Seattle's Income Tax Quest: An Impossible Dream?

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This edition of Skookum Tax News focuses on Seattle's proposed income tax, which, if enacted, should be challenged in court. The authors outline the likely legal challenges the ordinance will face in the context of Washington's long history of failed income tax adoption efforts.

In a state with no income tax, the Seattle City Council is on a quixotic quest to redistribute wealth. On May 1, the council took a first step toward creating a city income tax. It unanimously passed a resolution establishing an ambitious timeline for developing — in conjunction with "the Trump-Proof Seattle Coalition" — an income tax ordinance. The timeline calls for adopting the new ordinance by July 10. In the meantime, at least one council member is stoking passions "to build a movement to Tax the Rich!"[1] The movement is replete with signs and T-shirts bearing this slogan, and the city income tax figures as the movement's centerpiece.[2] The big wrinkle in the plan is that the tax would be illegal and would likely only end up costing the city.

The History of Failed Income Tax Efforts

Washington's lack of an income tax has not been for lack of trying. Income taxation was on the minds of many Washingtonians from the earliest years of statehood. By 1894 the platform of the state Democratic Party followed the lead of the national party in calling for income taxation by stating it "approved the policy of the Democratic party which, by a reasonable income tax, would compel gigantic fortune owners to contribute their fair share of the tax burdens of the government."[3] This lively rhetoric would be right at home in Seattle's city hall today.

But in the early years of statehood, most efforts to broaden the tax base and otherwise redistribute the cost of government focused on the general property tax. The ultimate prize for property tax reformers was to tax intangible forms of wealth, but the courts foreclosed that option.[4] And even the reformers came to acknowledge that the general property tax, with its relatively high rate, was problematic for intangibles. If a bond paying 2 percent interest was subjected to a 2 percent property tax each year, its value would be destroyed.

The reformers proposed to solve this problem by amending the state constitution to allow a classified property tax. A classified property tax would subject intangible forms of wealth to lower and more appropriate tax rates. Classification

[1] Kshama Sawant, "District 3 'Tax the Rich!' Town Hall," Council Connection, May 23, 2017.

[2] *See, e.g.*, "Overwhelming Number of People Speak in Favor of Seattle Income Tax," MyNorthwest.com, May 31, 2017.

[3] State of Washington, "Legislative Manual and Political Directory" (Jan. 1, 1899), at 39.

[4] *State ex rel. Wolfe v. Parmenter*, 96 P. 1047 (Wash. 1908).

amendments were proposed without success in all but one legislative session from 1909 to 1925.[5] The 1927 Legislature finally approved a classification amendment, which was rejected by the voters in November 1928.[6]

This did not stop the widespread feeling that farmers and homeowners carried too heavy a tax load while the wealthy paid far too little.[7] The reformers went back to the drawing board, and in early 1929 the Legislature approved another classification amendment with revisions designed to address the two principal objections to the predecessor amendment. As the voter pamphlet declared: "It fixes real estate all in one class . . . and it defines property. These two changes met the commonest objections to the 1928 amendment and were largely responsible for the different factions uniting on this amendment in the [1929] Legislature."[8]

Meanwhile, the 1929 Legislature directed the creation of a Tax Investigation Commission to study tax reform more broadly.[9] The Legislature also dipped its toe in the income tax waters by passing a very limited income tax.[10] In June 1930, the Washington Supreme Court struck it down.[11] This decision was issued just as the Tax Investigation Commission was putting the finishing touches on its report recommending adoption of broad-based personal and corporate income taxes.

The other intervening event, of course, was the onset of the Great Depression in late 1929. In the dark days of November 1930, the voters approved the revised classification amendment. But the legislative response was not a low-rate property tax on intangibles. Instead, the Legislature promptly enacted a property tax exemption for intangible wealth, then referred to as credits.[12]

[5] Preston, Thorgrimson & Turner, et al. as Amici Curiae in *State ex rel. Egbert v. Gifford*, 275 P. 74 (Wash. 1929), at 44-47.

[6] Wash. Laws of 1927, ch. 180.

[7] *Seattle Post-Intelligencer*, preelection cartoons, Nov. 5, 1928, at M-2.

[8] Washington Secretary of State, Voter Pamphlet for November 4, 1930 General Election, at 29.

[9] Wash. Laws of 1929, ch. 127.

[10] Wash. Laws of 1929, ch. 151.

[11] *Aberdeen Savings & Loan Association v. Chase*, 289 P. 697 (Wash. 1930).

[12] Wash. Laws of 1931, ch. 96, section 1.

Voter-Approved Tax Struck Down

Income tax proponents regrouped and secured enough signatures to place an income tax initiative on the ballot in 1932. The voters adopted the initiative, but it was struck down in a 5-4 decision in *Culliton v. Chase*.[13] The majority believed that the case turned solely on the unique and extremely broad definition of property in the 1930 amendment to the state constitution's tax uniformity clause. Viewing income as property, the court concluded that a graduated income tax violated the uniformity clause.

The four dissenting justices acknowledged the strength of this rationale, but they advanced two answers. First, they concluded that an income tax is an excise tax and therefore outside the scope of the tax uniformity clause. Second, even if income is property under the broad definition in the recent constitutional amendment, the dissenters apparently believed that each band of income in a graduated income tax is a separate class of property, and, as such, each satisfies the uniformity requirement. These arguments failed to carry the day.

There was more unsuccessful income tax activity throughout the Depression. A variety of excise taxes arose to take the place of the income tax, and these were upheld by the courts. Excise taxes remain the primary source of state tax revenue today.

Interest in income taxation resumed in the 1960s under Gov. Daniel J. Evans, but the voters twice rejected the necessary constitutional amendments by overwhelming margins. In the late 1980s, Gov. Booth Gardner made another strenuous effort to secure public support for an income tax, but the necessary constitutional amendment and implementing legislation never emerged from the Legislature.

An Initiative Proposal With No Constitutional Amendment

In 2002, attorneys William H. Gates Sr. and Hugh Spitzer served as chair and vice-chair on a Tax Structure Study Committee that the Legislature formed to study "how well the

[13] 174 Wash. 363, 25 P.2d 81 (1933).

current tax system functions and how it might be changed to better serve the citizens of the state."[14] The Legislature directed the committee to focus on tax alternatives that "contain no income tax."[15] While following this directive, the committee obviously felt strongly attracted by income taxation as an alternative. Its report to the Legislature prominently featured an argument by Spitzer that the Washington Supreme Court could reverse its ruling in *Culliton*.[16]

Eight years later, in 2010, Gates proposed an initiative (I-1098) to impose a state income tax on high earners. Though proponents of the measure gathered enough signatures to land it on the ballot, 64 percent of voters opposed it. In Seattle, the proportion was reversed, with 63 percent voting in favor of the initiative. Had I-1098 passed, it would have provided the court the opportunity to reconsider its precedent on the constitutionality of an income tax because the initiative did not attempt to amend the state constitution.[17]

In substance, I-1098 followed a template similar to later city income tax efforts. It would have imposed tax on the adjusted gross income of Washington residents regardless of origin.[18] The individual income tax would thus also apply to the taxable income of passthrough entities (S corporations, limited liability company's, or partnerships), even if not distributed to the taxpayer. Unlike federal taxes, Washington's gross receipts tax applies at the entity level regardless of whether it is treated as having passthrough income. Nonresidents would have paid tax on the portion of AGI derived from or connected with sources in Washington. The tax would have applied at graduated rates between 5 and 9 percent on the amount of AGI exceeding $200,000 for individuals and $400,000 for married couples filing jointly.

I-1098 also resembled efforts before and after it by calling the income tax an excise tax. In section 1001, the initiative explained: "The tax established by this initiative is intentionally structured as an excise tax on the receipt of income during the taxable year rather than as a property tax on money as an asset, after it has been received." In this way, the initiative's proponents hoped to avoid the fate of the income tax overturned in *Culliton*. Yet, the Washington Supreme Court has remained consistently unpersuaded when presented with such efforts to rename the tax, saying in one instance, as it struck down a corporate income tax, "the tax is a mere property tax 'masquerading as an excise.'"[19]

After the state's voters dashed the hopes of those who wanted to put a statewide tax before the Washington Supreme Court, income tax proponents started looking to a city income tax as an alternative path.

Olympia Votes on a City Excise Tax

The Seattle-based Economic Opportunity Institute (EOI), whose executive director was chair of the campaign supporting the 2010 initiative, next considered where it might gain a foothold for a city income tax. EOI provided the template for the initiative to proponents in Olympia.[20] A political committee called Opportunity for Olympia, then proposed an initiative that would impose a 1.5 percent tax on the portion of household AGI exceeding $200,000 per year. The tax would have applied to residents or those domiciled in the city. It anticipated raising $2.5 million to pay community college tuition for local high school graduates.

Before the November 2016 elections, the Olympia city council sought a judicial decision declaring the initiative unlawful so it could keep the measure off the ballot.[21] The superior court ruled the initiative invalid on the basis that only

[14] Wash. Laws of 2001, ch. 7, section 138(2).

[15] *Id.*

[16] Washington State Tax Structure Study Committee, "Tax Alternative for Washington State: A Report to the Legislature" (Nov. 2002), at App. B.

[17] Washington Research Council, "Policy Brief 10-14: I-1098 Income Tax Proposal: Wrong Diagnosis, Wrong Prescription" (June 8, 2010).

[18] Except interest received on federal obligations.

[19] *Power Inc. v. Huntley*, 235 P.2d 173 (Wash. 1951). *See also Jensen v. Henneford*, 53 P.2d 607 (Wash. 1936); *Apartment Operators Association of Seattle Inc. v. Schumacher*, 351 P.2d 124 (Wash. 1960); and *Harbour Village Apartments v. City of Mukilteo*, 989 P.2d 542 (Wash. 1999).

[20] Andy Hobbs, "Will a Tax on Olympia's Richest Households Hold Up in Court?," *The Olympian*, Apr. 20, 2016.

[21] Hobbs, "City of Olympia Will Fight Local Income Tax Petition," *The Olympian*, July 13, 2016.

the city council could establish a tax, not the people through the initiative process. But the court of appeals granted a stay, allowing the initiative to remain on the ballot on the basis that several of the issues in the case were at least debatable. The court never had a chance to further consider those arguments, as 52 percent of Olympia voters opposed the initiative.

Spitzer, who believes the state supreme court should revisit *Culliton*, again made an appearance in the context of the Olympia initiative. This time, however, he advised against the tax initiative. In a presentation to the city council, Spitzer discussed Olympia's broad powers as a code city under the state's statutory classification for cities.[22] The power of code cities to tax within their territorial limits extends to anything not "expressly preempted by the state."[23] Spitzer advised that a court would likely rule that those powers do not include the power to tax individual income.[24] His analysis rested in part on a 1952 case *Cary v. City of Bellingham*, which struck down an ordinance requiring employees to secure an annual license and levying a tax on the gross income of all who received compensation for services performed in the city.[25] As the Washington Supreme Court explained in that decision, an excise tax must, by definition, be "levied for the exercise of a substantive privilege granted or permitted by the state."[26] The court concluded that the right to earn a living by working for wages was an unalienable right, not a privilege. As the city did not have the power to control the right to work for wages, it could not tax that right. Another reason a court would likely strike down the income tax in Olympia is that the Legislature, in 1984, specifically prohibited cities from levying a tax on net income.[27]

The initiative language carefully used the term "excise tax" that applies to income. Similarly, in arguments before the court, Opportunity for Olympia characterized the tax as "a permitted excise tax and not a prohibited net income tax" because it

> taxes the privileges of disproportionate use and benefit from city services enjoyed by wealthy residents, such as proximity to city parks which enhance private property enjoyment and values, and higher value police and fire protection services, by assessing a tax on the portion of AGI [adjusted gross income] in excess of $200,000.[28]

This line of reasoning may provide a key glimpse into what lies ahead in Seattle.

The Battle Moves to Seattle

In Seattle, the proponents of the Olympia initiative decided on a different approach and proposed the tax to the city council directly.[29] Seattle's city council has already championed a variety of causes meant to promote economic equality, but which have been described by business interests as "an onslaught of regulations," including a $15 minimum wage, secure scheduling for employees, plans for a new ordinance for paid family leave, and a newly enacted soda tax.[30]

The idea of a city income tax took center stage as the mayoral race got underway in April.[31] Former Mayor Mike McGinn, in announcing his candidacy, called for an income tax. Days later, incumbent Mayor Ed Murray (D) made a surprise announcement at a candidate forum that he would propose a city income tax on "high-end" households. But he had no details and only said he planned to propose a resolution stating an intent to pass an income tax. He also warned that "it's too soon to cheer," given the certainty of a court challenge.[32]

[22] Hobbs, *supra* note 20.

[23] Wash. Rev. Code section 35A.01.050.

[24] Hobbs, *supra* note 20.

[25] *Cary v. City of Bellingham*, 41 Wn. 2d 468 250 P.2d 114 (Wash. 1952).

[26] *Cary*, 41 Wn.2d at 472.

[27] Wash. Rev. Code 36.65.030.

[28] *City of Olympia v. Opportunity for Olympia*, No. 49333-1-II, Ruling Granting Stay Pending Appeal (Wash. Ct. App. Sept. 2, 2016), at 9.

[29] Paul Jones, "Coalition Proposes Local Income Tax in Seattle," *State Tax Notes*, Mar. 6, 2017, p. 817.

[30] Anthony Bolante, "Seattle Divided: Chasm Between City Hall and Businesses Threatens Economy," *Puget Sound Business Journal*, May 5, 2017. *See also* Jones, "Soda Tax Proponents Advise Seattle Leaders on Proposed Tax," *State Tax Notes*, May 29, 2017, p. 858.

[31] Daniel Beekman, "Seattle Mayor Ed Murray Proposes Income Tax for City's 'High-End' Households," *The Seattle Times*, Apr. 20, 2017.

[32] *Id.*

A little more than a week later, city council members unanimously adopted Resolution 31747.[33] Similarly light on particulars, the resolution expresses an "intent to adopt a progressive income tax targeting high-income households." It refers to a proposal by the Trump-Proof Seattle Coalition (backed in part by EOI) for a tax of 1.5 percent on the portion of AGI above $250,000, which the resolution says would raise $125 million per year. The resolution contemplates that the council, mayor, city attorney (a separately elected position), and coalition will work together, possibly with advice of outside legal counsel, to craft the ordinance. The resolution sets the goal of adopting the ordinance by July 10, 2017, with a city council vote.

The resolution anticipated that the council would begin considering the ordinance by May 31. Though the council met to discuss it that day, there was still no clarification of what the tax will look like.

Ben Noble, Seattle's budget director, tried to elaborate on the possible form of an ordinance at a business forum in May. He said the city was "working feverishly" but that many details are "yet to be determined." He said the tax might be on household income of $400,000 at a rate of 1 percent to 2 percent, which would raise approximately $100 million, according to an IRS ZIP Code estimate. Noble believes that collection would be through remittance, with enforcement likely based on some type of information-sharing agreement with the IRS. He also thought the effective date of the ordinance would be after resolution of a legal challenge, which the city expects to occur soon after the tax is passed. The practical reason for the delayed effective date is to save the expense of setting up infrastructure for a stand-alone tax if the city cannot collect the tax. Noble noted that Seattle still has painful memories of the refunds it had to make (plus attorney fees) when it illegally imposed residential street utility charges as fees that were held to be unconstitutional taxes in 1995.[34]

As of the time of writing, the outlines of the tax are just beginning to emerge thanks to a draft ordinance released June 12. Starting in 2019 (on 2018 income), the tax would apply at a rate of 2 percent to "total income" (for federal tax purposes) over $250,000 for individuals or $500,000 for married couples filing jointly, with annual upward adjustments consistent with any growth in the Consumer Price Index. It would apply to all Washington income of resident taxpayers — that is, those domiciled in the city or spending more than half the year in the city. Somehow, the city government plans to implement a structure to administer, collect, and enforce a tax without any analog in the state system. Interestingly, the resolution and draft ordinance call it an income tax, not an excise tax.

The city council says that it sees itself as "pioneer[ing] a legal pathway and build[ing] political momentum to enable the State of Washington and other local municipalities to put in place progressive tax systems" — that is, forging a path toward a statewide income tax.[35] At the state level, however, support is scarce. Gov. Jay Inslee (D) recently said of the proposal, "I don't think it's right for the State of Washington."[36]

The Likely Court Challenge

A court challenge to a city income tax seems inevitable. The first legal hurdle for Seattle is the scope of the city's powers. Unlike Olympia, Seattle is classified under Washington law as a first-class city. This category of city derives its powers from its charter.[37] Seattle's charter provides for assessing, levying, and collecting "taxes on real and personal property for the corporate uses and purposes of the City" and "for the payment of the debts and expenses" of the city.[38] Income tax proponents will surely avoid any possible characterization of it as a property tax due to the uniformity clause. They will have to either persuade voters to agree to amend the charter or somehow frame the tax as payment of

[33] Search for Resolution No. 31747 on the Seattle Office of the City Clerk website.

[34] *Covell v. City of Seattle*, 905 P.2d 324 (Wash. 1995).

[35] Resolution 31747.

[36] Kip Robertson, "Inslee: Income Tax Is Not Right for Washington State," MyNorthwest.com, May 3, 2017.

[37] *See* Wash. Rev. Code ch. 35.22.

[38] Charter of the City of Seattle, Art. IV, section 14.

debts and expenses. The resolution and draft ordinance list a number of potential revenue needs, including potential gaps left by "federal budget cuts proposed by the Trump administration." While calling the tax a "vital new revenue tool," neither states exactly how the revenue would be used. Further, like other classes of city, Seattle can only impose taxes that are authorized by the Legislature, and all cities face an express statutory prohibition on taxing net income.[39] Nor is taxing "total income" permitted. The Legislature has granted only limited authority to levy license taxes to raise revenue and regulate business.[40] That authority remains limited by *Cary v. Bellingham*.

Another issue will likely be the constitutional arguments. However, courts are reluctant to decide cases on constitutional grounds when they can be decided on other grounds. So the court would likely not even reach constitutional issues. Foremost among the constitutional issues is the court's precedent under the *Culliton* line of cases. Though Spitzer believes the Washington Supreme Court should overrule *Culliton*, it may do so only upon a clear showing that the precedent is both incorrect and harmful.[41] The justices who decided *Culliton* were interpreting a uniformity clause that had only recently been added to the state constitution — one that they emphasized is unlike any other state's uniformity clause. Who could say that today's interpretation would be more accurate than that contemporaneous one? It is difficult to say that the precedent is incorrect. Nor should the court conclude that the precedent is harmful when a majority of state voters rejected an income tax in 2010. If the case were to reach the Washington Supreme Court, whose justices are elected on a statewide basis, and if that court were to reach the issue of Washington's uniformity clause, it should decide to follow prior case law. Under the *Culliton* line of cases, this tax is a property tax. The city has no power to override the Legislature's exemption of income from the general property tax.

Conclusion

Proponents of tax reform in Washington should remain within the law. If they want to change the law, they should do so by means of a constitutional amendment. If there is not enough political support for that (which there is not), then they should not attempt to circumvent the constitution and other laws through a plainly illegal city ordinance and a "Hail Mary" heave to the courts. ■

[39] *See* Hugh Spitzer, "'Home Rule' vs. 'Dillon's Rule' for Washington Cities," 38 *Seattle U. L. Rev.* 809, 834 (2015) (citing *State ex. rel. School District No. 37 v. Clark County*, 31 P.2d 897 (Wash. 1934), and *Great Northern Railway Co. v. Stevens County*, 183 P. 65 (Wash. 1919)).

[40] Wash. Rev. Code section 35.22.570; Wash. Rev. Code section 35.23.440(8); and Wash. Rev. Code section 35A.82.020.

[41] *City of Federal Way v. Koenig*, 217 P.3d 1172 (Wash. 2009).