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Douglas County Superior Court Judge

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March 1, 2022

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Re: ***Quinn/Clayton, et. al. v. State of Washington, et. al.***
Douglas County Cons. Cause Nos. 21-2-0075-09 & 21-2-00087-09

Dear Counsel,

This letter sets forth the Court's rulings on the parties' Cross Motions for Summary Judgment which were argued at the February 4, 2022 hearing.

In this letter the Court will start by discussing its analysis and rulings on the State's Motion to Strike the Declaration of Jason Mercier. Then the Court will address the State's argument that the Plaintiffs lack standing to bring this lawsuit. Finally, the Court will outline its rulings on the parties' Cross Motions for Summary Judgment.

State's Motion to Strike Mercier Declaration

The State and the Plaintiffs have each filed a Motion for Summary Judgment under CR 56. That rule states that affidavits or declarations must set forth facts showing that the affiant is competent to testify as a witness, and must be limited to "such facts as would be admissible in evidence." Billings v. Town of Steilacoom, 2 Wash. App. 2d 1 (Div. 2 2017). Factual matters that would be inadmissible if offered at trial will be disregarded by the court in a summary judgment proceeding. See, e.g., Germain v. Pullman Baptist Church, 96 Wash. App. 826 (Div. 3 1999) (trial court properly refused to consider affidavit from unqualified expert). If a declaration or affidavit contains both admissible and inadmissible portions, only the inadmissible portions should be stricken. See, e.g., Simmons v. City of Othello, 199 Wash. App. 384 (Div. 3 2017) (irrelevant statements and legal conclusions in summary judgment affidavit properly stricken).

The State has moved to strike the Declaration of Jason Mercier from the record, arguing that it is inadmissible and cannot be considered under CR 56. The State's argument is that Mr. Mercier's statements, as well as the declaration exhibits, constitute inadmissible hearsay. State's Opp. Brief filed 1-10-22 at n. 4 on p. 18.

The Plaintiffs counter by arguing as follows:

> Mr. Mercier testifies as an expert on tax policy. Mercier Decl. ¶ 2. His opinions on taxing capital gains are based on a state-by-state survey he conducted. See id. ¶¶ 1, 4-5. The survey results are "'of a type

> reasonably relied upon by experts in the particular field in forming opinions or inferences on the subject.'" See State v. Mohamed, 186 Wn.2d 235, 242, 375 P.3d 1068 (2016) (quoting ER 703). His general opinion is admissible even if the underlying correspondence is not. Additionally, Exhibit C to the Mercier declaration is a report on ESSB 5096 prepared by the Department of Revenue that is an admission of a party-opponent. ER 801(d)(2).

Plaintiffs' Reply filed 1-21-22, at n. 9 on p. 11.

The Motion to Strike is granted in part and denied in part. The following portions of the Mercier declaration are hereby deemed to be inadmissible hearsay and will be stricken:

- The last two sentences of paragraph 4 ("A true and correct copy of all written responses I received is attached as **Exhibit B**. The responses for every state are summarized in the table below:")
- The table that follows paragraph 4 at page 2 line 1 through page 4 line 22.
- Paragraph 7 and the referenced **Exhibit D** (letter from IRS to U.S. Congressman Dan Newhouse).

Paragraphs 1 and 2 contain no inadmissible hearsay. Nor does paragraph 3 which merely attaches a copy of ESSB 5096. The first two sentences of paragraph 4 contain no inadmissible hearsay, although they describe how Mr. Mercier gathered the data underlying his expert testimony under ER 702. This Court deems paragraphs 1 through 3 and the first two sentences of paragraph 4 to be admissible.

The last two sentences of paragraph 4, as well as the table that follows paragraph 4, are deemed to be inadmissible and will be stricken even though Mr. Mercier appears to have considered the various states' survey responses as a basis for his testimony in paragraph 5. See ER 703 (providing in part that "[i]f reasonably relied upon by experts in the particular field in forming opinions or inferences on the subject, the facts or data [upon which the expert bases his/her opinion or inference] need not be admissible in evidence.") In other words, this Court may consider any properly admitted expert

testimony from Mr. Mercier, but the data underlying that testimony need not be admissible.

In Paragraph 5 Mr. Mercier testifies that while some states responded that they did not tax capital gains at all, no state that was surveyed taxed capital gains through an excise tax or in any way other than through an income tax. This Court deems Paragraph 5 to be admissible expert testimony under ER 702 which provides as follows:

> If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise.

ER 702. This Court finds that paragraph 5 sets forth "scientific, technical, or other specialized knowledge" that satisfies the requirements of ER 702. To the extent the State argues paragraph 5 should be disregarded because Washington's tax statutes may be different from the tax statutes in those other states, such objection goes to the weight of the evidence rather than to its admissibility.

Paragraph 6 and the referenced Exhibit C are both deemed to be admissible. The Washington State Department of Revenue's (DOR's) analysis of ESSB 5096 provides in pertinent part as follows:

> Another issue with the charitable deduction [set forth in Section 9 of ESSB 5096] is that, because it is a common feature of income taxes, it may increase the chance that the courts will determine that the Washington capital gains tax is an income tax. At least one lawsuit has already been filed seeking to invalidate the capital gains tax on several grounds, including that the tax is an income tax and, as such, violates article VII, sections 1 and 2 of the Washington Constitution, because the tax is non-uniform and the tax rate exceeds the 1% aggregate limit.
>
> It is impossible to quantify the extent to which the charitable deduction may strengthen the argument that the capital gains tax is an income tax.

> All we can say is that the charitable deduction likely incrementally strengthens the argument that the capital gains tax is an income tax. The charitable deduction is not the only provision in the bill that opponents of the capital gains tax can point to in support of their argument that the capital gains tax is an income tax.

DOR Bill Report on ESSB 5096, at pp. 5-6, attached as Exhibit C to Mercier declaration. This Court deems the DOR Bill Report to be admissible as an admission of a party-opponent under ER 801(d)(2).

As mentioned above, paragraph 7 and the referenced Exhibit D (the letter from the IRS to Rep. Newhouse stating, *inter alia*, that under federal law "capital gains are treated as income under the tax code and taxed as such") is inadmissible hearsay and will be stricken. Mr. Mercier's declaration merely attaches a copy of Exhibit D without providing any testimony or other information relating to it, other than a statement that it was obtained through a public records request. This Court finds no basis to deem paragraph 7 or Exhibit D to be admissible.

Cross Motions for Summary Judgment

1. The State's Objection Re: Plaintiffs' Standing.

This Court once again rejects the State's argument that none of the Plaintiffs have standing to bring this facial challenge to the constitutionality of ESSB 5096. The Court previously rejected the State's arguments on standing that were asserted as part of the State's Rule 12 Motion to Dismiss.

It is true that the pending Cross Motions for Summary Judgment have been brought under CR 56 rather than under CR 12. However, under CR 56 the Court must still view the evidence in a light most favorable to the non-moving party for purposes of the motion. See, e.g., Afoa v. Port of Seattle, 176 Wn.2d 460 (2013).

The Court incorporates by this reference its analysis as set forth in its letter ruling dated September 10, 2021 in which it rejected the State's prior arguments and objections

regarding Plaintiffs' standing to bring this lawsuit. The Court also notes that multiple additional sworn declarations filed since this Court issued that letter ruling only further support this Court's finding that the Plaintiffs have standing.

2. The Scope of Matters Considered by this Court.

The Court has reviewed a wealth of material filed in connection with the pending motions. Much of the information and argument, particularly in some of the amicus briefs but also in the State's filings,[1] centered around discussions involving policy considerations such as whether schools are appropriately funded and whether the new tax statute makes Washington's tax structure more fair.

This Court is not permitted to consider such policy considerations when ruling on the constitutionality of ESSB 5096.

> It is not the function of [the courts] . . . to consider the propriety of the tax, or to seek for the motives or to criticize the public policy which may have prompted adoption of the legislation. [Citation omitted.]

State ex rel Namer Inv. Corp. v. Williams, 73 Wn.2d 1, 7 (1968). Accordingly, this Court's sole function in these consolidated cases is to provide a ruling, at the trial court level, whether ESSB 5096 is unconstitutional pursuant to established Washington caselaw, without any regard to any motives or public policy considerations that may have led to the adoption of ESSB 5096.

3. Analysis of Cross Motions for Summary Judgment.

Under Washington law, it is up to the courts to decide whether a tax law is constitutional. Kunath v. City of Seattle, 10 Wn.App.2d 205 (2019) involved a challenge to a city ordinance that imposed a graduated income tax on high-income residents. Division I of the Washington State Court of Appeals stated in Kunath:

[1] See, e.g., State's MSJ filed 12-6-21, at 2-6.

> Before addressing the tax's statutory and constitutional validity, we must address [plaintiff] Shock's threshold contention that these issues are nonjusticiable political questions. Shock contends: "The City's request that this Court reverse nearly a century of case law holding that income is personal property, and therefore subject to the Constitution's uniformity requirement, is not appropriate for judicial determination." But it is well settled that Washington courts have the power to hear constitutional challenges to tax laws, which is why we are guided by "nearly a century of case law" on these issues. The issues raised in this case are justiciable. [Emphasis supplied; internal citations omitted.]

Kunath, at 216. See also Wash. Const. art. IV § 6 and RCW 2.08.010 (both of which provide that superior courts have original jurisdiction over "the legality of any tax").

This Court has reviewed the "nearly a century of case law" as referenced by the Kunath court, see list of appellate decisions recited in Kunath at p. 213-16. That caselaw makes clear that the starting point for this Court's analysis is certain language that was added to the Washington State Constitution by a constitutional amendment adopted in 1930. The Kunath court stated:

> 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."

Kunath, at 213. See also article VII, section 2 of the Washington State Constitution (placing 1% annual limit on the aggregate of all tax levied on real and personal property).

Three years after article VII, section 1 was adopted, Washington voters passed a statewide initiative levying a graduated tax on net income. Taxpayers challenged the new graduated tax statute, arguing it was unconstitutional because it taxed property and

therefore violated the uniformity requirement set forth in article VII, section 1. In Culliton v. Chase, 174 Wash. 363 (1933), the Washington Supreme Court declared the statute to be unconstitutional. In so doing, the Culliton court made clear that income taxes are different from excise taxes inasmuch as excise taxes are levied on an activity (e.g., the sale, consumption or manufacture of goods) rather than on income generated by an activity. Culliton, at 377. Next the Culliton court characterized income as within the broad definition of "property" and ruled the new statute to be unconstitutional because the graduated income tax was not uniform as required by article VII, section 1. Culliton, at 378-79.

The Washington Supreme Court's decision in Jensen v. Henneford, 185 Wash. 209 (1936) was issued only three years after Culliton. Jensen involved a challenge to a 1935 tax statute that levied a graduated income tax on every Washington resident "for the privilege of receiving income therein while enjoying the protection of its laws." Jensen, at 212 (quoting Laws of 1935, ch. 178, Sec. 2). As in the instant case, the State in Jensen argued that the new tax statute should be deemed an excise tax (which would be constitutional) and not an income tax (which would be unconstitutional). The Jensen court rejected the State's argument, stating that "[t]he character of a tax is determined by its incidents, not by its name." Jensen, at 217. Because the new statute taxed income below $4,000 at three percent and income above $4,000 at four percent, and because Culliton had established that income constitutes property for purposes of Article VII, Section 1, the Jensen court ruled the 1935 tax statute to be an unconstitutional non-uniform tax on property. Jensen, at 220.

These principles were revisited in 1951 when the Washington Supreme Court decided the case of Power, Inc. v. Huntley, 39 Wn.2d 191 (1951). In 2019 the Kunath court summarized Power as follows:

> In 1951, Power, Inc. v. Huntley evaluated a statewide "corporation excise tax" that levied a four percent tax on a corporation's net income "for the privilege of exercising its corporate franchise in this state or for the privilege of doing business in this state." The tax did not apply to sole proprietorships or partnerships. The central question before the court was whether the tax fell on income rather than being a true excise. If a tax on

> income, then it violated the uniformity clause of article VII, section 1 by affecting only certain forms of corporations and not other companies in competition with them. The Power court set aside the language of the tax, analyzed its incidents, and concluded it was "a mere property tax masquerading as an excise." Under the taxing scheme, a Washington corporation with zero net income would not pay any income tax, while a foreign corporation doing business in Washington would pay taxes on activities unconnected to the privilege of conducting business in Washington. Also, the scheme hewed closely to federal corporate income tax law, illustrating its true nature as an income tax. The court concluded the tax was a nonuniform property tax and therefore unconstitutional. [Citations omitted.]

Kunath, at 215. One way to summarize Power would be to say that when deciding a challenge as to the facial constitutionality of a tax statute (specifically including where the State argues it is an excise tax and not an income tax), the court must look through any labels the State has used to describe the statute, analyze the "incidents" of the statute, and determine whether it is a "property tax masquerading as an excise." Id.

As Power makes clear, rather than merely relying upon whatever label or characterization the State has used to describe a tax statute, it is the State's choices about "who is being taxed, what is being taxed, and how the tax is measured" that determine its "incidents" and whether it should be deemed a tax on income as opposed to an excise. See Kunath, at 221. In the instant case, some of the most significant "incidents" of ESSB 5096 show the hallmarks of an income tax rather than an excise tax. They include the following:

- It relies upon federal IRS income tax returns that Washington residents must file and is thus derived from a taxpayer's annual federal income tax reporting. See Kunath, at 215 ("scheme [that] hewed closely to federal corporate income tax law" held to be an unconstitutional property tax).
- It levies a tax on the same long-term capital gains that the IRS characterizes as "income" under federal law.

- It is levied annually (like an income tax), not at the time of each transaction (like an excise tax).
- It is levied not on the gross value of the property sold in a transaction (like an excise tax as demonstrated by the examples cited by the State[2]), but on an individual's net capital gain (like an income tax).
- Like an income tax, it is based on an *aggregate* calculation of an individual's capital gains over the course of a year from all sources, taking into consideration various deductions and exclusions, to arrive at a single annual taxable dollar figure.
- Like an income tax, it is levied on all long-term capital gains of an individual, regardless whether those gains were earned within Washington and thus without concern whether the State conferred any right or privilege to facilitate the underlying transfer that would entitle the State to charge an excise. See, e.g., Jensen, at 218 ("When a tax is, in truth, levied for the exercise of a substantive privilege granted or permitted by the state, the tax may be considered as an excise tax.")
- Like an income tax and unlike an excise tax, the new tax statute includes a deduction for certain charitable donations the taxpayer has made during the tax year.[3]

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[2] See, e.g., State's MSJ filed 12-6-21, at pp. 11-16, discussing *inter alia*, Morrow v. Henneford, 182 Wash. 625, 631 (1935) (upholding business and occupation tax imposed on the privilege of engaging in business activity in the state and measured by the total gross income earned from business activity in Washington); Mahler v. Tremper, 40 Wn.2d 405 (1952) (upholding real estate excise tax measured by selling price of the property); Black v. State, 67 Wn.2d 97, 98 (1965) (upholding sales tax imposed on lease and measured by total cost of the lease); Wash. Pub. Ports Ass'n v. Dept of Revenue, 148 Wn.2d 637, 642-43 (2003) (upholding leasehold excise tax measured by total taxable rent); High Tide Seafoods v. State, 106 Wn.2d 695, 700 (1986) (measure of tax on enhanced fish food was total value of the fish at first possession); Sheehan v. Cent. Puget Sound Reg'l Transit Auth., 155 Wn.2d 790, 800 (2005) (measure of motor vehicle excise tax was value of the vehicle at registration); In re Estate of Hambleton, 181 Wn.2d 802 (2014) (upholding estate tax that was measured by the value of the property at the time of decedent's death and is apportioned to the extent any of the property was located outside Washington).

[3] See Section 9 of ESSB 5096, entitled "Additional Deduction for Charitable Donations." See also, Washington State Department of Revenue (DOR) bill report on ESSB 5096, at 5-6, attached at Exhibit C to Declaration of Jason Mercier, which as explained earlier, the Court deems to be admissible as an admission of a party opponent under ER 801(d)(2). The DOR bill report states in part:

- If the legal owner of the asset who transfers title or ownership is not an individual, then the legal owner is not liable for the tax generated in connection with the transaction, unlike the excise taxes identified by the State.

The State characterizes the new tax statute as a "tax that applies on the sale or transfer of property" and argues that such taxes are excise taxes. State's MSJ filed 12-6-21, at 1. But as noted above, the new tax is not levied upon "the sale or transfer" of capital assets. Instead, the new tax statute levies a tax on receipt, and thus ownership, of capital gains. See Jensen v. Henneford, 185 Wash. 209, 219 (1936) ("The right to receive" is an incident of property ownership).

In attempting to label the new tax as an excise and not an income tax, the State also argues that the tax "applies only upon the voluntary sale of a long-term asset." State's MSJ filed 12-6-21 at 9-10. However, the new tax would be levied not only upon capital gains from voluntary transactions, but also in a number of scenarios where the sale or transfer of a capital asset would occur without any voluntary act by the transfer, e.g., transactions involving a minority shareholder, non-managing member of a limited liability company, or trust beneficiary. To the extent the new tax is unavoidable – at least for some taxpayers – it constitutes an "absolute and unavoidable" tax that meets the definition of a property tax, see authorities cited in Plaintiff's MSJ filed 12-6-21 at 9-

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Another issue with the charitable deduction is that, because it is a common feature of income taxes, it may increase the chance that the courts will determine that the Washington capital gains tax is an income tax. At least one lawsuit has already been filed seeking to invalidate the capital gains tax on several grounds, including that the tax is an income tax and, as such, violates articles VII, sections 1 and 2 of the Washington Constitution, because the tax is non-uniform and the tax rate exceeds the 1% aggregate rate limit.

It is impossible to quantify the extent to which the charitable deduction may strengthen the argument that the capital gains tax is an income tax. All we can say is that the charitable deduction likely incrementally strengthens the argument that the capital gains tax is an income tax. The charitable donation deduction is not the only provision in the bill that opponents of the capital gains tax can point to in support of their argument that the capital gains tax is an income tax.

10, that is subject to the uniformity and limitation requirements of article VII, sections 1 and 2 of the Washington State Constitution.

ESSB 5096 is properly characterized as an income tax pursuant to Culliton, Jensen, Power and other applicable Washington caselaw, rather than as an excise tax as argued by the State. As a tax on the receipt of income, ESSB 5096 is also properly characterized as a tax on property pursuant to that same caselaw.

This Court concludes that 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%.

CONCLUSION

For the reasons set forth above, this Court grants Plaintiffs' Motion for Summary Judgment and denies the State's Motion for Summary Judgment. Having ruled that ESSB 5096 is invalid because it violates the uniformity and limitation requirements of article VII, sections 1 and 2 of the Washington State Constitution, this Court does not reach the additional arguments raised by the parties.

It is hoped that the parties will seek to agree upon the form of the written orders that will memorialize the Court's rulings set forth in this letter. If a presentment hearing is needed, it may be scheduled as a special set hearing by emailing the Court Administrator.

Sincerely,

Brian C. Huber
Judge of the Superior Court
BCH/jlj
cc: Court File