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Inside the Washington State Capital Gains Tax

The Washington Supreme Court recently upheld the state's proposed excise tax which was signed into law in 2021 but faced legal challenges. The law, which is now in effect, assesses a 7% flat tax on long-term capital gains above $250,000. As it looks, feels, and acts like a capital gains tax, we will refer to it as such going forward.

How the Tax Works

The Washington State Capital Gains Tax provides a standard deduction of $250,000 annually for all types of taxpayers - single, married filing jointly, married filing separately, or heads of household.

Regardless of your filing status, if you generate **less than $250,000** in long term capital gains in a given year (from any source), the tax does not apply to you.

If you generate **more than $250,000** in net long-term capital gains in a given year from the sale or exchange of an asset such as stocks, bonds, mutual funds, (or anything not listed in the exemptions below), the tax will apply to you, assuming that you do not have long-term capital losses than can offset those gains. Note that this tax is applicable to long-term capital gains only. For the purposes of this tax, long-term gains cannot be offset by short term losses in the same year. Only long term-losses will be able to offset long-term gains for this calculation. In addition, carryforward losses for prior years are not considered as an offset to gains.

Only individuals owing capital gains tax are required to file a capital gains tax return, along with a copy of their federal tax return for the same taxable year. The return is typically filed along with the federal return and is due at the same time (either April or October each year, depending on whether you extend).

Exemptions

The sale or exchange of the following assets are exempt from the new tax:

- Real estate
- Qualified Family Owned Small Business interests in a privately-held entity to the extent that the capital gain or loss from such sale or exchange is directly attributable to the real estate owned directly by the entity
- Assets held in certain retirement accounts
- Assets subject to condemnation, or sold or exchanged under imminent threat of condemnation
- Certain livestock related to farming or ranching.
- Assets used in a trade or business to the extent those assets are depreciable under Title 26 U.S.C. Sec. 167(a)(1) of the internal revenue code or qualify for expensing under Title 26 U.S.C. Sec. 179 of the internal revenue code
- Timber, timberlands, and dividends and distributions from real estate investment trusts derived from gains from the sale or exchange of timber or timberlands
- Commercial fishing privileges
- Goodwill received from the sale of a franchised auto dealership

The Importance of Tax Planning

This capital gains tax reinforces the need for effective tax planning, especially for small business owners and other taxpayers who see large year-to-year swings in taxable income and marginal rates. Portfolio assets such as stocks, bonds, funds, and ETFs are subject to the tax, but only on those net long term gains that are in excess of $250,000 in a given year. Importantly, the sale or exchange of real estate properties, including both primary residences and rental properties, are exempt.

Other Notes

While we have gotten much more clarity about the law, there are still some elements which may be confusing. The following are some items that we would like to see more discussion about:

- There is no adjustment in the exemption whether filing individually or jointly. This seems inconsistent with federal tax law and discriminatory to joint filers.
- It is unclear how other tax laws such as those related to Opportunity Zones fit in.
- In the past, Washington has been a state that attracts residency based on the lack of capital gains taxes. This may lead to wider implications for both tax payers and lawmakers.
- Gains allocated to Washington state are the target of the language, but what happens if the gain is outside of Washington but the principal owner is in Washington?

Conclusion

Depending on the circumstances, there may be ways to minimize or eliminate this tax over the long run. If you anticipate needing to take significant capital gains, spreading the realization of long term gains over multiple tax years can be helpful. If cash is needed in the second half of the year, there may be an opportunity to realize some gains at the end of the year and the remaining gains in the first quarter of the following year.

As always, new tax legislation can be complex and requires a thoughtful conversation with your tax professional. Working together with your CPA or tax advisor, we look forward to building a plan that helps you achieve your goals without incurring unnecessary taxes. If you have questions about this tax and how it may affect your financial situation, please do not hesitate to reach out to us at any time. We are here to help.

You can read the specifics on the tax from the Washington Department of Revenue here.

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