

HB 1730 and SB 5111 would impose a capital gains income tax in Washington state

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Key Findings

1. **House Bill 1730 and Senate Bill 5111 would impose a 7.9% tax on certain capital gains income.**
2. **If enacted, this would be the first stand-alone capital gains income tax in the country.**
3. **No other state without an income tax taxes capital gains, and those states that do tax this type of income collect it through their state income tax code.**
4. **Supporters of House Bill 1730 and Senate Bill 5111 say the proposed tax is not on income; instead they call it an “excise tax for the privilege of selling or exchanging long-term capital assets.”**
5. **It is arguably, however, an unconstitutional form of income tax that will be challenged in court.**
6. **House Bill 1730 and Senate Bill 5111 supporters say a capital gains income tax is needed to provide a dependable funding source for education spending.**
7. **The volatile history of capital gains income taxes in other states, however, shows this form of taxation does not provide a predictable revenue stream.**

Introduction

Washington is currently one of nine states without a personal income tax. This includes no state tax on capital gains income. House Bill 1730 and Senate Bill 5111, however, would impose a new 7.9% tax on certain capital gains income.

If enacted, this would be the first stand-alone capital gains income tax in the country. No other state without an income tax taxes capital gains, and those states that do tax this type of income collect it through their state income tax code.

Supporters of these bills say the proposed tax is not on income; instead they call it an “excise tax for the privilege of selling or exchanging long-term capital assets.” It is arguably, however, an unconstitutional form of income tax that will be challenged in court.¹ This legal challenge could be used by proponents in attempt to overturn the state’s 84-year-old income tax ban that is based on past court decisions.²

Volatility of capital gains income taxes

House Bill 1730 and Senate Bill 5111 supporters say a capital gains income tax is needed to provide a dependable funding source for education spending. The volatile history of capital gains income taxes in other states, however, shows this form of taxation

1 “HB 1730: Enacting an excise tax on capital gains to improve the fairness of Washington’s tax system and provide funding for the education legacy trust account,” Washington State Legislature, January 27, 2017, at <http://app.leg.wa.gov/billsummary?BillNumber=1730&Year=2017>

2 “SJR 8204: Prohibiting a personal state or local income tax by amending the state constitution,” by Jason Mercier, Washington Policy Center, February 13, 2017 at <https://www.washingtonpolicy.org/publications/detail/sjr-8204-prohibiting-a-personal-state-or-local-income-tax-by-amending-the-state-constitution>

does not provide a predictable revenue stream. Here are reports about the experiences of other states with capital gains income taxes:

- California’s Legislative Budget Office (LAO) says: “Probably the single most direct way to limit the state’s exposure to the kind of extreme revenue volatility experienced in the past decade would be to reduce its dependence on the source of income that produced the greatest portion of this revenue volatility—namely, capital gains and perhaps stock options.”³
- More from the LAO: “California’s tax revenues have numerous volatile elements, but among the more significant sources of revenue volatility are the state’s tax levies on net capital gains through the personal income tax. Every budget outlook must make assumptions about Californians’ capital gains realizations, either explicitly or implicitly.”⁴
- Standard & Poor’s said in a national report, “State tax revenue trends have also become more volatile as progressive tax states have come to rely more heavily on capital gains from top earners.”⁵
- The Pew Charitable Trusts recently said, “The problem for states trying to predict revenues is that stock market fluctuations and other cyclical events have a larger impact on incomes at the top, causing revenues from income taxes and capital gains taxes to vary widely from year to year . . .

“The report said the growth in forecasting errors is mostly attributable to tax revenue volatility, which is driven by increased reliance on capital gains income taxes, and on corporate

income taxes, personal income taxes and sales taxes, besides volatility in corporate income taxes. Lesser errors are attributable to fluctuations in sales taxes . . . “

“Certainly when there are capital gains there is roller coaster revenue coming in when people sell (stocks) and pay the capital gains tax. If you budget that way for the next year and it doesn’t happen, you have a deficit,” Connecticut Democratic state Rep. Patricia Widlitz said.”⁶

The Washington state Department of Revenue (DOR) analysis of an earlier capital gains tax income bill (House Bill 2563 in 2012) found that:

“Capital gains are extremely volatile from year to year. Revenue from this proposal will depend entirely on fluctuations in the financial markets and can be expected to vary greatly from the amounts presented here.”⁷

DOR analysts do not include this warning in the fiscal note for this year’s bills, explaining that lawmakers are already informed about the well-understood volatility of a capital gains tax:

“When staff prepare the fiscal notes, they may or may not look at prior years’ notes as their starting point. In this case, staff said the volatility issue is understood and discussed by folks on the hill.”⁸

California’s budget has been particularly hard hit by the volatility of the state’s capital gains income taxes. So much so that in November 2014 voters there approved a constitutional amendment to require the state to put a specific percentage of its capital gains income tax revenue into a protected savings account so it could not be spent and exacerbate

3 “Revenue Volatility In California,” Legislative Analyst’s Office, State of California, January 2005 at http://www.lao.ca.gov/2005/rev_vol/rev_volatility_012005.htm.

4 “The 2015-16 Budget: California’s Fiscal Outlook,” Legislative Analyst’s Office, State of California, November 2014 at www.lao.ca.gov/reports/2014/budget/fiscal-outlook/fiscal-outlook-111914.pdf.

5 “Income Inequality Weighs On State Tax Revenues,” Standard & Poor’s, September 15, 2014 at https://www.globalcreditportal.com/ratingsdirect/renderArticle.do?articleId=1359059&SctArtId=263028&from=CM&nsl_code=LIME&sourceObjectId=8819204&sourceRevId=2&fee_ind=N&exp_date=20240914-19:27:33

6 “Volatile Income Tax Revenue Stumps States,” by Elaine S. Povich, The Pew Charitable Trusts, October 13, 2014 at <http://www.pewtrusts.org/en/research-and-analysis/blogs/stateline/2014/10/13/volatile-income-tax-revenue-stumps-states>.

7 “HB 2563: Establishing a state tax on capital gains,” Washington State Legislature, 2011-12 at <http://apps.leg.wa.gov/billinfo/summary.aspx?year=2011&bill=2563>.

8 E-mail from Kim Schmanke, Communications Director, Department of Revenue, February 10, 2015, copy available on request.

future budget shortfalls.⁹ Explaining the purpose of the voter-approved constitutional amendment the LAO said:

“This constitutional amendment separates state spending from the rollercoaster of revenue volatility. This measure takes capital gains revenues that make up more than 8% of the General Fund - the average for the last 10 years - off the table rather than being used for unsustainable permanent tax cuts or ongoing programs.

The spiking revenues (along with 1.5% of overall General Fund revenues) will be used for debt payments and deposited into the BSA [protected savings account], to be withdrawn during economic downturns to avoid program cuts and middle class tax increases.”¹⁰

California’s volatile experience with its capital gains income tax revenue, and the voters’ effort there to prevent the legislature from spending it too fast, shows that a state capital gains income tax is an unreliable source of revenue for funding ongoing government services.

Constitutional considerations

Supporters of House Bill 1730 and Senate Bill 5111 call their 7.9% capital gains income tax proposal an “excise tax for the privilege of selling or exchanging long-term capital assets,” but it may not be constitutional in Washington as an income tax. None of the states that do not have an income tax have a capital gains income tax. This is likely due to the fact capital gains are considered income.

Under the Washington state constitution, property cannot be taxed at a rate greater than 1% and the taxes must be uniform. The state supreme court has repeatedly ruled that “income” is property and that taxes on income must conform to the uniform 1% limit.

The Department of Revenue has confirmed that although the current fiscal notes for the most recent capital gains income tax proposal do not mention litigation, the concerns expressed in 2015 in the fiscal note for House Bill 1484 remain.¹¹ According to that fiscal note:

“We assume that because the capital gains tax is a new tax actions challenging its constitutionality will be filed in Superior Court . . . We assume up to five Superior Court actions will be filed challenging the constitutionality of the capital gains tax and that such court challenges will be filed after the effective date of the capital gains tax . . .”¹²

Although the bill supporters hope to prevail against these legal challenges by describing their capital gains income tax as an “excise tax,” it is arguably an income tax. As described by former supreme court justice Phil Talmadge in his legal analysis of 2010’s Income Tax Initiative 1098 (legal citations omitted):

“Washington law is unambiguous. Income is property. Beginning in Aberdeen Savings and Loan Association v. Chase, 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 7, section 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 7, section 2 of the Washington Constitution establishes the upper limit upon ad valorem property taxes. That constitutional restriction essentially limits any

9 “California Proposition 2, Rainy Day Budget Stabilization Fund Act (2014),” Ballotpedia at http://ballotpedia.org/California_Proposition_2,_Rainy_Day_Budget_Stabilization_Fund_Act_%282014%29.

10 “Bill Analysis,” Legislative Analyst’s Office, State of California, May 12, 2014 at http://www.leginfo.ca.gov/pub/13-14/bill/asm/ab_0001-0050/acax2_1_cfa_20140515_091436_asm_floor.html.

11 E-mail from Kim Schmanke, Communications Director, Department of Revenue, January 21, 2017, copy available on request.

12 HB 1484: Enacting an excise tax on capital gains to improve the fairness of Washington’s tax system and provide funding for the education legacy trust account,” Washington State Legislature, 2015-16 at <http://apps.leg.wa.gov/billinfo/summary.aspx?bill=1484&year=2015>.

property tax to no more than one percent of the value of the property.”¹³

On the issue of the Legislature trying to call an income tax an “excise tax” to pass constitutional muster, Justice Talmadge highlighted the decision in the case *Jensen v. Henneford*:

“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 . . . Subsequently, in Power, Inc v. Huntley, the Legislature enacted what it described as a corporate excise tax, which was actually a graduated new income tax on corporations. Again, the Supreme Court indicated that legislative labels for a tax are not controlling.”¹⁴

The national, nonpartisan Tax Foundation has also taken issue with calling the proposed capital gains income tax an “excise tax.” According to the Tax Foundation (emphasis added):

*“Forty-one states tax capital gains income. In all cases, it is captured by the state’s individual income tax and not by a discrete tax on capital gains. **Indeed, all states currently treat capital gains as income.** Proposals to label a Washington tax as an excise on buying and selling stock, designed to elide constitutional restrictions, fall apart when one considers that the ‘excise’ is imposed on realized gains less losses (that is, income), and not on total share value or financial transactions . . .”*

*“Foregoing an income tax is the Washington tax system’s competitive advantage, an inducement to individuals and entrepreneurs alike. **And make no mistake, a capital gains tax is a form of income tax.** Every tax system has its selling point, and this is Washington’s— one that could be seriously undermined by capital gains taxation. More importantly, such*

a tax could undermine the very programming it is designed to fund.”¹⁵

It is clear that litigation is certain if a capital gains income tax is adopted. It is likely the fact that no other state without an income tax has a capital gains income tax will be used to justify the position of those who believe a capital gains tax is a tax on income.

State Department of Commerce reported lack of capital gains income tax as a “competitive advantage”

To help market the state of Washington to potential businesses the state’s Department of Commerce runs a website called “Choose Washington.” Under the tab “Why Washington” you can select “Our Strengths.” Under that tab you will find a page called “Pro-Business.”

Up until at least February 8, 2015, that “Pro-Business” page read (emphasis added)

*“We offer businesses some competitive advantages found in few other states. **These include no taxes on capital gains** or personal or corporate income. We also offer industry-specific tax breaks to spur innovation and growth whenever possible.”¹⁶*

That highlighted text advertising no state capital gains income tax has since been removed from the “Choose Washington” page. When asked why this decision was made the Department of Commerce said:

“Currently there are multiple revenue proposals and tax preferences in play in the Legislature, including capital gains and R&D incentives, for example. You see a normal refresh of online marketing content to reflect that. We think it would be disingenuous not

¹³ “Constitutionality of Initiative 1098,” by Phil Talmadge, August 19, 2010 at <http://www.washingtonpolicy.org/sites/default/files/Talmadge-Letter-Initiative-1098.pdf>.

¹⁴ Ibid.

¹⁵ “Capital gains taxes are too unreliable to fund education,” by Jared Walczak, *Tri-City Herald*, May 12, 2016 at <http://www.tri-cityherald.com/opinion/editorials/article77338462.html>

¹⁶ “Choose Washington – Pro-Business,” Washington State Department of Commerce, February 8, 2015 archive via *Internet Archive Way Back Machine* at <https://web.archive.org/web/20150208055407/http://choosewashingtonstate.com/why-washington/our-strengths/pro-business/>

to adjust our marketing messages about tax policy and preferences accordingly.”¹⁷

Based on archived versions of the “Pro-Business” page, the reference to no capital gains income taxes as being a “competitive advantage” for businesses in Washington had been on that page from at least 2012 until February 8, 2015.¹⁸

Conclusion

Supporters of House Bill 1730 and Senate Bill 5111 argue their proposed 7.9% capital gains income tax proposal would provide a dependable revenue source that can be used for education spending. Experience shows, however, that capital gains income tax revenue is highly volatile.

The volatility of capital gains income taxes in California has wreaked havoc on that state’s budget. This is why voters there recently approved a constitutional amendment to require the state put a specific percentage of its capital gains tax revenue into protected savings, so it couldn’t be spent and make future budget shortfalls worse.

If enacted, the capital gains income tax would certainly face legal challenges for being an unconstitutional tax on income. The bill proposes a rate of 7.9%, far above the uniformed 1% limit required by the constitution. It is noteworthy that none of the states without an income tax have a capital gains tax. This is likely due to the fact capital gains are considered to be income. There is also the risk that adoption of a capital gains income tax could be used in attempt to create a test case to get today’s state supreme court to overturn the state’s well-established 84-year-old income tax ban.

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construed as an attempt to
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17 E-mail from Penny Thomas, Communications Director, Department of Commerce, March 2, 2015, copy available on request.

18 “Choose Washington – Pro-Business,” Washington State Department of Commerce, December 13, 2012 archive via *Internet Archive Way Back Machine* at <https://web.archive.org/web/20121213195601/http://choosewashingtonstate.com/why-washington/our-strengths/pro-business/>