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Dann Mead Smith
Washington Policy Center
924 Capitol Way South, Suite 218
Olympia, WA 98501

Re: Constitutionality of Initiative 1098

Dear Mr. Smith:

Thank you for the opportunity to evaluate Initiative 1098 and provide you my opinion regarding its constitutionality.

(1) The Contents of Initiative 1098

Initiative 1098 purports to create a new trust fund financing education, health services, and "middle class tax relief" funded by a graduated net income tax on incomes in excess of \$200,000 for individuals and \$400,000 for persons filing jointly.

The tax relief provided in the initiative is a small reduction of 20% in the state portion of the ad valorem property tax in section 301, and an increase in the tax credit available under the business and occupation tax to \$4,800 per year in sections 302 and 303. These tax relief provisions are not effective, however, unless the income tax provisions of the measure are enacted. Section 1002.¹

The central portion of Initiative 1098 is the enactment of a graduated net income tax in Section 501. For married couples² filing jointly, the first \$400,000 of taxable income is exempted. A 5% rate is

¹ It appears that the tax relief afforded under the measure is substantially less than the revenue the measure generates. Thus, it appears that the proponents of the measure are principally seeking additional revenues for purposes of health and educational services as articulated in section 201 of Initiative 1098.

² The married couples exemption also applies to those registered as Washington domestic partners. The use of married couples hereafter incorporates domestic partners.

applied to income between \$400,000 and \$1 million. For income over a million dollars, the tax is \$30,000 plus 9% of any excess over \$1 million. Similar rates apply to income levels (reduced by half) for individuals.

(2) Constitutional Issues Surrounding Initiative 1098

Initiative 1098 clearly contemplates that its enactment will result in litigation over its constitutionality because its provisions represent a challenge to a long line of Washington cases that hold income is property and therefore subject to certain constitutional restrictions on property taxes in Washington's Constitution. Throughout the measure, proponents have used the term "excise tax" to describe the graduated net income tax of Section 501. The reason for this use of terminology is candidly set forth in Section 1001 of the measure, described as "Context," which states:

In 1932, more than seventy percent of Washington voters approved an income tax initiative and simultaneously cut property taxes in half. The following year, the state supreme court, in an opinion that ultimately relied on United States supreme court cases that have long since been overruled, treated Washington's graduated income tax, as then drafted, as a nonuniform property tax. This threw the state's tax system into confusion and led to Washington's over reliance on high sales taxes and the business and occupations tax. The sales tax is regressive and stunts business growth.³ The business and occupation tax, which is particular to Washington state, discourages investment and encourages many potential employers to take their business elsewhere. The tax established by this initiative is intentionally structured as an excise tax on the receipt of income during the taxable year rather than as a property tax on money as an asset, after it has been received. As an excise tax rather than a property tax, this tax is intended to conform to the legal framework adopted by almost all states, consistent with the United States supreme court rulings as they have evolved during the past eight decades. This initiative is also aimed at replicating the voters' 1932 action to reduce property taxes while installing a much fairer tax system overall and providing more stable funding to enable the state to meet its constitutional duty to

³ Initiative 1098 provides no reduction in state or local sales taxes.

provide for the education of all children, and to enable the state to better provide for the costs of health care.

Washington law is unambiguous. Income is property. Beginning in *Aberdeen Savings and Loan Ass'n v. Chase*, 157 Wash. 351, 289 P. 356 (1930), and continuing through a series of cases, the Washington Supreme Court has held that income is property. As such, this tax is subject to the provisions of the so-called uniformity clause, article VII, § 1 of the Washington Constitution, which provides that all taxes “shall be uniform upon the same class of property within the territorial limits of the authority levying the tax . . .” Moreover, article VII, § 2 of the Washington Constitution establishes the upper limit upon ad valorem property taxes. That constitutional restriction essentially limits any property tax to no more than one percent of the value of the property.

As a result of the Washington Supreme Court’s definition of income as property, that Court has struck down graduated net income taxes over the years because they violate the uniformity provision and the cap on property taxes in our Constitution. In *Culliton v. Chase*, 174 Wash. 363, 25 P.2d 81 (1933), a 5-4 decision, the Supreme Court first invalidated an income tax measure adopted by initiative in Washington. In *Jensen v. Henneford*, 185 Wash. 209, 53 P.2d 607 (1936), the Supreme Court again overturned a 1935 legislative enactment of the graduated net income tax which was designed to address the issues first outlined by the Supreme Court in *Culliton*. The Legislature attempted to describe the income tax as an excise tax on “the privilege of receiving income” in the State of Washington. The Supreme Court was unmoved. The *Jensen* court stated that the 1935 Legislature’s effort to rename the tax did not make it an excise tax:

It is true that the Legislature has so labeled the 1935 act. But the legislative body cannot change the real nature and purpose of an act by giving it a different title or by declaring its nature and purpose to be otherwise, any more than a man can transform his character by changing his attire or assuming a different name. The Legislature may declare its intended purpose in an act, but it is for the courts to declare the nature and effect of the act. The character of a tax is determined by its incidents, not by its name.

Id. at 217. Subsequently, in *Power, Inc. v. Huntley*, 39 Wn.2d 191, 235 P.2d 173 (1951), the Legislature enacted what it described as a corporate

excise tax, which was actually a graduated net income tax on corporations. Again, the Supreme Court indicated that legislative labels for a tax are not controlling:

We have no hesitancy in saying that an analysis of the present act convinces us that the tax is a mere property tax ‘masquerading as an excise.’

Id. at 196. The Court, therefore, invalidated the corporate income tax because it was a property tax. *See also, Apartment Operators Association of Seattle, Inc. v. Schumacher*, 56 Wn.2d 486, 351 P.2d 124 (1960) (in a per curiam opinion, the Court held that a tax on rents which exceeded \$300 per month was a property, not an excise, tax and was, therefore, unconstitutional).⁴

The proponents of a graduated net income tax in Washington have vociferously argued that these older cases are no longer viable, because they allegedly rely on United States Supreme Court precedent that no longer finds that income-based taxes constitute taxes on property. This argument finds full flower in a 1993 law review article. Hugh Spitzer, *A Washington State Income Tax-Again?* 16 U. Puget Sd. L. Rev. 515 (1993). The essence of the argument advanced by Mr. Spitzer is found in the Context section of Initiative 1098.⁵

However, since 1993, the Washington Supreme Court has been confronted with cases in which the continuing validity of the “income as property” cases was questioned and has rejected the argument articulated in the Spitzer law review article. For example, in *Harbour Village Apartments v. City of Mukilteo*, 139 Wn.2d 604, 989 P.2d 542 (1999), the Court struck down a residential dwelling unit fee imposed by the City on every dwelling unit rented, leased, or offered for rent or lease by a business within Mukilteo, which the City argued was part of its licensure activities. The Court concluded that the fee was actually a tax. Moreover, it was not

⁴ At least two Attorney General Opinions in the early 1970’s, AGLO 1972 No. 79, and AGLO 1974 No. 105, concluded that the “income as property” analysis of the Washington Supreme Court remains viable and graduated net income tax bills were therefore unconstitutional.

⁵ While Spitzer is correct in repeating Justice Cardozo’s observation in *Hale v. St. Bd. of Assessment and Review*, 302 U.S. 95, 106, 58 S. Ct. 102, 82 L.Ed. 72 (1937) that most states do not deem income to be property, a number of states have concluded that an income tax is neither a property tax nor an excise tax, but something of a hybrid that is *sui generis*. 16 U. Puget Sd. L. Rev. at 561.

an excise tax. The Court cited with favor the cases beginning with *Jensen* and running through *Schumacher*. *Id.* at 607-08. The dissent in that case, which I authored, questioned the continuing validity of the *Jensen/Schumacher* line of cases. *See, e.g.*, 139 Wn.2d at 615 n. 4, but that position commanded only two other votes on the Court. Subsequently, in *Washington Public Ports Association v. Dep't of Revenue*, 148 Wn.2d 637, 62 P.3d 482 (2003), the Court re-again affirmed the continuing viability of the cases holding that a tax on income was a property tax. *Id.* at 650, n. 12. Based upon this authority, it is likely the Washington Supreme Court would find the tax created by Initiative 1098 is a property, not an excise, tax.

Finally, a feature of Initiative 1098 that has not received substantive analysis is the large exemption contained in the measure before the income tax applies, essentially targeting certain income earners for the tax. The constitutionality of such a provision on equal protection grounds is questionable. Both the 14th Amendment to the United States Constitution and Article I, § 12, of the Washington Constitution provide that Washington citizens are entitled to equal treatment under the law. These constitutional provisions still permit the Legislature in legislation to classify and treat such classes of citizens differently. In the absence of suspect classifications such as those based on race, for example, courts defer to the Legislature's authority to make classifications. In the context of tax measures, more so than with respect to regulatory measures, Washington courts have been deferential to the Legislature's policy determinations in making classifications. *Texas Co. v. Cohn*, 8 Wn.2d 360, 376, 112 P.2d 522 (1941). "Legislative bodies have extensive authority to make classifications for purposes of legislation and even broader discretion in making classifications for taxation than it [sic] has for regulation." *City of Seattle v. Rogers Clothing Store for Men, Inc.*, 114 Wn.2d 213, 234, 787 P.2d 39 (1990). Courts will, however, intrude if the classification is clearly arbitrary and without any reasonable basis. *Pacific NW Annual Conference of United Methodist Church v. Walla Walla County*, 82 Wn.2d 138, 144, 508 P.2d 1361 (1973).

There must be a rational basis for classifications in legislation. This rational basis analysis is the most minimal level of judicial scrutiny. *Rogers Clothing Store*, 114 Wn.2d at 233. As noted in *Associated Grocers, Inc. v. State*, 114 Wn.2d 182, 787 P.2d 22 (1990), *cert. denied*, 498 U.S. 1023 (1991), the proper test for analyzing if there is a rational basis for a legislative classification is as follows:

(1) whether the classification applies alike to all members within the designated class; (2) whether some basis in reality exists for reasonably distinguishing between those within and without the class; and, (3) whether the challenged classification bears any rational relation to the purposes of the challenged statute.

Id. at 187.

Equal protection challenges to taxation have succeeded. *See, e.g., Associated Grocers, supra.* (B&O tax exemption for distributors but not wholesalers was discriminatory as to wholesalers); *Simpson v. State*, 26 Wn. App. 687, 615 P.2d 1297, *review denied*, 94 Wn.2d 1022 (1980) (use tax exemption limited to articles purchased in American states discriminated against persons buying articles in foreign nations like Canada without any rational basis); *Power, Inc., supra* (credit allowed only to taxpayers accounting on a fiscal year basis discriminated against taxpayers accounting on a calendar year basis); *State v. Inland Empire Refineries*, 3 Wn.2d 651, 101 P.2d 975, *cert. denied*, 311 U.S. 713 (1940) (exemption from tax on petroleum products for vessels in foreign commerce was discriminatory as an attempt to provide a privilege to such persons not afforded to rail or truck transportation).

Some commentators have argued that there are structural differences between the 14th Amendment and article 1, § 12 of Washington's Constitution rendering the state charter more antagonistic toward the granting of special privileges or immunities for select societal groups. Jonathan Thompson, *The Washington Constitution's Prohibition on Special Privileges and Immunities: Real Bite for "Equal Protection" Review of Regulatory Legislation?* 69 Temp. L. Rev. 1247 (1996). *See also, American Legion Post #149 v. Wash. St. Dep't of Health*, 164 Wn.2d 570, 606-08, 192 P.3d 306 (2006). Indeed, in certain instances, our Supreme Court has found legislation unconstitutional that provides for special treatment or favoritism for particular groups. *See, e.g., Adams v. Hinkle*, 51 Wn.2d 753, 322 P.2d 844 (1958) (legislation regulating comic books but exempting comics of newspapers); *Ralph v. City of Wenatchee*, 34 Wn.2d 638, 209 P.2d 270 (1949) (ordinance banning itinerant sales of photographic services and requiring only photographers who were not Wenatchee residents to be licensed); *City of Seattle v. Rogers*, 6 Wn.2d 31, 106 P.2d 598 (1940) (city ordinance requiring licensure of solicitors for charity that exempted Seattle Community Fund); *State ex rel. Bacich v. Huse*, 187 Wash. 75, 59 P.2d 1101 (1936) (initiative prohibiting fishing

except by hook and line which exempted gill netters); *Ex Parte Camp*, 38 Wash. 393, 80 P. 547 (1905) (Spokane ordinance exempting farmers from general prohibition on peddling of produce within city limits).

As the Supreme Court stated in *American Legion*, in the regulatory context, a privilege “normally relates to an exemption from a regulatory law that has the effect of benefitting certain businesses at the expense of others.” 164 Wn.2d at 607. Taxation is somewhat different for this constitutional analysis, given its revenue generating purpose, *Cohn*, 8 Wn.2d at 376, but the structure of the tax relief in Initiative 1098 (a reduction in the state ad valorem property tax and a larger credit on the B&O tax) coupled with the broad income exemption for the income tax suggests that the measure’s proponents are offering benefits to certain societal segments at the expense of another, something article 1, § 12 may forbid. This argument is enhanced because only businesses paying the B&O tax and property owners receive any benefit. Although almost everyone pays sales taxes, no beneficial relief is provided to that group.

Moreover, it is difficult to understand the rational basis for the initiative’s conclusion that the magical point at which a graduated net income tax should start to apply is \$200,000 for individuals and \$400,000 for married couples in our state. Seemingly, if a graduated net income tax is wise public policy for Washington’s tax structure, it should apply more broadly to all income earners.

(3) Conclusion

In sum, for the foregoing reasons, it is my opinion that Initiative 1098 would violate Washington’s Constitution, in particular, article VII, §§1 and 2. In this opinion, I echo the observation of Deputy Attorney General Philip H. Austin in AGLO 1974, No. 105 in concluding that a graduated net income tax would be unconstitutional:

Of course, it is possible that the supreme court, as presently constituted, could be persuaded to reverse its earlier rulings and uphold a graduated net income tax such as is here proposed without a constitutional amendment. But this, obviously, is something upon which we cannot properly speculate in attempting to provide you with an objective opinion as to the constitutionality of such a tax at the present time. Until and unless those decisions are overruled, we must continue to be guided by them—and so conclude that at this


time, the constitution of this state continues to prohibit the imposition of a tax upon corporate or individual net income ...

In other words, Initiative 1098 is clearly unconstitutional on the basis of existing case law. Its enactment will only guarantee protracted litigation to determine if the initiative meets constitutional muster.

It is also my opinion, though, that Initiative 1098 is susceptible to an equal protection challenge for the reasons articulated above.

I hope that the foregoing opinion is of utility for you. I have focused what I perceive to be the two principal legal challenges to the Initiative, should the people enact it in November. There may be other potential challenges to the measure. If I can provide further information to you on Initiative 1098, please do not hesitate to let me know.

Very truly yours,

A handwritten signature in black ink that reads "Philip A. Talmadge". The signature is written in a cursive style with a long horizontal flourish extending to the right.

Philip A. Talmadge