

SB 5096 would impose a 9% income tax on capital gains in Washington state

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Key Findings:

1. There is no question SB 5096 would impose an income tax in Washington state. The Federal Internal Revenue Service (IRS) unequivocally says a capital gains tax is an income tax.
2. If enacted, SB 5096 would be the first stand-alone income tax on capital gains in the country.
3. No other state without a personal income tax has a capital gains tax, and those states that do tax capital gains income collect the tax through their state income tax code.
4. Officials in every state revenue department across the country agree that income taxes on capital gains are extremely volatile and unpredictable.
5. If enacted, the proposed 9% income tax on capital gains would certainly face legal challenges for being an unconstitutional tax on income.
6. Washington's Department of Commerce has made the state's lack of an income tax a major selling point for its "Choose Washington" campaign.

Introduction

Washington is currently one of nine states without a personal income tax. This includes no state tax on capital gains income. Senate Bill 5096, however, would impose a new 9% tax on certain capital gains income. The bill's tax would apply to personal income defined as "Federal net long-term capital gain - the net long-term capital gain reportable for federal income tax purposes..."

Senate Bill 5096 was introduced for the 2021 Legislative Session would also

require that "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."¹

There is no question SB 5096 would impose an income tax in Washington state. The Federal Internal Revenue Service (IRS) unequivocally says a capital gains tax is an income tax. In a September 25, 2018 letter the IRS said:

"This is in response to your inquiry regarding the tax treatment of capital gains. You ask whether tax on capital gains is considered an excise tax or an income tax? It is an income tax. More specifically, capital gains are treated as income under the tax code and taxed as such."²

If enacted, SB 5096 would be the first stand-alone income tax on capital gains in the country. No other state without a personal income tax has a capital gains tax, and those states that do tax capital gains income collect the tax through their state income tax code.³

Supporters say the tax proposed by SB 5096 is not an income tax; instead they call it an "excise tax." It is arguably, however, an unconstitutional form of income tax that will be challenged in court. This legal challenge could be used by proponents in an attempt to

1 "SB 5096: Concerning an excise tax on gains from the sale or exchange of certain capital assets," Washington State Legislature, January 6, 2021, at <https://app.leg.wa.gov/billsummary?BillNumber=5096&Initiative=false&Year=2021>.

2 "IRS: Capital gains tax 'is an income tax,'" by Jason Mercier, Washington Policy Center, September 25, 2018, at <https://www.washingtonpolicy.org/publications/detail/irs-capital-gains-tax-is-an-income-tax>.

3 "State Revenue Departments Describe Capital Gains Income Taxes," by Jason Mercier, Washington Policy Center, April 10, 2017, at <https://www.washingtonpolicy.org/library/docLib/statedorscapitalgainsincome-1.pdf>.

overturn the state's graduated income tax ban that is based on past court decisions.⁴

Volatility of revenue from income taxes on capital gains

Senate Bill 5096 supporters say an income tax on capital gains is needed to provide dependable and stable funding for state spending. The volatile history of income taxes on capital gains in other states, however, shows this form of taxation 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."⁵
- More from California's 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."⁶
- Virginia's state economist told me: "Capital gains is the most volatile tax source that any state has to forecast. It is not dependable or stable."

In fact, officials in every state revenue department across the country agree that

income taxes on capital gains are extremely volatile and unpredictable.⁷

Constitutional considerations

Supporters of Senate Bill 5096 call their 9% income tax on capital gains an "excise tax." It is clearly an income tax, however. None of the states that do not have a personal income tax have an income tax on capital gains. This is likely due to the fact capital gains is considered income.

Under the Washington state constitution, property cannot be taxed at a rate greater than 1% and the taxes must be uniformly applied to all residents. The state supreme court has repeatedly ruled that a person's "income" is property and that taxes on income must conform to the uniform 1% limit.

Although the bill supporters this year hope to prevail against these legal challenges by describing their income tax on capital gains as an "excise tax," it is clearly 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

4 "Lawmaker's emails confirm goal for capital gains proposal is broad income tax," by Jason Mercier, Washington Policy Center, March 26, 2020, at <https://www.washingtonpolicy.org/publications/detail/lawmakers-emails-confirm-goal-for-capital-gains-proposal-is-broad-income-tax>.

5 "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.

6 "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.

7 "State tax officials across country agree – capital gains income taxes are extremely volatile and unpredictable," by Jason Mercier, Washington Policy Center, September 30, 2019, at <https://www.washingtonpolicy.org/publications/detail/state-tax-officials-across-country-agree-capital-gains-income-taxes-are-extremely-volatile-and-unpredictable>.

taxes. That constitutional restriction essentially limits any property tax to no more than one percent of the value of the property.”⁸

On the issue of the legislature trying to call an income tax an “excise tax” to pass constitutional muster, former 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.”⁹

On September 13, 1960 the state Supreme Court issued a unanimous one-page ruling with this sage advice: Don’t ask the Court to reverse its numerous rulings prohibiting a graduated income tax; instead amend the state constitution.¹⁰ Washington state voters have already rejected 6 constitutional amendments to allow a graduated income tax.¹¹

State Department of Commerce reported lack of income tax on capital 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.”¹²

That highlighted text advertising no state income tax on capital gains has since been removed from the “Choose Washington” page. Based on archived versions of the “Pro-Business” page, the reference to no income tax on capital gains as being a “competitive advantage” for businesses in Washington had been on that page from at least 2012 until February 8, 2015 when Governor Inslee issued his support of an income tax on capital gains.¹³ In the meantime, the competitive advantage that the policy of having no income tax brings to the people of Washington state has not changed.

Conclusion

Supporters of Senate Bill 5096 argue their proposed 9% income tax on capital gains would provide a dependable and stable revenue source that can be used for government spending. The experience of other states shows, however, that income taxes on capital gains are highly volatile.

If enacted, the income tax on capital gains would certainly face legal challenges for being

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

9 Ibid.

10 “Timeless advice from WA Supreme Court on income taxes,” by Jason Mercier, Washington Policy Center, September 6, 2017, at <https://www.washingtonpolicy.org/publications/detail/timeless-advice-from-wa-supreme-court-on-income-taxes>.

11 “Income Tax Ballot Measures,” Washington State Secretary of State’s Office, accessed on January 8, 2021, at <https://www.sos.wa.gov/elections/research/income-tax-ballot-measures.aspx>.

12 “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/>

13 “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/>

an unconstitutional tax on income. The bill proposes a rate of 9%, far above the 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 income. There is also the risk that adoption of an income tax on capital gains could be used in attempt to create a test case to get today's state supreme court to overturn the state's well-established graduated income tax ban.

Whether or not Washington state has an income tax is an appropriate policy and economic debate if conducted within constitutional constraints. Pretending a proposed income tax isn't one, however, is disingenuous and does a great disservice to that debate.

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