



MULTISTATE TAX

Washington State Supreme Court determines investment income is broadly taxable

Tax Alert

Overview

In [Antio v. Dep't of Rev.](#), No. 102223-9, the Washington State Supreme Court denied the taxpayer's request for a refund of tax paid on investment income because the income was not from the incidental investment of surplus funds. This decision reverses the customary application of the state's investment income deduction statute which had been applicable since 2002.

This Tax Alert summarizes some of the significant provisions of the decision.

Business and Occupation tax generally

Washington's Business and Occupation ("B&O") tax is a gross receipts tax that applies broadly to all receipts derived from Washington sources, unless a deduction, exclusion, or exemption applies. The tax applies at the entity level, including those entities disregarded at the federal level.

Historic treatment of investment income under B&O

Under the Revised Code of Washington (RCW) 82.04.4281 prior to 2002, taxpayers were allowed a deduction for "amounts derived from investments;" with limitations on the deduction applicable to banks, lenders, and securities businesses (i.e., brokers, dealers and broker dealers). "Other financial businesses" were also excluded from taking the investment income deduction.

The Washington State Supreme Court narrowed the applicability of this deduction through a series of court cases that specified who could take the deduction and what could be deducted by defining "other financial businesses" and "investment income." In 1986, the court held that investment income was not eligible for deduction unless the investment income was generated from "incidental investment of surplus funds." *O'Leary v. Dep't of Revenue*, 105 Wn.2d 679, 682, 717 P.2d 273 (1986). Furthermore in 2000, the court further refined who could take the deduction when it determined a holding company constituted an "other financial business" as the holding company only provided

services to subsidiaries, and only received 4.26% of its gross receipts from investment income. *Simpson Inv. Co. v. Dep't of Revenue*, 141 Wn.2d 139, 142-43, 3 P.3d 741 (2000).

Legislative response to judicial decisions

In 2002, the Washington legislature responded to these cases by eliminating the term “other financial businesses” from RCW 82.04.4281 and providing a [stated intent](#):

The decision of the state supreme court in *Simpson Investment Co. v. Department of Revenue* could lead to a restrictive, narrow interpretation of the deductibility of investment income for business and occupation tax purposes. ... The legislature intends, by adopting this recommended revision of the statute, to provide a positive environment for capital investment in this state, while continuing to treat similarly situated taxpayers fairly.

After the law change in 2002, the investment income deduction was understood by many to be broadly applicable to all investment income and permitted for all entities other than banks, lenders, and securities businesses.

Decision in *Antio*

The court held that the legislative change in 2002 was only intended to delete the ambiguous term “other financial business.” The amendment did not change the definition of “investment income” outlined in *O’Leary*, which limited deductible investment income only to “incidental investments of surplus funds.” Therefore, only income from the incidental investment of surplus funds is eligible for the investment income deduction for Washington B&O purposes.

Impact of decision

Entities which have not historically reported investment income may have a B&O tax liability. Because the decision held that the definition from 1986 has always been correct, the liability could be extended back for Washington’s full statute of limitations (generally 4 years for registered taxpayers, 7 years for unregistered).

Without a definition or test for what qualifies as “incidental,” all entities with investment income related to Washington may be subject to B&O tax on the investment income. The applicable rate for this income will be 1.5% or 1.75% (if Washington-sourced receipts exceed \$1 million per calendar year).

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