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JUDGE JOHN R. RUHL

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CASE NUMBER: 17-2-18848-4 SEA

SUPERIOR COURT OF THE STATE OF WASHINGTON  
FOR KING COUNTY

S. MICHAEL KUNATH,

Plaintiff,

v.

CITY OF SEATTLE,

Defendant.

No. 17-2-18848-4 SEA

AMICUS CURIAE MEMORANDUM  
OF RENTAL HOUSING  
ASSOCIATION OF WASHINGTON

I. INTRODUCTION

The Seattle City Council wants to make housing more affordable for most residents by shifting taxes to the wealthiest residents. But the income tax will hit not just high-salary earners, but those who sell personal homes or rental properties for a one-time gain in Seattle’s red-hot market. This will shrink nest eggs for retired people and make it harder for working-wage families to re-locate to more affordable places. Also, by increasing costs for rental property owners living in Seattle, the income tax will encourage rent increases in an area where soaring real estate prices and record-breaking demand already are making it difficult for low- and middle-income families to get by. Seattle will be even *less* affordable as the only city in Washington with an income tax.

The “high-income” tax is not only counter-productive; it is counter to law. Washington courts have consistently held that any city tax must be expressly authorized by the Legislature. Yet

1 Seattle is taxing net income, which the Washington Legislature expressly *prohibited*. If this tax is  
2 upheld, the Seattle City Council could expand it at any time to reach all residents at all income  
3 levels, and other cities around the state could start imposing income taxes on all their citizens as  
4 well. This would contradict the sound policy of the Washington Legislature to prevent cities from  
5 enacting their own versions of the federal income tax, and threaten the state’s ability to attract and  
6 retain major employers. For these reasons, this Court should declare Seattle’s ill-conceived tax to  
7 be invalid.

## 8 II. IDENTITY AND INTEREST OF AMICUS CURIAE

9 Rental Housing Association of Washington (RHA) is a statewide non-profit organization in  
10 existence since 1935. RHA provides education and assistance to comply with rental housing laws,  
11 and regularly advocates for uniformity and fairness in state and local policymaking.

12 Most of RHA’s over 5,500 members rent out single-family homes, often on a temporary  
13 basis for work, personal or financial reasons. RHA is interested in this consolidated action because  
14 the challenged income tax, SMC 5.65.030, will unfairly increase the cost of owning, leasing and  
15 selling rental properties for residents of Seattle. RHA is concerned that, rather than promoting  
16 affordable housing as intended, the income tax will drive up rents for locally owned properties and  
17 encourage absentee ownership in Seattle.

## 18 III. STATEMENT OF THE CASE

### 19 A. The Income Tax Ordinance Was Pitched as an Affordable Housing Measure.

20 When adopting an income tax in July 2017, the Seattle City Council complained that  
21 “Seattle’s robust economic growth” has “increased the lack of affordable housing” for low- and  
22 middle-income households. Docket 10 (Kunath First Amended Complaint), Appendix 1 (City of  
23 Seattle Ordinance 125339), ¶2. The City Council asserted that Seattle’s sales tax – “among the  
24

1 highest in Washington” – is “highly regressive” and therefore reinforces “the privilege of the  
2 wealthy.” *Id.*, ¶5. The City Council determined that a tax on “high-income residents” will “help  
3 the City continue to grow and thrive for all of its citizens,” and will not interfere with “the ability  
4 of individuals and households to amply provide for a high quality of life.” *Id.*, ¶¶11, 12.  
5 Accordingly, the City Council adopted Seattle Municipal Code Chapter 5.65 labeled “INCOME  
6 TAX ON HIGH-INCOME RESIDENTS,” requiring Seattle residents to pay a 2.25 percent tax on  
7 incomes above \$250,000 per year as explained below.

8         The ordinance limits the City’s use of income tax revenues to the following purposes: 1)  
9 lowering the impact of other taxes; 2) “addressing the homelessness crisis”; 3) “providing  
10 affordable housing, education and transit”; 4) responding to potential changes in federal policy or  
11 potential federal budget cuts; 5) “creating green jobs and meeting carbon reduction goals”; and 6)  
12 administering the tax. SMC 5.65.010.A. Thus, the tax was pitched as a means to help homeless  
13 people and promote affordable housing, among other purposes. *Id.* and Docket 10, Appendix 1,  
14 ¶¶1-2. But the Seattle City Council gave itself the ability to change revenue uses in the future, and  
15 did not provide for repealing the tax if it actually worsens the affordability of living in Seattle.  
16 SMC 5.65.010.

17         B. Every Seattle Resident Is Subject to the Tax Ordinance.

18         The income tax ordinance applies to every person living in Seattle more than half the year.  
19 SMC 5.65.030 (imposing a tax on “every resident taxpayer”); SMC 5.65.020.D (“resident” means  
20 a natural person who “maintains a permanent place of abode and spends in the aggregate more than  
21 183 days or any part of a day of the tax year in the City”). The tax is 0 percent on “total income”  
22 (not gross income) of up to \$250,000 for the tax year. SMC 5.65.030.B. For individuals whose  
23 “total income” (not gross income) exceeds \$250,000 in the tax year, the tax is 2.25 percent on the  
24

1 amount which is “in excess of” \$250,000. SMC 5.65.030.B. For Seattle residents whose federal  
2 tax status is “married filing jointly,” the tax is 0 percent on “total income” (not gross income) up  
3 to \$500,000 in the tax year, and 2.25 percent on the amount in excess of \$500,000. *Id.* “Total  
4 income” is defined as the amount shown on line 22 of the individual federal tax return, Form 1040,  
5 or equivalent on any tax form. SMC 5.65.020.G.

6 Residents with a 0 percent rate need not file a tax return. SMC 5.65.070.A. However, every  
7 resident must be prepared for the City to investigate whether a tax was owed, including maintaining  
8 “such records as may be necessary to determine taxpayer’s domicile and residence and the amount  
9 of any tax for which the taxpayer may be liable.” SMC 5.65.090. Monetary penalties and criminal  
10 prosecution are threatened for those violating the ordinance. SMC 5.65.130 and .240.

11 C. The City’s Definition of “Total Income” Reflects Income After Expenses.

12 As noted above, the tax is based on line 22 of the federal Form 1040. Docket 10, Ex. A  
13 (Form 1040). Line 22 uses the shorthand designation “total income” to indicate that it is the total  
14 of 15 types of income reported on lines 7 through 21. *Id.* Among the types of income counted in  
15 Line 22 are business income or loss from Schedule C, capital gain or loss from Schedule D, and  
16 income from “[r]ental real estate, royalties, partnerships, S corporations, trusts, etc.” from Schedule  
17 E. *Id.*

18 Schedule E, used by rental property owners, subtracts total expenses from total rents to  
19 arrive at the amount entered on Line 17 of Form 1040. *Id.* and Docket 10, Ex. E (Schedule E).  
20 Line 17 is counted as part of Line 22, and therefore is subject to Seattle’s tax. Docket 10, Ex. A  
21 (Form 1040); SMC 5.65.020.G (the tax is on “total income” reported on Line 22 of Form 1040).  
22 Thus, although the term “total income” in Seattle’s ordinance may sound like gross income, it  
23 actually reflects *income after expenses* for rental property owners using Schedule E. *Id.*

1 Similarly, Schedule D – used for gains or losses from selling rental properties, personal  
2 homes, or other capital assets – subtracts “Cost” from “Proceeds” in arriving at a “Net” amount of  
3 gain or loss. See <https://www.irs.gov/pub/irs-pdf/f1040sd.pdf> (Schedule D) and  
4 <https://www.irs.gov/pub/irs-pdf/i1040sd.pdf>, p. 2 (instructions for Schedule D). Schedule D  
5 expressly uses the term “net” in describing the gain or loss calculated for tax purposes. *Id.*; Docket  
6 10, Ex. A. The Schedule D amount is entered on Line 13 of Form 1040, which is counted as part  
7 of Line 22 and therefore is subject to Seattle’s tax. Docket 10, Ex. A; SMC 5.65.020G and .030.  
8 In sum, for owners and sellers of rental properties, the “total income” that is subject to Seattle’s tax  
9 is income after expenses.

#### 10 IV. ARGUMENT

##### 11 A. For Rental Real Estate Investors, The City’s Tax is a Tax on *Net Income*.

12 Investors who own rental real estate typically choose a form of ownership other than an  
13 entity taxed as a C corporation, which is why their rental income usually appears on their individual  
14 tax returns, and would be subject to the Seattle income tax. Often, such investors choose to own  
15 property through a limited partnership, a limited liability company taxed as a partnership or an S  
16 corporation (generally referred to as a “pass-through” entity). Others may own the real property  
17 themselves, directly. In either case (pass-through or direct ownership), the investor’s income from  
18 rental real estate is entered on Schedule E of his or her federal return: in Part I in the case of direct  
19 personal ownership, or Part II in the case of a pass through entity. Docket 10, Ex. E.

20 A pass-through entity is not a taxpayer, but it prepares a Form 1065 informational return,  
21 and gives to its owners a Schedule K-1, showing an amount referred to on the form itself as the  
22 “Net rental real estate income.” See <https://www.irs.gov/pub/irs-pdf/f1065sk1.pdf>. This amount is  
23 then entered in Part II of Schedule E, whereas the direct owner’s rental income minus expenses is  
24

1 entered in Part I of Schedule E. Docket 10, Ex. E, pp. 1-2.

2 In both cases, the *net* amount of income after expenses that appears on Schedule E is entered  
3 on Line 17 of the taxpayer's form 1040, and is counted in "total income" on Line 22. Docket 10,  
4 Ex. A. Thus, the real estate investor's *net* income from rent will be taxed by Seattle. SMC  
5 5.65.020G and .030.

6 Similarly, Schedule D calculates the "net" short-term or long-term gains (or losses) from the  
7 sale of rental properties or other capital assets as explained above. Thus, whether a Seattle resident  
8 receives money from renting out or selling housing, the City will tax the resident's *net* income from  
9 the home when it exceeds the tax threshold.

10 Seattle's income tax ordinance refers to income reported on Line 22 of Form 1040 "before  
11 any adjustments, deductions, or credits," as if to suggest that Line 22 – the basis for Seattle's tax -  
12 reflects gross income rather than net income after expenses are deducted. SMC 5.65.020G. But the  
13 phrase "before any adjustments, deductions or credits" merely reflects that, *after* line 22, a Form  
14 1040 counts certain specific deductions allowed to individuals (such as alimony payments and IRA  
15 contributions), then either a standard deduction or itemized deductions allowed to individuals on  
16 Schedule A (such as medical expenses and home mortgage interest) and a personal exemption,  
17 before arriving at "taxable income" on line 43. See <https://www.irs.gov/pub/irs-pdf/f1040.pdf>.  
18 The fact that Form 1040 counts various deductions and credits on lines 23 through 42 does not  
19 negate the fact that Line 22 itself reflects deductions reported on Schedules C, D and E. *Id.*

20 B. The City's Tax on Net Income Is Illegal.

21 1. **The Legislature, which must authorize city taxes, prohibits taxes on net income.**

22 Washington courts "have consistently held that municipalities must have *express* authority,  
23 either constitutional or legislative, to levy taxes." *King County v. Algona*, 101 Wn.2d 789, 791  
24

1 (1984) (emphasis in original). Twice in the past decade, courts have stricken other taxes imposed  
2 by the City of Seattle because they were not authorized – or were prohibited – by statute. *Group*  
3 *Health Coop. v. City of Seattle*, 146 Wn.App. 80, 84 (2008) (RCW 48.14.0201(7) precluded the city  
4 from assessing taxes on health care premiums paid to health maintenance organizations); *City of*  
5 *Seattle v. T-Mobile W. Corp.*, 199 Wn.App. 79, 81 (2017) (cell-phone roaming charges “are beyond  
6 the scope of the taxing authority the legislature has granted to the city”). Yet, once again, Seattle  
7 has reached beyond its taxing authority by adopting a tax on net income.

8 In adopting the income tax, the Seattle City Council declared that it has “all powers of  
9 taxation for local purposes except those which are expressly preempted by the state,” quoting RCW  
10 35A.11.020. Docket 10, Appendix 1, ¶14. The ordinance did not identify any statute expressly  
11 authorizing the City’s income tax. *Id.* Because there is no such statute, the income tax should be  
12 held invalid, just as the City’s tax on roaming charges was stricken in *T-Mobile W. Corp.*, 199  
13 Wn.App. at 81.

14 Nor did the City Council ordinance mention RCW 36.65.030, which says a city “*shall not*  
15 *levy a tax on net income.*” (emphasis added). For rental property owners and sellers living in  
16 Seattle, the tax on income over \$250,000 reported on Line 22 of Form 1040 is “a tax on net  
17 income” as reflected in Schedules D and E and as explained above. Because the taxation of net  
18 income is prohibited by RCW 36.65.030, it should be ruled invalid, just as the city’s taxation of  
19 health care premiums was halted in *Group Health*, 146 Wn.App. at 84.

## 20 2. Net income means income after expenses are deducted.

21 *Black’s Law Dictionary* defines “net income” to mean “[t]otal income from all sources  
22 minus deductions, exemptions, and other tax reductions, adding: “Income tax is computed on net  
23 income.” *Black’s Law Dictionary* (7th ed., 1999) at 767 (underlining added).

1 Washington courts have consistently recognized that “net income” means income after  
2 expenses. For example, in distinguishing between the State’s Business and Occupations (B&O) tax  
3 and a tax on net income, the Washington Supreme Court said, “Because the [B&O] tax is based on  
4 gross income rather than net income, a business is taxed on the entire gain it accrues from its  
5 transactions, and no deduction is allowed for the expenses involved in conducting the business.”  
6 *Rho Co. v. Dep’t of Revenue*, 113 Wn.2d 561, 566 (1989). *See also St. Joseph Gen. Hosp. v. Dep’t*  
7 *of Revenue*, 158 Wn. App. 450, 464 (2010) (as a general rule, because the B&O tax is based on  
8 gross income rather than net income, “the base amount from which the B&O tax is calculated does  
9 not allow for deductions for the expenses of conducting business”). The expenses involved in  
10 conducting a rental real estate business *are* deducted in reaching the Line 22 figure upon which the  
11 Seattle tax accrues; therefore that amount is net income.

12 The fact that the B&O tax comes up repeatedly in Washington cases interpreting the phrase  
13 “net income” in a tax context should not be surprising: the distinguishing characteristic of the B&O  
14 tax is that, unlike Seattle’s new income tax, it is *not* a net income tax. Indeed, it appears likely that,  
15 when the Legislature prohibited cities from assessing a net income tax, the reason for including the  
16 word “net” was so that the statute did not prohibit cities from imposing B&O taxes which, of  
17 course, Seattle already does. The new Seattle income tax is not a B&O tax.

18 The only way the City of Seattle can possibly defend its tax is by positing a strained  
19 interpretation of the phrase “net income” to exclude its common meaning as the income of a  
20 business, after subtracting its expenses. Even the consultant hired by the City of Seattle to design  
21 its tax scheme agrees with this position. An attorney for the Economic Opportunity Institute, Claire  
22 Tonry, wrote in an email message: “Household adjusted gross income is fundamentally different  
23 from ‘net income,’ which is a measure of business income after expenses.” *See, Is a City Income*  
24

1 *Tax Legally Feasible in Seattle? Your Burning Questions, Answered!*, Seattle Weekly, May 1, 2017  
2 ([http://www.seattleweekly.com/news/is-a-city-income-tax-legally-feasible-in-seattle-your-burning-](http://www.seattleweekly.com/news/is-a-city-income-tax-legally-feasible-in-seattle-your-burning-questions-answered/)  
3 [questions-answered/](http://www.seattleweekly.com/news/is-a-city-income-tax-legally-feasible-in-seattle-your-burning-questions-answered/)) (emphasis added).<sup>1</sup> “Business income after expenses” is *exactly* what Seattle  
4 will tax, in the case of real estate investors, and it was described as net income by the City’s own  
5 tax consultant.

6 Seattle may take the position that the phrase “net income” in RCW 36.65.030 refers  
7 specifically and only to “taxable income” as shown on line 43 of an individual taxpayer’s Form  
8 1040, and nothing else. There is no case law or statute supporting that view. To defend it, Seattle  
9 must take the position that, for example, either (i) a pass-through entity’s net income is *not* “net  
10 income” within the meaning of RCW 36.65.030, while – if the entity were taxed as a corporation –  
11 the same figure would be “net income,” or else (ii) a tax on the net income of a corporation would  
12 not be a tax on “net income” within the meaning of RCW 36.65.030. Such arguments are absurd.  
13 Washington courts avoid interpretations “which would result in unlikely, absurd, or strained  
14 consequences.” *Fraternal Order of Eagles, Tenino Aerie No. 564 v. Grand Aerie of Fraternal*  
15 *Order of Eagles*, 148 Wn.2d 224, 239 (2002).

16 The City’s ordinance does not define the term “net income.” This does not give Seattle  
17 license to invent whatever strained meaning it wishes to give the term. More to the point, it does  
18 not allow Seattle to interpret the phrase “net income” so that it does not refer to the net income of a  
19 rental real estate business, as such term is commonly used and, indeed, as it is used by the Internal  
20 Revenue Service in the forms that determine the amount that appears on line 22 of Form 1040.

21  
22  
23 \_\_\_\_\_  
24 1 Seattle engaged the Economic Opportunity Institute to provide expertise on “policy research and design, drafting  
legislation and legal issues to inform the drafting and defense of legislation” for the city income tax. *See*  
<http://thelens.news/wp-content/uploads/2017/08/Consultant-Contract.pdf>.

1 C. The City's Tax Will Encourage Absentee Ownership.

2 In today's market, it is common for retirees and other longtime owners to command selling  
3 prices that are hundreds of thousands of dollars more than they originally paid. *See, "King County*  
4 *Home Prices Surge 18 percent, most on record for this time of year,"* Seattle Times, September 6,  
5 2017, reporting an increase in Seattle's median selling price from \$625,000 to \$730,000 in just one  
6 year from August 2016 to August 2017.<sup>2</sup> Thus, the income tax threatens to hit not just those with  
7 steadily high incomes, but those with one-time gains from selling personal homes or investment  
8 properties. Because the City of Seattle income tax applies only to residents of Seattle, it creates an  
9 incentive for sellers to move out of Seattle before selling. By moving first, a seller can avoid the  
10 City's 2.25 percent tax on capital gains over \$250,000. SMC 5.65.020 and .030.

11 Similarly, an owner of rental properties in Seattle can avoid paying income tax on net rental  
12 income by choosing to live outside the City of Seattle. SMC 5.65.020 and .030. It is the owner's  
13 residence, not the location of the rental housing, which determines whether the income tax applies.  
14 *Id.* This creates an incentive for Seattle's rental property owners to become absentee landlords.  
15 This is not fair to the owners or to the renters, whose interests are better served by proximity.

16 Another option for avoiding income tax is to exchange one rental real estate property for  
17 another in a transaction qualifying as a like-kind exchange under 26 U.S.C. §1031. If a Seattle  
18 resident exchanged a Seattle property for a property outside Seattle owned by a non-resident, those  
19 living in the rental property in Seattle would find themselves with a new absentee landlord, the  
20 Seattle investor would himself become an absentee landlord of a rental property somewhere else,  
21 and the new non-resident owner would pay no income tax to the City of Seattle (either on rentals or  
22 on a later sale of the property). The transaction itself would not result in any tax being payable to

23 \_\_\_\_\_  
24 <sup>2</sup> The article is linked here: <https://www.seattletimes.com/business/real-estate/king-county-home-prices-surge-18-percent-most-on-record-for-this-time-of-year/>.

1 the City of Seattle, because the capital gain would be excluded from “total income” under the  
2 Internal Revenue Code, 26 U.S.C. §1031. A person doing the same with his own residence, on the  
3 other hand, would not get the benefit of Section 1031, as it applies only to business and investment  
4 properties. 26 U.S.C. 1031(a)(1).

5 In sum, imposing an income tax only on Seattle residents will have a negative impact on  
6 owners and renters of rental housing in the Seattle area. It will encourage Seattle residents owning  
7 rental real estate to move out of the City – resulting in more absentee ownership of Seattle housing.  
8 It also will promote rent increases for housing around the region, as owners living in Seattle will  
9 have to pay income taxes on net rental income regardless of where the housing is located. Thus, the  
10 ordinance will not support affordable housing as intended, another reason why the Legislature’s  
11 prohibition on net income taxes should be enforced.

## 12 V. CONCLUSION

13 For the foregoing reasons, the income tax should be held invalid.

14  
15 Submitted this 23<sup>rd</sup> day of October, 2017, by:

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