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New Washington Capital Gains Tax Impacts Estate Planning

Article By:

Catherine (Cat) N. L. Connell

Alexander E. Hurt

Mark W. Roberts

Sarah B. Bowman

US Corporate Alert

The Washington Supreme Court recently upheld as constitutional the state's capital gains tax (WA Cap Gains Tax) that was enacted in 2021. The new WA Cap Gains Tax creates new wrinkles and provides new planning opportunities for individuals' estate plans.

This alert addresses the impact of the WA Cap Gains Tax on estate planning for Washington residents and nonresidents. For a more general overview of the new law, which was upheld by the Washington Supreme Court on Friday, 24 March 2023, please see the prior alert linked here.

OVERVIEW OF LAW

Effective as of 1 January 2022, the WA Cap Gains Tax imposes a tax on "Washington capital gains," i.e., a taxpayer's net long-term federal capital gains, subject to certain adjustments. The tax is imposed on persons who are domiciled in or are residents of Washington. Each person has an annual exemption of the first US$250,000 of Washington capital gains, but gains exceeding this amount are taxed at the rate of 7% (in addition to any federal tax that may be owed).

The WA Cap Gains Tax applies generally to sales of financial assets, such as stocks and other securities and tangible personal property held for investment. It does not apply to sales of real estate, privately held entities that directly hold real estate (to the extent the value of the entity is attributable to the real estate), and assets held in a 401(k), 403(b), or an IRA.

Generally, corporate entities are not subject to the WA Cap Gains Tax. However, if capital gains are realized on the disposition of assets owned by a pass-through entity for federal income tax purposes, such as a partnership, limited liability company, or S corporation, the WA Cap Gains Tax will apply to the portion of these gains allocable to individual owners who are domiciled in Washington.

THE IMPACTS OF CURRENT AND FUTURE ESTATE PLANNING

1. Domicile and Residency

Gains or losses on the sale of intangible personal property (such as stocks and other securities) are allocated to Washington under the WA Cap Gains Tax if the taxpayer was domiciled in Washington at the time of the sale. An individual is domiciled in Washington if he or she resides in Washington with the intent to remain indefinitely. Persons who are not domiciled in Washington are not subject to the tax.

The taxpayer’s residency (as opposed to domicile) is irrelevant to the sales of intangible personal property.

For sales of tangible personal property, however, the location of such property and the taxpayer’s residence are taken into consideration. For tangible personal property located in Washington at the time of the sale, the WA Cap Gains Tax applies regardless of the taxpayer’s residence. Conversely, for tangible personal property located outside of Washington at the time of sale, the WA Cap Gains Tax will only apply if the taxpayer was a Washington resident at the time of sale and the tangible personal property was located in Washington at some point in the year of sale or the prior year.

Washington law defines a “resident” as an individual domiciled in Washington unless such individual did not maintain a home in Washington, maintained a home in a different state, and spent no more than 30 days of the taxable year in Washington. Additionally, an individual is deemed a resident if they are not domiciled in Washington but kept a home in Washington and were present in the state for more than 183 days.

Individuals considering moving out of Washington should be cautious of any immediate sales of tangible personal property that may trigger long-term capital gains. While domicile is an intent-based test, the Washington residency rules are more rigid and could potentially cause the WA Cap Gains Tax to apply to a sale of tangible personal property after a move.

2. Lifetime Gifting

Lifetime gifting is a key component of many estate plans. A person may wish to make gifts for family reasons, estate tax minimization purposes, a combination of both, or other reasons. The WA Cap Gains Tax may affect decisions related to lifetime gifting and also the form of such gifting.

a. ***Types of Gifts*****.**

Frequently, lifetime gifts take one of two forms: (i) outright gifts; or (ii) gifts in trust. Outright gifting is the simplest form of making gifts; an individual gives property to the recipient with no strings attached. Gifts in trust, by contrast, require additional planning and administration. For gifts in trust, a trust agreement must be drafted, and the donor must determine the terms of the trust and designate a trustee. Generally, when a donor makes a gift of appreciated property, the donee of the gift assumes the donor’s cost basis for purposes of calculating any capital gain on a subsequent sale of the asset.

b. ***Outright Gifts.***

If the donor is a Washington domiciliary and the recipient is not a Washington domiciliary, making an outright gift of capital gains assets may be a positive planning strategy to avoid any WA Cap Gains Tax on a sale of the asset; WA Cap Gains Tax would not apply upon the sale of the asset by the non-Washington domiciled recipient. By contrast, if the recipient of the outright gift is also a Washington domiciliary, the recipient will report the gain on the sale and would be subject to the WA Cap Gains Tax law. However, depending upon the circumstances, gain on the sale could be exempt by reason of the recipient's own US$250,000 exclusion.

c. *Gifts in Trust*.

If a Washington donor gives appreciated assets to an irrevocable nongrantor trust that are later sold, the WA Cap Gains Tax will be avoided because an irrevocable nongrantor trust is not subject to the WA Cap Gains Tax. However, if the donor transfers assets to a trust that the client is deemed to own for federal income tax purposes (a grantor trust), the Washington donor still could be subject to the WA Cap Gains Tax upon the trust's sale of the capital assets.

It is important to consider, as well, how capital gains inside the trust will be taxed at the federal level. The federal capital gains tax rates on assets sold by and taxed to a trust are compressed and reach the highest bracket with very little gain recognized. If planning to avoid or minimize the WA Cap Gains Tax is undertaken, there should be a careful examination of the federal tax consequences as well as the Washington consequences.

3. Basis

Basis should also be considered for any gift or estate plan involving appreciated assets. Under current federal law, assets transferred at death receive a basis adjustment to the fair market value at the decedent's death (a so-called "stepped-up basis"). Holding on to appreciated assets until death can avoid or reduce the capital gains tax otherwise payable if the assets are sold during life and allow those assets to pass to one's ultimate beneficiaries without any built-in capital gain. In Washington, the treatment is even more favorable for married couples owning community property because all community property, even the one-half community property owned by the surviving spouse, receives a basis adjustment on the death of the first spouse. However, if assets are given away during life, whether outright or in trust, the donor's existing basis generally carries over to the recipient and there is no basis adjustment at the donor's subsequent death.

Consequently, if an individual has assets with significant built-in capital gains that would be subject to the federal or WA Cap Gains Tax if sold, it may be wise to consider retaining those assets until death in order to receive a stepped-up basis, and instead make lifetime gifts of assets with a high basis to minimize the capital gain (both federal and Washington) if the recipient sells the assets.

Because a strategy of making lifetime gifts to family members and younger generations may be an effective means to minimize both the federal and Washington estate taxes at death, many individuals will want to consider which assets may be the best to give away during life. In making these determinations, careful consideration will need to be given to the federal and WA Cap Gains Tax consequences as well as to the potential estate tax savings.

4. Charitable Planning

Many individuals have an existing donor-advised fund or may consider creating one in the future. In order to qualify for a charitable deduction against the WA Cap Gains Tax, the charitable organization must be "principally directed or managed" in Washington. Many donor-advised funds will not meet these requirements. Individuals should consider the method of their future charitable contributions, as well as the location in which their donor-advised fund is organized, in order to take advantage of a charitable deduction.

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