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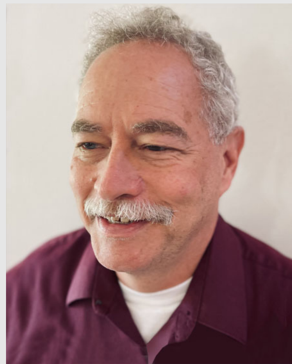

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In this article, the authors examine Washington's new 7 percent capital gains tax, analyzing the tax from constitutional, practical, and policy perspectives.

On May 4 Washington Gov. Jay Inslee (D) signed into law a 7 percent excise tax on net long-term gains from sales or exchanges of some capital assets by individuals starting on January 1, 2022. The law, Engrossed Substitute Senate Bill 5096 (ESSB 5096), provides for a standard deduction of the first $250,000 of capital gain, regardless of filing status so that single and married-filing-separately taxpayers receive the same $250,000 deduction that a couple receives when they file a joint return. Bill sponsors claimed that the capital gains tax would reduce regressivity in the state's tax system and bring in needed tax revenue to support education initiatives.

Our purpose is to analyze the Washington capital gains tax from a constitutional, practical, and policy perspective. To do this, we first explain the main features of the new capital gains tax and show how it is calculated using federal tax return information. Second, we evaluate the Washington capital gains tax in the context of the state constitution, relevant case law, and the cases that have been filed to challenge the constitutionality of ESSB 5096. Third, we consider the possibility that instead of intending to create only a long-standing tax on capital gains, lawmakers are using the capital gains tax as a tool to address an important tax policy issue: Washington's highly regressive tax system. If so, the capital gains tax is a test of whether the Washington Supreme Court will affirm its holding in a key 1933 case that prevents the Legislature from enacting a progressive income tax.

Fourth, we apply finance theory and policy principles to evaluate the capital gains tax. Despite concerns from policymakers about the high cost of Seattle-area real estate, we argue that the capital gains tax will impose an implicit tax that further inflates real estate prices. Fifth, we discuss two implementation issues and related recommendations: (1) the responsible party for the initial tax report — taxpayers or the Department of Revenue — and (2) concerns that the statute's language on capital loss carryforwards could produce unusual and possibly unfair results. A summary offers concluding remarks.

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I. The Washington Capital Gains Tax

A. Who Is Subject to the Tax and What Is Included in the Tax Base?

Starting in January 2022 each taxpayer who has gains or losses allocated to Washington from the sale or exchange of long-term capital assets will be subject to an excise tax on adjusted capital gain, as defined in the bill under section 4(1).[1] Adjusted capital gain is federal net long-term capital gain modified by (1) adding any Washington-exempt long-term capital loss, any long-term capital loss not allocated to Washington, and any loss carryforward not allocated to Washington, and (2) subtracting any Washington-exempt long-term capital gain and any long-term capital gain not allocated to Washington. From adjusted capital gain, section 7 allows the taxpayer to subtract (1) the $250,000 standard deduction, (2) any gain prohibited from being subject to the capital gains tax by the state constitution, (3) any gain derived from selling or transferring a qualified family-owned small business, and (4) any charitable contribution described in section 9. The result is the tax base known as Washington capital gains. The capital gains tax applies directly to individuals and indirectly to them through their ownership in passthrough business entities, but C corporations are not subject to the tax.

Section 7(1) permits a standard deduction of $250,000 in computing adjusted capital gain, regardless of the taxpayer's filing status.

With a $250,000 standard deduction, the capital gains tax targets wealthy taxpayers.

Married taxpayers filing joint returns are limited to a combined $250,000 standard deduction. As a result, the uniform $250,000 standard deduction imposes a marriage penalty on high-income (and typically influential) taxpayers.

Why does the statute apply a harsh marriage penalty? A partial marriage penalty would be more consistent with federal tax policy.

The sale or exchange of intangible personal property, which in Washington appears to include stocks and bonds, is taxed based on whether the taxpayer is domiciled in Washington at the time of the sale or exchange of the stock (section 11(b)). The capital gains tax does not apply to a taxpayer who maintains no permanent place of abode in Washington, maintains a permanent abode outside Washington, and spends less than 31 days of the tax year in Washington (section 4(10(a)(i))).

Wealthy taxpayers could have multiple homes — a first home in Washington and a second home outside the state. Although the rules are strong about including these taxpayers, a taxpayer could avoid the tax by switching tax domicile to the jurisdiction where the second home is located and, for example, telecommuting to a Washington-based employer. If the capital gains tax chases the taxpayer out of Washington, the state loses out on both this revenue and the sales tax revenue it would have collected from sales made to the taxpayer while living in Washington.

The sale or exchange of tangible personal property is taxed in Washington if it is in the state at the time of the sale or exchange (section 11(a)). A base-broadening exception applies, however. If tangible property is not located in the state at the time of the sale or exchange, any long-term capital gains and losses will be allocated to the state if (1) the property is located in the state at any time during the current or immediately preceding tax year in which the sale or exchange occurred, (2) the taxpayer is a resident at the time of the sale or exchange, and (3) the taxpayer is not already subject to an excise tax or income tax on the transaction by another taxing jurisdiction. For this purpose, a taxpayer is a Washington resident if she maintains a place of abode in Washington and is physically present in the state for more than 183 days of the tax year, even if she considers another jurisdiction to be her tax home (section 4(10)).

The rules on domicile and residency are complicated and likely to be highly subjective in practice. Lawmakers should consider whether the DOR should be concerned with taxing sales of personal property that are rarely sold at a gain. Sales of securities (and real estate, if included) are much better documented and easier to tax.

Under section 4, adjusted capital gain begins with federal net long-term capital gain (that is,

[1] Section references are to ESSB 5096 passed by the Senate on April 25.

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line 15 of Form 1040 Schedule D). Short-term capital gains are not subject to the capital gains tax.

The exclusion of sales or exchanges resulting in short-term capital gains creates an unusual incentive for Washington taxpayers to adopt a short-term investment horizon. Favoring short-term gains opposes the federal tax system that applies lower rates to long-term capital gains. Do Washington policymakers want to encourage short-term trading given that federal policymakers have long encouraged long-term investments? If so, this goal should be made explicit and the rationale for it should be explained.

Adjustments to federal net long-term capital gain exclude (1) capital gains and losses that ESSB 5096 exempts in sections 6(1) and 6(2); (2) capital loss carrybacks; and (3) gains, losses, and loss carryforwards that are not allocable to Washington. Section 6(1) exempts gains and losses from the sale or exchange of real estate, and section 6(2) exempts gains and losses relating to the sale or exchange of private entities to the extent they pertain to real estate owned by the entity.

We will discuss this more in Section IV. We have questions about the rationale for excluding real estate gains, including how it could affect the already high prices of Seattle-area real estate.

Section 6(3) exempts all gains and losses from the sale or exchange of assets held in tax-deferred retirement accounts.

Gains on stocks and bonds held in tax-deferred retirement accounts completely avoid the capital gains tax while they are only deferred for federal income tax purposes. If policymakers aim to encourage taxpayers to save for retirement, perhaps this goal should be made explicit.

In addition to exempting real estate and tax-deferred retirement investment sales or exchanges, section 4 exempts gains related to government condemnations, livestock owned by full-time farmers, depreciable property, timber and timberland, commercial fishing privileges, and goodwill involved in the sale of an auto dealership.

With so many exemptions and a $250,000 standard deduction, it is difficult to argue that the capital gains tax has a broad base. The DOR estimates that only 7,000 taxpayers of Washington's 7.8 million residents (0.1 percent) will be liable for the tax in 2022.[2]

The capital gains tax is asymmetrical. That is, net capital gains are subject to the tax, while net capital losses on assets allocable to Washington provide no benefit in the current year. For comparison, the federal tax system allows up to $3,000 of net capital losses to be deducted against ordinary income.

The federal and Washington capital gains tax regimes are both progressive — imposing higher tax rates on larger capital gains. With a flat 7 percent rate and a $250,000 standard deduction, Washington imposes 0 percent tax on the first $250,000 of Washington net long-term capital gains. Under the federal capital gains tax regime (which we assume will continue through 2024), the first $80,800 of net long-term capital gain is subject to 0 percent tax, the next $420,800 is subject to 15 percent tax, and net long-term capital gain over $501,600 incurs 20 percent tax. By combining the federal and Washington tax rates, we can determine the marginal tax rates for joint-return taxpayers with only Washington capital gains and losses. They face combined federal and Washington long-term capital gains marginal rates of 0 percent on up to $80,800, 15 percent from $80,101 to $250,000 (federal), 22 percent (15 percent federal and 7 percent Washington) from $250,001 to $501,600, and 27 percent (20 percent federal and 7 percent Washington) for long-term capital gains that exceed $501,600.

B. How Is the Washington Capital Gains Tax Determined?

As an example, in Table 1 (Scenario A), we apply the tax for a married couple that files a joint federal tax return in 2022. The couple reaps a Washington $1 million capital gain in 2022 and has no capital loss carryforwards from previous years. For federal purposes, Panel A shows that the entire $1 million is subject to the three-bracket federal capital gains tax, which produces $162,800 of federal tax. Panel B shows that the calculation of the Washington capital

[2]*See* Washington DOR, "Multiple Agency Fiscal Note Summary," at 4.

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gains tax base starts with federal net long-term capital gain including the effects of federal capital loss carryforwards. Lines 11, 12, and 13 remove non-Washington capital losses, capital loss carryforwards, and capital gains. Lines 14 and 15 adjust for capital gain and loss items that are exempt from the Washington capital gains tax. Our simple example assumes no adjustments on lines 11-15. After considering the $250,000 annual standard deduction, the Washington capital gains tax base is $750,000, which at the 7 percent tax rate causes $52,500 of Washington tax (see Panel B). The combined federal and state capital gains tax is $215,300 ($162,800 + $52,500), or a total capital gain effective tax rate of slightly more than 21.5 percent ($215,300/$1,000,000).

II. The Constitutionality Issue

A. Does the Capital Gains Tax Qualify as an Excise Tax?

Two lawsuits have been filed to challenge the constitutionality of ESSB 5096. The first, *Quinn v. State of Washington*, was filed on April 28, just three days after the Washington Senate passed the bill and six days before Inslee signed it into law.[3] The lawsuit was filed in Douglas County Superior Court by a Seattle law firm, Lane Powell, and the conservative group Freedom Foundation on behalf of seven Washington residents led by Chris Quinn. The second lawsuit, *Clayton v. State of Washington* was filed on May 20 in the same Douglas County Superior Court.[4] Former Washington State Attorney General Rob McKenna filed the complaint for the plaintiffs — a coalition of farmers, business owners, and investors, and the Washington State Farm Bureau, which represents more than 46,000 members.

The main arguments in *Quinn* and *Clayton* are that (1) Washington's constitution requires that taxes on property must be applied using a uniform (that is, flat) tax rate no greater than 1 percent, (2) a capital gains tax is a tax on income, and (3) income is property. If these arguments are valid, the filings argue that ESSB 5096 is unconstitutional because the $250,000 standard deduction violates the flat tax requirement of taxes on property and the 7 percent tax rate exceeds the 1 percent limit. We consider each of the three arguments.

First, the relevant portion of Amendment 14 to Article VII, section 1 of the state constitution reads:

> The power of taxation shall never be suspended, surrendered or contracted away. All taxes shall be *uniform* upon the same class of property within the territorial limits of the authority levying the tax and shall be levied and collected for public purposes only. The word *"property" as used herein shall mean and include everything, whether tangible or intangible, subject to ownership.*[5] [Emphasis added.]

In conjunction, Amendment 95 to Article VII, section 2 stipulates that taxes on property cannot exceed 1 percent of the value of the property:

> Except as hereinafter provided and notwithstanding any other provision of this Constitution, the aggregate of all tax levies upon real and personal property by the state and all taxing districts now existing or hereafter created, *shall not in any year exceed one percent of the true and fair value of such property in money*. [Emphasis added.][6]

Despite the 1 percent cap, Washington sales and use tax rates range from 7 percent to 20.5 percent, business and occupation (B&O) tax rates range from 0.138 percent to 3.3 percent, hard liquor is subject to a 20.5 percent sales tax, and a variety of per-unit excise taxes apply rates that well exceed 1 percent (e.g., $3.025 per pack of 20 cigarettes).[7] These rates are constitutionally

[3] *See* Complaint for Declaratory and Injunctive Relief, *Quinn v. State of Washington* (Wash. Super. Ct. 2021) (henceforth *Quinn*).

[4] *See* Complaint for Declaratory and Injunctive Relief, *Clayton v. State of Washington* (Wash. Super. Ct. 2021) (henceforth *Clayton*).

[5] Wash. Const.

[6] *Id.*

[7] Washington DOR, "Sales & Use Tax Rates"; Washington DOR, "Business & Occupation Tax Classifications"; and Washington DOR, "Other Taxes."

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allowed because they are not considered taxes on property.

Second, the *Quinn and Clayton* plaintiffs argue that capital gains are income and should be taxed as that. They reference the long-standing tradition of including capital gains in adjusted gross income for the purpose of determining federal income tax. They claim that every other state considers capital gains to be income. It is therefore difficult to conclude that capital gains are not income in the context of U.S. taxation.

Third, the lawsuits rely on decisions of the Washington Supreme Court, which determined that income is property for Washington tax purposes. The suits claim that as property, income is subject to the uniform-rate requirement and a 1 percent maximum rate.

The focal point is a 1933 case, *Culliton v. Chase.* In determining that income is property, the Washington Supreme Court rationalized that a person is legally entitled to income earned or received and thus "is legally entitled to keep it, or else to use and dispose of it." The court explained that whether the tax applies to gross or net income is irrelevant — both are income taxes that apply a levy on property. Because an income tax is a tax on property, collectively the two amendments quoted above prohibit a progressive tax with any rate greater than 1 percent.[8]

B. Other Arguments Made in the *Quinn* and *Clayton* Complaints

The plaintiffs in both cases argue that the capital gains tax violates the commerce clause of the U.S. Constitution because taxpayers are subjected to the tax based on their residence and not based only on either the location of the asset being sold or a Washington-based business privilege. We discount the validity of this argument because many states impose income taxes on their residents regardless of the location of the source of the income or a privilege granted by the state.

The *Quinn* plaintiffs make three additional arguments that the capital gains tax is unconstitutional. First, they argue that the capital gains tax violates commerce clause requirements that state taxes should be nondiscriminatory and fairly apportioned. However, the plaintiffs provide no explanation as to how the capital gains tax discriminates or is unfairly apportioned. Second, they argue that the capital gains tax violates the privileges and immunities clause of Article I, section 12 of the Washington Constitution because it assesses the tax on some individuals but not on other individuals and it entirely avoids applying the tax to entities. Yet, taxes are often assessed at the federal level based on income thresholds, and they often apply specifically or differentially based on the type of taxpayer. Third, the complaint argues that the privacy rights of Washington citizens are protected under Article I, section 7 of the constitution. This is true; however, IRC section 6103(d)(1) clearly grants the DOR access to federal tax return information. Further, other states commonly request that taxpayers provide federal tax return information with their state tax returns. Together, these claims in the *Quinn* complaint appear unlikely to gain traction in court.

The *Clayton* complaint fleshes out the term "excise tax" and claims that Washington's capital gains tax fails to meet "the most fundamental test of an excise tax." Unlike the B&O tax, the *Clayton* plaintiffs argue that the capital gains tax "does not attach to any privilege to conduct business — to sell goods or services — within Washington that is subject to state licensure and regulation." Nor, the lawsuit contends, does the capital gains tax apply to a particular transaction type, such as the sale of cigarettes, alcohol, or gasoline. Instead, the lawsuit argues that ESSB 5096 "flaunts well-settled rules requiring that excises bear a substantial relationship to the transaction or business activity that is the taxable event." Unfortunately, the complaint does not cite these rules, and thus it appears that the term "excise tax" is not as uniformly understood as the suit would like the court to believe.

[8] Subsequent Washington Supreme Court cases have found that income is property for the purpose of Amendment 14: *Jensen v. Henneford*, 185 Wash. 209, 53 P.2d 607 (1936); *Power Inc. v. Huntley*, 39 Wn.2d 191, 235 P.2d 173 (1951); and *Apartment Operators Association of Seattle Inc. v. Schumacher*, 56 Wash. 2d 46, 47-48, 351 P.2d 124, 125 (1960).

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III. The Problem and a Stepping-Stone Solution

A. The Problem: Severe Regressivity in the Washington Tax System

Washington is a progressive state with a Democratic "trifecta" — the party controls both legislative houses and the governorship. For the past nine presidential elections, most Washington residents have voted for the Democratic presidential candidate.[9] The 2020 Democratic Party platform demonstrates the connection between Democratic values and tax burdens across income levels. It states:

> Democrats will reform the tax code to be more progressive and equitable, and reduce barriers for working families to benefit from targeted tax breaks, including the Earned Income Tax Credit and the Child Tax Credit.[10]

The problem that Washington's policymakers face is that the state has the country's most regressive tax system. Washington relies on several types of regressive taxes — sales, property, B&O, and excise levies — to make up for the revenue it lacks from a progressive income tax. To illustrate the depth of Washington's tax regressivity, Table 2 excludes Washington and compares the tax burdens of the bottom 20 percent of income earners with the top 1 percent. Panel A shows this comparison graphically, and Panel B shows it statistically by comparing the 14 non-Washington jurisdictions, including the District of Columbia, that have Democratic trifecta governments with the 24 states that have Republican trifecta governments after the 2020 election.[11]

Table 2 shows that state and local tax burdens are regressive in both Democratic and Republican states. In Washington, the effective state and local tax rate is 17.8 percent for the bottom 20 percent of income earners and 3 percent for the top 1 percent of income earners. For comparison, in the Democratic states, the bottom 20 percent of income earners pay an across-state average tax rate of 10.23 percent of income, and the top 1 percent pay, on average, 8 percent. The difference, 2.23 percent, is statistically significant ($p < 0.05$). In Republican states, the bottom 20 percent of income earners pay 10.54 percent, while the top 1 percent of income earners pay only 5.5 percent, and this difference, 5.04 percent — more than double the 2.23 percent difference in Democratic states — is even more significant ($p < 0.01$).

Democratic benchmark states are significantly less regressive than Republican states. This can be seen in the last column of Table 2 Panel B. In each of the 38 non-Washington trifecta jurisdictions, we proxy tax regressivity as the average tax rate for the bottom 20 percent minus the average tax rate for the top 1 percent. We find that this difference averages 2.23 percent in Democratic states and 5.04 percent in Republican states. The $p < 0.02$ statistic indicates less than a 2 percent chance that this difference would have occurred in a random draw of the states without identifying their political party. By comparison, however, Washington's tax regressivity measure, 14.8 percent (17.8 percent minus 3 percent), exceeds that of any other state and is 6.6 times the average regressivity of benchmark Democratic states (14.8 percent/2.23 percent = 6.6).

Given Washingtonians' liberal inclinations, it would seem illogical that voters support and encourage its regressive tax system. But Washington voters have defeated "ten initiatives and referendums to allow an income tax."[12] Most recently, in 2010, 64 percent of Washington residents voted to reject an income tax. Perhaps most interesting, however, is that 36 percent voted to create a new tax when it is probably safe to say that no one likes to pay taxes. While most of us understand that a colonoscopy can save one's life through early detection of cancer and pre-cancerous polyps, few of us look forward to the preparation work and the procedure that yield the health benefits. Similarly, while some voters may understand the potential improvement in social fairness that could result from shifting away from reliance on

[9] Washington state election data is from https://www.270towin.com/states/Washington.

[10] *See* "2020 Democratic Party Platform," at 23 (Aug. 18, 2020).

[11] Our analysis excludes the 13 non-trifecta states.

[12] *See Clayton* complaint at p. 2, para. 4.

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regressive taxes, given a choice, few of us would choose to impose a new income tax on ourselves. Choosing to have a new tax, or a colonoscopy, is simply too tough.

Constituents of Washington lawmakers seem to want a progressive tax system but they are unable to say yes to the colonoscopy (that is, vote for an income tax). Since the state constitution effectively prohibits a progressive income tax, lawmakers' hands are tied when it comes to reforming the tax system. In their effort to "fix" the problem, lawmakers appear to be challenging *Culliton*, which classified a tax on income as a tax on property, which is subject to the flat rate requirement and the 1 percent maximum. Indeed, the *Clayton* suit argues that ESSB 5096 is a "test case" to introduce a Washington income tax. On this point, we agree.

To summarize, Washington residents vote heavily Democratic, and the Democratic party favors progressive taxation. But Washington has the most regressive state and local tax system in the United States, in substantial part because under Washington's Constitution, lawmakers are unable to enact a progressive income tax. Under the constitution, taxes on property are subject to a 1 percent maximum and must be applied uniformly at a flat rate. A 1933 supreme court case deemed a tax on income to be a tax on property, and for 88 years, this classification has prevented Washington from creating a progressive income tax system. Proponents of a progressive income tax have taken the issue directly to voters, and voters have consistently voted against creating an individual income tax. Instead, it appears that lawmakers created the capital gains tax to test the willingness of the Washington Supreme Court to either allow the capital gains tax to be classified as an excise tax, as ESSB 5096 says it is, or to reverse *Culliton*.

B. The Capital Gains Tax as a Possible Stepping Stone to an Income Tax

What then is the answer to Washington's regressive tax system? The legislative history supports the theory that the Legislature seeks a judicial opinion and not a public opinion. When the bill was introduced by Sen. June Robinson (D), it contained a traditional emergency clause that prevents a referendum. But the Senate determined that the people should be allowed to call for a referendum, so the emergency clause was removed from the bill when it passed the Senate.[13] House Democrats, however, replaced it with another emergency clause in a different part of the bill rather than at the end of the bill, where most standard emergency clauses appear. The revised emergency clause states that the capital gains tax is "necessary for the support of the state government and its existing public institutions." This is a direct reference to the wording in the state constitution regarding when a bill may be protected from a referendum by an emergency clause.

Other than a referendum, what options are available to the opposition? The only remaining path appears to be to argue that the law is unconstitutional. This begins in the superior court, where the *Quinn* and *Clayton* suits have been filed, and most likely ends in the Washington Supreme Court. It seems possible that the courts will hold that the capital gains tax is an income tax rather than an excise tax. As a tax on income, which *Culliton* deems to be a tax on property, the capital gains tax would fail both the constitution's flat rate requirement and the 1 percent maximum rate.

What is a reasonable solution? We believe it lies in the Washington Supreme Court reconsidering *Culliton*. The Washington Constitution does not prohibit the Legislature from creating an income tax. The underlying issue is that *Culliton* determined, erroneously in our view, that taxation of a flow of income across time is considered taxation of property.[14] We are struck by the oddity of Washington's seemingly unique interpretation that income is property that falls under the constitution's property tax limitations. Given clear and consistent indications from statewide elections over the past four decades, we believe it is likely that Washington voters would prefer a tax system

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[13] *See* Maxford Nelsen, "Capital Gains Income Tax Moves Towards Passage in Final Days of WA Legislature," Freedom Foundation (Apr. 22, 2021).

[14] Professor Hugh Spitzer asserts that *Culliton* was determined based on misapplication of preceding case law. *See* Mike Lewis, "Excise or Income? Washington State Capital Gains Tax Already Faces a Lawsuit — Here's What to Know," GeekWire (Apr. 29, 2021); and Spitzer's bio at https://www.law.uw.edu/directory/faculty/spitzer-hugh.

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that incorporates a progressive, well-designed, and digitally facilitated income tax over its existing highly regressive tax system. Thus, we believe it would be an unfortunate betrayal of Washington's democracy to have *Culliton* prevent the Legislature from reforming the Washington tax system to reduce its extreme regressivity. To get a tax system that reflects the values of Washington voters, we believe the supreme court should overturn *Culliton* and halt the practice of deeming income to be property.

IV. A Partial Evaluation of the Policy Behind the Capital Gains Tax

A. The Implicit Tax on Real Estate

Section 6(1) of ESSB 5096 excludes all real estate transfers from the Washington capital gains tax. But investments in stocks and bonds are subject to the tax if they are held outside qualified retirement accounts. As a result, real estate investments are tax-favored and stocks and bonds, for example, are tax-disfavored. Washington's Legislature played favorites and tipped the scales in favor of investing in real estate. As a result, some investors will sell securities and use the proceeds to bid up the price of real estate. The price bid-up is called "implicit tax."[15] Higher real estate costs would burden potential homeowners by further pricing them out of homeownership and tenants, who will likely see rent increases.

Interestingly, the implicit tax that drives up the cost of real estate comes when lawmakers are active in confronting a housing crisis.[16] Laws have been passed to address the crisis.[17] No doubt, lawmakers had good intentions when they enacted the capital gains tax in ESSB 5096 and the bills to address the housing crisis. Still, policymakers should recognize that their decision to exempt real estate likely exacerbates Washington's housing problem.

B. Principles-Based Tax Policy Concerns

A range of tax policy principles has developed over many years, perhaps starting in modern times with Adam Smith in 1776.[18] Essentially, however, policy principles are value statements. Therefore, to capture the values of Washington taxpayers, we rely on the tax policy principles prescribed by the 2002 Committee Report of the Washington State Tax Structure Study Committee. This committee was chaired by William H. Gates Sr. (the Gates Report).[19]

The Gates Report outlines six basic principles: adequacy/stability/elasticity; equity/fairness; economic vitality and harmony with other states; economic neutrality and efficiency; transparency and administrative simplicity; and homeownership. We use these principles to evaluate Washington's capital gains tax on an A through F grading scale.

Adequacy/stability/elasticity. The Gates Report argues that a tax system, of which the capital gains tax is a new component, should provide the state with adequate and stable revenues to support public services. Capital gains, especially when real estate is excluded, are inherently linked to the stock market. As a result, capital gains tax revenues are likely to fall precipitously when stock prices fall. Fortunately, from the government's perspective, the capital gains tax was created so that capital losses would not require the state to issue refunds just when revenues are already on the decline. *Grade: C-*

Equity/fairness. The Gates Report evaluates fairness based on vertical equity — taxpayers with greater ability to pay should pay higher rates — on the basis that fairness can be reached in cases in which taxes are levied in relation to benefits received, and based on horizontal

[15] Since Stanford academics Myron Scholes and Mark Wolfson introduced the implicit tax concept in 1992, a slew of published empirical research validates the theory. *See* Scholes and Wolfson, *Taxes and Business Strategy* (1992).

[16] Examples of stories about Washington's housing crisis can be accessed at PugetSoundSage, "Seattle City Council Introduces New Affordable Housing Policy Options"; David Hyde, "Seattle's Hidden Housing Crisis: Middle-Class Workers Forced Out of the City," KUOW (Jan. 22, 2020); and Seattle.gov, Homelessness Response, The Roots of the Crisis.

[17] *See* Wash. Rev. Code section 36.70A.610, (2020) "Housing Supply and Affordability Report"; and ESSHB 1220, "Emergency Shelters and Housing — Local Planning and Development."

[18] *See* Smith's four canons of taxation on pp. 676-678 of the *Wealth of Nations*.

[19] William H. Gates Sr., "Tax Alternatives for Washington State: A Report to the Legislature," Washington State Tax Structure Study Committee (Nov. 2002). The Gates Report tax policy principles are described in Chapter 2 on pp. 3-7.

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equity (that is, similarly situated taxpayers should pay similar taxes). The capital gains tax meets the hurdle of vertical equity by allowing a $250,000 standard deduction. The benefits received notion is not relevant here because no additional government services are provided to taxpayers who pay the capital gains tax.

The capital gains tax falters on horizontal equity. A married couple with $500,000 of stock-driven capital gains would pay $17,500 in capital gains tax. If the couple is unmarried, however, they would face no tax because each would receive a $250,000 standard deduction. Similarly, consider two individuals, each with $10 million of gain on stock investments, but one invested through a tax-deferred retirement account, and the other used after-tax money to invest. Under the capital gains tax, none of the $10 million gain through retirement accounts would be taxed, but the $10 million gain on after-tax investments would, if realized in one year, require payment of $682,500 (the after-tax investment penalty). Note that in both the marriage penalty and the after-tax investment penalty, the taxpayers are penalized from decisions they likely made well before the capital gains tax becomes effective in 2022. There are few options available to avoid these penalties other than divorcing or holding on to stock investments until death when IRC section 1014 will allow a basis step-up. *Grade: B-*

Economic vitality and harmony with other states. The capital gains tax appears to have been created to avoid taxation in multiple states. While an argument can be made that the capital gains tax reduces the investment capital available for private investment, this concern is relatively mild in the current economic climate. *Grade: A*

Economic neutrality and efficiency. By not taxing short-term capital gains, gains on real estate, or gains inside tax-deferred retirement accounts, among other exempted categories, Washington lawmakers played favorites with some assets and penalized others. This violates the neutrality principle and causes market participants to make decisions that they would not otherwise make. Economic inefficiency is created, and market prices depart from where they otherwise would be (see, for example, the implicit tax discussion in subsection A above). *Grade: F*

Transparency and administrative simplicity. This remains to be seen because the tax has not been administered. While the basics of the tax are relatively simple, residency and domicile rules in the statute, among others, appear to be needlessly complex. Still, the DOR has time and ability to do well on this dimension. Our discussion below states our view that the DOR should be charged with providing the initial tax reports to taxpayers instead of taxpayers providing the DOR with tax returns. *Grade: I (Incomplete)*

Homeownership. The Gates Report says the Washington tax system should encourage homeownership. The implicit tax caused by exempting real estate is likely to exacerbate the problem of unattainable home prices for many middle-income Washington residents. In fact, if lawmakers wanted to tip the scale to reduce the price of real estate, they would have done just the opposite: tax real estate capital gains and exempt securities capital gains. *Grade: F*

Based on only the Gates Report's six principles of tax policy, the policy grade of the capital gains tax is about a C-, with "transparency and administrative simplicity" still largely not determinable. However, if the primary goal of the capital gains tax is to test the Washington Supreme Court's appetite for an income tax, perhaps these policy principles are not that important.

V. Implementation Concerns

A. ESSB 5096's Voluntary Filing Requirement

Section 12 requires that taxpayers file tax returns with the DOR. Because the tax system is new, we think decision-makers should reconsider this and shift the initial information collection, processing, and reporting burden from taxpayers to the DOR. Existing voluntary compliance systems are relics from the early 20th century. Today information about financial transactions is commonly reported directly to tax authorities. With effort, the DOR could automate the tax reports and send them to taxpayers. It befuddles us why taxpayers should

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report information to tax authorities that the authorities already have.

The shift of reporting responsibility to the DOR may seem subtle, but it has important implications for the role of the DOR. Substantial resources are spent on processing returns filed by taxpayers and auditing them. The move to a DOR-reports-to-taxpayer system would not be easy but the long-term payoff could be large. However, because this tax only applies to a small segment of Washington taxpayers, it provides the DOR an opportunity to move slowly into the new reporting paradigm. Under the shift, the DOR would become more of an information collector, processor, and reporter, and less emphasis would be placed on auditing returns. Taxpayers would need to digitally sign tax reports, and they could correct the reports if erroneous information is provided by the DOR. A potential downside of this approach is that taxpayers would likely be less inclined to voluntarily report information that the tax authority does not have. This is because the report provided by the DOR would reveal what it knows about taxpayer transactions. In response, the DOR would need to develop new sources of taxpayer information.

Tax systems around the world shift the compliance burden to the government.[20] The benefits to taxpayers are that they can comply with the law without spending much time or effort. Washington voters may have repeatedly rejected the income tax at the ballot box over concerns about the compliance burden and not the tax itself. For the DOR and policymakers, the benefits are multiple. First, the DOR changes from primarily questioning and auditing taxpayers to becoming information processors. Second, policymakers receive more timely information about revenues and can adjust spending decisions accordingly, without having to wait for tax returns to be filed by taxpayers. Third, policymakers could require securities brokers to withhold taxes on gains realized from sales of stocks and bonds. Fourth, policymakers benefit by freeing taxpayer time to be more productive, which builds the Washington economy. Fifth, taxpayers will likely have a better attitude toward paying taxes if they are not working for the DOR. Instead, the DOR would provide service for taxpayers, and this should create a better relationship with taxpayers than we typically find in tax authority-taxpayer settings.

B. The Devil in the Details — Capital Loss Carryforwards

To illustrate the mechanics of the Washington capital gains tax and its carryforward system, tables 3 and 4 assume different capital gain scenarios for a married couple that files joint tax returns and faces a 37 percent marginal federal ordinary income tax rate. Under the federal capital gains tax regime, which we assume will continue through 2024, the first $80,800 of net long-term capital gain is subject to 0 percent tax, the next $420,800 is subject to 15 percent tax, and capital gain over $501,600 incurs 20 percent tax.

In Scenario B (Table 3), we show the general operations of long-term capital loss carryforwards for federal income tax and Washington tax purposes. To do this, we assume our taxpayer couple has $2 million of capital losses in 2022, with $1 million of them allocated to Washington. In 2023 the couple has $1.3 million of capital gains, $600,000 of which pertains to Washington. In 2024 the couple has $1.7 million of capital gain, $900,000 of which relates to Washington. There are no pre-2022 capital loss carryforwards.

Federal rules allow the couple to deduct $3,000 of capital loss in 2022 (which saves $1,110 of ordinary income tax at 37 percent) and carry forward the remaining $1,997,000 (see line 9). When $1.3 million of long-term capital gains are realized in 2023, this carryforward eliminates all related federal tax and, again, saves $1,110 of tax by deducting $3,000 of capital losses against ordinary income at the assumed 37 percent ordinary income tax rate. The taxpayer uses $1,306,000 of the 2021 $2 million capital loss by the end of 2022, leaving $694,000 of carryforward remaining at the end of 2022. The entire $694,000 capital loss carryforward is used

[20] *See, for example,* tax systems in Scandinavia and New Zealand. This PBS news report describes tax administration in New Zealand and offers insight into how Americans could improve their tax systems: PBS NewsHour, "Dreading Doing Your Taxes? Other Countries Show Us There's Another Way," Apr. 13, 2017.

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to offset part of the $1.7 million of gain the couple realizes in 2024.

Table 3 Panel B shows the general operation of capital loss carryforward for Washington purposes. The Washington calculation begins with federal net long-term capital gain or loss from line 5, after capital loss carryforwards (line 4) but before the federal $3,000 allowable capital loss deduction against ordinary income. In 2022 the $1 million addition for non-Washington capital loss (line 11) leaves the remaining $1 million loss allocated to Washington. In 2023 line 12 adds the non-Washington portion, $650,000, of the line 4 loss carryforward. Although not specified by ESSB 5096, we calculate the non-Washington loss carryforward as the ratio of 2022 non-Washington capital loss (line 2) to total capital loss (line 3) applied to the federal capital loss carryforward (line 4) used in 2023 ($1,000,000/$2,000,000 * $1,300,000). Line 13 excludes from Washington tax the non-Washington portion of 2023 capital gain (line 2). Ultimately, line 16 indicates that the 2023 adjusted capital gain after the carryforward is $50,000, which is $300,000 more than necessary to reduce the 2023 Washington capital gains tax to $0 when considering the $250,000 capital loss standard deduction. In other words, the calculation requires the taxpayer to use $300,000 of the Washington capital loss carryforward without benefit.

In 2024 Panel B line 10 reflects the taxable $1,006,000 portion of the $1.7 million federal capital gain after applying the remaining $694,000 carryforward (from line 5). Line 12 adds the portion of the previously deducted loss carryforward that does not pertain to Washington. As assumed above, we apply the 2022 non-Washington ratio of capital losses (line 2 divided by line 3) to the 2024 federal capital loss carryforward used (line 4) to get the line 12 positive adjustment for the non-Washington capital loss carryforward used. Line 13 deducts non-Washington capital gain to reach adjusted capital gain of $553,000. After applying the $250,000 standard deduction, the taxable Washington capital gain is $303,000, which at 7 percent causes $21,210 of Washington capital gains tax.

We understand Washington lawmakers' desire to piggyback on the federal tax return. Federal laws, regulations, and case law provide rich definitions of capital assets and capital gains and losses, and conformity between federal and state systems is beneficial for administrators, practitioners, and taxpayers. In reading ESSB 5096 and related committee reports, however, we are led to believe that lawmakers intended to allow capital losses allocated to Washington to be carried forward to offset future capital gains. That is, the Washington capital loss carryforward should operate like the federal capital loss carryforward. Unfortunately, this result does not appear to consistently occur.

Table 3 Panel C hypothetically calculates Scenario B Washington capital gains and losses directly, without referring to the federal numbers. We compare the indirect legal interpretation of Panel B with the hypothetical Washington-only Panel C for insight into the differences. In 2022, the year the capital loss creates a capital loss carryforward, there appear to be no differences between Panel B and Panel C. But, in Panel C, when the couple has $600,000 of capital gain in 2023, because of the $250,000 standard deduction, hypothetically only $350,000 of the $1 million Washington capital loss carryforward is needed to reduce the Washington capital gains tax to $0. When the remaining hypothetical $650,000 of Washington capital loss carryforward is applied against the $900,000 2024 Washington capital gain, this reduces the Washington capital gains tax to $0 in 2024 because of the $250,000 standard deduction. Note that, without regard to the loss carryforward, the $250,000 standard deduction would cause the taxable portion of the 2023 $600,000 capital gain to be $350,000 and the taxable portion of the 2024 $900,000 capital gain to be $650,000.

Clearly, federal and Washington capital loss carryforwards operate differently. Under the federal system, all long-term capital losses can be used to offset either ordinary income (up to $3,000 annually) or future long-term capital gains. Washington capital gains, however, are reduced annually by a $250,000 standard deduction. Offsetting this benefit, however, is a

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Washington requirement to use capital loss carryforwards to reduce net long-term capital gain below $0 after subtracting the standard deduction. From the taxpayer's point of view, this requirement means that capital loss carryforwards sometimes, as in Scenario B, cannot be fully used.

We offer a potential solution if lawmakers intend to create a system using numbers from federal tax forms so that Washington capital losses can be used to fully offset future taxable Washington capital gain. Table 3 Panel D uses the facts of Scenario B to demonstrate. As with the approach in Panel B, we start with net long-term capital gain (loss) from federal Form 1040 Schedule D. To determine the pre-exemption Washington capital gain or loss realized in the current year on line 33, Panel D line 30 removes the effect of federal capital loss carryforward, line 31 removes the effect of non-Washington capital losses, and line 32 removes the effect of non-Washington capital gain. Lines 34 and 35 adjust for exemptions from the Washington capital gains tax that do not apply for federal tax purposes. Thus, line 36 is adjusted capital gain (loss) before the standard deduction. The standard deduction on line 37 applies only if Washington capital gains are realized; it has no effect otherwise. Subtracting the standard deduction, if applicable, produces line 38, adjusted capital gain (if the number is positive) or preliminary loss. The addition of the (negative) prior-year capital loss carryforward, if any, on line 39 produces line 40. If line 40 is positive, it represents taxable Washington capital gain that is subject to the 7 percent capital gains rate, producing tax due on line 42. If line 40 is negative, it represents the balance of capital loss to be carried forward to offset future taxable capital gain income.

Table 4 illustrates Scenario C, in which a capital loss allocated to Washington can be permanently lost because of capital gains that are realized outside Washington. This also appears to be because of how Washington relies on numbers in the federal tax forms. To demonstrate this, in Panel A lines 1 and 2, we assume that a joint-return taxpayer's only capital asset realizations are $1 million of Washington long-term capital loss in 2022, $1.1 million of non-Washington long-term capital gain in 2023, and $900,000 of Washington long-term capital gain in 2024. The taxpayer has no capital loss carryforward from 2021.

For federal purposes, Panel A shows that $997,000 of the 2022 Washington $1 million capital loss is carried forward to 2023 and fully used to offset 2023 non-Washington long-term capital gain. As a result, no capital loss carryforward is available to offset the 2024 non-Washington capital gain; all $900,000 of the 2024 capital gain is fully taxable for federal tax purposes.

Panel B follows the computation enacted in ESSB 5096. The 2023 non-Washington gain of $1.1 million completely consumes the federal capital loss carryforward (Panel A line 9 is $0 in 2023). As a result, when the taxpayer realizes $900,000 of long-term capital gain in 2024, the excess over the $250,000 standard deduction, $650,000, is fully taxable at 7 percent. Tax of $45,500 is due.

From a Washington-only perspective, in Scenario C, the taxpayer has a $1 million Washington capital loss in 2022 followed by a 2024 capital gain of $900,000, for a net loss of $100,000 over the three years. However, the taxpayer perversely incurs a negative tax rate of 45.5 percent on this loss, paying Washington tax of $45,500 in 2024 on this $100,000 net loss. Panel C offers our interpretation of how, hypothetically, a Washington capital loss carryforward system would offset future capital gains without relying on federal tax forms. It shows that in 2024, $650,000 of the $1 million loss carryforward would be used to fully offset the $650,000 taxable capital gain (that is, $900,000 less the $250,000 standard deduction); no Washington capital gains tax would be due in 2024, and $350,000 of capital loss carryforward would be available to offset post-2024 capital gains ($1 million capital loss in 2022 minus $650,000 used in 2024).

Table 4 Panel D applies our proposed remedy based on federal forms to the Scenario C facts. As with Scenario B, the result we obtain in Panel D using federal form information is identical to the result we obtain with the "hypothetically correct" Panel C. That is, the $1 million Washington capital loss in 2022 is

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preserved until 2024, when $650,000 of the capital loss carryforward is used to reduce Washington adjusted capital gain to $0. Line 40 shows the remaining $350,000 as a carryforward to offset taxable capital gain in 2025 and beyond.

VI. Conclusion

At first glance, the new Washington capital gains tax seems simple: a 7 percent tax on long-term capital gains. But the many exemptions and a generous $250,000 standard deduction mean that the tax applies to only about 7,000 of Washington's 7.8 million residents. The real estate exemption is especially troubling because it has the potential to further increase the cost of home occupancy in a market that — at least in the Seattle area — is characterized as a housing crisis. For this reason, and because real estate transactions are relatively easy to identify and tax, we urge lawmakers to reconsider the real estate exemption.

We believe the new capital gains tax provides Washington lawmakers and the DOR with an opportunity to establish goodwill with a set of taxpayers who have not previously dealt directly with the DOR. If policymakers really want positive relations with Washington residents, they should abandon the voluntary compliance system under which taxpayers provide the initial tax report. A key source of consternation among taxpayers is that they know that the DOR works for them, yet the voluntary compliance system creates a setting in which taxpayers work for the DOR. We believe that requiring taxpayers to annually collect, accumulate, understand, and report their tax return information is an inefficient use of Washington's labor resource. Instead, the DOR is well-positioned to capture economies of scale in preparing initial tax reports for taxpayers. The benefits of a system that works for taxpayers would persist for decades, show the rest of the country that Washington is a leader in tax administration, and make Washington's labor force more efficient by minimizing wasted time and effort.

Table 1. Scenario A: General Application of the Washington Capital Gains Tax

	Panel A — Federal long-term capital gain (loss) calculation	**2022**
1.	Washington capital gain (loss)	$1,000,000
2.	Non-Washington capital gain (loss)	$0
3.	Overall capital gain (loss) before carryforwards and limits	$1,000,000
4.	Capital loss carryforward used to offset long-term capital gains	$0
5.	Federal net capital gain (loss) (Form 1040 Schedule D line 15)	$1,000,000
6.	Taxable federal net capital gain (loss) after loss limitation	$1,000,000
7.	Federal tax on net capital gain using 0%, 15%, and 20% rates; 37% on losses	$162,800
8.	Long-term capital loss carryforward used for $3,000 federal deduction allowance	$0
9.	Federal capital loss carryforward balance (prior-year balance plus line 4 minus line 5 (if negative) minus line 8)	$0
	Panel B — Washington long-term capital gain (loss) calculation	
10.	Federal net long-term capital gain (loss) (Form 1040 Schedule D line 15, Sec. 4(1))	$1,000,000
11.	Add long-term capital loss not allocated to Washington, Sec. 4(1)(b)	$0
12.	Add long-term loss carryforward not allocated to Washington, Sec. 4(1)(c)	$0
13.	(Less) long-term capital gain not allocated to Washington, Sec. 4(1)(d)	$0
14.	(Less) capital gain exempt from the Washington capital gains tax, Sec. 4(1)(e)	$0
15.	Add capital loss exempt from the Washington capital gains tax, Sec. 4(1)(a)	$0
16.	Equals: Adjusted capital gain	$1,000,000
17.	Washington long-term capital gain standard deduction	($250,000)
18.	Washington capital gains (loss limited to $0)	$750,000
19.	Washington capital gains tax rate	7%
20.	Washington 7% capital gains tax	$52,500

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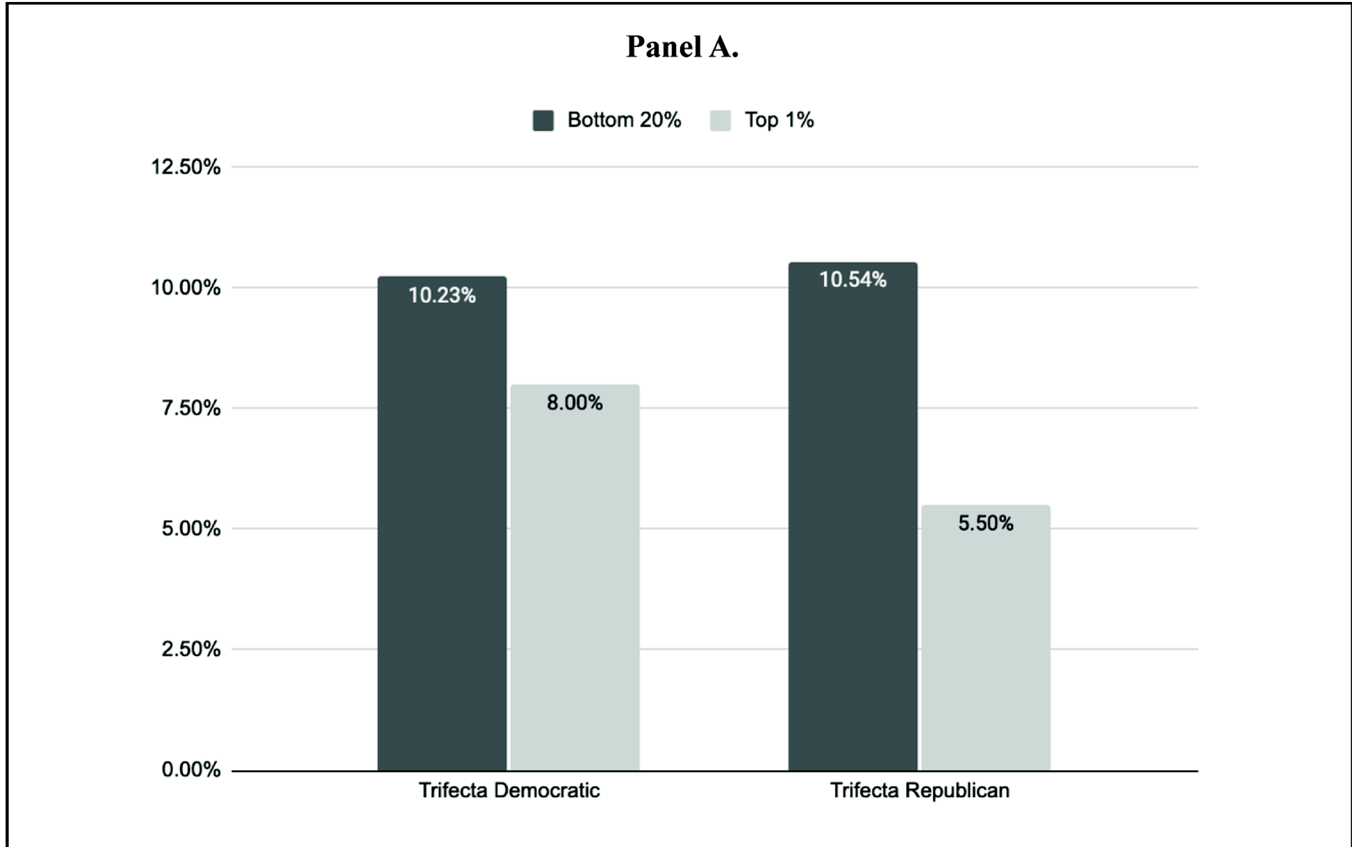
Table 2. Differences in Effective Tax Rates Between the Bottom 20 Percent and Top 1 Percent of Income Earners in Trifecta Democratic and Trifecta Republican States

Panel A — Chart comparison of the effective tax rates of income earners in the bottom 20 percent and top 1 percent of 14 Democratic and 24 Republican states with party trifecta governments other than Washington.



Panel B — T-test comparisons of the effective tax rates for income earners in the bottom 20 percent and top 1 percent of 14 Democratic and 24 Republican states with party trifecta governments other than Washington.

	Bottom 20% effective rate	Top 1% effective rate	T-test significance	Bottom 20% minus top 1%
Trifecta Democratic (14 jurisdictions)	10.23%	8%	$p < 0.05$	2.23%
Trifecta Republican (24 jurisdictions)	10.54%	5.5%	$p < 0.01$	5.05%
Democratic minus Republican	-0.29%	2.52%		-2.81%
T-test significance	n.s.	$p < 0.01$		$p < 0.02$

Note: This table excludes Washington, a trifecta Democratic state with a 17.8 percent effective state and local tax rate for the bottom 20 percent of income earners compared with a 3.0 percent tax rate for the top 1 percent of income earners. Source: Institute of Taxation and Economic Policy (https://itep.org/whopays).

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Table 3.
Scenario B: General Application of the Long-Term Capital Loss Carryforwards for Washington and Federal Income Tax Purposes

Panel A — Federal long-term capital gain (loss) calculation		2022	2023	2024
1.	Washington capital gain (loss)	($1,000,000)	$600,000	$900,000
2.	Non-Washington capital gain (loss)	($1,000,000)	$700,000	$800,000
3.	Overall capital gain (loss) before carryforwards and limits	($2,000,000)	$1,300,000	$1,700,000
4.	Capital loss carryforward used to offset long-term capital gains	$0	($1,300,000)	($694,000)
5.	Federal net capital gain (loss) (Form 1040 Schedule D line 15)	($2,000,000)	$0	$1,006,000
6.	Taxable federal net capital gain (loss) after loss limitation	($3,000)	($3,000)	$1,006,000
7.	Federal tax on net capital gain using 0%, 15%, and 20% rates; 37% on losses	($1,110)	($1,110)	$164,000
8.	Long-term capital loss carryforward used for $3,000 federal deduction allowance	$3,000	$3,000	$0
9.	Federal capital loss carryforward balance (prior-year balance plus line 4 minus line 5 (if negative) minus line 8)	$1,997,000	$694,000	$0
Panel B — Washington long-term capital gain (loss) calculation		**2022**	**2023**	**2024**
10.	Federal net long-term capital gain (loss) (Form 1040 Schedule D line 15, Sec. 4(1))	($2,000,000)	$0	$1,006,000
11.	Add long-term capital loss not allocated to Washington, Sec. 4(1)(b)	$1,000,000	$0	$0
12.	Add long-term loss carryforward not allocated to Washington, Sec. 4(1)(c)	$0	$650,000	$347,000
13.	(Less) long-term capital gain not allocated to Washington, Sec. 4(1)(d)	$0	($700,000)	($800,000)
14.	(Less) capital gain exempt from the Washington capital gains tax, Sec. 4(1)(e)	$0	$0	$0
15.	Add capital loss exempt from the Washington capital gains tax, Sec. 4(1)(a)	$0	$0	$0
16.	Equals: Adjusted capital gain	($1,000,000)	($50,000)	$553,000
17.	Washington long-term capital gain standard deduction	($250,000)	($250,000)	($250,000)
18.	Washington capital gains (loss limited to $0)	$0	$0	$303,000
19.	Washington capital gains tax rate	7%	7%	7%

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Table 3.
Scenario B: General Application of the Long-Term Capital Loss Carryforwards for Washington and Federal Income Tax Purposes *(Continued)*

20.	Washington 7% capital gains tax	$0	$0	$21,210
Panel C — Hypothetical direct calculation of Washington long-term capital gain (loss)		**2022**	**2023**	**2024**
21.	Adjusted capital gain	($1,000,000)	$600,000	$900,000
22.	Washington capital loss carryforward used	$0	($350,000)	($650,000)
23.	Washington net long-term capital gain (no loss allowed)	$0	$250,000	$250,000
24.	Washington long-term capital gain standard deduction	($250,000)	($250,000)	($250,000)
25.	Washington capital gains (loss limited to $0)	$0	$0	$0
26.	Washington capital gains tax rate	7%	7%	7%
27.	Washington capital gains tax	$0	$0	$0
28.	Washington loss carryforward balance at the end of the year	$1,000,000	$650,000	$0
Panel D — Proposed Washington computation of capital loss carryforward and gains (losses)		**2022**	**2023**	**2024**
29.	Federal net long-term capital gain (loss) (Form 1040 Schedule D line 15, Sec. 4(1))	($2,000,000)	$0	$1,006,000
30.	Add federal capital loss carryforward used (line 4 above times -1)	$0	$1,300,000	$694,000
31.	Add long-term capital loss not allocated to Washington, Sec. 4(1)(b)	$1,000,000	$0	$0
32.	(Less) long-term capital gain not allocated to Washington, Sec. 4(1)(d)	$0	($700,000)	($800,000)
33.	Equals: Washington current-year capital gain (loss) before exemptions	($1,000,000)	$600,000	$900,000
34.	(Less) capital gain exempt from the Washington capital gains tax, Sec. 4(1)(e)	$0	$0	$0
35.	Add capital loss exempt from the Washington capital gains tax, Sec. 4(1)(a)	$0	$0	$0
36.	Equals: Adjusted capital gain (loss)	($1,000,000)	$600,000	$900,000
37.	If line 36 is greater than 0, subtract the Washington capital gain standard deduction	$0	$250,000	$250,000
38.	Equals: Washington capital gains (preliminary loss)	($1,000,000)	$350,000	$650,000
39.	Washington long-term capital loss carryforward from the preceding year	$0	($1,000,000)	($650,000)

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Table 3.
Scenario B: General Application of the Long-Term Capital Loss Carryforwards for Washington and Federal Income Tax Purposes *(Continued)*

40.	Add lines 38 and 39. If the sum is positive, this is your taxable Washington capital gain. If the sum is negative, this is your Washington capital loss carryforward to next year.	($1,000,000)	($650,000)	$0
41.	Washington long-term capital gains tax rate	7%	7%	7%
42.	If line 40 is greater than 0, multiply lines 40 and 41. This is your Washington capital gains tax.	$0	$0	$0

Table 4.
Scenario C: Washington Capital Loss Carryforward Permanently Lost in the Shuffle

Panel A — Federal long-term capital gain (loss) calculation		2022	2023	2024
1.	Washington capital gain (loss)	($1,000,000)	$0	$900,000
2.	Non-Washington capital gain (loss)	$0	$1,100,000	$0
3.	Overall capital gain (loss) before carryforwards and limits	($1,000,000)	$1,100,000	$900,000
4.	Capital loss carryforward used to offset long-term capital gains	$0	($997,000)	$0
5.	Federal net capital gain (loss) (Form 1040 Schedule D line 15)	($1,000,000)	$103,000	$900,000
6.	Taxable federal net capital gain (loss) after loss limitation	($3,000)	$103,000	$900,000
7.	Federal tax on net capital gain using 0%, 15%, and 20% rates; 37% on losses	($1,110)	$3,330	$142,800
8.	Long-term capital loss carryforward used for $3,000 federal deduction allowance	$3,000	$0	$0
9.	Federal capital loss carryforward balance (prior-year balance plus line 4 minus line 5 (if negative) minus line 8)	$997,000	$0	$0
Panel B — Washington long-term capital gain (loss) calculation		**2022**	**2023**	**2024**
10.	Federal net long-term capital gain (loss) (Form 1040 Schedule D line 15, Sec. 4(1))	($1,000,000)	$103,000	$900,000
11.	Add long-term capital loss not allocated to Washington, Sec. 4(1)(b)	$0	$0	$0
12.	Add long-term loss carryforward not allocated to Washington, Sec. 4(1)(c)	$0	$0	$0
13.	(Less) long-term capital gain not allocated to Washington, Sec. 4(1)(d)	$0	($1,100,000)	$0

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Table 4.
Scenario C: Washington Capital Loss Carryforward Permanently Lost in the Shuffle *(Continued)*

14.	(Less) capital gain exempt from the Washington capital gains tax, Sec. 4(1)(e)	$0	$0	$0
15.	Add capital loss exempt from the Washington capital gains tax, Sec. 4(1)(a)	$0	$0	$0
16.	Equals: Adjusted capital gain	($1,000,000)	($997,000)	$900,000
17.	Washington long-term capital gain standard deduction	($250,000)	($250,000)	($250,000)
18.	Washington capital gains (loss limited to $0)	$0	$0	$650,000
19.	Washington capital gains tax rate	7%	7%	7%
20.	Washington 7% capital gains tax	$0	$0	$45,500
Panel C — Hypothetical direct calculation of Washington long-term capital gain (loss)		**2022**	**2023**	**2024**
21.	Washington capital gain (loss)	($1,000,000)	$0	$900,000
22.	Washington capital loss carryforward used	$0	$0	($650,000)
23.	Washington net long-term capital gain (no loss allowed)	$0	$0	$250,000
24.	Washington long-term capital gain standard deduction	($250,000)	($250,000)	($250,000)
25.	Washington adjusted capital gain	$0	$0	$0
26.	Washington capital gains tax rate	7%	7%	7%
27.	Washington capital gains tax	$0	$0	$0
28.	Washington loss carryforward balance at the end of the year	$1,000,000	$1,000,000	$350,000
Panel D — Proposed Washington computation of capital loss carryforward and gains (losses)		**2022**	**2023**	**2024**
29.	Federal net long-term capital gain (loss) (Form 1040 Schedule D line 15, Sec. 4(1))	($1,000,000)	$103,000	$900,000
30.	Add federal capital loss carryforward used, i.e., line 4 above times -1	$0	$997,000	$0
31.	Add long-term capital loss not allocated to Washington, Sec. 4(1)(b)	$0	$0	$0
32.	(Less) long-term capital gain not allocated to Washington, Sec. 4(1)(d)	$0	($1,100,000)	$0
33.	Equals: Washington current-year capital gain (loss) before exemptions	($1,000,000)	$0	$900,000
34.	(Less) capital gain exempt from the Washington capital gains tax, Sec. 4(1)(e)	$0	$0	$0

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Table 4.
Scenario C: Washington Capital Loss Carryforward Permanently Lost in the Shuffle *(Continued)*

35.	Add capital loss exempt from the Washington capital gains tax, Sec. 4(1)(a)	$0	$0	$0
36.	Equals: Adjusted capital gain	($1,000,000)	$0	$900,000
37.	If line 36 is greater than 0, subtract the Washington capital gain standard deduction	$0	$0	$250,000
38.	Equals: Washington capital gains (preliminary loss)	($1,000,000)	$0	$650,000
39.	Washington long-term capital loss carryforward from the preceding year	$0	($1,000,000)	($1,000,000)
40.	Add lines 38 and 39. If the sum is positive, this is your taxable Washington capital gain. If the sum is negative, this is your Washington capital loss carryforward to next year.	($1,000,000)	($1,000,000)	($350,000)
41.	Washington long-term capital gains tax rate	7%	7%	7%
42.	If line 40 is greater than 0, multiply lines 40 and 41. This is your Washington capital gains tax.	$0	$0	$0

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