

Memorandum

To: Andy Nicholas, Policy Analyst
Washington State Budget and Policy Center

From: Hugh Spitzer

Date: December 15, 2011

Subject: Character of Proposed State Capital Gains Tax

You have asked whether the capital gains tax described in the Washington State Budget & Policy Center's paper entitled *A Capital Reform*, would be treated as an excise tax or a property tax by Washington courts. Under the proposal, a five percent tax would be imposed on the capital gains above \$10,000 realized upon the sale or other transfer of assets. In my view, there is a reasonable likelihood that courts would treat this tax on the realization of capital gains as what it is structured to be, *i.e.*, an excise tax rather than a property tax.

It is likely that a tax on the realization of capital gains would be challenged on the grounds that it is an income tax or some other form of "property tax." In *Culliton v. Chase*, 174 Wash. 363, 25 P.2d 81 (1933), the Washington State Supreme Court held by a 5-4 vote that a net income tax is a property tax and therefore is subject to the Washington Constitution's property tax uniformity requirement and subject to the one percent limit on non-voted property taxes. The Court's lead opinion observed that Article VII, Section 1 of the State Constitution defines property as "everything, tangible or intangible, subject to ownership," and the opinion asserted that "income is either property...or no one owns it." 174 Wash. at 374. That opinion stated that if the tax had been imposed on corporate or business privileges, or on "the manufacture, sale or consumption of commodities," then it would have qualified as an excise tax. 174 Wash. at 378. Indeed, on the same day that *Culliton* was decided, the Court (also by a 5-4 vote) ruled that a gross receipts tax on business income (the "business and occupation tax") is an excise tax rather than a property tax. *State ex rel. Stiner v. Yelle*, 174 Wash. 402, 25 P.2d 91 (1933). In *Stiner*, Justice Tolman concluded that because the benefits of government enabled a businessperson to be "secure in his property, investment, and also in his gains therefrom," this privilege, "far above mere property," was the thing being taxed so that the beneficiary would pay his "fair share of the cost to the state of its creation and continuance." 174 Wash. at 406. Because a gross receipts tax was an excise tax, the Court held that there could be various exclusions and exemptions from its effect without violating the constitutional uniformity provision applicable to property taxes.

174 Wash. at 104-08. *See also, Supply Laundry v. Jensen*, 178 Wash. 72, 34 P.2d 363 (1934).¹

There are solid arguments to the effect that *Culliton* was out of step with prevailing legal theory both in 1933 and today, and therefore should be reversed, and that changes in federal and Washington law since 1933 might today lead the State Supreme Court to uphold a graduated income tax as an excise tax.² But a reversal of *Culliton* is not necessary to sustain a capital gains tax as an excise tax. In my opinion, a capital gains tax is distinct from a property tax (or, under *Culliton*, an income tax *qua* property tax) in that it is not an unavoidable annual tax on an asset, or even an annual tax on personal income, but instead is, as Justice Tolman put it, a tax on the *gains* from property or investment, gains that could not be enjoyed without the benefits of government. A capital gains tax, collected when the sale of property is made and a profit is realized, is conceptually the same as the real estate excise tax imposed under Chapter 82.45 RCW, a tax which was upheld as an excise tax by the Washington State Supreme Court soon after its enactment. *Mahler v. Tremper* 40 Wn.2d 405, 243 P.2d 627 (1952). In *Mahler*, the Court pointed out that the real estate excise tax was not a tax on the enjoyment or use of one's property, as is the case of the annual property tax. Instead, that tax was imposed on the one-time "act or incidence of transfer." 40 Wn.2d at 409-410. Similarly, a capital gains tax is not imposed on the property itself or on the enjoyment of it. Instead, it is imposed on the single sale of the asset, measured as a percentage of the gain.

A later case, *Black v. State*, 67 Wash.2d 97, 406 P.2d 761 (1965) upheld a retail sales tax imposed on the lease of a ship to serve as a floating hotel during the Seattle Worlds Fair. In *Black*, Justice Finley recited the basic theory concerning the difference between a property tax and an income tax:

First of all, this is an excise tax on the transaction of leasing tangible personal property. It is not a tax on property. A recitation of standard tax principles upholds this statement:

(T)he obligation to pay an excise is based upon the voluntary action of the person taxed in performing the act, enjoying the privilege or engaging in the occupation which is the subject of the

¹ The Washington Supreme Court has held that the uniformity provisions of Article VII apply solely to property taxes, and not to excise taxes. *See, e.g., State v. Collins*, 94 Wash. 310,312, 162 P. 556 (1917). The Court has also held motor vehicle excise taxes to be excise rather than property taxes. *State ex rel. Hansen v. Salter*, 190 Wash. 703, 70 P.2d 1056 (1937).

² *See, e.g., Harsch, State Income Taxation as Affected by Property Tax Limitations*, 6 WASH. L. REV. 97 (1931); *Note, Constitutionality of State Income Taxes*, 8 WASH. L. REV. 81 (1933); *Recent Cases*, 11 WASH. L. REV. 172 (1936); O'Conner & Schillberg, *A Study of State Income Taxation in Washington*, 33 WASH. L. REV. 398 (1958); Spitzer, *A Washington State income tax--again?*, 16 U. Puget Sound L. Rev. 515 (1993).

excise, and the element of absolute and unavoidable demand, as in the case of a property tax, is lacking. * * * 1 Cooley, *Taxation*, s 46, at p. 132 (4th ed. 1924).

If a tax is imposed directly by the legislature without assessment, and its sum is measured by the amount of business done or the extent to which the conferred privileges have been enjoyed or exercised by the taxpayer, irrespective of the nature or value of the taxpayer's assets, it is regarded as an excise; but if the tax is computed upon a valuation of property, and assessed by assessors either where it is situated or at the owner's domicile, although privileges may be included in the valuation, it is considered a property tax.

67 Wn.2d 99. This analysis was reinforced by *Washington Public Ports Association v. Department of Revenue*, 148 Wn.2d 637, 649-52 (2003), which ruled that the leasehold excise tax was not a property tax but “was actually an excise tax on the transaction of leasing tangible personal property.” Relying on *Black* and on *Covell v. City of Seattle*, 127 Wn.2d 874 (1995), the Court emphasized that the leasehold excise tax was not a tax on the *ownership* of property but rather a tax on the voluntary act of entering into a rental transaction. Quoting *Covell*, the Court repeated Cooley’s precept that an excise tax is based on “the voluntary action of the person taxed in performing the act...and the element of absolute and unavoidable demand, as in the case of a property tax, is lacking.” 148 Wn.2d at 651, quoting 127 Wn.2d at 889.³

Taking guidance from *Black*, *Covell* and *Washington Public Ports Association*, it would be important to make it clear in legislation that a capital gains tax is not based on the value of an asset and is not imposed on the holding or possession of the asset. Instead, the tax should be structured as an excise tax on the realization of capital gains from the one-time sale or other voluntary transfer of the asset. That sale or transfer must be discretionary on the owner’s part,⁴ and the tax must be capable of being avoided by the owner’s choosing not to sell or transfer.⁵ Unavoidability is a key factor in determining

³ In using that quote, *Covell* cited to *High Tide Seafoods v. State*, 106 Wn.2d 695, 699 (1986).

⁴ An exemption should be provided to a forced sale of property resulting from the threat or exercise of eminent domain because such a transaction is not voluntary on the seller’s part. This exemption is provided with respect to the real estate excise tax.

⁵ *Black* distinguished *Apartment Operators Association of Seattle, Inc. v. Schumacher*, 56 Wash.2d 46, 351 P.2d 124 (1960), which earlier had declared that a tax on rental income was a “property tax.” *Apartment Operators* was a short *per curiam* opinion without any reasoning, so one must infer what the Court might have thought was the rationale for its decision. Perhaps the reason was that the rental tax was ongoing and was imposed on property that the owner was using. In distinguishing that case, Justice Finley in *Black* referred the readers to “the above outlined principles” (*i.e.*, those quoted in the text above). 67 Wn.2d at 100.

whether a tax is a property tax. Avoidability, *e.g.*, the discretion not to buy, not to sell, not to rent, not to drive, etc., is key to a determination that a tax is an excise tax.⁶

Although the proposed tax would be measured by gains reported on a federal income tax return, the characterization of the tax for *state* purposes is the key factor in determining whether it would be a proper excise tax under Washington State law. The legislation imposing a state capital gains tax should include findings that will establish the character of the tax as a one-time transaction tax, measured by the profit received upon sale or transfer, rather than a tax on “income” from capital gains. The legislation should also include the practical reasons for excluding the first \$10,000 in gains. Classifications, exclusions and rate differentials are all permitted with respect to excise taxes so long as they are “neither capricious nor arbitrary, and [rest] upon some reasonable consideration of difference or policy.” *Black*, 67 Wn.2d at 100.

If I can provide you with additional analysis or other assistance on this matter, please do not hesitate to contact me. The views expressed in this memorandum are mine alone, and do not reflect the views of the University of Washington, my law firm, or any client of my law firm.

⁶ See also, *Harbor Village Apartments v. City of Mukilteo*, 139 Wash. 2d 604, 607 989 P.2d 542 (1999). See, generally, Spitzer, *Taxes vs. Fees: A Curious Confusion*, 38 Gonzaga L. Rev. 335 (2002/03).