



BUDGET LANDSCAPE: WASHINGTON'S CAPITAL GAINS TAX

May 2022

Executive Summary

During the 2021 legislative session, the legislature passed legislation ([Senate Bill 5096](#)) to create a 7% tax on capital gains profits (largely from the sale of stocks and bonds) greater than \$250,000 in a year. The revenue generated through this new tax was largely dedicated to childcare and early learning programs through the Fair Start for Kids Act ([Senate Bill 5237](#)). Since the passage of the capital gains tax, there have been two main attempts to repeal the tax: a lawsuit to overturn the capital gains tax, and an initiative to the people (I-1929) filed for the November 2022 ballot that would repeal the law passed by the legislature. If either attempt to repeal is successful, there would be significant impacts on not only the items funded through the Fair Start for Kids Act, but also potentially health care, human service, and other programs and services funded with state general fund dollars.¹

This policy brief provides a background on the passage of the capital gains tax in Washington and what is funded with the revenue, an overview of the two current main efforts to repeal the tax, and the potential impact on programs and services funded in the state budget if the tax were to be repealed.

Background on Capital Gains Tax in WA

Washington's Capital Gains Tax

During the 2021 session, the legislature passed legislation ([Senate Bill 5096](#)) to create a 7% tax on capital gains profits greater than \$250,000² in a year. A capital gains tax is a tax on the profit made from the sale of an investment or certain assets. The tax passed in Washington provided exemptions for some capital gains profits including from the sale of all real estate (land and structures), retirement funds, timber, and livestock related to farming or ranching. Deductions were also provided for the sale of certain qualifying small businesses. Given these exemptions, the tax will be levied primarily on profits from the sale of long-term assets, such as stocks and bonds.

The tax only applies to capital gains above \$250,000, which means that if, for example, an individual makes a profit of \$300,000, the tax would only be applied to \$50,000 (the amount over the \$250,000 threshold). Starting in 2024, the \$250,000 threshold will be adjusted annually for inflation.

¹ Of note, funding for basic education is protected under the state constitution and therefore not vulnerable to cuts in the same way other programs and services could be.

² For married couples filing separately and registered domestic partners filing separately, the combined standard deduction is limited to \$250,000

According to the [fiscal note](#) prepared for the legislature, this tax will be paid by approximately 7,000 (0.2%) of Washington taxpayers. The tax went into effect on January 1, 2022, with the first tax payments being collected in early 2023. The tax is estimated to generate about \$500 million in revenue per year.

What the Capital Gains Tax Funds

Revenue generated by the new capital gains tax is largely dedicated to early learning programs. The first \$500 million in revenue from the capital gains tax collected each fiscal year is deposited into the Education Legacy Trust Account (ELTA) to be used for early learning programs. Funding for early learning programs is directed through the Fair Start for Kids Act ([Senate Bill 5237](#)), which was also passed by the legislature during the 2021 session. The Fair Start for Kids Act was an expansive piece of legislation³ that made significant strides in improving access to child care, early learning, and other early childhood supports and services. The following is a summary of some of the major components of the Fair Start for Kids legislation⁴:

- Reduces copays and expands eligibility for [Working Connections Child Care](#) (WCCC), which is a subsidy program that helps low-income families pay for childcare.
- Expands eligibility and enrollment for the [Early Childhood Education and Assistance Program](#) (ECEAP), which is the state’s comprehensive preschool program that provides free services and supports to eligible children and their families.
- Provide supports for childcare and early learning providers including:
 - Expansion of the [Infant and Childhood Mental Health Consultation](#) program, which partners mental health professionals with early learning providers to support the social and emotional development of children.
 - Provide professional development resources including scholarships to meet education requirements for early learning providers.
 - Health care premium assistance and dedicated enrollment assistance for health insurance purchased through the Health Benefit Exchange for employees of childcare facilities.
 - Grants and other expanded resources for providers including the [Complex Needs Fund](#) (to support children with developmental delays, disabilities, or challenging behaviors due to complex trauma), dual language rate enhancements, infant rate enhancements, and early childhood equity grants.
 - Increases rates paid to ECEAP and WCCC providers.
- Strengthening prenatal to three supports including:
 - Expansion of the [Home Visiting](#) program, which is a voluntary, proven way to support and strengthen families in the first years of life by partnering parents with trained home visitors.

³ For a deeper dive into early learning, you can refer to the Prevention Alliance brief [Early Childhood Education and Its Impact on Health Outcomes](#). Please note that the brief was written prior to the passage of the Fair Start for Kids Act, so gaps and opportunities have evolved. However, the brief still provides a good overview of many of the programs funded under the Fair Start for Kids Act.

⁴ For more detail on these major components of the Fair Start for Kids Act, please see the Fair Start for Kids Act implementation webpage prepared by the Department of Children, Youth & Families: <https://www.dcyf.wa.gov/about/government-affairs/fair-start-for-kids-act>.

- Expansion of [ECLIPSE](#) (Early Childhood Intervention and Prevention Services), which offers developmentally appropriate therapeutic programming for families and children who have endured biological, familial, and environmental risk factors consistent with exposure to complex trauma in early childhood.
- Expansion of Family, Friend, and Neighbor Play and Learn Groups, which offer parents and other caregivers opportunities to support promote kindergarten readiness and encourage socialization.
- Funding for [Early ECEAP](#), which is a center-based, comprehensive services model for children Birth to 3.

The Fair Start for Kids Act also outlines additional spending goals and strategies beyond the major components outlined above. For a more comprehensive, section-by-section overview of the different components of the legislation, see this [summary of the final legislation](#) prepared by Prevention Alliance member, *Start Early*.

Any amounts over \$500 million collected through the capital gains tax each fiscal year are directed to be deposited into the [common school construction account](#), which is used exclusively for the purpose of financing the construction of facilities for common schools.

Current Efforts to Repeal the Capital Gains Tax in WA

Since the passage of Senate Bill 5096 during the 2021 session, there has been activity attempting to repeal the capital gains tax. The current activity around the tax falls into two buckets: a court case that is attempting to rule the tax unconstitutional, and a ballot initiative that is attempting to overturn the tax on the November 2022 ballot.

Court Case

Shortly after the capital gains tax was signed into law by Governor Jay Inslee, two separate lawsuits were filed against the new tax:

- The first [lawsuit, which was filed by the Freedom Foundation](#), alleges that the tax violates the Washington State Constitution, and also the Commerce Clause of the U.S. Constitution, by taxing the sale of capital held out-of-state by Washington residents.
- The second [lawsuit was filed by former Washington State Attorney General Rob McKenna](#) on behalf of a coalition of farmers, investors, manufacturing business owners, and the Washington State Farm Bureau. This lawsuit alleges the new tax violates the Washington State Constitution because it is a graduated income tax, not an excise tax as stated in the intent section of the bill.

In fall 2021, the two lawsuits were consolidated in Douglas County Superior Court. The legal arguments around capital gains tax and the issues raised in the lawsuit are very complex and have a long history in Washington state. A recent episode of [TVW's Inside Olympia hosts a helpful discussion about the lawsuit](#) with perspectives representing both sides of the issue.

On March 1, 2022, Douglas County Superior Court Judge Brian Huber [ruled](#) the capital gains tax as unconstitutional. In response, proponents of the capital gains tax stated that the ruling at this court level was anticipated and is the first step in a long legal journey that will eventually end up at the Washington Supreme Court. Shortly after the ruling, Attorney General Bob Ferguson [filed an appeal](#) on behalf of the state asking the state Supreme Court to review the Douglas County Court decision.

At the April 2022 meeting of the Economic & Revenue Forecast Council (ERFC), Rep. Ed Orcutt, an opponent of the capital gains tax, requested that the capital gains tax not be included in the revenue forecast given the Douglas County Court's ruling. Sen. Christine Rolfes, Rep. Ormsby, the Governor's budget director, and several other members of the ERFC voted 'no' arguing that the tax's fate was still unknown given it is expected to be considered by the State's Supreme Court. Therefore, the capital gains tax will continue to be considered in the ERFC's revenue forecasts until the state Supreme Court has issued a ruling on the case.

Initiative 1929

In addition to the lawsuit, opponents of the capital gains tax have also filed an initiative to the people⁵ ([I-1929](#)), which seeks to repeal the capital gains tax passed by the legislature. Under the initiative, the repeal would apply retroactively to January 1, 2022 (the implementation date of the tax), as well as prospectively.

If passed, I-1929 would repeal the capital gains tax and therefore eliminate the estimated \$500 million a year in revenue that, as discussed in the previous section, the legislature has slated to fund early learning and education-related items. To get on the ballot, the people running the initiative will need to gather at least 324,516 signatures⁶ from registered voters by 5pm on July 8th. If it collects enough signatures it will appear on the November 2022 ballot.

Potential Impact of Repeal

If the capital gains tax were to be repealed – either through the legal challenge, Initiative 1929, or another future tactic – the legislature will be faced with a \$500 million annual shortfall in the budget (\$1 billion per biennium) and will need to re-balance the state budget given that shortfall. Re-balancing the budget in the face of such a budget gap would create complex and difficult decisions, likely resulting in cuts to critical programs and services funded under the current budget.

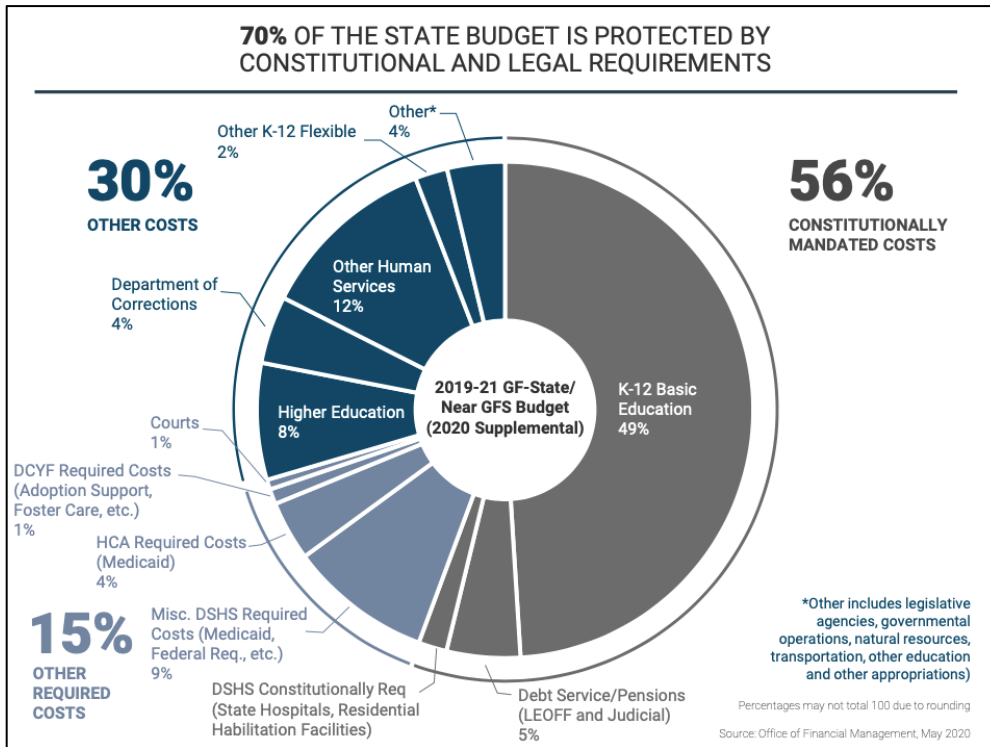
While most of the revenue from the capital gains tax is directed to the Education Legacy Trust Account (ELTA) and appropriated through the Fair Start for Kids Act, the legislature cannot 'simply cut' the items funded under that legislation given many of the programs and services under the Fair Start for Kids Act are now in statute, meaning they are required to be provided under state law. When looking at options for cuts, 70% of the state operating budget is

⁵ There are two types of initiatives in Washington State: Initiatives to the People and Initiatives to the Legislature. More information on these two types of initiatives can be found on the WA Secretary of State website here: <https://www.sos.wa.gov/elections/initiatives/referenda.aspx?y=2022>

⁶ Sponsors of I-1929 will need to turn in closer to 400,000 signatures to account for invalid or duplicate signatures.

protected by either constitutional obligations or legal requirements. As can be seen in figure 1 below, both the ‘constitutionally mandated costs’ (56%) and ‘other required costs’ (15%) are considered protected. That leaves just 30% of the budget as being considered unprotected and therefore vulnerable to cuts during a budget shortfall.

Figure 1: Composition of Washington State Budget



Source: Office of Financial Management, May 2020

If the legislature is faced with making cuts to make up for a repeal of the capital gains tax, state funded programs such as higher education, human services, health and prevention, early learning, and corrections could be significantly impacted. The legislature would be faced with difficult decisions such as potentially repealing all or part of the Fair Start for Kids Act from state law, or alternatively the legislature could make cuts in other areas funded with state general fund dollars. Items funded with those state general fund dollars range from state subsidies for health insurance to food security programs, and crisis response services to firearm prevention programs to homelessness services.⁷

Conclusion

There are many factors that can impact the stability of Washington’s state budget. Revenue, state spending, economic factors, caseloads, national and world affairs all play a role in shaping the budget landscape that the Washington legislature must account for as they craft and

⁷ Many health and prevention programs and services are funded with state general fund dollars. Some examples can be found in the [Prevention Alliance Final 2022 Supplemental Operating Budget Memo](#).

balance the state budget each session. If any of the current efforts to repeal the capital gains tax are successful, the result would create a budget shortfall that would likely lead to the legislature making cuts to programs and services to re-balance the budget in the absence of the capital gains tax revenue. Potential cuts to early learning, human services, health care, and other items funded with state general fund dollars would have very real and significant impacts on individuals and families throughout Washington.

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