WSCPA Feedback on Draft Capital Gains Rules
WAC 458-20-301
October 30, 2023

1. The imposition of the tax as defined in (3)(a)(ii) as "… generally conditioned on the sale or exchange of a long-term capital asset" is inconsistent with RCW 82.87.040(1) as well as the proposed trailer legislation from DOR. Both existing law and the proposed legislation state "an excise tax is imposed on the sale or exchange of long-term capital assets."

   a. RCW 82.87.040(1) does more than set a "general rule" that the tax is based on a sale or exchange. It explicitly states that is the fundamental basis for the scope of the tax.

   b. As we have noted in response to the proposed legislation and on the previous draft rule, we believe a two-pronged test must be followed based on the statute. **A limiting principle must be adopted and included within statute and/or rule to provide clarity to tax preparers and taxpayers on what transactions are subject to the Washington State Capital Gains Tax (WSCGT).**

      i. There are too many types of IRS recognized gains or losses for DOR to individually determine if each one can be considered a sale for the purpose of the tax, although some common items would be helpful to have, as you have heard in public comments and as described in our comments in this document.

      ii. The uncertainty for taxpayers on what is considered to be subject to the tax without a limiting principle is immense in the face of no safe harbors or penalty relief.

2. **Additional examples needed**

   a. Under the "Sales or exchange of long-term capital assets" section additional examples should be provided in addition to Examples 1-4. These examples should include, but not be limited to, IRC 1202, 301, and 1061.

   b. It would be helpful to include in the WAC at least one example of a long-term carryforward that <u>does</u> qualify, as the current draft presents three examples of carryforwards, short and long, each of which do not qualify.

   c. As drafted, examples 13, 14 and 15 show the taxpayers' tax liability if they sell an interest in an entity with various real estate scenarios. However, in each of the examples, the taxpayer owns 100% of the entity that they are selling. The more common occurrence, and that which we believe needs

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

to be added to the examples, is when the taxpayer owns a percentage, 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.

3. Depreciable property references to IRC 167 and IRC 197 contradict each other. The rule stating that "Intangibles amortizable under IRC 197 do not qualify for [the depreciable property exemption]" misses that IRC 197(f) (7) states intangibles of the section are treated as depreciable property as defined in IRC 167. So, an intangible under IRC 197 is treated as depreciable property under IRC 167. **The distinction that is being created in the rule is incompatible with the IRC and the language should be adjusted to clarify the proper treatment.**

4. While we appreciate the removal of the "high-level officers" language in the "principally directed or managed" definition for the charitable deduction in this latest draft, we are still concerned with the definition of directed or managed being essentially directed and managed, i.e., "primarily directed, controlled *and* coordinated in Washington". This artificially limits the number of charities that would qualify as exempted organizations against the plain meaning of an "or" conjunction as provided by statute. **To be consistent with existing law, this should be an "or," instead of an "and".**

5. **Clarify documentation requirements for long-term capital gains from passthrough entities which are not taxable for the WSCGT.**
   There are likely significant long-term capital gain transactions that appear on Schedule K-1 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 Form 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 non-subject income was or was not a valid exclusion. Additionally, the K-1 itself does not include this information. If the taxpayer were to inquire about the detail of the K-1 income items, they would likely get a very simple answer from the entity such as "it was real estate."

   With the above in mind, **the rules need to specify what documentation a taxpayer should 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 by contrast, when no tax is owed and no return is filed.

6. There is some clarity granted to the treatment of non-grantor trusts as not pass-through entities. However, **three problems still remain that need guidance.**

    a. The legal questions others have raised with the taxability of non-grantor trusts and their beneficiaries in light of the United States Supreme Court case *North Carolina v. Kaester* and Washington Supreme Court case *Covell v. City of Seattle* remain concerning due to the uncertainty they present for the legality during estate planning.

    b. Guidance is still needed on the definition of "residence" for these entities. If residence is defined as the residence of the beneficiary, when is the residence determined, at the time of the gain or the time of the distribution?

    c. Guidance is also needed on how distributions that span multiple tax years will be treated, i.e., if the sale happens in one year but the distribution is over several years, when is the income to be reported?

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

    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?

        i. **What types of documentation should a taxpayer collect and retain if no tax was paid?**

    b. **Establish by rule whether the statute of limitations period for filed returns and non-filed returns are the same.**

8. In the past, the DOR has administratively adopted a phased implementation approach (e.g., with digital products) when there was significant novelty and interpretation required for compliance.

    Specifically, many taxpayers will not know until late fall whether they will have a filing requirement, as the extended due date for federal Schedule K-1 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. **Penalty procedures need to be established that account for changes in tax payment or filing beyond the taxpayer's control.**

We have **highlighted** the changes that the CPA profession strongly recommends need to be made. As the tax experts in this state charged with assisting Washington state citizens to comply with the law and pay the tax, it is critical that our requested changes be included. If the department does not agree with our suggestions, we would appreciate a detailed response expressing why they disagree with our suggested recommendations, and we welcome a dialogue to achieve resolution.