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The Turbulent Ride for Washington's New Capital Gains Tax May Have Come to a Screeching Halt

03.02.22

As previously reported on May 7, June 17 and November 4 of last year, two lawsuits were filed in Douglas County Superior Court in Washington, seeking a declaration that the state's new capital gains tax is unconstitutional. The court consolidated the cases. The parties filed cross motions for summary judgment, along with legal briefs in support of their positions. The lawyers for the State of Washington asked for a judgment that the tax regime meets constitutional muster. On the other hand, the lawyers for the taxpayers that initiated the case sought a judgment that the tax regime is unconstitutional.

On February 4, 2022, Judge Brian C. Huber heard oral arguments on the motions. Much sooner than most of us tax practitioners envisioned, on March 1, 2022, Judge Huber issued his 12-page opinion. In a thoughtful and well-reasoned opinion, he strikes down the new law as unconstitutional. The court ultimately concludes:

ESSB 5096 violates the uniformity and limitation requirements of article VII, sections 1 and 2 of the Washington State Constitution. It violates the uniformity requirement by imposing a 7% tax on an individual's long-term capital gains exceeding $250,000 but imposing zero tax on capital gains below that $250,000 threshold. It violates the limitation requirement because the 7% tax exceeds the 1% maximum annual property tax rate of 1%.

Judge Huber started his analysis by looking at the court's standing to review the constitutional validity of tax laws. Quoting the court in *Kunath v. City of Seattle,* 10 Wn. App.2d 205 (2019), and citing Article IV, Section 6 of the Washington State Constitution and RCW 2.08.010, the court concluded that "the superior courts have original jurisdiction over "the legality of any tax.""

Then, the court (again referring to *Kunath*), looked to the Washington State Constitution. Quoting *Kunath*, Judge Huber stated:

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Since 1930, article VII, section 1 of our state constitution has required that "[a]ll taxes shall be uniform upon the same class of property within the territorial limits of the authority levying the tax and shall be levied and collected for public purposes only. The word 'property' as used herein shall mean and include everything, whether tangible or intangible, subject to ownership."

The court expressly noted that Article VII, Section 2, of the Washington State Constitution places an annual limit of 1% on the aggregate of all tax levied on real and personal property. Further, it examined prior attempts to enact a graduated tax on net income.

In *Culliton v. Chase*, 174 Wash. 363 (1933), the Washington Supreme Court held on two grounds a graduated income tax to be unconstitutional. First, it distinguished an income tax from an excise tax. Excise taxes are levied on activity such as the sale or consumption of goods rather than income generated by activity. Last, it concluded that income is within the Constitution's broad definition of property, but a graduated income tax is not uniform as required by the Constitution.

In this case, the court quickly dismissed the state's arguments that the tax is not an income tax. It looked through the label placed on it by lawmakers (i.e., an excise tax) and concluded the tax, which is measured by net capital gain (not gross income), is levied annually (not at the time of transaction), and allows certain deductions and exclusions, is an income tax. As my contract law professor in the first year of law school aptly stated:

"You can dress up a cow to look like a car, but it is still a cow."

So, at least for now, the new capital gains tax in Washington is dead. Will the State of Washington put down its sword and move on, or will it seek reconsideration by the Superior Court or appeal to a higher court? Time will tell. Seeking reconsideration is unlikely, especially given the court's emphatic opinion. So, if the State of Washington intends to continue the battle, it has 30 days to file its notice of appeal.

Posted in Legislation, State and Local Tax, Tax Laws

Tagged as capital gains tax, Douglas County Superior Court, graduated income tax, income tax, SB 5096, Unconstitutional, Washington constitution, Washington legislature, Washington state, Washington state capital gains tax

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