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POLICY NOTE

Home sellers and small business owners could pay Seattle's new income tax

By Jason Mercier, Director, Center for Government Reform October 2017

Introduction

In July, members of the Seattle city council, in defiance of state law, imposed the first-ever local income tax in Washington state.[1] The tax would charge 2.25% on all income over $250,000 for individuals and $500,000 for married couples filing jointly.

Several lawsuits have already been filed challenging the new City of Seattle income tax.[2] In an earlier study I showed why local income taxes are illegal in Washington State.[3] In this paper I will explain why people who sell their home or small business in Seattle could be subject to the new income tax.

Seattle income tax covers more than just salary

Though promoted by advocates as a "tax on the rich," the new Seattle income tax covers far more than just earnings from wages and salaries. According to the Seattle ordinance, the tax would apply to "total income", defined this way:[4]

> "'Total income' means the amount reported as income before any adjustments, deductions, or credits on a resident taxpayer's United States individual income tax return for the tax year, currently listed as 'total income' on line 22 of Internal Revenue Service Form 1040 or 'total income' on line 15 of Internal Revenue Service Form 1040A."

Line 22 of the IRS 1040 form includes the following types of income:

- wages;
- salaries;
- tips;

Key Findings:

1. The new Seattle income tax covers far more than just earnings from wages and salaries.
2. As a tax on "total income," it specifically taxes "capital gain" and "business income."
3. By far the largest capital gain the average taxpayer will realize during their lifetime is from the sale of a home or small business.
4. If the income tax survives legal challenges, it will snare far more than just "the rich" and will also burden many middle-class Seattle families.

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1 "City of Seattle Ordinance 125339: Imposing an income tax on high-income residents," City of Seattle, July 10, 2017, at http://seattle.legistar.com/ViewReport.ashx?M=R&N=Text&GID=393&ID=2834527&GUID=456E606A-307B-47C2-9107-94C4798E4913&Title=Legislation%20Text.

2 "More lawsuits filed against Seattle's illegal income tax," by Jason Mercier, Blogpost, Washington Policy Center, August 9, 2017, at http://www.washingtonpolicy.org/publications/detail/more-lawsuits-filed-against-seattles-illegal-income-tax.

3 "Why a local income tax is illegal in Washington state," by Jason Mercier, Policy Note, Washington Policy Center, September 7, 2017 at https://www.washingtonpolicy.org/publications/detail/why-a-local-income-tax-is-illegal-in-washington-state.

4 "City of Seattle Ordinance 125339: Imposing an income tax on high-income residents," City of Seattle, July 10, 2017, at http://seattle.legistar.com/ViewReport.ashx?M=R&N=Text&GID=393&ID=2834527&GUID=456E606A-307B-47C2-9107-94C4798E4913&Title=Legislation%20Text.

- taxable interest;
- dividends;
- taxable refunds;
- alimony;
- business income;
- capital gain;
- IRA distributions;
- pensions;
- annuities;
- rental real estate;
- royalties;
- partnerships;
- S corporations;
- trusts;
- farm income;
- unemployment compensation;
- and social security benefits.[5]

This is a comprehensive list, and it specifically includes "capital gain" and "business income." By far the largest capital gain the average taxpayer will realize during their lifetime is from the sale of a home or small business.

Revenue from selling a home could be taxed as capital gains

According to *The Seattle Times*, the median home price in Seattle was $730,000 in September 2017.[6] This means that many Seattle families who sell their homes could be subject to the new Seattle income tax.

The Seattle income tax owed on a qualified capital gain from a home sale would be in addition to the current 1.78% combined Seattle Real Estate Excise Tax due for selling a home.[7] As explained by Brett Durbin of the Seattle based law firm Stoel Rives LLP:[8]

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5 "From 1040, U.S. Individual Income Tax Return, 2016," U.S. Department of the Treasury-Internal Revenue Service, accessed September 13, 2017, at https://www.irs.gov/pub/irs-pdf/f1040.pdf.

6 "King County home prices surge 18 percent, most on record for this time of year," by Mike Rosenberg, *The Seattle Times,* September 6, 2017, at http://www.seattletimes.com/business/real-estate/king-county-home-prices-surge-18-percent-most-on-record-for-this-time-of-year/.

7 "Real Estate Excise Tax Rates – Effective July 1, 2017," Washington State Department of Revenue, at https://dor.wa.gov/sites/default/files/legacy/Docs/forms/RealEstExcsTx/RealEstExTxRates.pdf.

8 "Seattle's New Income Tax May Affect Many More People Than Initially Thought, Including People Living Outside the City," by Brett Durbin, Stoel Rives LLP, August 30, 2017, at http://www.jdsupra.com/legalnews/seattle-s-new-income-tax-may-affect-24330/.

> "The capital gains on home sales are taxable, except to the extent the home sale exclusion applies. While the home sale exclusion generally applies to gains up to $250,000 ($500,000 if married filing jointly), the Seattle real estate market makes it fairly easy to reach these thresholds, as more than one-half of Seattle homes are worth more than $730,000.
>
> In addition, some residents may not satisfy the requirements of the home sale exclusion. For example, a person who moved to Seattle from Tacoma during the Great Recession, and rented out their home or condo in Tacoma instead of selling it at a loss, might not even qualify for the home sale exclusion if they sell their house today."

Those suing the City of Seattle for imposing the local income tax also make this point. The plaintiffs point out that the Seattle income tax is not directed just at the "rich," because middle-class residents will have to pay it too under certain circumstances.

According to the legal brief filed by former State Attorney General Rob McKenna, former Chief Justice of the state Supreme Court Gerry Alexander and former state Supreme Court Justice Phil Talmadge:[9]

> "This lawsuit is intended to invalidate an unlawful income tax promoted to Seattle citizens under the false pretense that it will tax only the 'wealthiest residents' to satisfy a populist proposal to 'tax the rich.' However, the illegal tax is already targeted at, and certain to injure, numerous current and future residents who are nothing more than hard-working middle class citizens . . ."

The legal brief goes on to provide this hypothetical example:

> "Julia thinks taxing the rich is fair, but is surprised when her real estate agent informs her that, in addition to the excise tax of 1.78% on the sale price, she will pay an additional 2.25% in income tax on the amount by which her sales price, social security and pension for the year exceed $250,000. In other words, Julia is 'rich.' She had no idea that her nest egg, for which she already paid property taxes every year over 50 years, was targeted by the City's illegal Income Tax."

This means Seattle leaders treat Julia as if she is "rich" for one day (the day her house sold) and tax her income accordingly, even though she has never had $250,000 in annual earned income in her life.

Small business owners in Seattle could also be subject to city income tax

Along with those who sell a home in Seattle, small business owners who want to sell their businesses for retirement could also be subject to the new city income tax. The revenues realized from the sale of a business would be classified as capital gains. Consider this hypothetical from the McKenna legal brief:[10]

9 "Dena Levine, et al v. City of Seattle," Complaint for Declaratory and Injunctive Relief, King County Superior Court, August 9, 2017, at https://www.washingtonpolicy.org/library/docLib/income-tax-lawsuit.pdf.

10 Ibid.

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"Charles and Lynn could be first-generation residents of Seattle. Through hard work and ambition, they scrimped and eventually saved enough money to start their own small business. After more than 20 years of personal sacrifice, taking just enough in salaries to live on, they are ready to sell their business to fund their retirement, but with a gain of more than $500,000, and the City of Seattle will take a 2.25% cut. Regrettably, Charles and Lynn must sell their home in the International District and move to avoid Seattle's illegal tax on the sale of their business."

In this example Charles and Lynn are not "rich" by any common understanding of the term, yet they would be required to pay the Seattle income tax. The retirement savings of a modest-income couple who had worked hard their whole lives and sold their business would be unfairly targeted, even though income tax proponents say they only want to take additional money from "the rich."

Conclusion

The Seattle income tax is clearly an illegal local income tax so, depending on the decision of the courts, it is unlikely that Seattle homeowners and small businesses will ever face this added burden. Still, the text of the ordinance includes capital gains from the sale of a home or business as part of "total income" that would be taxed.

Thus, in the event the income tax does go into effect, it will snare far more than just "the rich" and will also burden many middle-class Seattle families.

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