Supreme Court No. 100769-8

IN THE SUPREME COURT
OF THE STATE OF WASHINGTON

CHRIS QUINN, AN INDIVIDUAL; CRAIG LEUTHOLD, AN INDIVIDUAL; LEWIS AND MARTHA RANDALL, AS INDIVIDUALS AND THE MARITAL COMMUNITY COMPRISED THEREOF; RICK GLENN, AN INDIVIDUAL; NEIL MULLER, AN INDIVIDUAL; LARRY AND MARGARET KING, AS INDIVIDUALS AND THE MARITAL COMMUNITY COMPRISED THEREOF; AND KERRY COX, AN INDIVIDUAL,

Respondents,

v.

STATE OF WASHINGTON, DEPARTMENT OF REVENUE, AN AGENCY OF THE STATE OF WASHINGTON, AND VIKKI SMITH, IN HER OFFICIAL CAPACITY AS DIRECTOR OF THE DEPARTMENT OF REVENUE,

Appellants,

EDMONDS SCHOOL DISTRICT, TAMARA GRUBB, ADRIENNE STUART, MARY CURRY, AND WASHINGTON EDUCATION ASSOCIATION,

Intervenors.

APRIL CLAYTON, AN INDIVIDUAL; KEVIN BOUCHEY, AN INDIVIDUAL; RENEE BOUCHEY, AN INDIVIDUAL; JOANNA CABLE, AN INDIVIDUAL; ROSELLA MOSBY, AN INDIVIDUAL; BURR MOSBY, AN INDIVIDUAL; CHRISTOPHER SENSKE, AN INDIVIDUAL; CATHERIN SENSKE, AN INDIVIDUAL; MATTHEW SONDEREN, AN INDIVIDUAL; JOHN MCKENNA, AN INDIVIDUAL; WASHINGTON FARM BUREAU; WASHINGTON STATE TREE FRUIT ASSOCIATION; WASHINGTON STATE DAIRY FEDERATION,

Respondents,

v.

STATE OF WASHINGTON, DEPARTMENT OF REVENUE, AN AGENCY OF THE STATE OF WASHINGTON, AND VIKKI SMITH, IN HER OFFICIAL CAPACITY AS DIRECTOR OF THE DEPARTMENT OF REVENUE,

Appellants,

EDMONDS SCHOOL DISTRICT, TAMARA GRUBB, ADRIENNE STUART, MARY CURRY, AND WASHINGTON EDUCATION ASSOCIATION,

Intervenors.

BRIEF OF AMICI THE BUILDING INDUSTRY ASSOCIATION OF WASHINGTON AND THE WASHINGTON RETAIL ASSOCIATION

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I. INTRODUCTION

Appellants have asked this Court to review a trial court ruling in favor of Respondents' constitutional challenges to the enactment of Engrossed Substitute Senate Bill 5096 (ESSB 5096), which levies an unconstitutional capital gains tax on the sale or exchange of non-exempt capital assets by Washington residents. Respondents' brief ably explains the constitutional defects of ESSB 5096. This amicus brief will focus on the very real economic harms this income tax will cause — and already is causing — for small business owners in our state.

The Court should rule in favor of the Respondents because this law is an unconstitutional assessment of tax on the income of the thousands of businesses and individuals represented by the Building Industry Association of Washington ("BIAW") and the Washington Retail Association ("WRA"). The hardworking business owners who make up these organizations' respective memberships deserve to have their income taxed fairly, consistently, and constitutionally. The illegal income tax that

ESSB 5096 disguises as an excise tax does none of those things, and instead introduces uncertainty, inconsistency, and arbitrariness into the tax code. It is both bad law and bad policy. For these reasons, as well as those stated by Respondents, this Court should decline the legislature's invitation to circumvent the longstanding constitutional limitations on income taxes in Washington, and uphold the trial court's ruling in this matter.

II. FACTUAL AND PROCEDURAL BACKGROUND

In the interest of judicial economy, this brief defers to the thorough recitation of the facts and procedural background of this case given by Respondents in their brief.

III. IDENTITY AND INTEREST OF AMICI CURIAE

BIAW represents nearly 8,000 members of the home building industry. It is made up of 14 affiliated local associations: the Building Industry Association of Clark County, the Central Washington Home Builders Association, the Jefferson County Home Builders Association, the Master Builders Association of King and Snohomish Counties, the

Home Builders Association of Kitsap County, the Lower Columbia Contractors Association, the North Peninsula Building Association, the Olympia Master Builders, the Master Builders Association of Pierce County, the San Juan Builders Association, the Skagit-Island Counties Builders Association, the Spokane Home Builders Association, the Home Builders Association of Tri-Cities, and the Building Industry Association of Whatcom County. The organization's members are engaged in every aspect of the residential construction industry, providing well-paying jobs for thousands of working families and sizable tax revenue for both state and local governments.

WRA, established in 1987, is concerned with advancing and safeguarding the well-being of the retail industry. WRA is the state's only association exclusively dedicated to advocating the unique interests of retailers on legislative and regulatory issues. WRA represents more than 4,000 storefronts statewide that range from large national chains to small shops. Our members include wholesalers, dealers, professional services, and

mall owners and operators. Though a unique state association, WRA maintains numerous partnerships with like-minded associations and chambers of commerce across the state and nation.

Collectively, BIAW and WRA are referred to as the "Business Associations."

The Business Associations have a strong interest in the resolution of the appeal in this case. Their members are sole proprietors and business owners who pay taxes in this state, as well as own non-exempt capital assets. These industrious taxpayers consider tax law when making plans for the future of their companies, and the tax imposed by ESSB 5096 has already hit their bottom lines. Even before the tax has been assessed, decisions about the sale of business assets, the timing of gain realization, whether to invest in non-exempt capital assets, and whether to move their businesses out of state are being made.

Assets once free of state capital gains tax are now subject to the levy imposed by ESSB 5096, thereby reducing their value

and harming their owners. The Business Associations have a very strong interest in protecting their respective memberships from these economic injuries.

The Business Associations offer this brief to assist the Court in considering the harmful impacts that the enactment of ESSB 5096 and the ensuing imposition of an unconstitutional income tax will have on business owners in Washington.

IV. ISSUES ADDRESSED

1. How the State's treatment of capital gains differs in manner from every other state as well as the federal government, and how that will impact business owners.

2. How business owners have been impacted by the enactment of ESSB 5096, and how they will be impacted by the imposition of an unconstitutional income tax.

3. How the enactment of ESSB 5096 disregards the rule of law and the ways in which that impacts Washington business owners.

4. How the enactment of a tax as complex as ESSB 5096 will prove to discourage budding entrepreneurs, legacy family businesses, and industrious taxpayers throughout our state from starting, continuing, and expanding their enterprises in Washington.

V. ARGUMENT

A. The treatment of capital gains in Washington will harm Washington businesses by increasing the complexity of doing business here.

ESSB 5096 purports to impose an excise tax on capital gains rather than an income tax. The legislation, by its own admission, is a tax on an individuals' receipt of capital *gains*, not an excise tax on capital *transfers*, as the State contends. The State's effort to mischaracterize the legislation as an excise tax represents a radical departure from how every other jurisdiction in our nation treats capital gains.

Starting with the federal government and the Internal Revenue Code, on which Washington's tax is entirely modeled and based, the gain on sale of long-term capital assets is

indisputably treated as personal income. The forty-one states that levy a tax on capital gains also treat them as income. The only states that do not tax capital gains as income are those that levy no income taxes at all — Alaska, Florida, Nevada, South Dakota, Texas, and Wyoming — and the two states, New Hampshire and Tennessee, that tax only dividends and interest income earned by individual taxpayers. Thus, every jurisdiction in our nation that taxes capital gains treats them as income, and duly recognizes its capital gains tax as an income tax. The solitary exception is Washington, thanks to ESSB 5096.

With the vote forty-nine to one, the unanimous weight of authority compels the conclusion that the capital gains tax imposed by ESSB 5096 is actually an income tax, not an excise tax. But how does the incongruity between Washington's taxation of capital gains and all other relevant jurisdiction's taxation of them affect businesses?

The simplest answer is that it harms Washington businesses by creating an inconsistency between the fiscal reality

of buying, owning, selling, and exchanging capital assets in Washington and the rest of the nation. Washington is not an economic island; its taxpayers own non-exempt capital assets and manage businesses that own such assets in many other states, including the forty-one states that tax gains from the sale or exchange of such assets as income. This fiscal inconsistency poses a problem for taxpaying business owners, both within and beyond our borders, which is recognized by the United States Supreme Court as undesirable. "Taxpayers should be treated equally without regard to the fortuity of residence," that court observed in *Comm'r v. Stern*, 357 U.S. 39, 49, 78 S. Ct. 1047, 2 L. Ed. 2d 1126 (1958), "and the additional complication and inconvenience in the administration of an already complex federal tax system which is certain to follow an attempt to apply the differing laws of [individual states] ought to be avoided, if at all possible." Although *Stern* involved transferee tax liability, its rationale applies to liability for the capital gains tax at issue here,

which is also based on federal law. *See* ESSB 5096, § 4 (defining capital gain as that reportable on federal income tax returns).

No other state charges an excise tax on the sale or exchange of non-exempt capital assets, and no state that charges an excise tax on certain sales or exchanges assesses it on transactions occurring outside of its taxing jurisdiction. For a business owner who lives in Washington and sells assets in another state, this disparity of capital gains treatment complicates bookkeeping, adds to the administrative complexity of interjurisdictional business, and discourages commerce. The lack of certainty over what capital gains *are* for Washington residents puts a structural burden in the way of their businesses. Are capital gains a type of income, as absolutely every other taxing jurisdiction in our country believes? If so, businesses can plan accordingly. Or are they part of the privilege of doing business while residing in Washington? ESSB 5096 obscures this question.

Washington's application of an excise tax to capital gains is a baffling singularity within the continuum of American capital gains taxation, one that adds complexity, confusion, and inconvenience to Washington taxpayers who own assets and businesses in multiple jurisdictions. This "complication and inconvenience" is exactly what our government should seek to avoid in creating and administering our state tax code. *See Stern*, 357 U.S. at 49.

B. The levy imposed by ESSB 5096 will harm businesses by illegally taxing their out-of-state business activities in violation of the Commerce Clause.

As explained in Respondents' brief, ESSB 5096 clearly violates the Commerce Clause of the United States Constitution, which grants to Congress the exclusive power "to regulate commerce . . . among the several states." The illegal income tax that ESSB 5096 imposes not just on income generated by sales and exchanges of property located in Washington, but also generated by such activities by Washington residents in *all* states

and indeed the world over, violates the well-established line of Commerce Clause cases that limit the ability of one state to tax activities occurring outside its borders. This is a terrible blow for Washington taxpayers engaged in interstate commerce.

In 1946, the United States Supreme Court held that in determining whether a tax imposes a prohibited burden on interstate commerce, the tax's practical effect rather than its label or appearance will be controlling. *See Nippert v. Richmond*, 327 U.S. 416, 66 S.Ct. 586, 593, 90 L.Ed. 760, 766 (1946); *Railway Express Agency v. Virginia*, 347 U.S. 359, 74 S.Ct. 558, 561, 98 L.Ed. 757, 762 (1954); *cf. Martin Ship Service Co. v. Los Angeles* 34 C.2d 793, 803, 215 P.2d 24 (1950). Under the Commerce Clause, this is our guide in interpreting the tax imposed under ESSB 5096: not what the state calls it, but how it practically affects Washington taxpayers, including the business owners authoring this brief.

It is not enough to characterize an event or transaction as local or to label a tax as an excise tax in order to make it so. To

pass scrutiny under the dormant Commerce Clause, ESSB 5096 must, in its practical effect, (1) apply to an activity with a substantial nexus with the taxing state, (2) be fairly apportioned, (3) not discriminate against interstate commerce, and (4) be fairly related to the services the state provides. *See Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274, 279, 97 S.Ct. 1076, 51 L.Ed.2d 326 (1977); *S. Dakota v. Wayfair, Inc*., 138 S. Ct. 2080, 2091, 201 L. Ed. 2d 403 (2018). The tax imposed by ESSB 5096 fails this test from the starting gate when one considers the practical effects the tax is having on the Washington business owners represented by the Business Associations. *See Nippert*, 327 U.S. at 416.

Consider a Washington taxpayer who owns a pass-through interstate business that sells or exchanges non-exempt capital assets in states throughout the country. She may sell capital assets in Tennessee that are subject to the capital gains tax imposed by ESSB 5096; there is no deduction or exemption available, since Tennessee does not assess a capital gains tax.

See ESSB 5096, § 11 (relieving taxpayers from allocation of extraterritorial gain if another taxing jurisdiction assesses tax on the transaction). Suppose the assets were made in Tennessee, bought in Tennessee, used in Tennessee, and sold in Tennessee. Does the taxation of gain from their sale by Washington pass constitutional muster? No: under the *Complete Auto* test, the tax imposed by ESSB 5096 applies to the capital gains of Washington residents like the business owner in our example, regardless of where the capital assets that generated her gains were located, Tennessee or otherwise. Thus, the tax can and will continue to apply to assets and activities with absolutely no nexus or connection to Washington, and it is not apportioned and does not fairly relate to the services Washington provides, rendering it federally unconstitutional and harming Washington businesses.

Likewise, consider the sale of a lumber company based in the Tri-Cities, which does significant business in Oregon. The purported excise tax imposed by ESSB 5096 would implicate

operational fiscal assets that may be located in both states. The tax would also implicate intangible assets like good will. How would a business, for example, calculate the value of goodwill generated in Oregon versus that in Washington State? The Oregon activities have no nexus or ties to Washington other than through the domicile of the company's owner. The tax creates a significant burden and logistical nightmare for the sale of a multistate business. The assessment of an excise tax on these out-of-state activities is a clear violation of the Commerce Clause, not to mention a significant hit to the company's bottom line.

The consequences of this illegal extraterritorial taxation are dire. It is one thing for a state to assess a unique tax within its territory, but in the case of ESSB 5096, as shown above, the tax's extension beyond our state's borders presents unique problems for taxpayers who own intangible capital assets in other states — assets over which Washington lacks jurisdiction, in transactions as to which it lacks any nexus whatsoever.

Washington's unique, unprecedented and unconstitutional tax on capital gains will discourage our state's resident entrepreneurs and investors from investing in new and expanded businesses in our state, or businesses with extraterritorial aspirations, in order to avoid the confusion and disparate tax treatment it introduces. It will also cause significant numbers of individual business owners to leave Washington to avoid the new tax on gains from sales and exchanges of not only their assets located within our state, but those located in jurisdictions across the United States, and literally anywhere in the world. Rather than raise net revenue for Washington's coffers, the income tax that ESSB 5096 imposes on capital gains could have the effect of reducing total revenues from taxes such as the B&O and sales taxes by encouraging taxpayer migration, business relocation, and capital flight.

It bears restatement: ESSB 5096 will harm Washington businesses by discouraging investment in capital assets owned by Washington residents and their companies. Business owners

who live within our borders may elect not to invest in capital assets because they do not know how they will be taxed if sold or exchanged: as income, like everywhere else, or part of the privilege of living in Washington, like nowhere else.

This not only renders the tax unconstitutional on Commerce Clause grounds, it also harms business owners by discouraging them from expanding their businesses beyond state lines. If their business activities in other states are subjected to Washington taxation solely based on their state residency, and not (as in all other states) based on the activities' connection to Washington, the natural choice for Washington taxpayers is to limit their acquisition of and investment in out-of-state assets and business operations, thereby limiting the growth of their businesses and contracting commerce in Washington. This artificial suppression of interstate commerce is exactly why the Framers included the Commerce Clause in the United States Constitution and exactly why ESSB 5096 is unconstitutional from a federal perspective. They knew that if states were

permitted to regulate interstate commerce, the commercial health of the nation would suffer, as businessmen and businesswomen are suffering under ESSB 5096 now.

C. The blatant illegality of ESSB 5096 harms Washington businesses because it shows a disregard for the rule of law by Washington lawmakers, which puts a chill on business in our state.

More difficult to quantify than the harms caused by the fiscal confusion and illegal extraterritorial taxation of ESSB 5096 is the harm caused by the obvious illegality of our state lawmakers' actions in enacting the tax. As noted above, Washington is the only state in the country that characterizes the sale or exchange of non-exempt capital assets as an excise tax event, not an income tax event. The motive for this semantic fiction is plain: our state constitution is crystal clear that taxes on property — an asset class which our judiciary has long held includes all forms of income — must be uniform and less than one percent. Notwithstanding these limitations, our legislature wanted to pass a graduated income tax with rates well in excess

of one percent. Previous attempts to do so through the ballot box had repeatedly failed, soundly rejected by Washington voters. What to do?

Our lawmakers landed on the solution of calling the tax imposed by ESSB 5096 an "excise" tax rather than an income tax, to sidestep the constitutional constraints on the latter. This political maneuvering is obvious to Washington taxpayers, and it is equally obvious that ESSB 5096 actually imposes an income tax that is *not* uniform and *not* less than one percent, in clear contravention of our constitution. Passing a nonuniform, seven percent tax on income earned by Washingtonians is a legislative policy choice that our constitution clearly forbids.

The problem is that ESSB 5096 suggests a dangerous disregard for the constitution on the part of our state legislature, a willingness to use semantics to circumvent well-established constitutional limitations on its taxing authority. Washington business owners are wary of lawmakers like this, as were our Founders, particularly in the area of taxation:

> *The apportionment of taxes on the various descriptions of property is an act which seems to require the most exact impartiality; yet there is, perhaps, no legislative act in which greater opportunity and temptation are given to a predominant party to trample on the rules of justice.*

THE FEDERALIST NO. 10 (James Madison, 1787). If Washington lawmakers are willing to trample on the rules of justice and ignore the constitution now in order to achieve their legislative agenda, what constitutional restraints will they flout next in the service of their political ends? Are our constitutional limits meaningless? Will this Court compromise its own standing in the eyes of citizens, and allow itself to be perceived as a hand maiden and facilitator of cynical legislative legerdemain to circumvent the voters repeated rejections of income taxes?

No business owner wants to live or do business in a jurisdiction with a weak commitment to the rule of law. Orderly commerce relies on consistent application of the law, and lawmakers who honor it. The legislature's imposition of an illegal income tax through ESSB 5096 signals to current and

prospective Washington businessmen and businesswomen that Washington is a place where lawmakers bend (or break) the law when it suits their politics — not the kind of place to do business. The insecurity created by this legislative misbehavior will cause longtime Washington businesses to relocate to other jurisdictions with leaders who respect the rule of law, and it will discourage entrepreneurs and out-of-state companies from forming new businesses in our state. No rational business owner wants to operate in an environment of legal uncertainty, under a tyrannical legislature that ignores constitutional limits on its power.

D. Even if ESSB 5096 were a legitimate income tax, it is bad policy.

Leaving aside the observations above and assuming, *arguendo*, that the tax imposed by ESSB 5096 is lawful, the authors submit for the Court's consideration that it is bad policy for Washington business owners. This income tax, as written, is both complex and replete with deductions and exemptions for seemingly incongruous interest groups, such as certain auto dealerships and timber owners, that appear more the result of

effective lobbying than sensible or cohesive policy. Navigating these narrow channels will prove difficult for all but the most sophisticated business owners in our state, and the resulting impact on small and midsized business owners runs contrary to the ideals that the BIAW and WRA, seek to further. The tax will discourage budding entrepreneurs, legacy family businesses, and industrious taxpayers throughout our state from starting, continuing, and expanding their enterprises in Washington. Thus, ESSB 5096 is not only bad law, it is bad policy. The amici urge the Court to apply settled law and uphold the trial court's ruling invalidating the tax.

VI. CONCLUSION

For the foregoing reasons, this Court should affirm the judgment of the Superior Court declaring ESSB 5096 unconstitutional and void under long-settled Washington constitutional precedent.

Respectfully submitted this 12th day of December 2022.

This document contains 3,444 words, excluding the parts of the document exempted from the word count by RAP 18.17.

CERTIFICATE OF SERVICE

I hereby certify that I caused the foregoing **Brief of Amici Curiae** to be served on counsel for all other parties in this matter via this Court's e-filing platform.

Dated December 12, 2022.

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