



# State & Local Tax **Alert**

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## County Court Invalidates Seattle Personal Income Tax

On November 22, 2017, the Superior Court of Washington for King County ruled that an income tax enacted in July by Seattle’s City Council violates a state statutory provision which prohibits a city from levying a tax based on net income.<sup>1</sup> As a result, the decision will prevent Seattle from implementing the personal income tax, which otherwise would have been imposed on high-income Seattle residents beginning with the 2018 tax year.

### Background

Seattle recently enacted an income tax ordinance intended to promote a progressive tax system to meet the city’s fiscal needs and further stimulate growth, in anticipation of a decrease in state funding from the federal government.<sup>2</sup> Specifically, the Seattle City Income Tax imposed a 2.25 percent net income tax on resident individuals and trusts with income exceeding \$250,000 (\$500,000 for joint filers) per year.<sup>3</sup> For purposes of the tax, “total income” is defined as the amount of income reported to the Internal Revenue Service on Forms 1040, 1040A or 1041 (for trusts), which does not account for any adjustments, deductions, or credits.<sup>4</sup>

Upon enactment, several residents filed lawsuits challenging the validity of the tax, which were consolidated for purposes of this motion. The Economic Opportunity Institute (EOI) also joined the City of Seattle as an additional defendant to the motion.

### Decision

Each of the residents’ lawsuits asserted several reasons as to why the Seattle City Income Tax should be declared void, resulting in over 1,200 pages of submitted materials. The Superior Court addressed many of these issues in its decision, which turned on whether Washington statutes permit imposition of the tax. Specifically, the Court considered: (i) Seattle’s authority to levy the tax; (ii) whether the tax was actually an income tax; (iii) the applicability of a state law prohibiting cities from enacting income taxes; and (iv) the constitutional “Single-Subject” and “Subject-in-Title” standards.

<sup>1</sup> *Kunath v. Seattle and Economic Opportunity Institute*, Washington Superior Court, King County, No. 17-2-18848-4 SEA, Nov. 22, 2017.

<sup>2</sup> Ordinance 125339, § 1, enacting SEATTLE, WA., CODE § 5.65. See [GT SALT Alert: City of Seattle Approves New Personal Income and Sweetened Beverage Taxes](#).

<sup>3</sup> SEATTLE, WA., CODE § 5.65.

<sup>4</sup> SEATTLE, WA., CODE § 5.65.020(G).

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*Authority to Levy Tax*

The City of Seattle claimed it had authority to enact the personal income tax because it is “within the taxing authority delegated by the state.” In support of its position, Seattle relied on two provisions of Washington’s Constitution. First, in addressing the general ability of Washington cities to impose taxes, the Washington Constitution provides that “[f]or all corporate purposes, all municipal corporations may be vested with authority to assess and collect taxes.”<sup>5</sup> A second provision of the Washington Constitution authorizes the state legislature to grant municipalities the power to levy taxes for “county, city, town, or other municipal purposes.”<sup>6</sup>

The Washington Supreme Court recently summarized existing limitations on the taxing authority of municipalities, noting that “the Washington State Constitution generally vests taxing power in the state legislature.”<sup>7</sup> The Court referenced this case as well as an older decision as establishing that municipalities must have express authority, either constitutional or legislative, to levy taxes.<sup>8</sup> Based on those decisions, the Court concluded that ***if Seattle was unable to identify a statute that specifically authorized it to impose its income tax, the tax could not sustain challenge.***

In support of its right to impose the tax, Seattle cited a state statute which generally provides city legislative bodies with the powers of taxation that are within constitutional limitations.<sup>9</sup> However, the Court found that the taxing power granted by the statute contains no express authority to levy a tax, and the requirement remains that the legislature must specifically authorize the tax.

*Classification as Income Versus Excise Tax*

The Court next addressed whether the tax at issue was an income tax or an excise tax. This distinction is significant because Washington statutes specifically grant cities the right to impose an excise tax for the privilege of being licensed to do business in a city.<sup>10</sup>

Despite being titled “Income Tax on High-Income Residents,” Seattle argued that the tax qualified as an excise tax imposed on a taxpayer for voluntarily exercising a certain right or privilege. Seattle asserted that its residents enjoy a taxable “privilege” by having the right to receive revenue in Seattle and live in Seattle. The Court rejected both of Seattle’s assertions and held that the right to live and earn a livelihood is not a “privilege” that may be subject to an excise tax. According to the Court, the “City’s tax, which is labeled, ‘Income Tax,’ is exactly that. It cannot be restyled as an ‘excise tax’ on the alternate ‘privileges’ of receiving revenue in Seattle or choosing to live in Seattle.”

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<sup>5</sup> WASH. CONST. art. VII, § 9.

<sup>6</sup> WASH. CONST. art. XI, § 12.

<sup>7</sup> *Watson v. City of Seattle*, 401 P.3d 1 (Wash. 2017).

<sup>8</sup> *King County v. City of Algona*, 681 P.2d 1281 (Wash. 1984).

<sup>9</sup> WASH. REV. CODE § 35A.11.020.

<sup>10</sup> WASH. REV. CODE § 35.22.280(32).

*State Prohibition of City Income Taxes*

Wash. Rev. Code Sec. 36.65.030 prohibits counties, cities and city-counties from levying “net income” taxes.<sup>11</sup> In considering the validity of the Seattle City Income Tax, the Court focused on the applicability of this provision and the meaning of “net income.”

Seattle cited definitions from Black’s Law Dictionary and Webster’s Dictionary in support of its assertion that its tax is not levied on net income, but rather “total income.” Both definitions included some form of income less deductions. In response, several of the plaintiffs cited the Multistate Tax Compact, which defines “income tax” as a tax that inherently requires a netting process. The Court found that, regardless of which definition is applied, the Seattle City Income Tax constitutes a tax on net income. Although the term “total income” is applied to the relevant amount of income reported on Federal Forms 1040, 1040A and 1041, that amount represents a net figure because it is determined after deduction of allowable expenses and losses related to each source of income. Therefore, the Court concluded that the Seattle City Income Tax imposes a tax on net income.

*Constitutional Single-Subject and Subject-in-Title Rules*

Lastly, the Court addressed whether Wash. Rev. Code Sec. 36.65.030, which prohibits municipalities from levying net income taxes, is itself void and unconstitutional. Specifically, Seattle argued that the statute violates the Single-Subject Rule and the Subject-in-Title Rule of the Washington Constitution.<sup>12</sup> In its analysis, the Court considered the bill which originally enacted the law. Substitute Senate Bill 4313, which later codified the statute at issue, is titled, “An act relating to local government; and adding a new chapter to Title 36 RCW.” The Court found that there was a rational basis between the general subject stated in the title and the general subject of the subsection at issue – namely, the prohibition against local governments levying net income taxes. Thus, the law did not violate the Single-Subject Rule. Further, for the same reasons, it did not violate the Subject-in-Title Rule.

Since Seattle was not able to prove beyond a reasonable doubt that Wash. Rev. Code Sec. 36.65.030 was unconstitutional, the Court ruled that it “must give full effect to RCW 36.050.030, which squarely prohibits the net income tax that the Ordinance imposes.” Therefore, the Court held the Seattle City Income Tax to be invalid.<sup>13</sup>

**Commentary**

Opponents of the Seattle City Income Tax began challenging the ordinance as unconstitutional almost immediately upon its passage. The numerous legal contentions in this case raised by affected Seattle residents is reflective of the heightened level of controversy surrounding the ordinance. It is worth noting that application of the tax also appears to violate Washington’s uniformity clause, as it is imposed only on residents

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<sup>11</sup> WASH. REV. CODE § 36.65.030.

<sup>12</sup> See WASH. CONST. art. II, § 19. The article is intended to prevent legislative members from advancing legislation by attaching it to other necessary or desirable legislation.

<sup>13</sup> The Court declined to consider constitutional arguments brought by the plaintiffs, namely, that the Seattle ordinance violated the uniformity requirement imposed by WASH. CONST. art. VII, § 1 and the equal protection provisions of WASH. CONST. art. I, § 12 and U.S. CONST. amend. XIV, § 1.

exceeding a certain income threshold. Furthermore, Washington's Constitution specifically requires cities to seek administrative authority from the state prior to taxing the income of city residents.<sup>14</sup> However, the Court declined to address these additional constitutional issues.<sup>15</sup>

Although the decision did not come as a surprise to many, it will be interesting to see how Seattle responds. While Seattle has indicated that it intends to appeal the decision, the appeal process will likely take months to complete. In the meantime, the Seattle City Council may begin searching for alternative forms of taxation, such as the recently enacted sweetened beverage tax.<sup>16</sup>

The Seattle City Income Tax saga reflects a trend of some governments expressly stating their intent in enacting policies designed to cure specific societal problems. With respect to the sweetened beverage tax, similar to the income tax, the Seattle City Council went to great lengths to explain why the ordinance was necessary from a societal perspective. Several other major municipalities, including Philadelphia, have enacted sweetened beverage taxes, and many have been challenged by affected industries. While Seattle's sweetened beverage tax is imposed on distributors, it is entirely possible that the ultimate cost of the tax is passed onto consumers through higher overall prices for sweetened beverages.

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<sup>14</sup> WASH. CONST. art. VII, § 1. Early in 2017, the Washington Senate sought to amend the state's constitution to explicitly prohibit state and local taxing authorities from being able to impose an income tax. However, the bill failed. See Senate Bill SJR 8204, March 8, 2017.

<sup>15</sup> It was unnecessary to reach these issues because the Seattle City Income Tax was determined to be invalid on statutory grounds under WASH. REV. CODE § 36.65.030.

<sup>16</sup> Ordinance 125324, § 1, enacting SEATTLE, WA., CODE § 5.53 (June 6, 2017).