NO. 102223-9

SUPREME COURT OF THE STATE OF WASHINGTON

ANTIO, LLC; AZUREA I, LLC; BACK BOWL I, LLC; CANDICA, LLC; CERASTES-WTB, LLC; GCG EXCALIBUR, LLC; LINDIA, LLC; OAK HARBOR CAPITAL, LLC; OAK HARBOR CAPITAL II, LLC; OAK HARBOR CAPITAL III, LLC; OAK HARBOR CAPITAL IV, LLC; OAK HARBOR CAPITAL VI, LLC; OAK HARBOR CAPITAL VII, LLC; OAK HARBOR CAPITAL X, LLC; OAK HARBOR CAPITAL XI, LLC; and VANDA, LLC,

Petitioners,

v.

WASHINGTON STATE DEPARTMENT OF REVENUE,

Respondent.

DEPARTMENT OF REVENUE'S ANSWER TO AMICUS CURIAE BRIEFS OF THE PRIVATE INVESTOR COALITION, INC. ET AL AND TWO FORMER MEMBERS OF THE "SIMPSON TASK FORCE"

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I. INTRODUCTION

The investment income deduction in RCW 82.04.4281 applies narrowly, allowing a deduction for incidental investment activity. The deduction is not, and never has been, a tax *exemption* that permits certain persons to completely avoid the business and occupation (B&O) tax. Yet, that is precisely what amicus curie The Private Investor Coalition, Inc. *et al*. (the Coalition) and amicus curie Simpson Task Force Members claim. They say that when the Legislature amended the deduction in 2002, it did so to permit certain "investment" vehicles to pay no tax. The claim cannot be squared with the statute's language or legislative history. Had the Legislature intended to change the deduction into a targeted tax exemption that favored certain types of businesses, there would be some evidence of that intent. That evidence does not exist.

Notwithstanding amici's unsupported claims of a legislative overhaul in 2002, this Court's 1986 decision in *O'Leary* remains in full force. *O'Leary* confirms that the

investment income deduction applies narrowly to amounts that are "'incidental' to the main purpose of a business." *O'Leary v. Dep't of Revenue*, 105 Wn.2d 679, 682, 717 P.2d 273 (1986). The Legislature has not stepped in to modify the holding in *O'Leary*, and it has not silently changed the deduction into a targeted tax exemption favoring "investment" vehicles.

Moreover, changing the deduction into a targeted tax exemption would be a legislative function. If amici believe that the law should be changed, their remedy lies with the legislative branch. This appeal is not a proper vehicle to change the law.

II. ANSWER TO AMICI

The Court of Appeals applied established precedent when it affirmed the trial court's conclusion that the LLCs were not entitled to deduct 100 percent of their income. *Antio v. Dep't of Revenue*, 26 Wn. App. 2d 129, 138, 527 P.3d 164 (2023). Neither amici offers a viable reason to disregard precedent in order to create a tax break for the sixteen LLCs that are seeking review of the decision below. Instead, they argue (wrongly) that

O'Leary is not controlling law and that, by following *O'Leary*, the Court of Appeals expanded the universe of persons required to pay B&O tax. These misguided arguments raise no issue of public importance requiring this Court's review.

A. The Court of Appeals Correctly Applied *O'Leary*, and its Decision is Entirely Consistent with *Sellen*

The Coalition argues that the Court of Appeals misread *O'Leary*. Coalition Br. at 7-9. In a similar vein, two members of the 2001 "Simpson Task Force" argue that the Court of Appeals decision is inconsistent with this Court's decision in an earlier case, *John H. Sellen Construction Co. v. Department of Revenue*, 87 Wn.2d 878, 558 P.2d 1342 (1976). Task Force Br. at 10. These arguments fail, as the Court of Appeals correctly applied established precedent.

Both amici take issue with the fact that the Court in *O'Leary* looked to *Sellen* to help formulate "an appropriate means" of distinguishing between income from investments and income from general business activity. *See O'Leary*, 105 Wn.2d at 682 (explaining that *Sellen* provides "an appropriate means

of distinguishing those investments whose income should be exempted from the B & O tax [under] RCW 82.04.4281"); *see generally* Coalition Br. at 8 (criticizing the *O'Leary* Court's reliance on *Sellen*); Task Force Br. at 10-11 (same). But nothing in *O'Leary* suggests that the appropriately narrow definition of "investment" is something other than what this Court said: an activity "'incidental' to the main purpose of a business." *O'Leary*, 105 Wn.2d at 682. And that same narrow definition has been applied to others. *See Browning v. Dep't of Revenue*, 47 Wn. App. 55, 58, 733 P.2d 594 (1987) (applying *O'Leary's* definition of investment).

Amici raise no issue of public importance by speculating that this Court meant something other than what it said in *O'Leary*. Moreover, the Legislature has not stepped in to redefine the term "investments," as it could do if it were unsatisfied with the narrow definition established in *O'Leary*. Instead, that term remains undefined in the statute, reinforcing

the presumption that the Legislature acquiesced to this Court's prior interpretation.

Further, the 2010 Joint Legislative Audit & Review Committee (JLARC) Report appended to the Coalition's brief describes the holding in *O'Leary* with approval. "In 1986, the Washington Supreme Court determined that interest on real estate contracts did not qualify for the deduction because the contracts were not incidental investments of surplus funds." JLARC Report 09-11 at p. 50 (Jan. 5, 2010) (citing *O'Leary*).[1] The Report goes on to explain that the decision in *O'Leary*, along with the other history outlined in the Report, advanced "[t]he public policy objective for this deduction" which is "to avoid taxing the income from *investment of incidental surplus funds of businesses* and the savings of individuals." *Id*. (emphasis added). There is no indication in the 2010 JLARC

[1] The relevant page of the 2010 JLARC report is provided as page 8 of the appendix to the Coalition's brief.

Report—or any other relevant document—that this Court meant something in *O'Leary* other than what it plainly held.

B. The Decision Below Has No Impact on Individual Investors or Others Who are Not Engaged in Business

The investment income deduction has always been construed as a narrow tax deduction that applies to income from the investment of surplus funds. *O'Leary* 105 Wn.2d at 682; *Browning*, 47 Wn. App. at 57-58. That did not change when the Legislature amended the statute in 2002 to remove the limitation that prevented "other financial businesses" from claiming the deduction. Any business that was eligible to claim the limited deduction prior to the 2002 amendment was still eligible to claim the deduction after the 2002 amendment.

Just as important, the 2002 amendment to the deduction statute did not impact who must file and pay the B&O tax. The B&O tax is *imposed* by RCW 82.04.220. Both before and after 2002, that statute imposed tax on those "engaging in business activities" in Washington. *See* former RCW 82.04.220 (2000) (imposing B&O tax "for the act or privilege of engaging in

business activities"); RCW 82.04.220 (same). Thus, persons engaging in business activities in Washington owe the tax, while those that do not engage in business activities in the state do not. This is a function of the tax-imposing statute, not a function of the deduction for investment income.

This simple but important distinction matters here, as amici toss out the specter of a vastly expanded B&O tax system based on the Court of Appeals decision below. But that decision has no impact whatsoever on who must pay the tax. This is so for two reasons.

First, the Court of Appeals was not asked to interpret RCW 82.04.220 or to analyze when the B&O tax applies. It was undisputed that the sixteen petitioners were all engaged in business in Washington, and each had filed B&O tax returns to report their gross income from in-state business activity. CP 3; CP 116. The dispute involved only whether they could exclude 100 percent of that gross income under the investment income

deduction, contrary to this Court's holding in *O'Leary*. The Court of Appeals decided only that controlling issue.

Second, the phrase "engaging in business activities" as set out in RCW 82.04.220 has historically been interpreted and applied to exclude the receipt of passive investment income by persons not otherwise engaged in a business endeavor. This has been the Department's stated policy for decades. As one example, the Department in 1995 issued an Excise Tax Bulletin (ETB) explaining in part that individuals are not engaging in a business if their "only source of income … is from investments or interest from loans or deposits." ETB 571.04.146/109 at 2.[2] In that circumstance, the individual is not "required to register with the Department, regardless of the amount of income or volume of investments or loans." *Id*. Thus, while "engaging in business" is broadly defined in RCW 82.04.150, it has not been

[2] Copy provided as Appendix A.

interpreted to include the passive receipt of investment income by individuals.

Ignoring this history, the Coalition argues that the Court of Appeals' decision will result in thousands of individuals and trusts suddenly becoming subject to B&O tax on otherwise passive investment activity. Coalition Br. at 3, 5, 13. That is simply not true. It was not true when *O'Leary* was decided in 1986 or in the decades that followed, and is not true now. The receipt of passive investment income, in and of itself, has never been treated in Washington as a taxed business activity.

The decision of the Court of Appeals below does not change this status quo. Moreover, even if there were some genuine risk that individual investors might owe B&O taxes under current law, the proper remedy is not to expand the investment income deduction through litigation. That deduction—as written and as historically applied—serves a valued public purpose. "By providing this deduction, the Legislature is accomplishing its objective of not taxing

incidental investment as engaging in business." JLARC Report 09-11 at 55 (Jan. 5, 2010) (page 13 of appendix to the Coalition brief). Expanding the deduction to allow businesses like the petitioners in this appeal to avoid all B&O tax on their in-state business activity is contrary to this policy objective.

Rather, if there were some actual concern that individual investors and their passive investment vehicles might suddenly be swooped up into the B&O tax, the proper remedy is to ask the Legislature to enact a targeted tax exemption. The legislature has broad powers to levy taxes, including the authority to enact tax exemptions and tax deductions. In fulfilling this role, the Legislature is capable of crafting statutory exemptions that make fiscal and tax policy sense, and it can carefully define and limit those entitled to the favored tax treatment. Conversely, enlarging an existing tax deduction through litigation to entirely exempt some currently undefined class of business, without any input from the legislative branch, serves no legitimate public purpose. *See generally Kilian v.*

Atkinson, 147 Wn.2d 16, 21, 50 P.3d 638 (2002) (plurality opinion) ("Courts … may not create legislation under the guise of interpreting a statute.").

The Court of Appeals decision below preserves the status quo by applying established precedent to undisputed facts. The term "investment" has a defined meaning under established Washington law, and applying that meaning to the facts of this case does not change the tax treatment of those receiving passive investment income.

C. The 2002 Amendment to the Deduction Did Not Create a Tax Exemption for Financial Businesses

Both amici contend that in 2002, the Legislature intended to enlarge the investment income deduction by effectively exempting certain financial businesses from B&O tax. In support of this claim, the Coalition points to a proviso included in the statutory definition of "security business" that was added to the statute in 2002. Coalition Br. at 10-11. The two members of the Simpson Task Force point to the general statement of legislative intent relating to the 2002 "Simpson" legislation and

testimony provided to a legislative committee in 2001. Task Force Br. at 4-8. These arguments misrepresent the Legislature's intent when it amended the deduction in 2002 and do not offer a legitimate reason for this Court to accept review.

As an initial matter, there is absolutely no evidence that the Legislature was dissatisfied with this Court's decision in *O'Leary*. In fact, the evidence is to the contrary, as the positive mention of *O'Leary* in the 2010 JLARC Report attests. More importantly, the Legislature did not amend the investment income deduction for many years after *O'Leary* was decided in 1986. That lengthy period of inactivity shows that the Legislature fully acquiesced to this Court's analysis. *City of Federal Way v. Koenig*, 167 Wn.2d 341, 348, 217 P.3d 1172 (2009).

And when the Legislature finally did amend the statute in 2002, it did so for an entirely different reason. Namely, the Legislature was dissatisfied with the holding in *Simpson Investment Company*. That case involved a common business

practice where a parent holding company would collect surplus cash of its subsidiaries each day and invest it overnight. The issue in that case was not the meaning of the term "investment," but whether Simpson Investment Company was disqualified from claiming the deduction as an "other financial business." *Simpson Inv. Co. v. Dep't of Revenue*, 141 Wn.2d 139, 142-143, 3 P.3d 741 (2000).

The Legislature responded to *Simpson* by directing the Department of Revenue to propose an amendment to RCW 82.04.4281 that would "clarify the application of [the statute] to *other financial businesses*." Laws of 2001, ch. 320, § 20 (emphasis added). Consistent with that directive, the Department formed a workgroup to study the issue and to propose legislation. *See* Final Legislative Report, 57th Wash. Leg., at 98 (Wash. 2002) (describing the background to the 2002 amendment to RCW 82.04.4281).

The proposed legislation adopted by the workgroup became House Bill 2641, an "ACT Relating to implementing

the recommendations of the investment income tax deduction task force ….” Laws of 2002, ch. 150. The Legislature enacted findings expressing a clear intent to override the holding in *Simpson*, explaining “that the application of the business and occupation tax deductions provided in RCW 82.04.4281 for investment income of persons deemed to be ‘other financial businesses’ has been the subject of uncertainty, and therefore, disagreement and litigation.” *Id.*, § 1. The Legislature intended the 2002 amendment to “provide certainty and stability for taxpayers and the state.” *Id.* Notably, there had been no similar “uncertainty” about the meaning of the term “investment,” which had been decided in *O’Leary*, followed in *Browning*, and applied in the decades that followed without controversy.

The legislative history pertaining to the 2002 amendment never mentions *O’Leary*. Nor does it show any disagreement with the historical application of the deduction in general. Rather, it shows only that the Legislature intended to address the deduction’s prior application to holding companies that fell

within the excluded class of "other financial businesses." If the Legislature truly intended to supersede *O'Leary*, there would be evidence of that intent somewhere in the legislative record. The evidence does not exist.

A fair reading of the legislative history pertaining to the 2002 amendment to the investment income deduction does not support amici's theory that the Legislature intended to change the deduction into a targeted tax exemption that benefits some undefined group of "financial" businesses, or that this undefined group would include the sixteen related petitioners in this appeal. Again, if amici believe there is some value in excluding certain financial businesses entirely from the B&O tax, they can ask the Legislature to make that change. It is not a proper use of this Court's resources to seek that change through this litigation. *Kilian*, 147 Wn.2d at 21.

III. CONCLUSION

Amici offer no viable reason for this Court to grant the LLCs' petition for discretionary review. Accordingly, the Department respectfully requests that this Court deny review.

This document contains 2,482 words, excluding the parts of the document exempted from the word count by RAP 18.17.

RESPECTFULLY SUBMITTED this 18th day of October, 2023.

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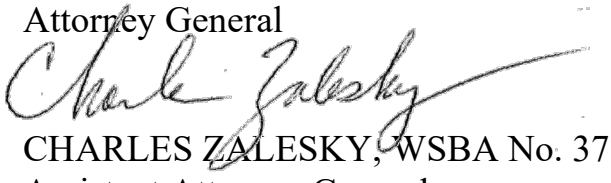

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I certify under penalty of perjury under the laws of the State of Washington that the foregoing is true and correct.

DATED this 18th day of October, 2023, at Chehalis, WA.

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APPENDIX A

WASHINGTON STATE DEPARTMENT OF REVENUE

EXCISE TAX BULLETIN

ETB 571.04.146/109 Issued: June 30, 1995

TAXABILITY OF INVESTMENT INCOME

This bulletin is a clarification and not a change of the Department's position on the taxability of income from investments. RCW 82.04.4281 gives a deduction from the measure of the business and occupation (B&O) tax for amounts received from investments or the use of money as such for taxpayers not engaged in banking, loan, security, or other financial business. This bulletin explains how this deduction applies in some situations.

A two part inquiry is used to determine if the taxpayer is a "banking, loan, security, or other financial business". The first inquiry requires determining whether the primary purpose and objective of the taxpayer is to earn income through the utilization of significant cash outlays or whether these activities are merely "incidental" to the taxpayer's nonfinancial business activities. This inquiry is made by applying a percentage test. The Department conclusively presumes that the income is not from engaging in a financial business, but is incidental to the nonfinancial business activities, if the financial income is five percent or less of the annual gross receipts. The percentage of financial income will be computed by including all calendar or fiscal year financial income from "loans and investments or the use of money as such" in the numerator, whether taxable, exempt, or deductible, and including all calendar or fiscal year revenues as normally measured by the B&O tax, including all revenues otherwise exempt or deductible, in the denominator.

If the first inquiry results in five percent or less of financial income in each of the years, it is unnecessary to proceed to the second inquiry. The taxpayer will not be considered as engaging in a "financial business". If the percentage exceeds five percent in any of the years, it is necessary to proceed with the second inquiry, but only for those years in which the percentage exceeds five percent.

The second inquiry for determining when a taxpayer's activities constitute a "financial business" involves whether the taxpayer's activities are similar to, or comparable to, those of "banking, loan, [or] security businesses", even though the taxpayer might not technically fall within one of those three categories. The factors which will be considered include, but are not limited to, the source of the income, frequency of investments, volume of investments, percentage of income from investments in relation to the total income of the business, and the relationship of the investment income to the other activities of the business.

For a business activity to be considered "similar" and "comparable" to "banking, loan, [or] security" businesses, the activity must be regular and recurrent. Indicia of regular and recurrent activities "similar or comparable" to those of a "banking, loan [or] security business" include, but are not limited to: (1) For a bank and loan business: the making of loans on a continuing

basis. (2) For a securities business: (a) a diversified portfolio, (b) a need for expertise, whether from an internal or external source, in the selection and management of investments; and (c) trading activities.

"Investments or the use of money as such" encompasses not only investment activity, but also lending activity, or a combination of both lending and investment activities. However, businesses who sell merchandise on an installment basis and directly carry these accounts receivable are not considered as receiving the interest from investments or the use of money as such. The interest received from these transactions is directly related to the sale of the merchandise and the deduction for "investments or use of money as such" does not apply. This interest is not related to a banking, loan, security, or other financial business activity with respect to these transactions. (See WAC 458-20-109.)

SPECIAL APPLICATION TO SOLE PROPRIETORS/INDIVIDUALS:

It is the Department's position that an individual is not engaged in a banking, loan, security, or other financial business if the individual is not engaged in any business activity which would require the individual to register with the Department. If the only source of income by an individual is from investments or interest from loans or deposits, the individual is not considered to be engaged in a business activity and is not required to register with the Department, regardless of the amount of income or volume of investments or loans. If a sole proprietor is engaged in a business activity which requires registration, it is necessary to apply the two inquiries indicated above.

If an individual has made investments in the past and later starts a business, any continuing income from investments which were made prior to starting the business will not be taxable. This income may be excluded from the numerator and the denominator in computing the percentage discussed above. Changes in these investments will continue to not be taxable if the investments are unrelated to the sole proprietor's current taxable business activities.

ATTORNEY GENERAL'S OFFICE - REVENUE & FINANCE DIVISION

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