

## Updates



The Washington Court of Appeals has held that investment funds are subject to Washington state business and occupation (B&O) tax on their investment income.

Although Washington law allows taxpayers to deduct "amounts derived from investments" from their gross income,<sup>[1]</sup> the court concluded that the deduction was limited to investments "incidental to the main purpose of a business." Because the funds' investments in debt instruments were not "incidental" to the funds' businesses, the funds' investment income was subject to B&O tax. *Antio, LLC v. Department of Revenue*, 527 P.3d 164 (Wash. Ct. App. 2023). The court of appeals denied the taxpayers' petition for reconsideration on June 27, 2023, and the taxpayers filed a petition for discretionary review with the Washington Supreme Court on July 27, 2023.

## Who Is Affected?

This decision will likely have significant B&O tax impact on investment vehicles with operations (and potentially investments, investors, or beneficial owners)<sup>[2]</sup> in Washington, including:

- Private equity funds.
- Venture capital funds.
- Mutual funds.
- Other collective investment vehicles.
- Family trusts and offices.
- Businesses that conduct treasury or investment functions in special purpose entities (including federally disregarded entities) outside the entities that conduct the businesses' primary business operations.

The decision may also affect many individual investors with investment income in excess of Washington's small business credit.<sup>[3]</sup>

While some investors (particularly individual investors that do not invest through a business entity) may have an argument that they are not engaged in "business," Washington broadly defines "business" to include "all activities engaged in with the object of gain, benefit, or advantage to the taxpayer or to another person or class, directly or indirectly."<sup>[4]</sup> Washington courts have noted that Washington's B&O tax is imposed "upon virtually all business activities" and "leave[s] practically no business and commerce free of... tax."<sup>[5]</sup>

## What Is the Impact?

Persons with investment income that is not incidental to other business activity may be subject to a 1.5% or 1.75% Washington B&O tax on their gross income from investments.<sup>[6]</sup> This B&O tax liability may be partially offset by a small business credit and a credit for B&O tax attributable to transactions that are subject to the Washington capital gains tax.<sup>[7]</sup>

## History of Washington's Investment Income Deduction

Washington has had a deduction for amounts derived from investments since the adoption of the B&O tax in 1935.<sup>[8]</sup> That deduction was available to all taxpayers except those "engaging in banking, loan, security, or other financial businesses."<sup>[9]</sup>

The original investment income deduction generated disputes about whether taxpayers were "other financial businesses" and, thus, not entitled to the deduction. In *John H. Sellen Constr. Co. v. Dep't of Revenue*, 87 Wn.2d 878 (1976), the state supreme court interpreted "other financial businesses" to mean "a business whose primary purpose and objective is to earn income through the utilization of significant cash outlays." In *O'Leary v. Dep't of Revenue*, 105 Wn.2d 679 (1986), the supreme court concluded a taxpayer's interest income from real estate contracts was not deductible investment income because the amounts did not constitute the incidental investments of surplus proceeds. The Washington Department of Revenue subsequently characterized the "incidental investment" limitation as part of the test to determine whether a taxpayer was disqualified as a "financial business."<sup>[10]</sup> Finally, in *Simpson Investment Co., v. Dep't of Revenue*, 141 Wn.2d 669 (2000), the state supreme 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.

The *Simpson* case together with Department of Revenue audits and assessments of investment funds produces a strong reaction by the investment community, legislature, and governor. In 2001, the legislature and governor set

up a task force to develop proposed language to "fix" the investment income deduction to protect investment activity by investment funds and "other financial businesses." In 2002, the legislature amended the investment income deduction to remove the "other financial business" limitation. Thus, the current deduction for "investment income" is—or until the recent *Antio* decision was—available to all taxpayers except "banking, lending, or security business[es]" and investments in most loans.<sup>[11]</sup>

The *Antio* decision effectively resurrects the "other financial business" limitation on the investment income deduction that the legislature deleted in 2002.

## What Is Next?

The taxpayers in *Antio* filed a petition for discretionary review of the court of appeals' decision by the Washington Supreme Court. Unless the supreme court grants review and reverses the court of appeals on review (or the legislature acts again to restore the deduction), investment funds; special purpose investment entities; and potentially individual investors, estates, and trusts will be subject to B&O tax on investment income unless their investment activity is incidental to a primary business activity conducted by the taxpayer.<sup>[12]</sup>

## Endnotes

[1] RCW 82.04.4281(1)(a).

[2] Largely because investment income was deductible, Washington has little guidance on how to apportion gross income from investments.

[3] RCW 82.04.4451.

[4] RCW 82.04.140.

[5] *Lowe's Home Centers, LLC v. Dep't of Revenue*, 195 Wn.2d 27, 43, 455 P.3d 659, 667 (2020) (internal citations omitted).

[6] RCW 82.04.290(2)(a).

[7] RCW 82.04.4451, 82.04.4497(1).

[8] Revenue Act of 1935, Laws of 1935, ch. 180, § 12(a).

[9] *Id.*

[10] Dep't of Revenue, Excise Tax Advisory 571.04.169 (June 30, 1995) (cancelled July 2, 2002).

[11] RCW 82.04.4281(2)(b).

[12] Taxpayers' B&O tax liability on investment income may be reduced or eliminated as a result of the small business tax credit, the credit for transactions that are subject to Washington capital gains tax, and apportionment of gross investment income to other jurisdictions.

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## Authors



[Robert L. Mahon](#)

Partner

[RMahon@perkinscoie.com](mailto:RMahon@perkinscoie.com) [206.359.6360](tel:206.359.6360)



## **Gregg D. Barton**

Partner

[GBarton@perkinscoie.com](mailto:GBarton@perkinscoie.com) [206.359.6358](tel:206.359.6358)

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