

## Proposed Washington Capital Gains Tax – HB 1484/SB 5699

Governor Inslee is proposing a capital gains tax on the sale of stocks, bonds and other assets to increase the share of state taxes paid by Washington's wealthiest taxpayers. The state would apply a 7 percent tax to capital gains earnings above \$25,000 for individuals and \$50,000 for joint filers.

The new tax would affect an estimated 32,000 taxpayers. Retirement accounts, homes, farms and forestry are exempt. The proposal will raise an estimated \$798 million in fiscal year 2017. The actual amount collected will depend on fluctuations in the financial markets, and can be expected to vary from year to year. The state can manage these fluctuations through careful budgeting.

Earned income from salaries and wages are not capital gains and will not be taxed at all under this proposal.

## Frequently Asked Questions

### What is the threshold amount for owing the proposed tax?

The proposal applies only to long-term capital gains income above the threshold amount of \$25,000 for single filers and \$50,000 for married couples or state-registered domestic partners filing jointly. For example, a single filer with an adjusted federal long-term capital gain of \$30,000 in a taxable year would report Washington capital gains of just \$5,000.

### Do I have to file anything if I don't have any capital gains?

No. Washington residents with no capital gains will not need to file a return with the Washington State Department of Revenue.

### What if I pay capital gains taxes to another state?

Individuals can take a credit equal to the amount of tax paid to another taxing jurisdiction on capital gains derived from sources within the other taxing jurisdiction and also subject to the proposed Washington capital gains tax.

A "taxing jurisdiction" includes other states, territories or possessions of the United States, including the District of Columbia and the Commonwealth of Puerto Rico.

Federal taxes are **not** considered taxes paid to another taxing jurisdiction.

### **Does the proposed tax apply to short-term gains?**

No. The proposal applies only to long-term capital gains because the tax is based on the amount of net long-term capital gain reportable for federal purposes. Short-term capital gain is ordinary income for federal tax purposes, and would not be taxed under the Washington capital gains tax proposal.

### **Do any federal tax exemptions or deferrals apply?**

Yes. The proposal is based on the amount of capital gains reported on your federal taxes. If an amount of gain is not reportable on your federal tax return because it is exempt under federal law, it is also exempt from the Washington capital gains tax. It is the same for federal deferrals. If you are allowed to defer reporting capital gains for federal tax purposes, you may also defer reporting for Washington capital gains tax purposes.

### **Do my capital losses carry over?**

If your federal capital gains are less than zero, you will report zero capital gains for Washington tax purposes. Any long-term losses that you carry over for federal tax purposes will also be carried over for Washington tax purposes. If your total Washington capital gains are reduced below zero as a result of Washington-specific deductions, those deductions are not losses that can be carried over to future years.

### **Will the proposed tax apply to my retirement accounts?**

No. The proposed Washington capital gains tax does not apply to sales of assets within, or distributions from, a 401(k), individual retirement account (IRA), Roth IRA, individual retirement annuity, defined benefit plan or defined contribution program, 403(b) tax-sheltered annuity or custodial account, or similar retirement savings vehicles.

### **What is the personal residence exemption?**

Gains from the sale of a home you have owned for at least 20 years, and used as your principal residence for at least 10 years, are exempt from the capital gains tax. There is no limit on the gain that is exempt, or the number of times this “20/10” exclusion is available.

If you do not qualify for the 20/10 exclusion, you may still exclude gain if you qualify for the federal income tax exemption for a personal residence (IRC § 121). For federal tax purposes, you may generally exclude up to \$250,000 in gain, or \$500,000 for married filing jointly, if you:

- Have owned the residence for at least two years; and
- Used the home as your principal residence for an aggregate of two years during the five years immediately prior to the date of sale.

The period of ownership and the period of use need not be concurrent.

This \$250,000/\$500,000 exclusion is available to take every two years, and is expanded for Washington purposes to also apply to registered domestic partners.

A recent [National Association of Home Builders](#) study found that the average length of homeownership is about 13 years.

More details on the federal exemption (IRC § 121) are available in the IRS Publication 523 (located at <http://www.irs.gov/publications/p523/ar02.html>).

## How does the personal residence exemption work?

The following examples illustrate how the personal residence exemption works.

### **Example 1** (*20/10 exclusion*)

Taxpayer A purchased a house in 1975, using it as A's principal residence until 1990, and then converted the house to a rental. Taxpayer A sells the house in 2015. Taxpayer A may exclude all gain from the sale of the home because A owned the home for at least 20 years and used it as a principal residence for at least 10 years.

### **Example 2**

Taxpayer B, an unmarried individual, purchases a house Jan. 1, 2010, and uses it as B's principal residence until Dec. 31, 2013. Beginning Jan. 1, 2014, Taxpayer B rents the home to tenants. On Jan. 1, 2015, Taxpayer B sells the house. Taxpayer B qualifies to exclude up to \$250,000 in gain from the sale of the house because:

- B owned the house for at least two of the years as of the date of sale.
- B used the house as a principal residence between Jan. 1, 2010, and Dec. 31, 2013, and this satisfies the two-year use requirement.

### **Example 3**

Taxpayer C owns and uses a house as C's principal residence from Jan. 1, 2002, until the end of 2004. On Jan. 1, 2005, Taxpayer C moves to another state. Taxpayer C's son moves into the house and lives there until the house is sold on July 1, 2008. Taxpayer C may not exclude any gain from the sale because C used the house as a principal residence for less than two years (July 1, 2003, to the end of 2004) in the five years immediately preceding the date of sale.

#### **Example 4**

Taxpayer D lives in a house rented from its owner from 1998 through 2002. On Jan. 1, 2003, Taxpayer D purchases the house. On Jan. 1, 2004, Taxpayer D moves into a care facility. Taxpayer D sells the house on July 1, 2005, while still living at the care facility. Taxpayer D may exclude up to \$250,000 of gain from the sale, or up to \$500,000 if filing jointly with a spouse or domestic partner, because D owned the house for at least two years and used the house as D's principal residence for at least two years in the five-year period immediately preceding the date of sale.

#### **How does the capital gains tax apply to the sale of a rental home?**

The sale of a rental home may qualify for the personal residence exemption, discussed above. If the rental home does not qualify, gain from the sale of the rental home will be subject to the proposed capital gains tax if it is reported as capital gain for federal tax purposes.

The sale of depreciated business real estate may be reported as ordinary income or as capital gains for federal tax purposes ("Section 1231 property"). Generally, the portion of gain that results from depreciation must be reported as ordinary income, with the rest taxable as capital gains. However, there are some federal tax deferral mechanisms that may apply (e.g., §1031 exchanges).

#### **What is my gain on the sale of my residence?**

The gain on the sale of your residence is the same amount of gain you would report for federal tax purposes, which is generally the difference between your home's basis and the amount you are selling it for.

Information on determining basis is available from the IRS Publication 523, Selling Your Home (<http://www.irs.gov/publications/p523/ar02.html>), but in general:

- Your home's basis is equal to your costs to acquire the home plus the cost of home improvements that have a useful life of more than one year.
- Costs to acquire a home include cash as well as debt obligations (loans), and certain settlement fees and closing costs, although not financing fees.
- Improvements with a useful life of more than one year include such things as new additions, windows, security systems, heating systems or furnaces, insulation, wiring upgrades, fences, driveways and walkways.
- Your basis may be reduced by such things as insurance payments for casualty losses or depreciation deductions if you have used the home for business or as a rental.

## **What if I pay B&O tax on the gain from the sale of assets?**

A B&O tax deduction is available if a taxpayer pays B&O tax on the sale of assets, and that income is also subject to the proposed Washington capital gains tax.

For example, if a taxpayer is engaged in the business of selling the type of asset at issue, B&O tax is generally due on the income from that sale. Income from the sale of such assets is also potentially reportable under the proposed Washington capital gains tax. If both the B&O tax and the capital gains tax apply, a B&O tax deduction would be available to the extent necessary to avoid being taxed twice on the same income.

## **How does the tax work for a pass-through entity such as a limited liability company, partnership or S-corporation?**

For federal tax purposes, when one of these “pass-through” entities sells a long-term capital asset, the entity does not report capital gain. Instead, the capital gain is reported, and the tax paid, by the entity owner or owners (each paying a proportionate share).

Just like at the federal level, under the proposed Washington capital gains tax, when a pass-through entity sells a long-term capital asset, the capital gain would be reported and paid by the entity owner(s).

However, many sales of assets by a business entity are not capital in nature, such as the sale of inventory. In addition, the proposed Washington capital gains tax expressly exempts many asset sales by a business, such as:

- The sale or exchange of certain depreciable tangible personal property used in a business
- The sale or exchange of certain expensed tangible personal property used in a business, up to the federal limit.

In addition, capital gain income of C-corporations is not passed through to corporate owners (shareholders) and would not be subject to the proposed Washington capital gains tax.

## **Are distributions from my limited liability company or dividends from a corporation considered capital gains?**

Distributions are generally not treated as capital gains for federal tax purposes and would not be subject to the proposed Washington capital gains tax. While some types of ordinary dividends (“qualified dividends”) are reported as capital gains for federal tax purposes, they are not gains of the individual derived from the sale of assets and not subject to the Washington capital gains tax.

## How does the tax apply when I sell my stock or ownership interests in my business?

Ownership interests or stock in your business are treated the same as other investments in securities. If the sale of ownership interests or stock in your business is reportable as long-term capital gain for federal tax purposes, it is reportable under the proposed Washington capital gains tax.

However, there are some federal tax exemptions related to the purchase or sale of business stock, and those will also apply to the proposed Washington capital gains tax.

## How does the capital gains tax apply to trusts?

### **Grantor trusts:**

A grantor trust is a disregarded entity for federal tax purposes. Any long-term capital gains on the sale or disposition of assets held by the trust will be reported on the grantor's federal tax return. Therefore, a grantor who is an individual will also report those capital gains for Washington capital gains tax purposes.

### **Non-grantor trusts:**

In general, a non-grantor trust does not distribute income from the sale of capital assets. Gains from the sale of a capital asset are typically held as additions to principal and taxed at the trust level. Because a trust is not an individual subject to the Washington capital gains tax, no Washington capital gains tax would be due on gains retained by the trust. However, in some cases a non-grantor trust will distribute income that represents gain from the sale of capital assets rather than retain the income. Individual beneficiaries will need to report distributed long-term capital gain income under the proposed Washington capital gains tax.

There are also circumstances where the trustee will declare capital gain to be distributable income rather than an addition to principle, but not actually distribute the income to the beneficiaries. Under the proposed Washington capital gains tax, these amounts are reportable by individual beneficiaries when the income is declared as distributable.

## How does the capital gains tax apply to distributions from real estate investment trusts (REIT)?

Please read about capital gains and trusts, above.

REIT income generally includes collected rents, interest income and gains from the sale or disposition of property. If the REIT income is retained as principal, capital gains would be taxed at the trust level. Because a trust is not an individual subject to the Washington capital gains tax, no tax would be due on gains retained by the trust.

Like other non-grantor trusts, a REIT may also declare capital gains income as distributable income. Individual beneficiaries will need to report any distributed capital gain income under the proposed Washington capital gains tax. If a REIT declares capital gain income as distributable income but does not actually make a distribution, the capital gain income is reportable by individual beneficiaries when the income is declared as distributable.

### **How do the proposed tax exemptions apply for agriculture and timber?**

Agriculture:

The sale or exchange of cattle, horses or breeding livestock held for more than 12 months is exempt from the proposed Washington capital gains tax, provided more than more than 50 percent of the taxpayer's gross income is from farming or ranching. The sale of agricultural land held for at least 10 years if the taxpayer has regular, continuous and substantial involvement in the operation of the agricultural land is exempt from the proposed Washington capital gains tax.

Timber:

A taxpayer who sells or cuts timber and elects to treat the activity as a capital gain for federal tax purposes under Section 631(a) or (b) is exempt from the proposed Washington capital gains tax.

### **How much will the state collect under the tax?**

After exemptions to remove any capital gains tax on retirement accounts, homes, farms and forestry, the proposal will raise an estimated \$798 million in fiscal year 2017. This estimate is an average based on 10 years of data; the actual amount collected from this tax would be expected to vary from year to year depending on fluctuations in the financial markets. The state can manage these fluctuations through careful budgeting. For example, Governor Inslee's budget projects the state would have about \$2 billion in total reserves by the end of the 2017–19 biennium.