

**Breaking Developments in Trusts and Estates Law****10/25/2010****Initiative I-1098 — Proposed New Washington Tax on Income**

Several clients have asked for a summary of the provisions and impact of ballot initiative I-1098 (the proposed New Washington Tax on Income) if adopted. This summary has been prepared for those and other clients interested in an unbiased review of I-1098.

Washington currently is one of seven states in the country without a personal income tax. The primary sources of tax revenue for Washington state are the retail sales tax (which generates more than 50 percent of Washington's tax revenue), the business and occupation (B&O) tax (a tax on the gross receipts from business activities), and the state portion of the property tax (which is dedicated to education). See the attached Table 1 prepared by the Washington Department of Revenue that summarizes the tax receipts collected by the state in Fiscal years 2009 and 2010.

On November 2, 2010, Washington residents will vote on Initiative I-1098 to approve or reject a state income tax. The proposed income tax would impose a 5 percent tax on individuals with adjusted gross income in excess of \$200,000 (and on married couples with joint income in excess of \$400,000). The tax would be imposed only on adjusted gross income in excess of the \$200,000 and \$400,000 thresholds. For individuals with taxable income over \$500,000 (or over \$1 million for a married couple filing a joint return), the tax rate increases to 9 percent of the excess. The new tax on income would apply to almost every form of income received by a Washington-resident individual that is subject to federal income tax. The new income tax, if enacted, will become effective in 2012.

The Washington income tax return will be due at the same time, including extensions, as the federal income tax return. The Washington income tax statute will incorporate the definitions and rules applied under the federal income tax code to the extent not inconsistent with Washington law.

I-1098 provides:

- The tax rate is applied to the taxpayer's adjusted gross income, not the taxpayer's taxable income. Taxpayers will not be allowed a deduction for expenses and deductions that do not enter into the calculation of adjusted gross income. In general, adjusted gross income is the number at the bottom line of page 1 of Form 1040 of the federal income tax return. Federal itemized deductions, such as charitable contributions, home mortgage interest,

and many tax credits will not reduce the Washington income tax because they do not reduce the amount of adjusted gross income reported on the federal income tax return.

- Individuals, partnerships, limited liability companies and S Corporations carrying on business in Washington pay Washington B&O tax on the business's Washington taxable receipts. The owners of these "pass-through" entities would also pay personal income tax on the pass-through income of such entities attributable to the owner's ownership interest.
- The new income tax would not apply to estates or trusts but would apply to income distributed or deemed distributed from estates or trusts to individuals.
- The new income tax will probably take effect in 2012 if Initiative I-1098 is approved.
- The state is estimating that the proposed income tax would yield \$2.2 billion in additional revenue in 2012. This new revenue would be offset by an increase to the B&O small business tax credit (\$250 million) and a 10 percent reduction in the state property tax (\$383 million), resulting in a net total revenue of \$1.58 billion. Net revenue means the total revenue from the new income tax, less the cost to the State of Washington for the property tax relief and the cost of the increased B&O tax credit.
- Seventy percent of the net revenue generated by the new income tax will be paid to the Education Legacy Trust Account to be used exclusively for education purposes. Thirty percent of the net revenue will be used for health care purposes.

For non-Washington residents, the new tax will apply to income from sources within Washington. Examples of Washington source income include:

- Income and deductions attributable to the ownership or disposition of any real or tangible personal property in Washington.
- Income and deductions attributable to the ownership or disposition of any business, profession or occupation carried on in Washington.
- Distributed and undistributed income from an electing S Corporation derived from sources within Washington.
- Annuities, dividends, interest and gains from disposition of intangible personal property constitutes income derived from sources within Washington only to the extent the intangible personal property was employed in a business, profession or occupation carried on within Washington. Intangible personal property includes shares of stock in a corporation (other than shares of stock in an S Corporation which are subject to a separate rule), promissory notes, etc.
- A partner's distributed share of income from a partnership (or a limited liability company) derived from sources within Washington.

Initiative I-1098 includes rules to adjust the amount of income tax payable by individuals who are potentially subject to income tax in more than one state including: (i) taxpayers who are residents of two or more states; (ii) taxpayers who pay income tax to two or more states; and (iii)

taxpayers who own a business, profession or occupation carried on both inside and outside the state.

The legislature can repeal or amend an initiative by two-thirds vote of each house during the first two years of enactment and by majority vote thereafter.

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**Table 1**  
**SUMMARY OF WASHINGTON STATE TAX COLLECTIONS**  
**Fiscal Years 2009 and 2010 (\$000)**

State Tax Source	Fiscal Year 2009	Fiscal Year 2010	Percent Change
<b><u>Sales Taxes</u></b>			
Retail sales and use	\$7,369,072	\$6,876,666	(6.7)%
Motor fuels	1,181,459	1,238,592	4.8
Alcoholic beverages	275,859	282,672	2.5
Cigarette and tobacco	422,707	421,404	(0.3)
Other	168,767	153,534	(9.0)
<b><u>Gross Receipts Taxes</u></b>			
Business and occupation	2,650,526	2,577,618	(2.8)
Public utility	386,101	373,621	(3.2)
Insurance premiums	408,464	405,918	(0.6)
Other	10,395	10,424	0.3
<b><u>Property &amp; In-lieu Taxes</u></b>			
State property tax	1,785,323	1,822,667	2.1
Other	89,896	80,943	(10.0)
<b><u>Other State Taxes</u></b>			
Real estate excise	426,048	411,871	(3.3)
Estate	137,116	78,717	(42.6)
Hazardous substance	127,055	149,417	17.6
All other taxes	166,725	238,857	43.3
<b>TOTAL STATE TAXES</b>	<b>\$15,605,513</b>	<b>\$15,122,921</b>	<b>(3.1) %</b>