WASHINGTON

Washington Supreme Court Upholds Capital Gains Tax

by Paul Jones

Washington state's capital gains tax is a lawful excise tax, not an unconstitutional income tax, the state supreme court has held.

"The capital gains tax is appropriately characterized as an excise because it is levied on the sale or exchange of capital assets, not on capital assets or gains themselves," the Washington Supreme Court's majority wrote in its March 24 decision upholding the levy in the consolidated cases *Quinn v. Washington* and *Clayton v. Washington*. The majority opinion was authored by Justice Debra L. Stephens.

The decision is a win for the State Legislature's Democratic majority, which approved the tax in 2021 to serve as a progressive source of revenue to fund education and child care and early learning. It also means the Legislature won't have to fill a potential hole in the state's budget that was anticipated if the tax were struck down. Taxpayers must file the tax by April 18.

"This legal victory represents a significant win for education," state Attorney General Bob Ferguson (D) said in a March 24 tweet after the ruling's release. He said the ruling "protects funding for early learning, child care programs, and school construction."

Gov. Jay Inslee (D) also tweeted out his reaction, stating that "For 134 years, Washington state has been waiting for the day when a fairer tax system came about" and thanking lawmakers and justices. "Washington's capital gains tax helps right an upside-down tax structure."

Two justices dissented, arguing that the court should have treated the capital gains tax as an income tax that violated constitutional rules for taxing property.

The Freedom Foundation, a group backing one of the consolidated cases to overturn the tax, said in a statement that the decision was "stupefying" and subordinated "the state constitution and the expressed will of the people to the political whims of Washington's tax-and-spend liberals." Accusing the court of judicial activism, the group argued that the tax violates the U.S. Constitution and that it has been preparing "for an appeal to the U.S. Supreme Court" in anticipation of an adverse ruling.

Progressives said they hope the decision will have broader effects. The Washington State Budget and Policy Center argued that advocates will be "bolstered by this win" and advocated that lawmakers consider approving a wealth tax proposal and other progressive changes. Tax watchdogs warned the decision could have greater consequences as well.

"For all intents and purposes, the court just legalized a wage income tax as well," tweeted Jared Walczak, vice president for state projects at the Tax Foundation. "They acknowledge a century of precedent against income tax, but absurdly distinguish because this income is earned by an exercise of rights. Well, what income isn't?"

The levy — a 7 percent tax on residents' annual long-term capital gains exceeding $250,000, with exceptions — was targeted by businesses and other critics as soon as it was passed in 2021, with opponents arguing it violated the state's long-standing prohibition on progressive taxation of income. Washington treats income as a form of property under long-standing precedent dating back to 1933 (*Culliton v. Chase*), and the state constitution requires all property within a class to be uniformly taxed at a rate of no more than 1 percent.

A trial court sided with opponents of the tax in March 2022, striking it down for violating the state constitution, and the supreme court decided to review the decision directly. The state argued that the tax was an excise tax on the sale and exchange of capital assets, not an income tax, and was thus not subject to the uniformity requirement. Intervenors representing education groups argued that the court should overturn the 1933 precedent, which would open the door to progressive income taxation in the state.

The supreme court determined that the tax was an excise tax, not a tax on income, and thus didn't violate the state constitution's requirement for uniform taxation of property. It didn't revisit the 1933 precedent, however, noting that it declined to reexamine *Culliton* because "article VII's uniformity and levy limitations on property taxes do not apply" to excise taxes.

Viewing the levy as an excise tax rather than a tax on income "is consistent with a long line of precedent recognizing excise taxes as those levied on the exercise of rights associated with property ownership, such as the power to sell or exchange property, in contrast to property taxes levied on property itself," the court reasoned. "Because the capital gains tax is an excise tax under Washington law, it is not subject to the uniformity and levy requirements of article VII. We further hold the capital gains tax is consistent with our state constitution's privileges and immunities clause and the federal dormant commerce clause."

"We therefore reject Plaintiffs' facial challenge to the capital gains tax and remand to the trial court for further proceedings consistent with this opinion," the court said.

A Tax on Activity

The court endorsed progressives' policy argument for the tax, agreeing that "the poorest individuals bear the greatest tax burden due in large part to our heavy reliance on sales taxes and the lack of a graduated income tax, with low wage earners paying nearly six times more in state taxes as a percentage of personal income than Washington's wealthiest residents." It reviewed the history of the state's unique tax regime, stating that the regressive system that resulted "perpetuates systemic racism by placing a disproportionate tax burden on BIPOC [Black, Indigenous, and People of Color] residents" who are disproportionately lower earners in the state.

In reviewing the legal arguments, the court sided with the state in rejecting opponents' characterization of the levy as a tax on Washingtonians' income from capital gains, writing that the "capital gains tax is an excise tax because taxpayers do not owe the capital gains tax merely by virtue of owning capital assets or capital gains, like a property tax," but only as a result of selling long-term assets. Justices wrote that the levy "taxes transactions involving capital assets — not the assets themselves or the income they generate."

The court noted that on the same day in 1933 that it ruled that income was property in *Culliton*, it also upheld the state's first business and occupation tax — Washington's gross receipts tax — in *State ex rel. Stiner v. Yelle*. That levy "assessed a tax on 'the privilege of engaging in business activities' in this state, as measured by 'gross proceeds of sales, or gross income, as the case may be,'" the majority said. The 1933 court "held the B&O tax is an excise [tax], reasoning it 'does not concern itself with income which has been acquired.'" According to the 1933 decision in *Stiner*, "that the amount of the tax is measured by the amount of the income in no way affects the purpose of the act or the principle involved."

"*Stiner* therefore distinguished between a property tax *on* income and an excise tax on a particular activity or privilege, which tax is *measured by* income," the court continued (emphasis in original), applying that reasoning to the capital gains tax, which is measured by net income from the sale of gains.

The court noted that a property tax is "'a tax which falls upon the owner merely because [they are an] owner, regardless of the use or disposition made of [their] property.'" It said excise taxes include those on "a particular use of property or the exercise of a single power over property incidental to ownership." The court added that the state's tax on the sale of real estate was upheld as an excise tax, even though it involves the sale of property.

It also asserted that the capital gains tax isn't like the income taxes barred under the *Culliton* precedent. "This tax is wholly unlike the broad-based net income taxes we previously invalidated under *Culliton*. Those taxes applied to the taxpayer's aggregate net income and were untethered to any specific taxable activity; rather, the taxable incident was the receipt of income itself," the court said. "This tax specifically targets an activity long recognized as subject to excise taxation — the sale or exchange of property." The tax "is not levied on capital gains; rather, it is measured by capital gains," the court said.

The majority opinion rejected the opponents' argument that basing the tax on the amount of gains effectively made it a tax on income from the sale of assets. "We have upheld many excise taxes measured by income," the court said. Regarding the many deductions allowed by the tax, such as for retirement accounts, real estate transactions, qualifying family-owned businesses, and

charitable donations, the court said that "many valid excise taxes contain similar features."

The court rejected the argument that the tax isn't an excise tax because it applies to sales of capital assets that aren't undertaken voluntarily by their owners, as when assets are sold by a trust on beneficiaries' behalf: "'Voluntariness' in this context is best understood as pertaining to some action that results in a sale or transfer of property as the taxable event, whether or not reflecting the individual will of the taxpayer." The court also found that the lack of a specific privilege being taxed wasn't relevant: "The capital gains tax belongs to this distinct category of excise taxes relating to incidents of property ownership, so the lack of any taxable privilege is immaterial."

The supreme court said the lower court's decision had improperly determined that the tax was an income tax in part by noting similarities between its incidents and those of the federal income tax. The high court said the federal income tax "is considered an excise tax under federal law" and that to evaluate whether the capital gains tax is a property tax — and thus in violation of the state's constitution — required evaluating Washington cases that "have articulated clear principles for distinguishing property and excise taxes."

In reviewing the trial court's reasoning, the court dismissed the idea that the use of a taxpayer's federal income tax return to calculate the tax was relevant, noting that "reliance on federal tax reporting mechanisms does not transform the capital gains tax into a property tax."

The court also rejected the arguments that the tax violated the state's privileges and immunities clause and determined that the tax doesn't violate the U.S. Constitution's dormant commerce clause, reviewing it in the context of the four-pronged *Complete Auto* test. For example, regarding the state's taxation of sales of out-of-state capital assets owned by a Washington resident, the court determined that U.S. Supreme Court precedent supports the right of the state to tax those sales.

"The taxable incident is the taxpayer's exercise of their power to dispose of capital assets," the court said. "That power is exercised in the state where the taxpayer is domiciled."

The court also determined that the tax was fairly apportioned, noting that the statute "also includes a tax credit to prevent any possible multiple taxation" and that "limited possibility of multiple taxation" isn't enough to overturn a tax.

Dissenting Opinion

The dissenting minority opinion, authored by Justice Sheryl Gordon McCloud and joined by Associate Chief Justice Charles W. Johnson, disputed the majority's reasoning.

"The majority . . . concludes that the capital gains tax constitutes an excise tax because 'it taxes transactions involving capital assets — not the assets themselves or the income they generate,'" Gordon McCloud said. But the "plain language, context, and practical impact of the statute all compel the opposite conclusion: [the capital gains tax] taxes the 'gains' or income 'recognized' by the transferrer of a qualifying capital asset. The statute does not tax the transfer itself."

Gordon McCloud said the capital gains tax statute's "plain language provides that '[t]he tax applies when the Washington capital gains *are recognized by the taxpayer* in accordance with this chapter'" (emphasis in dissenting opinion) and notes that no tax is due if there are no gains from the sale of assets.

Acknowledging that the court's cases "have held that an excise tax may be measured by some kind of income," Gordon McCloud added that "in every case where this court upheld an excise tax that was measured by income, the tax was measured by gross income — not by net income."

"I can find no Washington case upholding a tax as an excise where the measure of the tax was *net* income or gain. Instead, such taxes have consistently been invalidated as nonuniform property taxes," Gordon McCloud said (emphasis in original).

The dissent also asserted that the tax is levied on income and thus violates the state constitution's uniformity requirements for taxes on property. "A tax is determined by its incidents, not by its legislative label. The structure of the capital gains tax shows that it is a tax on income resulting from certain transactions — not a tax on a transaction *per se*" (italics in original). "Deciding whether to retain our regressive tax structure or to replace it with a more equitable one is up to the

legislature through legislation and the people through constitutional amendment. The duty of the judiciary when faced with a direct conflict between a statute and the constitution is to uphold the constitution."

Jason Mercier with the Washington Policy Center, a critic of the tax, told *Tax Notes* March 24 that opponents may indeed pursue a U.S. Supreme Court case to overturn it. He argued that the majority's opinion treating the tax as an excise tax raised commerce clause issues and rejected the majority's conclusion to the contrary.

"There are 41 states that tax capital gains income . . . not as standalone taxes" but rather as income taxes, he said. "You can't tax activities in other states, and if this is an excise tax, you're taxing activities in other states."

Mercier said there may also be an effort by opponents to overturn the tax via a ballot measure — but he said the court's decision could also be an indication that justices with the majority might also ultimately overturn *Culliton*'s long-standing precedent treating income as property.

"They had a lot of Easter eggs in this opinion that made it sound like they might be sympathetic to a future case on that," he said.

The consolidated cases' docket number is 100769-8. The respondents in *Quinn v. Washington* are represented by attorneys with Lane Powell PC and the Freedom Foundation. The respondents in *Clayton v. Washington* are represented by attorneys with Orrick Herrington & Sutcliffe LLP and Foreman, Hotchkiss, Bauscher & Zimmerman PLLC. The intervenors are represented by attorneys with Pacifica Law Group LLP. ■