(1)(b)).

See ESSB 5096 § 11(1) (a)-(b). For two of these allocations, the State impermissibly sources the tax not based on the location of activity purportedly being taxed—i.e., the sale or exchange of the property—but rather on the taxpayer's residency or domicile in the State.

With respect to the first sentence in section 11(1)(a), it is true that the State has nexus to tax sales of tangible personal property located in the state when the sale is consummated there. *See* State's Br. at 56 (citing *Jefferson Lines*, 514 U.S. at 184). The State however ignores entirely the second sentence of the same provision, which allocates to Washington gains on the sale of tangible property "even though the [tangible personal] property was not located in the state at the time of the sale or exchange." *See* ESSB 5096 § 11(1)(a)(i)–(iii). This provision indisputably imposes the tax based on the *residency* of the taxpayer, disregarding the constitutionally determinative fact that the *activity* on which the excise tax is purportedly based (i.e., the sale or exchange) occurred outside the jurisdictional reach of the State. *See Allied-Signal, Inc.*, 504 U.S. at 777 ("[W]e have not abandoned the requirement that, in the case of a tax on an activity, there must be a connection to the activity itself, rather than a connection only to the actor the State seeks to tax.").

With respect to the provision in section 11(1)(b) allocating gains derived from intangibles solely based on the taxpayer's domicile, the State overstates the rule. *See* State's Br. at 56. States have authority to impose taxes on the sale or transfer of intangible property in cases "where the owner of the intangibles *confines* his *activity* to the place of his domicile." *Curry v. McCanless*, 307 U.S. 357, 367, 59 S. Ct. 900, 83 L. Ed. 1339 (1939) (emphasis added).[10] The Supreme Court also explained that the maxim of *mobilia sequuntur personam*[11] applied in this

[10] The State contends *Curry* held that transactions in intangible property are deemed to occur only in the state of the owner's domicile. State's Br. at 56. The Supreme Court created no such black-letter rule in *Curry*. Addressing a Fourteenth Amendment challenge, *Curry* refused to impose a one-size-fits-all rule, explaining "[w]e find it impossible to say that taxation of intangibles can be reduced in every case to the mere mechanical operation of locating at a single place, and there taxing, every legal interest growing out of all the complex legal relationships which may be entered into between persons." *Id.* at 908–09. The Court declined to hold "that the Fourteenth Amendment may be invoked to compel the taxation of intangibles by only a single state by attributing to them a situs within that state." *Id.* at 909 (citation omitted).

[11] The maxim means "that it is the identity or association of

context is one of convenience that must yield to factual reality when the activity involves more than one state:

> [W]hen the taxpayer extends his activities with respect to his intangibles, so as to avail himself of the protection and benefit of the laws of another state, in such a way as to bring his person or property within the reach of the tax gatherer there, the reason for a single place of taxation no longer obtains, and the rule is not even a workable substitute for the reasons which may exist in any particular case to support the constitutional power of each state concerned to tax.

Id. at 367 (emphasis added); *accord Mobile Oil Corp. v. Comm'r of Taxes of Vermont*, 445 U.S. 425, 444–45, 100 S. Ct. 1223, 63 L. Ed. 2d 510 (1980) (permitting sourcing based on a state's connection to the activity generating the income from intangibles). The State disregards that ESSB 5096 allocates all income derived from the sale or exchange of intangible capital assets entirely to Washington based only on the taxpayer's

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intangibles with the person of their owner *at his domicile* which gives jurisdiction to tax." *Curry*, 307 U.S. at 367 (emphasis added).

domicile, without regard to whether the capital gains resulted from activity outside the state. *See* ESSB 5096 § 11(1)(b).

The State also disregards the fact that a taxpayer may have no control over sale or exchange of the intangibles at issue because the capital gains tax applies based solely on "whether the taxpayer was the legal or beneficial owner" of the assets at the time of sale or exchange. ESSB 5096 § 5(4)(a). In other words, the taxpayer may not engage in any activity or even have power to do so to be subject to the tax, such as in the case of a beneficiary of a trust or the minority shareholder of a corporation. *See, e.g.*, CP Vol. I 639-95, 697-99. Yet the capital gains tax here is imposed "to the extent of the individual's ownership interest" or to the extent the individual recognizes the gains on their personal federal income tax forms. *See id.* at § 5(4)(a), (b)(i)-(ii). The Supreme Court, however, has explicitly rejected the notion that "intangibles—stocks, bonds—in the hands of the holder of the legal title with definite taxable situs at its residence" may be taxed based on the *equitable* owner's

domicile. *Safe Deposit & Trust Co. of Baltimore, Md. v. Commonwealth of Virginia*, 280 U.S. 83, 92–93, 50 S. Ct. 59, 74 L. Ed. 180 (1929). Just as in *Curry*, the Supreme Court found in *Safe Deposit & Trust Co.* that "the fiction of *mobilia sequuntur personam*" must yield to the "established fact of *legal* ownership, actual presence and control elsewhere." *Id.* (emphasis added). Here, the State has tried to reinstate the "fiction" that the power to tax transactions involving intangible personal property should be based exclusively on domicile, instead of where the activity related to the intangible occurs. *See id.* at 93.

In sum, the State unconstitutionally overreached its jurisdiction with the capital gains tax.

3. ESSB 5096 Lacks Fair Apportionment.

The fact that ESSB 5096 taxes transactions that occur entirely outside Washington's borders also dooms the Act under *Complete Auto*'s fair apportionment requirement. Income earned from interstate commerce must be "fairly apportioned" to the activities carried on within that state. See *Western Live Stock v.*

Bureau of Revenue, 303 U.S. 250, 255, 58 S. Ct. 546, 82 L. Ed. 823 (1938). This principle of "fairness" derives from the Commerce Clause's prohibition against "multiple taxation, which is threatened *whenever* one State's act of overreaching combines with *the possibility* that another State will claim its fair share of the value taxed." *Jefferson Lines, Inc.*, 514 U.S. at 184–85 (emphasis added). Despite the State's claim, ESSB 5096 contains no method for apportioning gains derived from the sale or exchange of long-term capital assets outside of the state.

To assess ESSB 5096's "threat of malapportionment" the court must ask "whether the tax is 'internally consistent' and, if so, whether it is 'externally consistent' as well." *Jefferson Lines, Inc.*, 514 U.S. at 185 (citation omitted). "Internal consistency is preserved when the imposition of a tax identical to the one in question by every other State would add no burden to interstate commerce that intrastate commerce would not also bear." *Id.* This test requires "hypothetically assuming that every State has the same tax structure" to determine whether the state "tax

scheme[]" "inherently discriminates against interstate commerce without regard to the tax policies of other States." *Wynne*, 575 U.S. at 562. External consistency, in contrast, looks "to the economic justification for the State's claim upon the value taxed, to discover whether a State's tax reaches beyond that portion of value that is fairly attributable to economic activity within the taxing State." *Jefferson Lines, Inc.*, 514 U.S. at 185. There must be "a rational relationship between the income attributed to the State and intrastate values of the [business being taxed]." *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 165-66, 103 S. Ct. 2933, 77 L. Ed. 2d 545 (1983). If the income apportioned to the State is "out of all appropriate proportion to business transacted in that State," the tax lacks "fair apportionment." *See id.* at 180–81. ESSB 5096 fails these requirements.

The State contends that ESSB 5096 is internally consistent because it allocates gains based on where the property is located for tangible personal property and based on domicile of the

owner for purposes of intangible personal property. State's Br. at 59. The State again ignores the second sentence of ESSB 5096 § 11(1)(a), which allocates gains based on the taxpayer's Washington residency when the state where the transaction actually occurs chooses not to tax. The very fact that another state *could* tax means that ESSB 5096 fails the test for internal consistency. *See Armco, Inc. v. Hardesty*, 467 U.S. 638, 644–45 and n.8, 104 S. Ct. 2620, 82 L. Ed. 2d 540 (1984) (validity of one state's tax does not turn on how another state has chosen to exercise its taxing authority); *Mobile Oil Corp.*, 445 U.S. at 444 (constitutionality of state's law does not depend on proof of actual multiple taxation; fact that another state could tax governs the analysis).

Further, the State grossly mischaracterizes the tax credit provision in ESSB 5096 § 11(2)(a), when it asserts the provision "eliminates any chance of multiple taxation." State's Br. at 60 (referencing RCW 82.87.100(2)). The credit is extended only to capital gains paid by the taxpayer to another state "from capital

assets *within* the other taxing jurisdiction to the extent such capital gains are included in the taxpayer's Washington capital gains," ESSB 5096 § 11(2)(a) (emphasis added). In short, a credit is allowed but only if the gains were derived from capital assets within the other state—for example, the value of goodwill in an out of state business. No credit is allowed against another state's taxes on the same capital gains sourced to that state by other means, such as if the taxpayer has multiple residencies. For example, consider a situation in which Washington allocates for itself capital gains derived from the sale or exchange of tangible personal property solely because the taxpayer was a resident of Washington at the time of the event. If the taxpayer is also a resident of California, the taxpayer runs the risk of being taxed on the entirety of the income from the sale or exchange twice—once by Washington and once by California, without any apportionment between the two under ESSB 5096.[12]

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[12] ESSB 5096 § 4(10)(a) defines "resident" as someone who is "domiciled in this state" or who "maintained a place of abode

Contrary to the State's assertion, the lack of full credit by Washington for other states' taxes does create a "genuine risk" that gains derived from the transfer of long-term capital assets will be taxed by multiple states. *See* State's Br. at 59. ESSB 5096 lacks internal consistency and thus impermissibly burdens interstate commerce. *See Wynne*, 575 U.S. at 545 (striking down part of state income tax that did not offer residents a full credit against income taxes paid to other states); *Tyler Pipe Indus.*, 483 U.S. at 247–48 (version of Washington's B&O tax unconstitutionally discriminated against interstate commerce because it was internally inconsistent).

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here and was physically present in this state for more than 183 calendar days." For purposes of its income tax (of which capital gains are included), California defines resident as any individual who is (1) in California for other than a temporary or transitory purpose; or (2) domiciled in California, but who is outside California for a temporary or transitory purpose. Cal. Rev. & Tax Code § 17014. Thus, a person can be both a resident of Washington at the time of sale and also a resident of California for purposes of the tax.

The State next repeats its same arguments regarding allocation for tangible and intangible personal property in defense of ESSB 5096's external inconsistency. *See* State's Br. at 60. However, Washington's alleged economic justification for allocating the gains to itself (i.e., the residency or domicile of the taxpayer) cannot overcome the fact that the State is reaching "beyond that portion of value that is fairly attributable to economic *activity*" within the state. *Jefferson Lines, Inc.*, 514 U.S. at 185 (emphasis added). As previously stated, external consistency requires that gross receipts taxes or taxes on income "be apportioned to reflect the location of the various interstate activities by which [the amount] was earned." *Jefferson Lines, Inc.*, 514 U.S. at 190. Allocating capital gains derived from a sale or exchange of tangible personal property that occurs outside Washington entirely to Washington solely because the beneficial owner happened to be a Washington resident is externally inconsistent because the state in which the sale occurred has power to tax the income.

The Legislature here failed to incorporate *any* principles of apportionment in ESSB 5096 so that the capital gains tax is constitutionally imposed only on that portion of income reasonably attributed to the taxpayer's in-state activities in connection with the sale. This is the same defect that doomed Washington's early B&O tax. *See Gwin*, 305 U.S. at 438–39 (striking down Washington privilege tax derived from gross receipts incurred from sales in interstate commerce and without apportionment).

The State's arguments also suggest it believes that apportionment is not required for income earned from intangible personal property at all by application of its legally unsupported "fiction" that all intangible personal property is sourced to its owner's domicile. *See* State's Br. at 60. But, as previously discussed, the State is wrong. *See also Mobil Oil Corp*., 445 U.S. at 445 ("The Court also has recognized that the reason for a single place of taxation no longer obtains when the taxpayer's activities with respect to the intangible property involve relations

with more than one jurisdiction. . . . *Moreover, cases upholding allocation to a single situs for property tax purposes have distinguished income tax situations where the apportionment principle prevails*.") (emphasis added; citations omitted); *Wheeling Steel Corp. v. Fox*, 298 U.S. 193, 212, 56 S. Ct. 773, 80 L. Ed. 1143 (1936) (recognizing that tax on net profits from intangible property demands a method of apportionment among different jurisdictions with respect to the processes by which the profits are earned).

ESSB 5096 tries to allocate taxable gains derived from the sale of certain capital assets to Washington solely because the taxpayer resides or is domiciled within the State. But the act of simply living in the State does not bear a rational relationship to the amounts earned from the long-term ownership and eventual sale or transfer of those assets. And, even if some link were identified, there would still be no basis for Washington to allocate to itself —as it does in ESSB 5096—*all* of the gains earned without any apportionment for the value earned in other

jurisdictions. By doing so, the gains allocated to Washington are "out of all appropriate proportion" to the activities conducted here. *Container Corp. of America*, 463 U.S. at 180–81. The State here has unconstitutionally extended its taxing authority to activities conducted wholly or predominantly outside its borders with no rational relationship between the income on which the state's tax is measured and the activity purportedly being taxed.

4. ESSB 5096 Discriminates Against Interstate Commerce.

Last, the State's arguments against ESSB 5096's discriminatory nature focus on the wrong test. *See* State's Br. at 60-61. The State focuses only on the portion of the Commerce Clause inquiry that seeks to identify discriminatory tax treatment of in-state and out-of-state interests. *See id.* (quoting *Washington Banker's Ass'n v. State*, 198 Wn.2d 418, 430, 495 P.3d 808 (2021) and *Filo Foods, LLC v. State*, 183 Wn.2d 770, 809, 357 P.3d 1040 (2015)).[13] But that aspect of the test for discrimination

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[13] In both cases, the petitioners had asserted that the statute at issue discriminated against interstate commerce by unfairly

under the Commerce Clause has never been asserted here and is not the only way a state can discriminate against interstate commerce. As the Supreme Court has explained:

> among other things, [] a State may not tax a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State. *Nor may a State impose a tax which discriminates against interstate commerce* either by providing a direct commercial advantage to local business, or *by subjecting interstate commerce to the burden of multiple taxation*.

Wynne, 575 U.S. at 549-50 (citations omitted; emphasis added); *see also Armco, Inc. v. Hardesty*, 467 U.S. 638, 644–45 and n.8, 104 S. Ct. 2620, 82 L. Ed. 2d 540 (1984) ((“A tax that unfairly apportions income from other States is a form of discrimination against interstate commerce.”). ESSB 5096 discriminates against interstate commerce because it subjects income earned across state lines to risk of multiple taxation. *See Wynne*, 575 U.S. at 549-50. While gains earned from sales of tangible personal

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taxing out-of-state businesses. *See Wash. Bankers Ass’n*, 198 Wn.2d at 426; *Filo Foods, LLC*, 183 Wn.2d at 809.

property located in Washington are subject to tax only once by Washington, gains earned from out-of-state tangible personal property or gains earned from intangible personal property can be taxed not just by Washington but other states as well—simply because Washington has chosen to allocate the gains based on the taxpayer's residency or domicile and without apportionment. This tax treatment burdens interstate commerce, which the State cannot constitutionally do. *Armco*, 467 U.S. at 644; *see also Gwin*, 305 U.S. at 438–39.

* * *

In sum, ESSB 5096 violates the dormant Commerce Clause because the capital gains tax imposed impermissibly allocates the tax to Washington based on the taxpayer's location instead of where the activity of sale or transfer of the asset occurs, imposes a tax that is not fairly apportioned to activities occurring within the state, and discriminates against interstate commerce. The legislation cannot stand.

V. CONCLUSION

For these reasons, the Court should hold that the capital gains tax in ESSB 5096 is unconstitutional and void in its entirety.

This document contains 11,750 words, excluding the parts of the document exempted from the word count by RAP 18.17.

Respectfully submitted September 8, 2022,

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CERTIFICATE OF SERVICE

I hereby certify that I caused the foregoing Quinn Respondents' Response to State of Washington's Opening Brief to be served on counsel for all other parties in this matter via this Court's e-filing platform.

Dated September 8, 2022.

s/Callie A. Castillo
Callie A. Castillo
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APPENDIX A

CERTIFICATION OF ENROLLMENT

ENGROSSED SUBSTITUTE SENATE BILL 5096

Chapter 196, Laws of 2021

67th Legislature
2021 Regular Session

CAPITAL GAINS TAX

EFFECTIVE DATE: July 25, 2021

Passed by the Senate April 25, 2021
Yeas 25 Nays 24

DENNY HECK

President of the Senate

Passed by the House April 24, 2021
Yeas 52 Nays 44

LAURIE JINKINS

Speaker of the House of Representatives

Approved May 4, 2021 2:58 PM

JAY INSLEE

Governor of the State of Washington

CERTIFICATE

I, Brad Hendrickson, Secretary of the Senate of the State of Washington, do hereby certify that the attached is **ENGROSSED SUBSTITUTE SENATE BILL 5096** as passed by the Senate and the House of Representatives on the dates hereon set forth.

BRAD HENDRICKSON

Secretary

FILED

May 5, 2021

Secretary of State
State of Washington

ENGROSSED SUBSTITUTE SENATE BILL 5096

AS RECOMMENDED BY THE CONFERENCE COMMITTEE

Passed Legislature - 2021 Regular Session

State of Washington 67th Legislature 2021 Regular Session

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

READ FIRST TIME 02/18/21.

1 AN ACT Relating to investing in Washington families and creating
2 a more progressive tax system in Washington by enacting an excise tax
3 on the sale or exchange of certain capital assets; amending RCW
4 83.100.230; adding a new section to chapter 82.04 RCW; adding a new
5 chapter to Title 82 RCW; creating new sections; and prescribing
6 penalties.

7 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF WASHINGTON:

8 NEW SECTION. **Sec. 1.** INTENT. The legislature finds that it is
9 the paramount duty of the state to amply provide every child in the
10 state with an education, creating the opportunity for the child to
11 succeed in school and thrive in life. The legislature further finds
12 that high quality early learning and child care is critical to a
13 child's success in school and life, as it supports the development of
14 the child's social-emotional, physical, cognitive, and language
15 skills. Therefore, the legislature will invest in the ongoing support
16 of K-12 education and early learning and child care by dedicating
17 revenues from this act to the education legacy trust account and the
18 common school construction account.
19 The legislature further recognizes that a tax system that is
20 fair, balanced, and works for everyone is essential to help all
21 Washingtonians grow and thrive. But Washington's tax system today is

the most regressive in the nation because it asks those making the least to pay the most as a percentage of their income. Middle-income families in Washington pay two to four times more in taxes, as a percentage of household income, as compared to top earners in the state. Low-income Washingtonians pay at least six times more than do our wealthiest residents.

To help meet the state's paramount duty, the legislature intends to levy a seven percent tax on the voluntary sale or exchange of stocks, bonds, and other capital assets where the profit is in excess of $250,000 annually to fund K-12 education, early learning, and child care, and advance our paramount duty to amply provide an education to every child in the state. The legislature recognizes that levying this tax will have the additional effect of making material progress toward rebalancing the state's tax code.

The legislature further intends to exempt certain assets from the tax including, but not limited to, qualified family-owned small businesses, all residential and other real property, and retirement accounts.

NEW SECTION. **Sec. 2.** DISTRIBUTION OF REVENUES. (1) All taxes, interest, and penalties collected under this chapter shall be distributed as follows:

(a) The first $500,000,000 collected each fiscal year shall be deposited into the education legacy trust account created in RCW 83.100.230; and

(b) Any remainder collected each fiscal year shall be deposited into the common school construction account.

(2) The amounts specified under subsection (1)(a) of this section shall be adjusted annually as provided under section 17 of this act.

Sec. 3. RCW 83.100.230 and 2019 c 415 s 990 are each amended to read as follows:

The education legacy trust account is created in the state treasury. Money in the account may be spent only after appropriation. Expenditures from the account may be used only for support of the common schools, and for expanding access to higher education through funding for new enrollments and financial aid, early learning and child care programs, and other educational improvement efforts. ((~~During the 2015-2017, 2017-2019, and 2019-2021 fiscal biennia appropriations from the account may be made for support of early~~

~~learning programs. It is the intent of the legislature that this policy will be continued in subsequent fiscal biennia.~~))

NEW SECTION. **Sec. 4.** DEFINITIONS. The definitions in this section apply throughout this chapter unless the context clearly requires otherwise.

(1) "Adjusted capital gain" means federal net long-term capital gain:

(a) Plus any amount of long-term capital loss from a sale or exchange that is exempt from the tax imposed in this chapter, to the extent such loss was included in calculating federal net long-term capital gain;

(b) Plus any amount of long-term capital loss from a sale or exchange that is not allocated to Washington under section 11 of this act, to the extent such loss was included in calculating federal net long-term capital gain;

(c) Plus any amount of loss carryforward from a sale or exchange that is not allocated to Washington under section 11 of this act, to the extent such loss was included in calculating federal net long-term capital gain;

(d) Less any amount of long-term capital gain from a sale or exchange that is not allocated to Washington under section 11 of this act, to the extent such gain was included in calculating federal net long-term capital gain; and

(e) Less any amount of long-term capital gain from a sale or exchange that is exempt from the tax imposed in this chapter, to the extent such gain was included in calculating federal net long-term capital gain.

(2) "Capital asset" has the same meaning as provided by Title 26 U.S.C. Sec. 1221 of the internal revenue code and also includes any other property if the sale or exchange of the property results in a gain that is treated as a long-term capital gain under Title 26 U.S.C. Sec. 1231 or any other provision of the internal revenue code.

(3) "Federal net long-term capital gain" means the net long-term capital gain reportable for federal income tax purposes determined as if Title 26 U.S.C. Secs. 55 through 59, 1400Z-1, and 1400Z-2 of the internal revenue code did not exist.

(4) "Individual" means a natural person.

(5) "Internal revenue code" means the United States internal revenue code of 1986, as amended, as of the effective date of this

1 section, or such subsequent date as the department may provide by
2 rule consistent with the purpose of this chapter.
3 (6) "Long-term capital asset" means a capital asset that is held
4 for more than one year.
5 (7) "Long-term capital gain" means gain from the sale or exchange
6 of a long-term capital asset.
7 (8) "Long-term capital loss" means a loss from the sale or
8 exchange of a long-term capital asset.
9 (9) "Real estate" means land and fixtures affixed to land. "Real
10 estate" also includes used mobile homes, used park model trailers,
11 used floating homes, and improvements constructed upon leased land.
12 (10)(a) "Resident" means an individual:
13 (i) Who is domiciled in this state during the taxable year,
14 unless the individual (A) maintained no permanent place of abode in
15 this state during the entire taxable year, (B) maintained a permanent
16 place of abode outside of this state during the entire taxable year,
17 and (C) spent in the aggregate not more than 30 days of the taxable
18 year in this state; or
19 (ii) Who is not domiciled in this state during the taxable year,
20 but maintained a place of abode and was physically present in this
21 state for more than 183 days during the taxable year.
22 (b) For purposes of this subsection, "day" means a calendar day
23 or any portion of a calendar day.
24 (c) An individual who is a resident under (a) of this subsection
25 is a resident for that portion of a taxable year in which the
26 individual was domiciled in this state or maintained a place of abode
27 in this state.
28 (11) "Taxable year" means the taxpayer's taxable year as
29 determined under the internal revenue code.
30 (12) "Taxpayer" means an individual subject to tax under this
31 chapter.
32 (13) "Washington capital gains" means an individual's adjusted
33 capital gain, as modified in section 7 of this act, for each return
34 filed under this chapter.

35 NEW SECTION. **Sec. 5.** TAX IMPOSED. (1) Beginning January 1,
36 2022, an excise tax is imposed on the sale or exchange of long-term
37 capital assets. Only individuals are subject to payment of the tax,
38 which equals seven percent multiplied by an individual's Washington
39 capital gains.

1 (2) The tax levied in subsection (1) of this section is necessary
2 for the support of the state government and its existing public
3 institutions.

4 (3) If an individual's Washington capital gains are less than
5 zero for a taxable year, no tax is due under this section and no such
6 amount is allowed as a carryover for use in the calculation of that
7 individual's adjusted capital gain, as defined in section 4(1) of
8 this act, for any taxable year. To the extent that a loss
9 carryforward is included in the calculation of an individual's
10 federal net long-term capital gain and that loss carryforward is
11 directly attributable to losses from sales or exchanges allocated to
12 this state under section 11 of this act, the loss carryforward is
13 included in the calculation of that individual's adjusted capital
14 gain for the purposes of this chapter. An individual may not include
15 any losses carried back for federal income tax purposes in the
16 calculation of that individual's adjusted capital gain for any
17 taxable year.

18 (4)(a) The tax imposed in this section applies to the sale or
19 exchange of long-term capital assets owned by the taxpayer, whether
20 the taxpayer was the legal or beneficial owner of such assets at the
21 time of the sale or exchange. The tax applies when the Washington
22 capital gains are recognized by the taxpayer in accordance with this
23 chapter.

24 (b) For purposes of this chapter:

25 (i) An individual is considered to be a beneficial owner of long-
26 term capital assets held by an entity that is a pass-through or
27 disregarded entity for federal tax purposes, such as a partnership,
28 limited liability company, S corporation, or grantor trust, to the
29 extent of the individual's ownership interest in the entity as
30 reported for federal income tax purposes.

31 (ii) A nongrantor trust is deemed to be a grantor trust if the
32 trust does not qualify as a grantor trust for federal tax purposes,
33 and the grantor's transfer of assets to the trust is treated as an
34 incomplete gift under Title 26 U.S.C. Sec. 2511 of the internal
35 revenue code and its accompanying regulations. A grantor of such
36 trust is considered the beneficial owner of the capital assets of the
37 trust for purposes of the tax imposed in this section and must
38 include any long-term capital gain or loss from the sale or exchange
39 of a capital asset by the trust in the calculation of that

individual's adjusted capital gain, if such gain or loss is allocated to this state under section 11 of this act.

NEW SECTION. **Sec. 6.** EXEMPTIONS. This chapter does not apply to the sale or exchange of:

(1) All real estate transferred by deed, real estate contract, judgment, or other lawful instruments that transfer title to real property and are filed as a public record with the counties where real property is located;

(2)(a) An interest in a privately held entity 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.

(b)(i) Except as provided in (b)(ii) and (iii) of this subsection, the value of the exemption under this subsection is equal to the fair market value of the real estate owned directly by the entity less its basis, at the time that the sale or exchange of the individual's interest occurs, multiplied by the percentage of the ownership interest in the entity which is sold or exchanged by the individual.

(ii) If a sale or exchange of an interest in an entity results in an amount directly attributable to real property and that is considered as an amount realized from the sale or exchange of property other than a capital asset under Title 26 U.S.C. Sec. 751 of the internal revenue code, such amount must not be considered in the calculation of an individual's exemption amount under (b)(i) of this subsection (2).

(iii) Real estate not owned directly by the entity in which an individual is selling or exchanging the individual's interest must not be considered in the calculation of an individual's exemption amount under (b)(i) of this subsection (2).

(c) Fair market value of real estate may be established by a fair market appraisal of the real estate or an allocation of assets by the seller and the buyer made under Title 26 U.S.C. Sec. 1060 of the internal revenue code, as amended. However, the department is not bound by the parties' agreement as to the allocation of assets, allocation of consideration, or fair market value, if such allocations or fair market value do not reflect the fair market value of the real estate. The assessed value of the real estate for property tax purposes may be used to determine the fair market value

of the real estate, if the assessed value is current as of the date of the sale or exchange of the ownership interest in the entity owning the real estate and the department determines that this method is reasonable under the circumstances.

(d) The value of the exemption under this subsection (2) may not exceed the individual's long-term capital gain or loss from the sale or exchange of an interest in an entity for which the individual is claiming this exemption;

(3) Assets held under a retirement savings account under Title 26 U.S.C. Sec. 401(k) of the internal revenue code, a tax-sheltered annuity or custodial account described in Title 26 U.S.C. Sec. 403(b) of the internal revenue code, a deferred compensation plan under Title 26 U.S.C. Sec. 457(b) of the internal revenue code, an individual retirement account or individual retirement annuity described in Title 26 U.S.C. Sec. 408 of the internal revenue code, a Roth individual retirement account described in Title 26 U.S.C. Sec. 408A of the internal revenue code, an employee defined contribution program, an employee defined benefit plan, or a similar retirement savings vehicle;

(4) Assets pursuant to, or under imminent threat of, condemnation proceedings by the United States, the state or any of its political subdivisions, or a municipal corporation;

(5) Cattle, horses, or breeding livestock if for the taxable year of the sale or exchange, more than 50 percent of the taxpayer's gross income for the taxable year, including from the sale or exchange of capital assets, is from farming or ranching;

(6) Property depreciable under Title 26 U.S.C. Sec. 167(a)(1) of the internal revenue code, or that qualifies for expensing under Title 26 U.S.C. Sec. 179 of the internal revenue code;

(7) Timber, timberland, or the receipt of Washington capital gains as dividends and distributions from real estate investment trusts derived from gains from the sale or exchange of timber and timberland. "Timber" means forest trees, standing or down, on privately or publicly owned land, and includes Christmas trees and short-rotation hardwoods. The sale or exchange of timber includes the cutting or disposal of timber qualifying for capital gains treatment under Title 26 U.S.C. Sec. 631(a) or (b) of the internal revenue code;

(8)(a) Commercial fishing privileges.

(b) For the purposes of this subsection (8), "commercial fishing privilege" means a right, held by a seafood harvester or processor, to participate in a limited access fishery. "Commercial fishing privilege" includes and is limited to:

(i) In the case of federally managed fisheries, quota and access to fisheries assigned pursuant to individual fishing quota programs, limited entry and catch share programs, cooperative fishing management agreements, or similar arrangements; and

(ii) In the case of state-managed fisheries, quota and access to fisheries assigned under fishery permits, limited entry and catch share programs, or similar arrangements; and

(9) Goodwill received from the sale of an auto dealership licensed under chapter 46.70 RCW whose activities are subject to chapter 46.96 RCW.

NEW SECTION. **Sec. 7.** DEDUCTIONS. In computing tax for a taxable year, a taxpayer may deduct from his or her Washington capital gains:

(1) A standard deduction of $250,000 per individual, or in the case of spouses or domestic partners, their combined standard deduction is limited to $250,000, regardless of whether they file joint or separate returns. The amount of the standard deduction shall be adjusted pursuant to section 17 of this act;

(2) Amounts that the state is prohibited from taxing under the Constitution of this state or the Constitution or laws of the United States;

(3) The amount of adjusted capital gain derived from the sale or transfer of the taxpayer's interest in a qualified family-owned small business pursuant to section 8 of this act; and

(4) Charitable donations deductible under section 9 of this act.

NEW SECTION. **Sec. 8.** QUALIFIED FAMILY-OWNED SMALL BUSINESS DEDUCTION. (1) In computing tax under this chapter for a taxable year, a taxpayer may deduct from his or her Washington capital gains the amount of adjusted capital gain derived in the taxable year from the sale of substantially all 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, to the extent that such adjusted capital gain would otherwise be included in the taxpayer's Washington capital gains.

1 (2) For purposes of this section, the following definitions
2 apply:
3 (a) "Assets" means real property and personal property, including
4 tangible personal property and intangible property.
5 (b) "Family" means the same as "member of the family" in RCW
6 83.100.046.
7 (c)(i) "Materially participated" means an individual was involved
8 in the operation of a business on a basis that is regular,
9 continuous, and substantial.
10 (ii) The term "materially participated" must be interpreted
11 consistently with the applicable treasury regulations for Title 26
12 U.S.C. Sec. 469 of the internal revenue code, to the extent that such
13 interpretation does not conflict with any provision of this section.
14 (d) "Qualified family-owned small business" means a business:
15 (i) In which the taxpayer held a qualifying interest for at least
16 five years immediately preceding the sale or transfer described in
17 subsection (1) of this section;
18 (ii) In which either the taxpayer or members of the taxpayer's
19 family, or both, materially participated in operating the business
20 for at least five of the 10 years immediately preceding the sale or
21 transfer described in subsection (1) of this section, unless such
22 sale or transfer was to a qualified heir; and
23 (iii) That had worldwide gross revenue of $10,000,000 or less in
24 the 12-month period immediately preceding the sale or transfer
25 described in subsection (1) of this section. The worldwide gross
26 revenue amount under this subsection (2)(d)(iii) shall be adjusted
27 annually as provided in section 17 of this act.
28 (e) "Qualified heir" means a member of the taxpayer's family.
29 (f) "Qualifying interest" means:
30 (i) An interest as a proprietor in a business carried on as a
31 sole proprietorship; or
32 (ii) An interest in a business if at least:
33 (A) Fifty percent of the business is owned, directly or
34 indirectly, by any combination of the taxpayer or members of the
35 taxpayer's family, or both;
36 (B) Thirty percent of the business is owned, directly or
37 indirectly, by any combination of the taxpayer or members of the
38 taxpayer's family, or both, and at least:
39 (I) Seventy percent of the business is owned, directly or
40 indirectly, by members of two families; or

(II) Ninety percent of the business is owned, directly or indirectly, by members of three families.

(g) "Substantially all" means at least 90 percent.

NEW SECTION. **Sec. 9.** ADDITIONAL DEDUCTION FOR CHARITABLE DONATIONS. (1) In computing tax under this chapter for a taxable year, a taxpayer may deduct from his or her Washington capital gains the amount donated by the taxpayer to one or more qualified organizations during the same taxable year in excess of the minimum qualifying charitable donation amount. For the purposes of this section, the minimum qualifying charitable donation amount equals $250,000. The minimum qualifying charitable donation amount under this subsection (1) shall be adjusted pursuant to section 17 of this act.

(2) The deduction authorized under subsection (1) of this section may not exceed $100,000 for the taxable year. The maximum amount of the available deduction under this subsection (2) shall be adjusted pursuant to section 17 of this act.

(3) The deduction authorized under subsection (1) of this section may not be carried forward or backward to another tax reporting period.

(4) For the purposes of this section, the following definitions apply:

(a) "Nonprofit organization" means an organization exempt from tax under Title 26 U.S.C. Sec. 501(c)(3) of the internal revenue code.

(b) "Qualified organization" means a nonprofit organization, or any other organization, that is:

(i) Eligible to receive a charitable deduction as defined in Title 26 U.S.C. Sec. 170(c) of the internal revenue code; and

(ii) Principally directed or managed within the state of Washington.

NEW SECTION. **Sec. 10.** OTHER TAXES. The tax imposed under this chapter is in addition to any other taxes imposed by the state or any of its political subdivisions, or a municipal corporation, with respect to the same sale or exchange, including the taxes imposed in, or under the authority of, chapter 82.04, 82.08, 82.12, 82.14, 82.45, or 82.46 RCW.

NEW SECTION. **Sec. 11.** ALLOCATION OF GAINS AND LOSSES. (1) For purposes of the tax imposed under this chapter, long-term capital gains and losses are allocated to Washington as follows:

(a) Long-term capital gains or losses from the sale or exchange of tangible personal property are allocated to this state if the property was located in this state at the time of the sale or exchange. Long-term capital gains or losses from the sale or exchange of tangible personal property are also allocated to this state even though the property was not located in this state at the time of the sale or exchange if:

(i) The property was located in the state at any time during the taxable year in which the sale or exchange occurred or the immediately preceding taxable year;

(ii) The taxpayer was a resident at the time the sale or exchange occurred; and

(iii) The taxpayer is not subject to the payment of an income or excise tax legally imposed on the long-term capital gains or losses by another taxing jurisdiction.

(b) Long-term capital gains or losses derived from intangible personal property are allocated to this state if the taxpayer was domiciled in this state at the time the sale or exchange occurred.

(2)(a) A credit is allowed against the tax imposed in section 5 of this act equal to the amount of any legally imposed income or excise tax paid by the taxpayer to another taxing jurisdiction on capital gains derived from capital assets within the other taxing jurisdiction to the extent such capital gains are included in the taxpayer's Washington capital gains. The amount of credit under this subsection may not exceed the total amount of tax due under this chapter, and there is no carryback or carryforward of any unused credits.

(b) As used in this section, "taxing jurisdiction" means a state of the United States other than the state of Washington, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, or any foreign country or political subdivision of a foreign country.

NEW SECTION. **Sec. 12.** FILING OF RETURNS. (1)(a) Except as otherwise provided in this section or RCW 82.32.080, taxpayers owing tax under this chapter must file, on forms prescribed by the department, a return with the department on or before the date the

taxpayer's federal income tax return for the taxable year is required to be filed.

(b)(i) Except as provided in (b)(ii) of this subsection (1), returns and all supporting documents must be filed electronically using the department's online tax filing service or other method of electronic reporting as the department may authorize.

(ii) The department may waive the electronic filing requirement in this subsection for good cause as provided in RCW 82.32.080.

(2) In addition to the Washington return required to be filed under subsection (1) of this section, taxpayers owing tax under this chapter must file with the department on or before the date the federal return is required to be filed a copy of the federal income tax return along with all schedules and supporting documentation.

(3) Each taxpayer required to file a return under this section must, without assessment, notice, or demand, pay any tax due thereon to the department on or before the date fixed for the filing of the return, regardless of any filing extension. The tax must be paid by electronic funds transfer as defined in RCW 82.32.085 or by other forms of electronic payment as may be authorized by the department. The department may waive the electronic payment requirement for good cause as provided in RCW 82.32.080. If any tax due under this chapter is not paid by the due date, interest and penalties as provided in chapter 82.32 RCW apply to the deficiency.

(4)(a) In addition to the Washington return required to be filed under subsection (1) of this section, an individual claiming an exemption under section 6(2) of this act must file documentation substantiating the following:

(i) The fair market value and basis of the real estate held directly by the entity in which the interest was sold or exchanged;

(ii) The percentage of the ownership interest sold or exchanged in the entity owning real estate; and

(iii) The methodology, if any, established by the entity in which the interest was sold or exchanged, for allocating gains or losses to the owners, partners, or shareholders of the entity from the sale of real estate.

(b) The department may by rule prescribe additional filing requirements to substantiate an individual's claim for an exemption under section 6(2) of this act. Prior to adopting any rule under this subsection (4)(b), the department must allow for an opportunity for

1 participation by interested parties in the rule-making process in
2 accordance with the administrative procedure act, chapter 34.05 RCW.
3 (5) If a taxpayer has obtained an extension of time for filing
4 the federal income tax return for the taxable year, the taxpayer is
5 entitled to the same extension of time for filing the return required
6 under this section if the taxpayer provides the department, before
7 the due date provided in subsection (1) of this section, the
8 extension confirmation number or other evidence satisfactory to the
9 department confirming the federal extension. An extension under this
10 subsection for the filing of a return under this chapter is not an
11 extension of time to pay the tax due under this chapter.
12 (6)(a) If any return due under subsection (1) of this section,
13 along with a copy of the federal income tax return, is not filed with
14 the department by the due date or any extension granted by the
15 department, the department must assess a penalty in the amount of
16 five percent of the tax due for the taxable year covered by the
17 return for each month or portion of a month that the return remains
18 unfiled. The total penalty assessed under this subsection may not
19 exceed 25 percent of the tax due for the taxable year covered by the
20 delinquent return. The penalty under this subsection is in addition
21 to any penalties assessed for the late payment of any tax due on the
22 return.
23 (b) The department must waive or cancel the penalty imposed under
24 this subsection if:
25 (i) The department is persuaded that the taxpayer's failure to
26 file the return by the due date was due to circumstances beyond the
27 taxpayer's control; or
28 (ii) The taxpayer has not been delinquent in filing any return
29 due under this section during the preceding five calendar years.

30 <u>NEW SECTION.</u> **Sec. 13.** JOINT FILERS. (1) If the federal income
31 tax liabilities of both spouses are determined on a joint federal
32 return for the taxable year, they must file a joint return under this
33 chapter.
34 (2) Except as otherwise provided in this subsection, if the
35 federal income tax liability of either spouse is determined on a
36 separate federal return for the taxable year, they must file separate
37 returns under this chapter. State registered domestic partners may
38 file a joint return under this chapter even if they filed separate
39 federal returns for the taxable year.

1 (3) The liability for tax due under this chapter of each spouse
2 or state registered domestic partner is joint and several, unless:
3 (a) The spouse is relieved of liability for federal tax purposes
4 as provided under Title 26 U.S.C. Sec. 6015 of the internal revenue
5 code; or
6 (b) The department determines that the domestic partner qualifies
7 for relief as provided by rule of the department. Such rule, to the
8 extent possible without being inconsistent with this chapter, must
9 follow Title 26 U.S.C. Sec. 6015.

10 NEW SECTION. **Sec. 14.** ADMINISTRATION OF TAXES. Except as
11 otherwise provided by law and to the extent not inconsistent with the
12 provisions of this chapter, chapter 82.32 RCW applies to the
13 administration of taxes imposed under this chapter.

14 NEW SECTION. **Sec. 15.** CRIMINAL ACTIONS. (1) Any taxpayer who
15 knowingly attempts to evade payment of the tax imposed under this
16 chapter is guilty of a class C felony as provided in chapter 9A.20
17 RCW.
18 (2) Any taxpayer who knowingly fails to pay tax, make returns,
19 keep records, or supply information, as required under this title, is
20 guilty of a gross misdemeanor as provided in chapter 9A.20 RCW.

21 NEW SECTION. **Sec. 16.** A new section is added to chapter 82.04
22 RCW to read as follows:
23 BUSINESS AND OCCUPATION TAX CREDIT. (1) To avoid taxing the same
24 sale or exchange under both the business and occupation tax and
25 capital gains tax, a credit is allowed against taxes due under this
26 chapter on a sale or exchange that is also subject to the tax imposed
27 under section 5 of this act. The credit is equal to the amount of tax
28 imposed under this chapter on such sale or exchange.
29 (2) The credit may be used against any tax due under this
30 chapter.
31 (3) The credit under this section is earned in regards to a sale
32 or exchange, and may be claimed against taxes due under this chapter,
33 for the tax reporting period in which the sale or exchange occurred.
34 The credit claimed for a tax reporting period may not exceed the tax
35 otherwise due under this chapter for that tax reporting period.
36 Unused credit may not be carried forward or backward to another tax

reporting period. No refunds may be granted for unused credit under this section.

(4) The department must apply the credit first to taxes deposited into the general fund. If any remaining credit reduces the amount of taxes deposited into the workforce education investment account established in RCW 43.79.195, the department must notify the state treasurer of such amounts monthly, and the state treasurer must transfer those amounts from the general fund to the workforce education investment account.

NEW SECTION. **Sec. 17.** ANNUAL ADJUSTMENTS. (1) Beginning December 2023 and each December thereafter, the department must adjust the applicable amounts by multiplying the current applicable amounts by one plus the percentage by which the most current consumer price index available on December 1st of the current year exceeds the consumer price index for the prior 12-month period, and rounding the result to the nearest $1,000. If an adjustment under this subsection (1) would reduce the applicable amounts, the department must not adjust the applicable amounts for use in the following year. The department must publish the adjusted applicable amounts on its public website by December 31st. The adjusted applicable amounts calculated under this subsection (1) take effect for taxes due and distributions made, as the case may be, in the following calendar year.

(2) For purposes of this section, the following definitions apply:

(a) "Applicable amounts" means:

(i) The distribution amount to the education legacy trust account as provided in section 2(1)(a) of this act;

(ii) The standard deduction amount in sections 4(13) and 7(1) of this act;

(iii) The worldwide gross revenue amount under section 8 of this act; and

(iv) The minimum qualifying charitable donation amount and maximum charitable donation amount under section 9 of this act.

(b) "Consumer price index" means the consumer price index for all urban consumers, all items, for the Seattle area as calculated by the United States bureau of labor statistics or its successor agency.

(c) "Seattle area" means the geographic area sample that includes Seattle and surrounding areas.

1 NEW SECTION. **Sec. 18.** The provisions of RCW 82.32.805 and
2 82.32.808 do not apply to this act.

3 NEW SECTION. **Sec. 19.** Sections 1, 2, 4 through 15, and 17 of
4 this act constitute a new chapter in Title 82 RCW.

5 NEW SECTION. **Sec. 20.** (1) If a court of competent jurisdiction,
6 in a final judgment not subject to appeal, adjudges section 5 of this
7 act unconstitutional, or otherwise invalid, in its entirety, section
8 16 of this act is null and void in its entirety. Any credits
9 previously claimed under section 16 of this act must be repaid within
10 30 days of the department of revenue's notice to the taxpayer of the
11 amount due.
12 (2) If the taxpayer fails to repay the credit by the due date,
13 interest and penalties as provided in chapter 82.32 RCW apply to the
14 deficiency.

15 NEW SECTION. **Sec. 21.** If any provision of this act or its
16 application to any person or circumstance is held invalid, the
17 remainder of the act or the application of the provision to other
18 persons or circumstances is not affected.

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--- END ---

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