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New Washington Business and Occupation Tax Legislation Affects Service Businesses

The Washington Legislature's 2019 session produced four bills increasing business and occupation (B&O) taxes on service businesses (E2SHB 2158), "specified financial institutions" (SHB 2167), international investment managers (ESB 6016), and travel agents and tour operators (ESSB 6004). These bills are currently awaiting the governor's signature.

Service B&O Tax Increases

Effective January 1, 2020, Washington will impose a "workforce education surcharge" on "select advanced computing businesses" and other "specified persons." The surcharge is equal to 0.3%, 0.5%, or 1.0% of gross income taxed under the "service and other" B&O tax classification. E2SHB 2158, § 74.

Also, effective January 1, 2020, "specified financial institutions" will pay an "additional tax" of 1.2% of gross income taxed under the "service and other" B&O tax classification. SHB 2167, § 1. A "specified financial institution" is a financial institution (or a company owned by a financial institution) that is a member of a "consolidated financial institution group" reporting at least \$1 billion in annual net income on its consolidated financial statement filed with the Federal Financial Institutions Examination Council for the previous calendar year. SHB 2167, § 2. The Washington Department of Revenue estimates that the bill will raise \$133 million from 20 taxpayers (none based in Washington) during the current biennium (2019-2021).

As a result of the surcharges and the additional B&O tax on specified financial institutions, businesses currently paying B&O tax under the service and other classification at the 1.5% rate will pay tax at one of *seven* rates under a complicated mix of service and other B&O tax, surcharges, and "additional tax":

- 3.7% for "specified financial institutions" that are a member of an affiliated group (a) with at least one member engaged in the business of advanced computing and (b) that had worldwide gross revenue of more than \$100 billion during the current or preceding calendar year. The 3.7% rate reflects the current 1.5% B&O tax, a 1.2% additional B&O tax on specified financial institutions, and a 1.0% workforce education surcharge.
- 3.2% for "specified financial institutions" that are a member of an affiliated group (a) with at least one member engaged in the business of advanced computing and (b) that had worldwide gross revenue of more than \$25 billion during the current or preceding calendar year. The 3.2% rate reflects the current 1.5% B&O tax, a 1.2% additional B&O tax on specified financial institutions, and a 0.5% workforce education surcharge.
- 3.0% for "specified financial institutions" that do not have a member of its affiliated group engaged in the business of advanced computing or with \$25 billion or less in worldwide gross revenue on a consolidated basis during the current or preceding calendar year.
- 2.5% for taxpayers (other than specified financial institutions) that are a member of an affiliated group (a) with at least one member engaged in the business of advanced computing and (b) that had worldwide gross revenue of more than \$100 billion during the current or preceding calendar year. The 2.5% rate reflects the current 1.5% B&O tax plus a 1.0% workforce education surcharge.
- 2.0% for taxpayers (other than specified financial institutions) that are a member of an affiliated group (a) with at least one member engaged in the business of advanced computing and (b) that had worldwide gross revenue of more than \$25 billion during the current or preceding calendar year. The 2.0% rate reflects the current 1.5% B&O tax plus a 0.5% workforce education surcharge.

- 1.8% for taxpayers (other than specified financial institutions and select advanced computing businesses) that are "primarily engaged" within Washington in any combination of 43 enumerated service businesses. The 1.8% rate reflects the current 1.5% B&O tax plus a 0.3% workforce education surcharge.
- 1.5% for taxpayers engaged in service and other activities that are not taxed in any of the preceding categories (e.g., taxpayers not "primarily" engaged in an enumerated service). This reflects the current 1.5% B&O tax rate and no surcharge. Because the 43 enumerated services are extremely broad, it is unclear whether this rate will apply to anyone other than taxpayers whose primary activity is expressly excluded from the surcharge (i.e., certain hospitals, commercial mobile services, and wired telecommunications services).

In addition, the legislation provides a \$7 million per year cap on the surcharge paid by an affiliated group with at least one member engaged in the business of advanced computing and that has worldwide gross revenue of more than \$25 billion during the current or preceding calendar year. E2SHB 2158, § 74. Strangely—and perhaps unconstitutionally—the bill also imposes a \$4 million minimum surcharge for such affiliated groups. *Id.* ("In no case will the combined surcharge ... paid by all members of an affiliated group be less than four million dollars.") For example, it is doubtful that Washington could constitutionally impose a \$4 million minimum "surcharge" on a Chinese-affiliated group with \$25 billion in worldwide gross income, but only \$1 million in Washington gross income.

Finally, the Legislature adopted two troubling hurdles for taxpayers struggling to comply with the new surcharge regime. First, the legislation reverses the normal rule of statutory construction and requires that the Department of Revenue, Board of Tax Appeals, and courts construe any ambiguities in the surcharge in favor of application of taxation. E2SHB 2158, § 74. Second, the legislation provides that the Department of Revenue's determination of surcharges is "presumed to be correct" and may be corrected only if the taxpayer establishes an error by "clear, cogent, and convincing evidence"—a higher standard of proof than applicable to other excise taxes. *Id.* Thanks to a last-minute intervention by Senator Jamie Pedersen, the rule of construction and higher burden of proof will not apply after 2021.

International Investment Managers

Effective July 1, 2019, Washington will increase B&O tax rates on most international investment managers by more than 550%, from 0.275% to 1.8% (including the new B&O tax "surcharge" on service businesses). "Qualifying international investment managers" (i.e., Russell Investments) will retain the 0.275% rate. ESB 6016, § 2. However, if a qualifying international investment manager fails to maintain more than 25% of its employees in Washington, the taxpayer loses the preferential rate and the Department of Revenue must claw back an amount equal to the entire economic benefit of the lower rate plus interest (but not penalties) going back to the shorter of (a) the current calendar year plus the previous nine calendar years or (b) July 1, 2019. ESB 6016, § 3.

Travel Agents and Tour Operators

Effective July 1, 2019, many travel agents and tour operators will see their B&O tax rates increase more than 225% from 0.275% to 0.9%. The rate increase applies only to taxpayers with more than \$250,000 in annual taxable gross income. ESSB 6004, § 1.

ENDNOTES

[1] The bill is unclear whether annual taxable gross income is based on the prior or current calendar year. The bill inconsistently provides that the lower rate applies to taxpayers "whose annual taxable amount *for the prior*

calendar year was [\$250,000 or less]" and that the higher rate applies to taxpayers "whose annual taxable amount *for the calendar year* was more than [\$250,000]." We assume that the Legislature inadvertently omitted "prior" in describing the higher rate classification. It would otherwise be possible to be subject to both the lower rate (based on the prior year's gross income) and the higher rate (based on the current year's gross income).

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