WSCPA Feedback on Draft Capital Gains Rules
WAC 458-20-301

July 28, 2023

INCONSISTENCIES BETWEEN PROPOSED DRAFT RULE & AUTHORIZING STATUTE

1. Capital Loss Carryforwards

As drafted, we believe the rules would preclude capital loss carryforwards that were included in statute.

Statute – RCW 82.87.040(3): "If an individual's Washington capital gains are less than zero for a taxable year, no tax is due under this section and no such amount is allowed as a carryover for use in the calculation of that individual's adjusted capital gain, as defined in RCW **82.87.020**(1), for any taxable year. *To the extent that a loss carryforward is included in the calculation of an individual's federal net long-term capital gain and that loss carryforward is directly attributable to losses from sales or exchanges allocated to this state under RCW **82.87.100**, the loss carryforward is included in the calculation of that individual's adjusted capital gain for the purposes of this chapter*. An individual may not include any losses carried back for federal income tax purposes in the calculation of that individual's adjusted capital gain for any taxable year."

Draft Rule – WAC 458-20-301(3)(a): "If your Washington capital gains are less than zero for a taxable year, no tax is due under this section, and you are not allowed to carryover this amount for use in the calculation of your adjusted capital gain for any other taxable year. You may not include any losses carried back for federal income tax purposes in the calculation of your adjusted capital gain for any taxable year."

The second sentence from the statute is missing in the draft rule, thereby eliminating the specifically allowed capital loss carryover provisions provided in the statute.

RCW 82.87.020(1)(b), in defining "Adjusted Capital Gain" provides that federal loss carryforwards are to be added back to federal net long-term capital gain but not in their entirety. The only portion to be added back is those loss carryforwards that are not allocated to Washington under RCW 82.87.100, i.e., the portion of the statute that defines which gains or losses are allocated to Washington.

Had the legislature intended for capital loss carryovers to be wholly excluded, they would have omitted the second sentence of RCW 82.87.040(3) and the addback in RCW 82.87.020(1) would have been all loss carryforwards, not just those which are not allocated to Washington.

Washington Society *of* Certified Public Accountants

TEL: 425.644.4800
memberservices@wscpa.org
www.wscpa.org

170 120th Ave NE
Ste E101
Bellevue, WA 98005

We agree with the Department of Revenue (DOR)'s position that pre-2022 capital losses cannot be carried forward to 2022 or future years. However, for capital loss carryforwards originating in 2022 or thereafter, the rule needs to provide for the situations when those will or will not be allowed. Accordingly, the draft rule should be revised to include the entirety of the related statute and to provide examples. Those examples should include a representative set of circumstances encountered by taxpayers including simple situations as well as those which are more complex such as 1) federal loss carryforwards which include both pre-2022 and post-2021 amounts, 2) federal loss carryforwards which include both short-term and long-term transactions, 3) federal loss carryforwards which include both transactions allocated to and not allocated to Washington.

2. A two-pronged test for what is subject to Washington Capital Gains Tax.

We believe there is a two-pronged test for a transaction to be included in Washington capital gains and that both prongs must be met.

Prong One: The transaction must first involve an actual sale or exchange of a long-term capital asset (RCW 82.87.040: "an excise tax is imposed on the sale or exchange of long-term capital assets"). Long-term capital asset is defined in RCW 82.87.020(6) as "a capital asset that is held for more than one year". Therefore, both a sale or exchange must occur, and the related asset must be held for more than one year. This logic is supported by the Quinn decision from the Washington State Supreme Court. On page 3, the court stated, "The capital gains tax is appropriately characterized as an excise because it is levied on the sale or exchange of capital assets, not on capital assets or gains themselves." Throughout statute and in the legal decision allowing the tax to be implemented a sale or exchange, and not merely the recognition of federal gain itself, is crucial.

Prong Two: The gain from the transaction must be included in the federal net long-term capital gain. The tax imposed in RCW 82.87.040(1) is "seven percent multiplied by an individual's Washington capital gain". Washington capital gain is defined in RCW 82.87.020, and the calculation begins with the Adjusted capital gain. Adjusted capital gain is also defined in that section to begin with Federal net long-term capital gain which is defined as "the net long-term capital gain reportable for federal income tax purposes" with exceptions for qualified opportunity zone and alternative minimum tax IRC provisions. Only those gains included in the federal net long-term capital gain treatment (less the statutory decoupled provisions) are potentially subject to tax.

Further supporting this interpretation, RCW 82.87.020 (1)(e) allows a reduction for "any amount of long-term capital gain from a sale or exchange that is exempt from the tax imposed in this chapter, to the extent such gain was included in calculating federal net long-term capital gain." There is no corresponding increase allowed in statute for the Washington Capital Gains Tax for amounts excluded in calculating the federal net long-term capital gain, thus supporting that both tests must be met. As

referenced above, RCW 82.87.020 (3), which defines federal net long-term capital gain, specifically references transactions under federal law which are not included in Washington's definition of federal net long-term capital gains. This implies the legislature knew there were other federal definitions and specifically chose to not include those in the imposition of the Washington Capital Gains Tax.

We believe this two-pronged test exists to determine if a gain is subject to the Washington Capital Gains Tax and should be clarified in a final rule.

The draft rule also provides examples 2, 3, 4 and 5 with respect to the question posed here. With the two-pronged test above, we believe that only Example 4, represents a taxable sale or exchange. The other examples (expatriation under IRC 877A, marking to market under IRC 1256 or excess partnership distributions under IRC 731), while taxable for federal income tax purposes, are not sales or exchanges and, therefore, are not subject to the Washington Capital Gains Tax.

3. The draft rules go beyond the legislative requirement of "principally directed or managed within the state of Washington" for purposes of allowing the charitable donation deduction.

<u>Statute – RCW 82.87.080(4)(b):</u> "Qualified organization" means a nonprofit organization, or any other organization, that is: Eligible to receive a charitable deduction as defined in Title 26 U.S.C. Sec. 170(c) of the internal revenue code; and principally directed or managed within the state of Washington.

<u>Draft Rule – WAC 458-20-301(2)(l):</u> "Principally directed or managed within the state of Washington" means that an organization's high-level officers primarily direct, control, and coordinate the organization's activities in Washington.

The statute at RCW 82.87.080(4)(b) has a two-pronged test, to be a "qualified organization;" first, the recipient organization must be eligible under IRC 170(c), and second, the organization must be "*principally directed <u>or</u> managed within the state of Washington."*

We emphasize the word "or" in the statute because of its relevance as compared to the definition in the draft rule. The organization can be directed or managed within the state of Washington; it is not required to have both characteristics.

The draft rules provide that the organization's high-level officers primarily direct, control and coordinate the organization's activities in Washington. By changing the "or" as found in statute to an "and" it is more restrictive and beyond the language of the statute.

For larger charities, it is very unlikely that their board of directors and C-Suite officers would be both directing and managing activities in each or any state. While there must be meaningful presence in the state of Washington for a charity to qualify

under the RCW, this can be either to direct or to manage; it is not required to be both.

Some large universities and nonprofits located entirely in the state of Washington, would likely not qualify under the draft rules as currently written, because their "high-level officers" are not directing, controlling and coordinating activities in Washington, rather they have key staff persons who fulfill those roles.

This section of the rules needs to provide for the possibility of either direction or management in the State of Washington.

We appreciate that the rules provide for an affidavit process, but unless that process will provide the latitude for attestation of direction or management within Washington, and not necessarily by high-level officers of the organization, then that will not be sufficient to fix this issue.

CLARIFICATION & DOCUMENTATION NEEDED

4. **More clarity is needed around the exclusion of estates or trusts, other than grantor trusts, as not being considered pass-through entities.**

In draft rule 3(b) it is stated that these entities are not pass-through entities. Does this also mean that long-term capital gains which appear on K-1s issued by those entities to Washington residents are excludable from the Washington Capital Gains Tax? The rule should clarify the inferred exclusion from the capital gains tax, as the current language only excludes these entities from being pass-through entities.

5. **Clarify documentation requirements for long-term capital gains from passthrough entities which are not taxable for the Washington Capital Gains Tax.**

There are likely significant long-term capital gain transactions that appear on K-1s and that are included in federal long-term capital gains on Schedule D, but which are excluded from the Washington tax for various valid reasons (real estate, depreciable property, etc.). Many individuals with these transactions will not be required to file a Washington return since the exclusions will put them under the threshold for tax owed. When IRS information is shared, the information on the taxpayer's 1040 will only reflect that there was a gain that flowed through from a passthrough entity, there will not be information to provide certainty that the omitted reporting was or was not a valid exclusion. Additionally, the K-1 itself does not include this information. If the taxpayer inquires about the sourcing of these distributions, they will likely get a very simple answer from the entity such as "it was real estate."

With the above in mind, what documentation should a taxpayer obtain and retain from the entity issuing the K-1? Documentation requirements should be defined for

situations when a tax is owed and exclusions applied, or when no tax is owed and no return filed.

6. Add clarity amortizable assets treatment.

The draft rules note in (4)(i) and example 13 that sales of intangibles are sales of amortizable assets and not excludible as a depreciable asset, and draft rules also note that a sale of goodwill is not excludible unless it is for an auto dealership.

There is ambiguity in the draft rules that a capital gain arising from goodwill or comparable intangibles would not be excludable in the sale of a qualified family-owned small business. In (4)(i) and Example 13, there should be a reference such as "unless excludible under RCW 82.87.070, Qualified family-owned small business deduction."

7. Provide additional examples for sales of interests in privately held entities owning real estate.

As drafted, examples 10, 11 and 12 provide that if the taxpayer sells an interest in an entity there is no exemption for the portion of the transaction allocated to real estate, unless that entity owns real property directly and not via an interest that disposed entity holds in some other entity.

However, in each of the examples in the draft rules, the taxpayer owns 100% of the entity that they are selling, i.e., they own the real estate via a Single-Member LLC (SMLLC), and then further, their SMLLC owns other SMLLCs that own real estate. These fact patterns (i.e., sale of an SMLLC that owns real estate, rather than selling the real estate itself) are rare, because if someone owns 100% of an LLC and that wholly owned LLC owns a building, the buyer is more likely to buy the building than to purchase someone's SMLLC.

The more common occurrence, and that which we believe needs to be added to the examples, is the taxpayer owns perhaps 10% of an LLC, and that LLC owns an SMLLC which owns real estate, and it is the 10% interest in the LLC that they are selling. This happens with far more frequency than the scenarios in the existing examples.

8. Additional clarity is needed for various common scenarios of other state tax credits.

Regarding Example 17, additional detail is needed for taxpayers with capital gain income subject to tax by another state but allocable to Washington under our statute.

A. Many states permit a partnership or S corporation to file a "composite" return and have the entity pay a state income tax on behalf of the nonresident owner if the owner has no other income derived from sources within the

state. This is the owner's tax and is treated as a distribution from the entity to the owner, i.e., a reduction of their capital account. The entity will typically show on the individual's state K-1 that composite tax was paid on their behalf. Will this be allowed as a credit for taxes paid to the other taxing jurisdiction to the extent the composite tax relates to long-term capital gain income allocable to Washington?

B. Similarly, some states require the partnership or S Corporation to withhold income tax on the distributive share of income derived from sources within the state. The withholding is claimed as a credit or payment on the individual's nonresident return. Will this be allowed as a credit for taxes paid to the other taxing jurisdiction to the extent the withheld tax relates to long-term capital gain income allocable to Washington?

C. As a variation to item C above, in some instances, the state allows that if the individual owner's tax is fully withheld at the source by the partnership or S Corporation, and if the individual owner has no other sources of income in the state, they are not required to file a state income tax return. In these cases, the pass-through entity withholding requirement operates as a de facto composite return. Will this be allowed as a credit for taxes paid to the other taxing jurisdiction to the extent the withheld tax relates to long-term capital gain income allocable to Washington?

D. Several states have enacted a passthrough entity (PTE) tax credit system which allows the passthrough entity to pay the state income tax for the owner and claim a deduction against ordinary income for federal tax purposes. The deduction is not allowed for state income tax purposes, and instead, the payment to the state is allowed as a credit against that state's income tax. Typically, in a PTE system, the taxpayer is generally not required to file a personal state income tax return with that state unless they have other income from that state. Will this be allowed as a credit for taxes paid to the other taxing jurisdiction, to the extent the PTE credit relates to long-term capital gain income allocable to Washington?

PROCESS & PENALTIES

9. Procedural issues

It will be prudent to clarify rules for situations when returns are not filled.

A. Clarify how audits will work when federal net long-term capital gains are above $250,000 but no Washington tax was paid. Will the DOR audit those instances automatically or after looking at other documentation?
   a. What types of documentation should a taxpayer collect and retain if no tax was paid?

B. Clarify whether the statute of limitations period for filed returns and non-filed returns are the same.

10. Extensions and Penalties

In the past, the DOR has administratively adopted a phased implementation approach (for example with digital products) when there was significant novelty and interpretation required for compliance. Considering that this tax was only ruled constitutional several weeks before the due date, and that final guidance remains unavailable on substantive issues such as examples 2-5 in the draft rule, this new law requires a similar phased implementation approach.

Specifically, many taxpayers will not know until later in the fall whether they will have a filing requirement, as the extended due date for federal K-1s is September 15. Penalties for late Washington extensions could be waived in circumstances where an individual has a federal extension for this initial year. Grace in applying any late payment penalties on extension payments would be beneficial due to the substantial uncertainty over whether certain transactions are exempt from the tax as outlined above and in the draft rules.