STATE OF WASHINGTON

DEPARTMENT OF REVENUE

WAC 458-20-301
Capital Gains Excise Tax – Definitions, deductions, exemptions, and allocation of gains and losses

CONCISE EXPLANATORY STATEMENT
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Anticipated adoption: June, 2024

RCW 34.05.325 requires that an agency prepare a concise explanatory statement before it files an adopted rule with the Code Reviser. This statement is to explain the agency's reasons for adopting the rule, identify the differences between the text of the proposed rule as published and the text of the rule as adopted, and summarize all comments received regarding the proposed rule and respond to those comments by category or subject matter.

1. **Reasons for adopting the rule.**

   The Department initiated rule making to create WAC 458-20-301 (Rule 301) to implement legislation creating a new excise tax on sales or exchanges of long-term capital assets (the capital gains tax). The purpose of this rule is to clarify substantive aspects of the capital gains tax by supplying definitions, explanations, and examples.

2. **Description of differences between the text of the proposed rule and the text of the rule to be adopted.**

   Example 5 of the rule proposal contained a typographical/calculation error in the result. That example was corrected in the adopted rule.

3. **Summary of comments received and Department of Revenue's response.**

   The Department held two public hearings in connection with this rulemaking. The Department proposed an initial draft rule proposal and made some revisions based on comments received on that proposed rule. We also received public comments on the revised proposed rule but generally did not make any revisions based on those comments. Any descriptions below of rule changes made in response to public comments refer to changes made by the Department to the first rule proposal, except for the correction of the error in Example 5 referenced above.

   The following are the comments received, grouped by topic, and the Department's responses to those comments.

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Calculation of Washington capital gains: operation of federal law

- Stakeholders raised questions regarding how the operation of certain federal income tax laws affect the calculation of Washington capital gains. For example, IRC § 1244 treats losses from the sale or exchange of a § 1244 stock as ordinary losses instead of as capital losses.
- Department response: The Department added examples to illustrate how the operation of federal tax law affects the calculation of Washington capital gain by adding, for instance, Example 8 on IRC § 1244 stock losses and Example 9 on IRC § 1061 gain from applicable partnership interests.

Sale or exchange requirement

- Stakeholder comments argued that the capital gains tax is conditioned on a sale or exchange and sought clarification of the general language provided in the first proposed rule draft.
- Department response: The Department revised the rule to clarify that the capital gains tax is conditioned on a sale or exchange and provided clarifying information in Section (3)(a)(ii) of the Rule.

Charitable donation deduction

- We received several public comments regarding the requirements for the charitable donation deduction. That deduction is available for certain donations made to qualified organizations. Qualified organizations, among other requirements, must be principally directed or managed within Washington.
- One comment objected to the Department's definition of the term, "principally directed or managed within Washington," which the rule defines to mean that "an organization's activities are primarily directed, controlled, and coordinated in Washington." The commenter argued that "or" should replace the "and" in the definition.
- Department's response: The Department did not make any changes in response to this comment. The Department interprets the word "principally" to be modifying both "directed" and "managed." The Department concluded that the terms "principally directed" and "principally managed" essentially mean the same thing and that the rule's definition adequately describes their meaning.
- We also received comments about language in the rule regarding donations to donor-advised funds, which inadvertently described a donor-advised fund as an entity.
- Department response: The Department clarified the language in the rule to focus on the entity that owns or controls the fund.

Characterization of mutual funds in Example 14:

- A comment agreed with the result in Example 14 but sought clarification that mutual funds are not a type of pass-through entity for federal income tax purposes.
- Department response: The Department did not make changes. Example 14 states that mutual funds are a type of pass-through entity for federal income tax purposes because the Internal Revenue Code bestows characteristics of pass-through taxation with respect to mutual funds similar to those of other entities provided as examples of pass-through entities in RCW 82.87.040.

Qualified opportunity funds:

- Comment: Stakeholders requested more examples of fact patterns involving qualified opportunity funds and detailing how long-term capital gains should be calculated.
- <u>Department response</u>: The Department did not make any changes. Hypotheticals presented by stakeholders are already addressed elsewhere in Rule 301. For instance, if a taxpayer holds a qualified opportunity fund beyond December 31, 2026, triggering federal recognition of capital gain without a sale or exchange, there are no capital gains tax implications because there is no sale/exchange. See subsection (3)(a)(ii) of Rule 301. Furthermore, the current draft rule provides in the Introduction section that examples are provided only as a general guide based on specified facts. Accordingly, we did not revise Examples 6 and 7 to address the possibility of exemptions and deductions that were not raised by the facts presented. Subsections (4) and (5) provide ample information about available exemptions and deductions.

Clarification on the change from "properly reported federal net long-term capital gain" to "had federal net long-term capital gain"

- Stakeholders inquired why the phrase "[taxpayer] properly reported federal net long-term capital gain" was changed to "[taxpayer] had federal net long-term capital gain."
- <u>Department response</u>: The phrase "properly reported" was altered to avoid confusion. The propriety of the taxpayer's reporting was not intended to be the focus of the examples in which this phrasing was used.

Recordkeeping and documentation requirements:

- Stakeholders requested guidance on specific documentation requirements, including for establishing qualification for deduction or exemption on gains passed-through from other entities, and including in situations where a return is not required to be filed because the taxpayer has no capital gains tax liability due to the application of deductions or exemptions.
- <u>Department Response</u>: Chapter 82.32 RCW and WAC 458-20-254 already cover recordkeeping requirements. The Department did not make any changes to the rule based on this feedback.

Treatment of gains and losses from sales or exchanges completed prior to January 1, 2022

- Stakeholders had questions about the capital gains tax consequences of transactions that predate the effective date of the capital gains tax. For example, a stakeholder inquired whether distributions of long-term capital gains from pre-2022 sales transactions by charitable remainder trusts would be subject to the capital gains tax.
- <u>Department Response</u>: To address and clarify that any long-term capital gains that are attributable to sale or exchanges completed prior to January 1, 2022, the Department added more information in Section (3)(a)(i) of the Rule.

Domicile

- Stakeholders objected to a domicile presumption contained in section (6)(c)(ii), which provided that "for allocation purposes, if you were a Washington domiciliary at any time during a particular year, the department will presume that you were a Washington domiciliary at the time you sold or exchanged any personal property during the same year."

- Department response: The Department removed this presumption from the rule.
- We received a comment requesting an example illustrating that the domicile of an individual owner of a pass-through entity is determinative of domicile for allocation of passed-through capital gain/loss, rather than the commercial domicile of the pass-through entity, by providing an example of an entity commercially domiciled in Washington and individual owner domiciled outside of Washington.
- Department response: The Department did not make any changes in response to this comment because the rule and Chapter 82.87 RCW are already clear in that it is the domicile of the taxpayer that is determinative of allocating capital gains and losses from intangible personal property. The rule and statutes state that a taxpayer can only be an individual.

Request for phased implementation

- The Department received comments arguing for eased or forgiven penalties related to the filing or payment of the capital gains tax due to the new nature of the tax.
- Department response: The Department did not make any changes in response to these comments. This topic was beyond the scope of the rulemaking. The Department did publish some separate interim guidance regarding how it would apply the late payment in situations where the taxpayer obtains a federal tax return filing extension.

Loss carryforwards:

- Additional examples were requested of a taxpayer able to use a capital loss carryforward to offset capital gains for purposes of the capital gains tax.
- Department response: We added an example of a qualifying loss carryforward, Example 10.

Qualified family-owned business deduction

- We received a comment suggesting a definition for the term "business" for purposes of the qualified family-owned business deduction, to mean sole proprietorship, a corporation, an LLC, a partnership, or any other entity.
- Department response: We did not make any changes in response to this comment because we did not identify any ambiguity on this topic.

Standard deduction

- A commenter recommended addressing how the standard deduction would be applied to spouses that file separately and do not coordinate their filing positions with each other, i.e., with regard to how split the standard deduction.
- Department response: We did not make any changes in response to this comment because the Department anticipates and is already able to respond to these situations through its administrative processes.

Statute of limitations

- A stakeholder comment asked the Department to identify the statute of limitations for filed returns versus the limitations period for non-filed returns.
- Department response: The Department did not make any changes because this topic was beyond the scope of the rulemaking.

Exemption for sale of entity holding real estate

- Stakeholders requested clarification on terms related to the exemption, such as "owned directly" and "legally own," and on how fair market value of real estate should be established for the purpose of the exemption.
- Department response: We provided clarifications in subsection (4)(b), including in the examples in that subsection.
- A stakeholder comment identified a calculation error in Example 13 of the first draft of the proposed rule.
- Department response: The Department fixed the calculation error in the example, which became Example 19 in the second proposed rule draft.

Exemptions for property depreciable under IRC § 167

- Stakeholders disagreed with the Department's position in the rule that intangible assets amortizable under IRC § 197 do not qualify for the RCW 82.87.050(6) exemption for property depreciable under IRC § 167.
- Department response: The Department did not take any action in response to this comment. The Department's position remains unchanged: the RCW 82.87.050(6) exemption does not apply to section 197 intangibles. While IRC § 197 states that section 197 intangibles are treated as property of a character subject to the allowance for depreciation provided in § 167, this language does not make section 197 intangibles depreciable under IRC § 167. Instead, the language essentially serves two purposes. One, it places section 197 intangibles within the definition of IRC § 1231 property. Two, the language appears to also mean that section 197 property is subject to IRC § 1245 recapture. Furthermore, RCW 82.87.050(9) provides an exemption for a specific type of section 197 intangible: goodwill received from sales of certain auto dealerships. If section 197 intangibles generally fall within the exemption under RCW 82.87.050(6), then no exemption under RCW 82.87.050(9) specific to auto dealerships would be needed. The existence of the RCW 82.87.050(9) exemption indicates that the Legislature, with one exception, did not intend section 197 intangibles to qualify for the exemption in RCW 82.87.050(6).

Nongrantor Trusts:

- A stakeholder submitted concerns regarding the department's interpretation of grantor and nongrantor trusts. The department has provided a definition of grantor trust consistent with the statutory definition in section (2)(f) of the Rule and provided a definition of nongrantor trust in section (2)(k) as trusts that are not grantor trusts. The stakeholder posited that there should be a third category of trusts that are neither grantor trusts nor nongrantor trusts. Two types of trusts would fall into this category: tax-exempt (IRC § 501(c)(3)) trusts and charitable remainder trusts (IRC § 664). Thus, incomplete gifts would not cause the grantor to either of these types of trusts to be taxable on the trust's capital gains.
- Department response: The Department did not take any action in response to this comment. The Department's position is that the plain language of Chapter 82.87 RCW contemplates only two broad categories of trusts: grantor and nongrantor trusts. If any revisions are required, they would need to be pursued through legislation.

- The commenter also asserts that the proposed rule does not make clear that a beneficiary of an incomplete gift nongrantor trust should remove from federal net long-term capital gain any gain allocated to the beneficiary from a trust to the extent the gain is allocated to the grantor.
- Department response: We did not make any changes. The rule states that grantor trusts are taxed on a pass-through basis and that beneficiaries of nongrantor trusts may be subject to capital gains tax on distributions of capital gains received from nongrantor trusts. In the scenario described by the commenter, the trust falls within the rule's definition of a grantor trust, so the provision on distributions of capital gain received from a nongrantor trust does not apply.
- A commenter requested guidance on residence, for allocation purposes, for gains distributed by a nongrantor trust, and for additional guidance on distributions from nongrantor trusts.
- Department response: The Department did not make any changes in response to this comment because timing and allocation of the tax are addressed in the rule and in Chapter 82.87 RCW.
- The Department also received a comment requesting guidance about the impact of *North Carolina v. Kaester* and *Covell v. City of Seattle*. *Kaester* held that the presence of in-state beneficiaries alone does not empower a state to tax the trust on income that has not been distributed to the beneficiaries where the beneficiaries have no right to demand that income and are uncertain to receive it. *Covell* held that a city ordinance that imposed residential street utility charge constituted an unconstitutional tax rather than a regulatory fee.
- Department response: The Department did not make any changes in response to this comment.

Section 1256 contracts

- The Department received a comment asking to specify the correct treatment of section 1256 contracts that are not held for more than one year or not sold.
- Department response: We did not make any changes in response to this comment. Example 5, which is specific to section 1256 contracts, states, "only long-term capital gains and losses from section 1256 contracts that were held for more than one year and were sold are included in calculating an individual's Washington capital gains excise tax."
- The comment also asks for clarification on the adjusted basis of a section 1256 contract described in Example 5.
- Department response: We did not make any changes in response to this comment. None of the examples in the rule discuss basis determinations because a capital asset's basis is a function of federal income tax law. The calculation of Washington capital gains is determined by reference to the net long-term capital gain reportable for federal income tax purposes.

We also received a number of questions not related to the proposed rule but rather were general questions about the application of the tax to specific facts, and other comments generally disputing the validity of the capital gains excise tax. We did not make any changes based on these comments.