

HOUSE BILL REPORT

HB 2156

As Reported by House Committee On: Finance

Title: An act relating to investing in quality prekindergarten, K-12, and postsecondary opportunities throughout Washington with excise taxes on sales and extraordinary profits of high valued assets.

Brief Description: Investing in quality prekindergarten, K-12, and postsecondary opportunities throughout Washington with excise taxes on sales and extraordinary profits of high valued assets.

Sponsors: Representatives Jinkins, Tarleton, Sullivan, Ormsby, Bergquist, Robinson, Senn, Appleton, Dolan, Frame, Macri, Pollet, Thai and Tharinger.

Brief History:

Committee Activity:

Finance: 4/4/19, 4/19/19 [DPS].

Brief Summary of Substitute Bill

- Imposes a 9.9 percent tax on Washington capital gains realized from the sale of long-term assets.
- Modifies the state real estate excise tax rate structure.
- Adds expenditures for early learning programs to authorized uses of Education Legacy Trust account moneys.

HOUSE COMMITTEE ON FINANCE

Majority Report: The substitute bill be substituted therefor and the substitute bill do pass. Signed by 8 members: Representatives Tarleton, Chair; Walen, Vice Chair; Chapman, Frame, Macri, Orwall, Springer and Wylie.

Minority Report: Do not pass. Signed by 5 members: Representatives Orcutt, Ranking Minority Member; Young, Assistant Ranking Minority Member; Morris, Stokesbary and Vick.

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.

Staff: Richelle Geiger (786-7139) and Tracey O'Brien (786-7152).

Background:

State Real Estate Excise Tax.

Real estate excise tax (REET) is due on the sale of real estate and transfer of controlling interest in an entity that owns real property in the state. The tax base is the selling price of real estate, including the amount of any liens, mortgages, and other debts. In the case of the transfer of controlling interest, the tax base is the true and fair value, or selling price, of the real property transferred. The tax is typically paid by the seller of the property, although the buyer is liable for the tax if it is not paid.

The state REET rate is 1.28 percent.

The state REET revenue are distributed as follows:

- 2 percent to the Public Works Assistance Account (PWAA) through June 30, 2023. After that date, 6.1 percent to the PWAA;
- 4.1 percent to the Education Legacy Trust Account (ELTA) through June 30, 2023. After that date, no revenue distribution to the ELTA;
- 1.6 percent to the City-County Assistance Account; and
- the remainder to the State General Fund.

Any penalties assessed for delinquent REET payments are deposited into the Housing Trust Fund.

Counties collect the state REET on behalf of the state and retain 1.3 percent of the collections to offset administrative costs.

Education Legacy Trust Account.

The ELTA was created in 2005. Money in the ELTA can only be used for kindergarten through grade 12 (K-12) and higher education. Revenues deposited into the ELTA are not considered as General State Revenue for purposes of the budget stabilization account.

Tax Preference Performance Statement.

State law provides for a range of tax preferences that confer reduced tax liability upon a designated class of taxpayer. Tax preferences include tax exclusions, deductions, exemptions, preferential tax rates, deferrals, and credits. Currently, Washington has over 650 tax preferences, including a variety of sales and use tax exemptions. Legislation that establishes or expands a tax preference must include a Tax Preference Performance Statement (TPPS) that identifies the public policy objective of the preference, as well as specific metrics that the Joint Legislative Audit and Review Committee (JLARC) can use to evaluate the effectiveness of the preference. All new tax preferences automatically expire after 10 years unless an alternative expiration date is provided.

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 one 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.

Some property is exempted from federal capital gains tax. 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 and the taxpayer's regular income tax rate. For tax year 2018, the five 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 an 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.

2018 Federal Capital Gains Tax Rates (Internal Revenue Service (IRS) Publication 550)

Source of net capital gain	Maximum capital gain rate
Collectibles	28%
Eligible gain on qualified small business stock minus the section 1202 exclusion	28%
Unrecaptured section 1250 gain	25%
Other gain and the regular tax that would apply is 37%	20%
Other gain and the regular tax rate that would apply is 22%, 24%, 32%, or 35%	15%
Other gain and regular tax rate that would apply is 10% or 12%	0%
"Other gain" means any gain that is not a collectibles gain, gain on small business stock, or unrecaptured section 1250 gain.	

Summary of Substitute Bill:

Capital Gains.

Beginning January 1, 2020, a tax of 9.9 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 Washington state, less \$100,000 for an individual or \$200,000 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 state's 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;
- certain property used in a trade or business; 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 eight 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 five of the eight 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 they were 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 Department of Revenue (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.

Persons are required to file, even if they do not owe Washington capital gains taxes, if their Washington capital gain for the calendar year is at least \$75,000 if an individual, \$150,000 if married and filing jointly.

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 taxes collected on the sale of a long-term capital asset must be deposited in the ELTA.

Education Legacy Trust Account.

The ELTA is amended to include expenditures for early learning programs as an authorized use of the ELTA funds.

Real Estate Excise Tax.

The state REET rate structure is modified. Beginning on January 1, 2020, through December 31, 2022, the rate is:

- if the selling price is equal to or less than \$500,000, 0.9 percent;
- if the selling price is greater than \$500,000:
 - 1.28 percent on the portion of the selling price that is equal to or less than \$1.5 million;
 - 2 percent on the portion of the selling price that is greater than \$1.5 million but equal to or less than \$7 million; and
 - 3 percent on the portion of the selling price that is greater than \$7 million.

The new rate structure does not apply to undeveloped land, timberland, agricultural land, and water or mineral rights. The rate for these types of property would continue to be 1.28 percent, the same rate under current law.

Beginning on January 1, 2023, and every four years thereafter the selling price thresholds are adjusted to reflect the lesser of the growth in the Consumer Price Index for Shelter (CPI-Shelter) over the past four years or 5 percent.

The DOR is directed to:

- calculate the updated thresholds on July 1, immediately prior to the effective date of the new thresholds;
- publish the updated thresholds on September 1, immediately prior to the effective date of the new thresholds; and
- report the updated thresholds to the fiscal committees of the Legislature within six months of the effective date of the new thresholds.

If the growth in CPI-Shelter is less than 0 percent, the current selling price thresholds will continue to apply.

Fifty-five and one half percent of the new REET revenue that is attributable to the rate structure modifications is dedicated to the ELTA. The remaining 44.5 percent of the new revenue is dedicated to the State General Fund. The distribution scheduled of the remaining REET revenue is unchanged.

Tax Preference Performance Statement.

This act is exempt from the requirements of a TPPS, a review by the JLARC, and the automatic 10 year expiration of any tax preferences.

Substitute Bill Compared to Original Bill:

The substitute bill makes a number of changes:

- The exemption for "property used in a trade or business" is modified to apply to tangible property which is subject to wear, tear, decay or decline from natural causes, exhaustion, or obsolescence, including tangible personal property, real property excluding land, and intangible property having a definable life.
- The REET revenue distribution schedule is amended to reduce the impact to accounts that currently receive a REET revenue distribution.

Appropriation: None.

Fiscal Note: Requested on March 25, 2019.

Effective Date of Substitute Bill: The bill contains an emergency clause and takes effect immediately.

Staff Summary of Public Testimony:

(In support) The lack of equity and fairness in our tax structure is surprising. A nonpartisan group that analyzes taxes has concluded Washington has the most regressive tax structure among the 50 states. There is a need to figure out a way to fix it in order to fund what Washington citizens want and deserve from the state, including funding for services, education and infrastructure. Washington's current taxes are inadequate to sustain our government.

Public services are underfunded and the needs of our population go unmet. The capital gains tax rate should be even higher than it is. The people expect the Legislature to give our children the best chance they can by investing heavily in the education system. Investments need to be made in early learning in order to set children up for later success. Special education funding needs to be substantially improved. Many children attend high poverty schools that have lots of special education needs, English as a Second Language (ESL) needs, and homeless students. Cuts to school staffing such as counselors and social workers are devastating to local communities. The homelessness crisis is statewide and can be improved through direct investments and expanded revenues.

This state is home to international companies and two individuals in the \$100 billion club. Washington has a duty to ensure that every student gets a world class education. The wealthiest top 1 percent in the state do not pay their fair share of taxes. In fact, many of the wealthiest are direct beneficiaries of our educational system.

The state revenue system does not keep pace with the growth in need of state services. Investing these revenues into the ELTA for basic and higher education programs is wonderful. In reproductive and maternal health, immigrants, working women, and people of color suffer worse outcomes with respect to reproductive health. New revenues from this bill could help fill gaps in existing coverage so that immigration status does not prevent someone from seeking maternal care. Additional revenue is needed to support our aging population.

A tax on capital gains is an idea that has strong and broad public support. It addresses structural budget issues resulting from a disconnect between revenue and the cost of providing government services. This bill provides a meaningful and long overdue correction to an inadequate tax system. In addition, the changes to the REET structure make the tax more progressive.

(Opposed) It is imprudent to structure a budget on revenue that is not likely to be collected. Washingtonians have rejected an income tax 10 times at the ballot box. In addition, this bill would be challenged in court if passed. Even if implemented, capital gains revenue is volatile and unreliable. The taxes proposed are on top of significant recent tax increases, and there is no evidence that implementation of these taxes would lead to the lowering of other taxes.

The impact of the capital gains tax on small businesses is concerning. Despite the exemption for family-owned businesses, there is little consideration for small business owners main source of retirement income—the sale of their business. Unlike other retirement income resulting from the sale of assets, small business owners would pay capital gains on the sale of their business. This is true for a wide variety of industries, including grocers and insurance firms.

Many families rely on the one-time sale of assets to make ends meet and take care of their families when faced with economic hardships. This bill would punish these struggling families.

Washington already has one of the highest REETs in the nation. Most states have lower rates, and many do not have REET. Although this proposal would assist many families, it would impact small businesses. It also disproportionately falls on multifamily as well as commercial properties. This will result in less revenue than anticipated because it may impact decisions related to real estate transactions. The impact on multifamily properties may cause an increase in rents. The behavior of the 2 percent affected by this bill will be disproportionately impacted by this bill. If only a fraction of these transactions are delayed or deferred, the impact to revenue will be substantial.

Project financing is key to advance construction projects, which this bill will undermine. Builders will respond by increasing rent charged. This transactional tax means many will change their asset holding strategy and delay or avoid sales. This will also affect investment decisions. A lot of property in Washington is owned by pension funds that are used to support retirement of residents; this will undermine that strategy. The extra cost will be passed onto the residents of buildings, whether they own or rent.

This bill hurts many small businesses twice with the double hit of capital gains and REET. It is truly regressive.

(Other) Work needs to be done on the exemption portion of the capital gains tax. The sale of a business often includes "good will." This is an asset that is very valuable in the sale of certain businesses, especially for auto dealerships. Imposing a capital gains tax on this asset will impact the retirement savings of the business owners.

The REET structure change may reduce the collections for the county administrative fee, especially for counties with lower property values. In order to make the changes work, we need to figure out how to mitigate this revenue loss for counties.

Persons Testifying: (In support) Representative Jinkins, prime sponsor; Andy Nicholas, Washington Budget & Policy Center; Jean Johnson; Ruth Lipscomb; Summer Stinson, Washington's Paramount Duty; Emily Carmichael; Cedar McKay; Sarah Reynevald; Cecelia Lehmann; Arielle Lehmann; Michele Thomas, Washington Low Income Housing Alliance; Peter Shapiro; Alex Bond, Balance Our Tax Code; Erin Haick, Service Employees International Union 925; Lorrell Noahr, Washington Education Association; Morgan Steele Dykeman, National Abortion and Reproductive Rights Action League; Dave Knutson, Washington Health Care Association; Emily Murphy, Early Learning Action Alliance, Retired Public Employee Council; Demas Nesterenko, Service Employees International Union 775; Dennis Eagle, Washington Federation of State Employees; Donna Patrick, Developmental Disabilities Council; and John Burbank, Economic Opportunity Institute.

(Opposed) Greg Hanon, National Association of Industrial and Office Properties; McKenzie Darr, The Wolf Company; Brian Franklin, PMF Investments; AP Hurd, Skipstone; Tim Eyman; Radona Devereaux; Jan Gee, Washington Food Industry Association; Greg Seifert, Professional Insurance Association and Washington Association of Health Underwriters; Barb Kaiser, Professional Insurance Association; Bob Lien, National Association of Insurance and Financial Advisers; Michael Foley, International Council of Shopping Centers; Mark Johnson, Washington Retail; Jeff Gadman, Washington State Association of County Treasurers; Patrick Connor, National Federation of Independent Business; and Clay Hill, Association of Washington Business.

(Other) Scott Hazlegrove, Washington State Auto Dealers Association; and Mellani McAleenan, Washington State Association of Counties.

Persons Signed In To Testify But Not Testifying: None.