No. 102223-9

SUPREME COURT OF THE STATE OF WASHINGTON

ANTIO, LLC, AZUREA, 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.

MEMORANDUM OF *AMICI CURIAE* THE PRIVATE INVESTOR COALITION, INC.; FAMILY OFFICE EXCHANGE LLC; AND POLICY AND TAXATION GROUP IN SUPPORT OF PETITION FOR REVIEW

[Counsel Listed on Following Page]

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Policy and Taxation Group

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I. INTRODUCTION

The Department of Revenue has estimated that up to 1,470,000 legal entities, estates, trusts, and individuals benefit from the investment income deduction in RCW 82.04.4281(1)(a). Under the Court of Appeals' erroneous interpretation of "investments," most of these investors will become subject to business and occupation (B&O) tax on their investment income.

The impact of this case is much greater than the taxation of private investment funds (although that alone would warrant this Court's review and reversal). The Court of Appeals' decision effectively eliminates the deduction historically enjoyed by all collective investment vehicles, including mutual funds and family offices. Even more significantly, the decision potentially subjects thousands of individual Washingtonians to the obligation to register with the Department of Revenue and report and pay B&O tax on their investment income. This is not what the legislature intended when enacting a deduction for

"[a]mounts derived from investments" and excluding only "banking, lending, [and] security business[es]" from the benefit. RCW 82.04.4281.

II. IDENTITY AND INTEREST OF *AMICI*

Amici consist of The Private Investor Coalition, Inc.;[1] Family Office Exchange LLC;[2] and Policy and Taxation Group.[3] Each of their members include family offices and high-net-worth individuals with collective investment vehicles that would be impacted by the Court of Appeals' narrow interpretation of the investment income deduction.[4]

III. ISSUES ADDRESSED BY *AMICI*

Amici will address the substantial importance of this case to individual Washington investors and the investment funds and family offices through which they often invest. *Amici* will

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[1] *See* https://privateinvestorcoalition.com/.
[2] *See* https://public.familyoffice.com/.
[3] *See* https://policyandtaxationgroup.com/.
[4] A family office is traditionally an entity established by a high-net-worth individual to manage the family's assets with investment management constituting a key purpose. Oftentimes, its sole source of revenue is from investments.

also address the importance of the Legislature's definition of "security business," which neither the parties nor the Court of Appeals addressed.

IV. STATEMENT OF THE CASE

Amici adopts the Court of Appeals' description of the facts. Most relevant, "the [petitioner] LLCs are investment funds and . . . all revenue that the LLCs receive is investment income." *Antio, LLC v. Dep't of Revenue*, 26 Wn.App.2d 129, 131-32, 527 P.3d 164 (2023).

V. ARGUMENT WHY REVIEW SHOULD BE GRANTED

The Court of Appeals' decision is (1) contrary to the plain language of the deduction statute, (2) renders the Legislature's 2002 clarifications to the statute a nullity, and (3) will subject thousands of Washington residents, family offices, and investment funds to a tax that the Legislature did not intend. For these reasons, this case "involves an issue of substantial public interest that should be determined by the

Supreme Court." RAP 13.4(b)(4).

A. The Decision Is Contrary to the Plain Language of the Deduction Statute.

RCW 82.04.4281(1)(a) provides a B&O tax deduction for "[a]mounts derived from investments." There are two limitations to this deduction. First, amounts received from most loans and extensions of credit are not deductible. RCW 82.04.4281(2)(a). Second, "banking, lending, or security business[es]" cannot take the deduction. RCW 82.04.4281(2)(b).

As the Court of Appeals acknowledged, "All of the LLCs' income is derived from investments. [RCW 82.04.4281(1)(a)] does not state or even suggest that the deduction is unavailable if the main purpose of the business is investments." *Antio*, 26 Wn.App.2d at 137. The Department of Revenue does not appear to dispute that the taxpayers in this case are not "banking, lending, or security business[es]" or that their investment income is not received from loans or

extensions of credit. RCW 82.04.4281(2). This should resolve the case.

Instead, the Court of Appeals relied on this Court's decision in *O'Leary v. Dep't of Revenue*, 105 Wn.2d 679, 717 P.2d 273 (1986), to limit the investment income deduction to investments "'incidental' to the main purpose of a business." *Antio*, 26 Wn.App.2d at 137–38. Contrary to the Court of Appeals' decision, *O'Leary* did not provide a judicial definition of "investments," but instead provided a limitation on the types of investments that were deductible: "Whether an investment is 'incidental' to the main purpose of a business is an appropriate means of distinguishing those investments whose income should be exempted from the B & O tax of RCW 82.04.4281." *O'Leary*, 105 Wn.2d at 682. In other words, "investments" could be either taxable or exempt (deductible) depending on whether they were "'incidental' to the main purpose of a business."

This "incidental" limitation to the deductibility of investment income was rooted in this Court's earlier decision in *John H. Sellen Constr. Co. v. Dep't of Revenue*, 87 Wn.2d 878, 588 P.2d 1342 (1976) ("*Sellen*"). Indeed, *O'Leary* cites *Sellen* as the sole authority for the "incidental" limitation. *Sellen* did not address the definition of "investment," but, rather, the definition of "other financial institutions," which were formerly denied the investment income deduction. In *Sellen*, this Court rejected the Department's argument that "equate[d] investing any income with being a financial business," which "in effect . . . render[ed] the statute a nullity." *Id.* at 883. Instead, this Court concluded that an "other financial business" was "a business whose primary purpose and objective is to earn income through the utilization of significant cash outlays." *Id.* at 882. Thus, taxpayers making incidental investments were not "other financial businesses" and were entitled to deduct their investment income.

In sum, relying on a flawed reading of *O'Leary*, the Court of Appeals created a narrow definition of "investments," which is contrary to the plain language of RCW 82.04.4281(1)(a), which says nothing about "incidental" investments.

B. The Decision Renders the 2002 Clarifications to the Deduction Statute a Nullity.

In 2001, this Court held that a holding company that invested its subsidiaries' surplus funds was an "other financial business" and, accordingly, was not entitled to the investment income deduction. *Simpson Inv. Co. v. Dep't of Revenue*, 141 Wn.2d 139, 164, 3 P.3d 741 (2000).

In response to *Simpson* and Department of Revenue audits of several investment funds, the Legislature amended RCW 82.04.4281 in two significant ways. First, the Legislature extended the investment income deduction to "other financial business."[5] After this amendment, everyone was entitled to

[5] The 2002 amendments were the culmination of a year-long effort by stakeholders spurred on by strenuous reaction in the business community to the

deduct "amounts derived from investments" except for specifically defined "banking, lending, or security business[es]." *See* RCW 82.04.4281. Second, the Legislature added definitions for those businesses that were not entitled to the deduction. While the Petitioner has rightly focused on the importance of the Legislature's elimination of the "other financial business" limitation, neither the parties nor the Court of Appeals discuss the importance of the Legislature's 2002 definition of "security business."

In defining "security business" the Legislature specifically excluded "any company excluded from the definition of broker or dealer under the federal investment company act of 1940 or any entity that is not an investment company by reason of sections 3(c)(1) and 3(c)(3) through 3(c)(14) thereof." RCW 82.04.4281(3)(d). This provision removes investment companies (*e.g.*, mutual funds) and most

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Simpson case. More than 20 years after the passage of legislation aimed at "fixing" *Simpson*, not even Simpson would qualify for the investment income deduction under the Court of Appeals' decision.

private investment funds (*i.e.*, entities that are not investment companies by reason of § 3(c)(1) and (7) of the Investment Company Act of 1940) from the definition of "security business" and, thus, enables them to deduct "amounts derived from investments."

The Court of Appeals' decision would render this portion of the definition of security business a nullity. An "investment company" under the Investment Company Act of 1940 (1940 Act) is, by definition, an entity that "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities." 15 U.S.C. § 80a-3(a)(1)(A) (1940 Act, § 3). If "investment" meant investments "incidental to the main purpose of the business," then the Legislature would not have carved investment companies and most private funds out of the definition of "security business." Under the Court of Appeals' interpretation, investment companies and private funds would never have "investment income" to deduct since their primary

business is investing. However, "the legislature does not engage in unnecessary or meaningless acts . . . ." *Sellen*, 87 Wn.2d at 883.

The Legislature's 2002 amendments removed the "other financial business" limitation and specifically confirmed that mutual funds and private investment funds—entities primarily engaged in the business of investing—were entitled to the deduction by excluding them from the definition of "security business."

C. The Decision Creates Significant Unintended Consequences for Funds, Family Offices, and Individual Investors.

The Court of Appeals' decision will have significant B&O tax consequences to investors located in Washington and the funds and investment vehicles in which they invest.

Mutual funds, venture capital funds, private equity funds, hedge funds, and other collective investment vehicles (most of which the Legislature excluded from the definition of "security business" in 2002) have historically not reported and paid B&O

tax.[6] Under the Court of Appeals' decision, these funds will be subject to B&O tax on their investment income because their primary or exclusive activity is investing and the resulting investment income is not "incidental to the main purpose of their businesses." *See Antio*, 26 Wn.App.2d at 138. This new tax will add costs and reduce returns to mutual and other funds that Washingtonians rely on for their retirement and economic security.[7]

In addition to funds, family offices commonly conduct investment activities for a family through an entity (*e.g.*, LLC or trust) that does not directly conduct another business. Unless a family office directly conducts another operating business, its investment activity would not be "'incidental' to the main

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[6] In contrast to the funds themselves, investment fund managers and advisors have long been subject to B&O tax on their management or advisory fees apportioned to Washington based on the location of the investor in the fund. *See* WAC § 458-20-19402(304)(d) (example 32) (concluding that the fees received by the manager of a mutual fund are attributable to "where the investors are located").

[7] This point was forcefully made in testimony to the Legislature. *See* H.B. 1853 (2001), H. Fin. Comm. Hr'g (Feb. 20, 2001) at 2:41:41 to 3:15:00, https://tvw.org/video/house-finance-38/.

purpose of a business" and would be taxable under the Court of Appeals' decision. *Id.* at 137.

The most significant potential impact is on the thousands of individual investors with investment income greater than Washington's small business credit (RCW 82.04.4451). The Court of Appeals decision has created great uncertainty about the B&O tax treatment of individual investors. Except individuals conducting other business as a sole proprietorship, individual investors will rarely have investment income "'incidental' to the main purpose of a business" and, thus, would not be entitled to the investment income deduction if this Court does not accept review.

While individual investors might reasonably assume that their investment activity is not subject to B&O tax because they are not "engaged in business," individuals are specifically included in the definition of "person" in the B&O tax chapter, and "business" is broadly defined as "all activities engaged in with the object of gain, benefit, or advantage to the taxpayer or

to another person or class, directly or indirectly." RCW 82.04.030, 82.04.140.

The Department of Revenue has described the investment income deduction as the reason individuals are not subject to B&O tax on investment income. In a 2016 tax exemption study, the Department estimated that 1,470,000 taxpayers benefited from the deduction and that, if repealed, "[t]he investment income of [resident] individuals would be taxed in Washington." App. at MEMAPP2–3.[8] An earlier 2012 study concluded that 49.2 percent of the beneficiaries of the deduction were individuals. App. at MEMAPP5. If individual investors were not "engaged in business," the repeal of the deduction would have no impact on individual investors. Likewise, the Legislature's Joint Legislative Audit and Review Committee reviewed the investment income deduction in 2009 and concluded that without the investment income deduction "[i]t

[8] The Department's 2020 report reaches a similar conclusion, although the report reduces the number of beneficiaries to 119,000.

would be more difficult for individuals to avoid a tax on investment earnings in Washington" without changing their domicile. App. at MEMAPP15.

VI. CONCLUSION

The Court of Appeals' decision in this case renders the Legislature's 2002 amendments a nullity and threatens to subject thousands of Washington residents and the funds and collective investment vehicles through which they invest to B&O tax. This was not the Legislature's intention.

This Court should accept review and reverse the Court of Appeals.

This document contains 2,075 words, in compliance with RAP 18.17(b), and complies with the applicable word-count limits set forth in RAP 18.17(c).

RESPECTFULLY SUBMITTED this 22th day of September 2023.

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CERTIFICATE OF SERVICE

On September 22, 2023, I caused to be served upon the below named counsel of record, at the address stated below, via the method of service indicated, a true and correct copy of the foregoing document.

Charles Zalesky, WSBA 37777 Heidi A. Irvin, WSBA 17500 P.O. Box 40123 Olympia, WA 98504-0123 chuck.zalesky@atg.wa.gov heidi.irvin@atg.wa.gov REVOlyEF@atg.wa.gov	x Via the Appellate Court Web Portal ___ Via hand delivery ___ Via U.S. Mail, 1st Class, Postage Prepaid ___ Via Overnight Delivery ___ Via Facsimile ___ Via Email
John M. Colvin, WSBA No. 20930 Jason A. Harn, WSBA No. 54017 Colvin + Hallett, P.S. 719 Second Avenue, Suite 711 Seattle, WA 98104 jcolvin@colvinhallettlaw.com Jharn@colvinhallettlaw.com	x Via the Appellate Court Web Portal ___ Via hand delivery ___ Via U.S. Mail, 1st Class, Postage Prepaid ___ Via Overnight Delivery ___ Via Facsimile ___ Via Email

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

EXECUTED at Seattle, Washington, on September 22, 2023.

Jessica Flesner

Jessica Flesner

APPENDIX

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2016 Tax Exemption Study

A Study of Tax Exemptions, Exclusions or Deductions From the Base of a Tax; a Credit Against a Tax; a Deferral of a Tax; or a Preferential Tax Rate

As Authorized by RCW 43.06.400

Vikki Smith, Director
Washington State Department of Revenue

Department of Revenue
Washington State

82.04.4281(a) - Investments by nonfinancial firms

Description

Businesses qualify for a B&O deduction for investment income provided they are not engaged in banking, lending or security businesses.

Purpose

Recognizes that investment income for nonfinancial businesses does not constitute business income.

Taxpayer savings

($ in millions):

	FY 2016	FY 2017	FY 2018	FY 2019
State Taxes	$307.000	$325.000	$342.000	$357.000
Local Taxes	$0.000	$0.000	$0.000	$0.000

Repeal of exemption

Repealing this exemption would increase revenues; however, most investment income could move out of Washington. Also, locating all taxpayers with taxable income may be difficult.

Potential revenue gains from full repeal

($ in millions):

	FY 2016	FY 2017	FY 2018	FY 2019
State Taxes	$0.000	$162.000	$198.000	$207.000
Local Taxes	$0.000	$0.000	$0.000	$0.000

Assumptions

- Investment income includes interest income, dividend income, and capital gains income.
- Non-financial businesses, trusts, and non-profits owing tax of $20,000 or more on investment income would restructure immediately to manage investment income outside of Washington and recoup the cost of restructuring within three years.
- Estates cannot restructure to manage investment income outside of Washington.
- The investment income of individuals would be taxed in Washington even if a person created a business outside of Washington to manage the investment income.
- Estates, trusts, non-profits, and individuals owing tax on investment income would utilize the small business credit to reduce the tax they owe. Non-financial businesses eligible for the small business credit use the credit against income taxable under current law.
- Interest income and dividend income grow at the national rate of growth for these types of income as forecasted by the Global Insights Division of IHS, Inc.
- Capital gains income grows at the rate of growth for real personal income as forecasted by the Economic and Revenue Forecast Council for Washington.

Continued

82.04.4281(a) - Investments by nonfinancial firms

Assumptions (continued)

- Washington's portion of national investment income by industry approximates the percentage of employment in Washington in that industry versus the industry's national employment.
- The Department of Revenue (Department) can easily notify non-financial firms, non-profits, estates, trusts, and individuals of the removal of this deduction. These businesses will pay the tax at a rate of:
  - 90 percent of revenue collections in Fiscal Year 2017, and
  - 95 percent of revenue collections in Fiscal Year 2018 and thereafter.
- The Legislature repeals this deduction effective July 1, 2016 impacting 11 months of collections in Fiscal Year 2017.

Data Sources

- Department of Revenue excise tax return data
- Internal Revenue Service Statistics of Income
- Bureau of Labor Statistics Employment Data by State
- Global Insight's Division of IHS, Inc's February 2015 Forecast
- Economic and Revenue Forecast Council's February 2015 Forecast

Additional Information

Additional Information	
Category:	Tax base
Year Enacted:	1935
Primary Beneficiaries:	Non-financial businesses, estates, trusts, non-profits, and individuals with investments
Taxpayer Count:	1,470,000
Program Inconsistency:	None
JLARC Review:	JLARC completed a full review in 2009

2012 Tax Exemption Study

A Study of Tax Exemptions, Exclusions, Deductions, Deferrals, Differential Rates and Credits for Major Washington State and Local Taxes

WASHINGTON STATE DEPARTMENT OF REVENUE
Brad Flaherty, Director

Research and Fiscal Analysis Division
Kathy Oline, Assistant Director

Analysis by the Research and Fiscal Analysis Division

Support by the Office of Legislation and Policy

January 2012

82.04.4281 INVESTMENT INCOME OF NONFINANCIAL FIRMS

Description: Deduction is provided for interest, dividends and capital gain income earned by persons who are not engaged in banking, loan, security or other financial businesses.

Purpose: The B&O tax is intended to apply for the privilege of engaging in business. This deduction reflects the perspective that investment income by nonfinancial firms is not considered as engaging in business.

Category/Year Enacted: Tax base. 1935; clarified in 2002.

Primary Beneficiaries: Nonfinancial corporations (44.2% of the total); individuals (49.2%); and partnerships (6.6%).

Possible Program Inconsistency: None evident.

Taxpayer Savings ($000)	FY 2012	FY 2013	FY 2014	FY 2015
State tax	$326,200	$346,800	$307,100	$329,700
Local taxes - not considered.				

If the exemption were repealed, would the taxpayer savings be realized as increased revenues? Yes, although compliance might be problematic.

82.04.4281 DIVIDENDS FROM SUBSIDIARIES

Description: A B&O tax deduction is provided for amounts derived as dividends received from subsidiaries and interest received on loans to related companies, if the total investment and loan income is less than five percent of the firm's annual gross receipts.

Purpose: To provide a positive environment for capital investment in Washington and to provide equivalent treatment for similarly situated taxpayers.

Category/Year Enacted: Tax base. 1970; clarified in 2002.

Primary Beneficiaries: Holding companies of financial institutions and other parent corporations.

Possible Program Inconsistency: None evident.

Taxpayer Savings ($000) Indeterminate. Information on these transactions does not appear on state excise tax returns or business financial statements. There is no good way to estimate the impact.

If the exemption were repealed, would the taxpayer savings be realized as increased revenues? Yes, although firms could easily shift such income to affiliated out-of-state entities.

State of Washington
Joint Legislative Audit & Review Committee (JLARC)

2009 Full Tax Preference Performance Reviews

Report 09-11

January 5, 2010

Upon request, this document is available in alternative formats for persons with disabilities.

INVESTMENTS OF NONFINANCIAL FIRMS DEDUCTION FROM B&O TAX – SUMMARY

Current Law

Statute provides a business and occupation (B&O) tax deduction for interest, dividends, and capital gain income earned by businesses not engaged in banking, loan, or security activities.

See pages A3-3 and A3-4 in Appendix 3 for the current statute, RCW 82.04.4281.

Legal History and Public Policy Objectives

1933 Lawmakers adopted a temporary tax imposed on the privilege of engaging in business activities, including financial business activities. The tax was to be in place from August 1933 through July 1935.

1934 The Legislature amended the 1933 statute to exempt from the new tax income from investment and endowment funds earned by nonfinancial businesses.

1935 As part of the 1935 Revenue Act, the Legislature created the business and occupation tax, containing the majority of the business activities included in the 1933 act. The Revenue Act also provided a specific deduction from the B&O tax for investment income by nonfinancial businesses. The language of this deduction remained essentially unchanged until 1970.

1937 The Legislature provided a B&O tax deduction for the income of national and state banks, trust companies, mutual savings banks, building and loan, and savings and loan associations.

1970 The Legislature repealed the B&O deduction for national and state banks, mutual savings banks, savings and loan associations and "other financial businesses." The gross income from engaging in financial business became subject to the B&O tax under the service classification of 1.5 percent.

With the repeal of the bank deduction, issues arose over the distinction between nonfinancial business that continued to receive the deduction and financial businesses now subject to the tax. For nonfinancial businesses, issues centered on what types of investments continued to qualify.

- What is a "financial business?" The Washington Supreme Court ruled in 1976 that businesses with the primary purpose of earning income through the use of substantial funds were "financial businesses" and not entitled to the deduction.[11]

[11] Sellen Construction v. Revenue, 87 Wn.2d 878 (1976).

- What types of investments are taxable?" 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.[12]

1995 Following these cases, the Department of Revenue announced a two-part inquiry for determining whether a taxpayer was an "other financial business." The Department asked:

1) Does a taxpayer's financial activity have the primary purpose and objective of earning income through a substantial outlay of funds? In making this determination, the Department held that if a taxpayer's financial income was 5 percent or less of its annual income, such income would be considered incidental, and the taxpayer would qualify as a nonfinancial business eligible for the deduction.

2) If the financial income exceeds 5 percent, is the taxpayer's activity comparable to those of banking, loan or security businesses? The Department considered such factors as 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.

2000 The issue of which businesses and activities qualified for the deduction again came before the Washington Supreme Court in 2000. In that case, the court ruled that Simpson Investment Company, a parent holding company for the Simpson lumber companies, was an "other financial business" under the statute, and thus its investment income did not qualify for the deduction.[13]

2001 As a result of the Simpson decision, the Legislature directed the Department to work with affected businesses to agree on a compromise to provide clarity. The Governor directed the Department of Revenue to convene a task force to develop proposed legislation for the 2002 Session.

2002 The Legislature passed the proposed changes eliminating the term "other financial business" and providing a deduction for "amounts derived from investments." The statute, however, specifically provided that this section did not apply to banking businesses, lending businesses, security business, or the extension of credit, revolving credit arrangements, installment sales, and the acceptance of payment over time for goods or services.

The public policy objective for this deduction is to avoid taxing the income from investment of incidental surplus funds of businesses and the savings of individuals. This activity is not engaging in business for the purposes of the B&O tax.

[12] O'Leary v. Revenue, 105 Wn.2d 679 (1986).

[13] Simpson Investment Co. Revenue, 141 Wn.2d 139 (2000).

Beneficiaries

Both nonfinancial businesses and individuals benefit from the deduction for investment income. Individuals with large investment portfolios could possibly be taxed without the deduction. Individuals with large investment portfolios reported over $20 billion in investment income in Washington in 2005. Washington's share of nonfinancial investment income received by corporations and partnerships was $15 billion in the same year.

Revenue and Economic Impacts

Nonfinancial businesses and individuals saved an estimated $310 million in B&O tax from the deduction for investment income in Fiscal Year 2008. This was a 50 percent decline from the previous year due to the slowing of the economy. Future taxpayer savings from the deduction for investments are expected to continue to decline and are not expected to recover until 2013.[14] The severe reduction is attributable largely to substantial losses from the sale of capital assets as a result of the recent economic downturn. Capital losses can be carried forward to subsequent tax years to offset capital gains and are predicted to exceed gains for several years after the economy is expected to recover.

Other States

Washington's B&O tax is unique in that no other state imposes such a broad-based gross receipts tax. The closest comparisons are net income taxes imposed in 45 states and the District of Columbia. Interest, dividends, and capital gains are taxed as part of a net income tax structure with no distinction between financial and nonfinancial businesses. Five states—Nevada, South Dakota, Texas, Wyoming and Washington—lack any form of income tax.

Recommendation

The Legislature should continue the deduction for investment income of nonfinancial businesses, because it is meeting the objective of not treating incidental investment as engaging in businesses.

Legislation Required: No.

Fiscal Impact: None – No change from status quo.

[14] Global Insights, March 2009 forecast.

INVESTMENTS OF NONFINANCIAL FIRMS DEDUCTION FROM B&O TAX – REPORT DETAIL

Current Law

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With the repeal of the bank deduction, issues arose over the distinction between nonfinancial business that continued to receive the deduction and financial businesses now subject to the tax. For nonfinancial businesses, issues centered on what types of investments continued to qualify.

- What is a "financial business?" The Washington Supreme Court ruled in 1976 that businesses with the primary purpose of earning income through the use of substantial funds were "financial businesses" and not entitled to the deduction.[15]

[15] Sellen Construction v. Revenue, 87 Wn.2d 878 (1976).

- What types of investments are taxable?" 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.[16]

1995 Following these cases, the Department of Revenue announced a two-part inquiry for determining whether a taxpayer was an "other financial business." The Department asked:

- Does a taxpayer's financial activity have the primary purpose and objective of earning income through a substantial outlay of funds? In making this determination, the Department held that if a taxpayer's financial income was 5 percent or less of its annual income, such income would be considered incidental, and the taxpayer would qualify as a nonfinancial business eligible for the deduction.
- If the financial income exceeded 5 percent, is the taxpayer's activity comparable to those of banking, loan or security businesses? The Department considered such factors as 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.

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[16] O'Leary v. Revenue, 105 Wn.2d 679 (1986).
[17] Simpson Investment Co. Revenue, 141 Wn.2d 139 (2000).

Public Policy Objectives

What are the public policy objectives that provide a justification for the tax preference? Is there any documentation on the purpose or intent of the tax preference?

The public policy objective is to avoid taxing investment of incidental surplus funds of businesses and the savings of individuals because this activity is not engaging in business for the purpose of B&O taxation.

What evidence exists to show that the tax preference has contributed to the achievement of any of these public policy objectives?

By providing this deduction, the Legislature is accomplishing its objective of not taxing incidental investment as engaging in business.

To what extent will continuation of the tax preference contribute to these public policy objectives?

The public policy objective is being fulfilled.

If the public policy objectives are not being fulfilled, what is the feasibility of modifying the tax preference for adjustment of the tax benefits?

The public policy objective is being fulfilled.

Beneficiaries

Who are the entities whose state tax liabilities are directly affected by the tax preference?

Both nonfinancial businesses and individuals benefit from the deduction for investment income. Individuals with large investment portfolios could possibly be taxed under the B&O tax were it not for the deduction. Individuals with large investment portfolios reported over $20 billion in investment income in Washington in 2005. Washington's share of nonfinancial investment income received by corporations and partnerships was $15 billion in the same year.

To what extent is the tax preference providing unintended benefits to entities other than those the Legislature intended?

Some confusion arose in 1970 after the Legislature repealed the B&O deduction for banks, savings and loan associations, and "other financial businesses." Major issues revolved around what type of entities qualified as nonfinancial businesses and what constituted a qualifying investment. The 2002 tax law changes eliminated the term "other financial business" and specifically provided that this deduction does not apply to banking businesses, lending businesses, security business, loans or the extension of credit, revolving credit arrangements, installment sales, and the acceptance of payment over time for goods or services. The law applies

to all investment income from qualifying business activities. These modifications appeared to clear up the confusion, and there has not been a significant problem with unintended beneficiaries since that time.

Revenue and Economic Impacts

What are the past and future tax revenue and economic impacts of the tax preference to the taxpayer and to the government if it is continued?

Nonfinancial businesses and individuals saved an estimated $310.1 million in B&O tax from the deduction for investment income in 2008. This is a 50 percent decline from the previous year. Future taxpayer savings from investments are expected to decline by over 50 percent and not expected to recover until 2013.[18] The severe reduction is attributable largely to substantial losses from the sale of capital assets as a result of the recent economic downturn. Capital losses can be carried forward to subsequent tax years to offset capital gains. Carry forward losses are predicted to exceed gains several years after the economy is expected to recover.[19]

Exhibit 14 – Estimate of B&O Tax Savings for Investment Income of Nonfinancial Businesses and High Income Individuals (in $Millions)

Year	Corporate	Partnership	Individual	Total
2006	$219.3	$34.3	$327.4	$581.1
2007	$238.3	$36.6	$347.8	$622.7
2008	$207.3	$13.9	$88.9	$310.1
2009	$192.3	$12.6	$82.6	$287.5
2010	$188.2	$12.4	$80.8	$281.4
2011	$198.2	$13.3	$85.0	$296.4

Source: Internal Revenue Service, Statistics of Income, 2005 and Department of Revenue.

Note: All figures are estimates projected forward using Global Insights and Washington Economic and Revenue Council forecasts.

If the tax preference were to be terminated, what would be the negative effects on the taxpayers who currently benefit from the tax preference and the extent to which the resulting higher taxes would have an effect on employment and the economy?

It is unlikely that the full amount of tax savings would be realized if the deduction were repealed because certain businesses could avoid the tax by reducing their presence in Washington.

[18] Global Insights, March 2009 forecast.

[19] National figures for corporations and partnerships are allocated to Washington by the ratio of Washington employees to U.S. employees by sector. Federal individual tax returns are available for Washington residents. Investment income of individuals with less than $200,000 in adjusted gross income is excluded because the average investment income per return is less than the $28,000 minimum reporting threshold for B&O tax purposes.

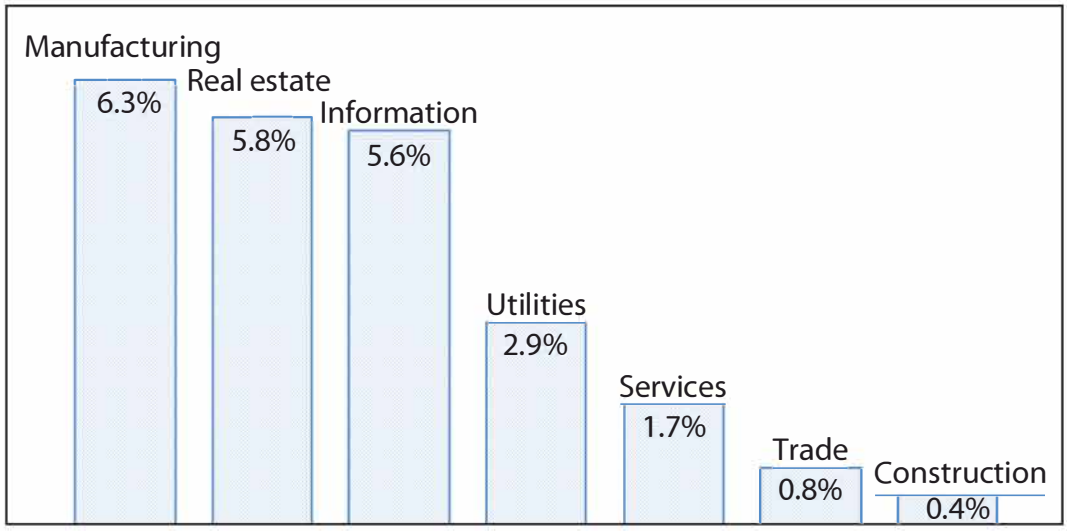
Businesses that operate both in Washington and other states could more easily avoid the tax than business operating solely in Washington or individuals residing in Washington.

For example, a business could form a subsidiary in Nevada, a state with no corporate or personal income tax. The subsidiary could invest surplus funds of the business and pass the earnings back to the Washington parent company in the form of a dividend. Dividends from subsidiaries to parent companies are exempt from the business and occupation tax.

It would be more difficult for individuals to avoid a tax on investment earnings in Washington. They could have to create a domicile in another state without an income tax or a with a low rate income tax to reduce their liability.

Impacts would be felt in nonfinancial industry sectors with a higher percentage of earnings in the form of interests, dividends, and capital gains from investments. According to Exhibit 15 below, manufacturing, real estate, and information sectors earn more from investments than other sectors.

Exhibit 15 – Investment Income as a Percent of Receipts



Source: Internal Revenue Service Corporate Tax Returns, Statistics of Income, 2005.

Employment in the manufacturing and information sectors makes up about 28 percent of all Washington employment. An increase in costs for these sectors would result in either increased prices or reduced employment on the margin. Increased revenues due to the elimination of the deduction would lead to increases in government spending and shift employment to the government sector.

Other States

Do other states have a similar tax preference and what potential public policy benefits might be gained by incorporating a corresponding provision in Washington?

Washington's B&O tax is unique in that no other state imposes such a broad-based gross receipts tax. The closest comparisons are net income taxes imposed in 45 states and the District of

Columbia. Interest, dividends, and capital gains are taxed as part of a net income tax structure with no distinction between financial and nonfinancial businesses. Five states—Nevada, South Dakota, Texas, Wyoming and Washington—lack any form of income tax.

Recommendation

The Legislature should continue the deduction for investment income of nonfinancial businesses, because it is meeting the objective of not treating incidental investment as engaging in businesses.

Legislation Required: No.

Fiscal Impact: None – No change from status quo.

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