
Finance Committee

HB 2967

Brief Description: Assisting Washington families by improving the fairness of the state's tax system by enacting a capital gains tax and providing property tax relief.

Sponsors: Representatives Lytton, Dolan, Wylie, Frame, Valdez, Pollet, Doglio, Santos and Macri.

Brief Summary of Bill

- Imposes a tax of 7 percent on long-term capital gains.
- Provides a mechanism to reduce the state property tax levy and fund the senior citizen, disabled persons, and qualifying veterans property tax exemption with revenues from the tax on long-term capital gains.
- Changes the income thresholds for the senior citizen, disabled persons, and qualifying veterans property tax exemption.

Hearing Date: 2/16/18

Staff: Tracey O'Brien (786-7152).

Background:

Capital Gains.

Most property owned by an individual for personal purposes is considered a capital asset, including houses, furniture, cars, stocks, and bonds. The sale of these items may result in a capital loss or a capital gain. Short-term capital gains or losses are gains or losses from assets held for a year or less. Long-term capital gains or losses are gains or losses from assets held for more than one year.

At the federal level, the gains on some of these capital assets may be subject to taxation, and the losses may be deducted, when computing an individual's net capital gain for tax liability purposes.

This analysis was prepared by non-partisan legislative staff for the use of legislative members in their deliberations. This analysis is not a part of the legislation nor does it constitute a statement of legislative intent.

At the federal level, some property is exempted from capital gains. This includes: stock in trade and other inventory; accounts or notes receivable; depreciable property; real estate used in a trade or business; and certain hedging transactions. In addition, an individual may not need to report the sale or exchange of a main home.

An individual filing a 1040 federal return calculates any capital gains or losses on Form 8949 and reports the gain or loss on Schedule D. Capital gains are generally taxed at a lower rate than other income. The rates are determined by the source of the net capital gain. For tax year 2016, the six maximum capital gains rates are 0 percent, 15 percent, 20 percent, 25 percent, and 28 percent. For example, if the net capital gain resulted from the sale of collectibles, the 28 percent rate applies; however, if the gain is not from the sale of collectibles, small business stock, or unrecaptured section 1250 gain, and the regular tax rate that would apply is 10 or 15 percent, then the capital gains tax rate is 0 percent.

Property Tax – Regular Levies.

All real property is subject to a tax each year based on the highest and best use, unless a specific exemption is provided by law. The annual growth of all regular property tax levy revenue other than the state levies is limited as follows:

- For jurisdictions with a population of less than 10,000, revenue growth is limited to 1 percent.
- For jurisdictions with a population of 10,000 or more, revenue growth is limited to the lesser of inflation or 1 percent plus the value of new construction.

The state collects two regular property tax levies for common schools. The original state levy was first imposed when Washington achieved statehood in 1889. In 2017 the Legislature adopted Engrossed House Bill 2242, which created the additional state levy. For taxes levied for collection in calendar years 2018–2021, the combined rate for both state levies is \$2.70 per \$1,000 of assessed value (AV). The revenue growth limit does not apply to the state levies during this time. Beginning with taxes levied for collection in calendar year 2022 and thereafter, the revenue growth limit applies to both levies.

The Washington Constitution limits regular property tax levies to a maximum of 1 percent of the property's value (\$10 per \$1,000 of AV). There are individual district rate maximums and aggregate rate maximums to keep the total tax rate for regular property taxes within the constitutional limit. For example:

- The state levy rate is limited to \$3.60 per \$1,000 of AV.
- County general levies are limited to \$1.80 per \$1,000 of AV.
- County road levies are limited to \$2.25 per \$1,000 of AV.
- City levies are limited to \$3.375 per \$1,000 of AV.

For property tax purposes, the state, counties, and cities, with respect to the levies listed above, are collectively referred to as senior taxing districts. Junior taxing districts—a term that includes fire, hospital, flood control zone, and most other special purpose districts—each have specific rate limits as well.

The tax rates for senior and junior taxing districts, excluding the state levies, must fit within an overall rate limit of \$5.90 per \$1,000 of AV. If the statutory \$5.90 or constitutional \$10 limit are exceeded, statute establishes the sequential order in which the levies must be proportionally

reduced or eliminated (a process referred to as prorationing) to conform to the statutory and constitutional limits.

Some regular property tax levies—including levies for criminal justice purposes, port districts, and emergency medical services—are not subject to the \$5.90 aggregate rate limit but are subject to the constitutional \$10 limit. These levies have protections from general prorationing requirements and exist within the "gap" that remains after subtracting the state levy and the \$5.90 in local regular levies from the constitutional \$10 limit per \$1,000 of AV.

Property Tax – Senior Citizen, Individuals with Disabilities, and Veterans Tax Relief.

Authorized by a constitutional amendment, qualifying senior citizens, persons retired due to disability, and veterans entitled to and receiving compensation from the United States Department of Veterans Affairs at a total disability rating for a service-connected disability are entitled to property tax relief on their principal residence (property tax exemption program). To qualify, a person must be 61 years old in the year of the application or retired from employment because of disability; own their principal residence; and have a combined disposable income of less than \$40,000 a year. Eligible individuals may qualify for a partial property tax exemption and a valuation freeze.

Combined disposable income is defined as the sum of federally defined adjusted gross income and the following, if not already included: capital gains; amount deducted for losses; depreciation; pensions and annuities; military pay and benefits; veterans benefits except attendant care, medical aid, disability compensation, and dependency and indemnity compensation; Social Security and federal railroad retirement benefits; and dividends and interest income on state and municipal bonds. Payments for the care of either spouse received in the home, in a boarding home, in an adult family home, or in a nursing home; prescription drugs; and Medicare health care insurance premiums are deducted when determining disposable income.

Exemptions for eligible individuals are provided as follows:

- If disposable income is \$30,000 or less, all excess levies, the additional state levy, and regular levies on the greater of \$60,000 or 60 percent of AV of the residence are exempted.
- If disposable income is \$30,001 to \$35,000, all excess levies, the additional state levy, and regular levies on the greater of \$50,000 or 35 percent of AV of the residence (\$70,000 maximum) are exempted.
- If disposable income is \$35,001 to \$40,000, all excess levies and the additional state levy are exempted.

In addition to the partial exemptions listed above, the valuation of the residence of an eligible individual is frozen, for the purpose of calculating property tax liability, at the AV of the residence on the later of January 1, 1995, or January 1 of the assessment year in which a person first qualifies for the program.

In addition to the exemption program, individuals who meet all of the requirements for the senior citizen and individuals with disabilities exemption program, except for the income and age requirements, are permitted to defer their property taxes if their combined disposable income is \$45,000 or less and they are 60 years or older.

Summary of Bill:

Part I – Capital Gains.

A tax of 7 percent is imposed on the adjusted capital gains of an individual for the privilege of selling or exchanging long-term capital assets or receiving Washington capital gains. This tax is in addition to any other taxes imposed by state and local governments. This tax also applies to beneficial owners who are individual owners of long-term capital assets held by a pass-through or other disregarded entity, to the extent the individual's ownership interest in the entity is reported for federal tax purposes.

"Washington capital gains" are defined as an individual's adjusted capital gains allocated to this state, less \$25,000 for an individual or \$50,000 if filing jointly.

"Adjusted capital gain" is defined as the federal net long-term capital gain plus any loss from a sale or exchange that is exempt from the tax imposed in this chapter, and less any gain from a sale or exchange that is exempt from the tax imposed in this chapter, to the extent that such gain or loss was included in calculating federal net long-term capital gain.

Long-term assets can include real estate and intangible or tangible personal property:

- For real estate, the capital gains tax will apply if the real property sold or exchanged is in Washington, or the majority of the fair market value of the property is in this state.
- For intangible personal property, the capital gains tax will apply if the taxpayer was domiciled in Washington at the time of sale or exchange.
- For tangible personal property, the capital gains tax will apply if the property was located in Washington at the time of the sale or exchange. The sale of tangible personal property will also be subject to the states capital gains tax if:
 1. the property was located in Washington at any time during the current or immediately preceding taxable year;
 2. the taxpayer was a Washington resident at the time of the sale or exchange; and
 3. the sale was not subject to income or excise tax on the adjusted capital gain by another taxing jurisdiction.

The following assets are exempt from the capital gains tax:

- any residential dwelling, which means property that consists solely of a single-family residence, a residential condominium unit, or a residential cooperative unit, including an accessory dwelling unit, a multifamily residential building consisting of common walls and fewer than four units, or a floating home;
- retirement assets, including 401(k), a tax-sheltered annuity and custodial account, deferred compensation plans, individual retirement accounts (IRAs), Roth IRAs, employee defined contribution programs, employee defined benefit programs, or similar retirement saving vehicles;
- assets condemned by the government;
- cattle, horses, or breeding livestock held for more than 12 months if 50 percent of the taxpayer's gross income for the year is from farming or ranching;
- agricultural lands for which the taxpayer has regular, continuous, and substantial involvement in the operation of the land and meets the federal criteria for "material participation" for 10 years previous to a sale;
- property used in a trade or business if it qualifies for depreciation under federal law; and

- timber, timberlands, or receipts from a Real Estate Investment Trust.

A deduction from the amount of adjusted capital gain is authorized for the sale of a qualified family-owned small business. The deduction is the amount of adjusted capital gain derived from the sale of at least 90 percent of all of the fair market value of the assets of, or transfer of at least 90 percent of the taxpayer's interest in, a qualified family-owned small business.

A "qualified family-owned small business" is defined as a business:

- in which the taxpayer held a qualifying interest for at least 8 years immediately preceding the sale or transfer;
- in which the taxpayer or a family member materially participated in the operation of the business for at least 5 of the 8 years immediately preceding the sale or transfer, unless the sale or transfer was to a family member;
- that had no more than 50 full-time employees at any time during the 12-month period immediately preceding the sale or transfer; and
- that had a worldwide gross revenue of \$7 million or less during the 12-month period immediately preceding the sale or transfer.

"Material participation" means an individual was involved in the operation of the business on a regular, continuous, and substantial basis.

"Qualifying interest" means an interest as a proprietor in a business carried on as a sole-proprietor. It can also mean an interest in a business if at least:

- 50 percent of the business is owned, directly or indirectly, by the taxpayer and members of the taxpayer's family;
- 30 percent of the business is owned, directly or indirectly, by the taxpayer and members of the taxpayer's family, and at least 70 percent of the business is owned, directly or indirectly, by members of two families; or
- 30 percent of the business is owned, directly or indirectly, by the taxpayer and members of the taxpayer's family, and at least 90 percent of the business is owned, directly or indirectly, by members of three families.

A "resident" is an individual domiciled in Washington during the entire taxable year. A resident also includes a person who is not domiciled in Washington during the taxable year, but maintained a place of abode and was physically present in Washington for more than 183 days during the taxable year. Such person will be a resident for that portion of the year in which domiciled or maintained a place of abode. If an individual maintained no permanent place of abode in this state during the entire taxable year, maintained a permanent place of abode outside of Washington for an entire taxable year, and spent an aggregate of no more than 30 days in Washington, the person is considered a nonresident.

Deductions are allowed for taxes prohibited by the United States or Washington constitutions or laws. In addition, a deduction for Washington capital gains tax paid is available for the business and occupation tax. Credits are allowed equal to the amount of any legally imposed income or excise tax paid by the taxpayer to another jurisdiction.

The administrative provisions for the DOR apply to this new tax, and additional provisions for the filing, payment, and applicable penalties are included. The DOR may enter into reciprocal agreements with other states to offset delinquent taxes.

It is a class C felony to knowingly attempt to evade payment of the capital gains tax. It is a gross misdemeanor to knowingly fail to pay tax, make returns, keep records, or supply information required.

All revenues from the capital gains tax will be deposited into the Education Legacy Trust Account.

Part II – Use of Tax Revenue.

A mechanism is provided to use revenue generated by the tax on long-term capital gains to reduce the state property tax levy and to fund the senior citizen, persons with disabilities, and veterans property tax exemption. This applies to taxes levied for collection beginning in 2021.

By December 1 of each year, the Department of Revenue (DOR) must calculate the revenue collected from the capital gains tax during the most recently completed fiscal year. By December 31 of each year, the DOR must:

- estimate the amount needed to fund the senior citizen property tax exemption;
- calculate the amount of revenue remaining from the imposition of the capital gains tax; and
- reduce the state property tax rate by the remaining revenue from the capital gains tax.

By December 1 of each year, each county assessor must provide the DOR with the necessary data to make these calculations.

When determining the regular property tax levy limit, the highest amount of regular property taxes levied in the three most recent years must be determined as if no property tax reduction is made.

Part III – Property Tax Relief.

Beginning with taxes levied for collection in 2021, the income thresholds are changed for the disposable income used to determine property tax exemption amounts for senior citizens, persons retired due to disability, and veterans entitled to and receiving compensation from the United States Department of Veterans Affairs at a total disability rating for a service-connected disability receiving a property tax exemption.

The income qualification thresholds for the exemption program are modified beginning January 1, 2020, as follows:

- Income Threshold 1 replaces the \$30,000 income threshold. Income Threshold 1 is defined as equal to the greater of "Income Threshold 1" for the previous year or 45 percent of the county median household income (CMI).

- Income Threshold 2 replaces the \$35,000 income threshold. Income Threshold 2 is defined as equal to the greater of "Income Threshold 2" for the previous year or 55 percent of CMI.
- Income Threshold 3 replaces the \$40,000 income threshold. Income Threshold 3 is defined as equal to the greater of "Income Threshold 3" for the previous year or 65 percent of CMI.

The income threshold for the deferral program is defined as equal to the greater of the income threshold for the previous year or 75 percent of CMI, replacing the \$45,000 income threshold.

CMI is defined as median household income estimates for Washington by county of the legal address of the principal place of residence, as published by the Office of Financial Management (OFM).

The DOR must publish updated income thresholds every five years beginning January 1, 2019. The adjusted thresholds must be rounded to the nearest dollar. The thresholds must be adjusted to reflect the most recent year available of estimated CMI, including preliminary estimates or projections, as published by the OFM.

For taxes levied prior to calendar year 2021, "Income Threshold 1" is a combined disposable income equal to \$30,000. For taxes levied in calendar year 2021 and thereafter, "Income Threshold 1" means a combined disposable income equal to the Income Threshold 1 of the previous year or 45 percent of the county median household income.

For taxes levied prior to calendar year 2021, "Income Threshold 2" is a combined disposable income equal to \$35,000. For taxes levied in calendar year 2021 and thereafter, "Income Threshold 2" means the greater of the previous year's Income Threshold 2 or 55 percent of the county median household income.

For taxes levied prior to calendar year 2021, "Income Threshold 3" is a combined disposable income equal to \$40,000. For taxes levied in calendar year 2021 and thereafter, "Income Threshold 3" means the greater of Income Threshold 3" for the previous calendar year or 65 percent of the county median household income.

Appropriation: None.

Fiscal Note: Available.

Effective Date: The bill takes effect on January 1, 2019.