The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 35909

October 30, 2024

Washington State Supreme Court Ruling Could Subject Funds to State Tax

[35909]

October 30, 2024

TO: ICI Members
Management Company Tax Subcommittee
Tax Advisory Committee
Tax Committee SUBJECTS: State Issues
Tax RE: Washington State Supreme Court Ruling Could Subject Funds to State Tax

On October 24th, the Supreme Court of the State of Washington issued an opinion that could subject investment funds to the state's Business and Occupation (B&O) tax.[1] The tax implications for funds could be significant, depending on:

- whether Washington's Department of Revenue will pursue claims against funds;
- whether it would do so prospectively or retroactively to prior years, and how broadly it interprets its taxing jurisdiction; and
- whether the Washington legislature can be successfully lobbied to change the law to exempt investment funds from the tax.

The very worst-case scenario is that funds, collectively, could face additional taxes over $300 million a year and owe back taxes for the past six years in the amount of approximately $1.8 billion.[2]

The Case: Washington's tax law provides a deduction for "amounts derived from investments." The taxpayers in this case, and most other investors, have relied on this deduction to exclude investment income from tax. The definition of this term was disputed in the case. Washington's Department of Revenue claimed that this deduction should be construed very narrowly. The Court agreed and interpreted that term to mean "amounts derived from incidental investment of surplus funds" (emphasis added) and found that the deduction was limited to investments that are "incidental to the taxpayer's business," citing a prior Washington Supreme Court case (O'Leary v. Department of Revenue). Therefore, investment income is taxable if the investments are not incidental to the taxpayer's business. The case related to tax year 2019. Prior to this case, Washington's Department of Revenue had not interpreted the investment income deduction this narrowly.

ICI Amicus Brief: The ICI filed an amicus brief in the case, advocating for a literal reading of

the statute, providing historical context demonstrating why the deduction was intended to include all investment income, emphasizing that the state legislature did not intend to subject investment companies to tax in Washington, and explaining that tax incurred by a fund would fall on investors and their retirement savings. The Court directly referenced the ICI's amicus brief and rejected its arguments.

> "If O'Leary 's definition of 'investment' stands, these businesses would not be able to deduct most of their investment income.... O'Leary held that businesses may not deduct income generated by their primary business activities under RCW 82.04.4281. This is true even if a company's primary activity is investing.... Businesses can claim only the deduction for investments that are incidental to the main purpose of a business."

Implications: If a fund is subject to B&O tax in Washington, tax would apply to its investment income, as apportioned to Washington. The case does not resolve several key issues, which weren't relevant prior to this case, but now are, such as:

- The circumstances that could subject a fund to B&O tax in Washington, which could include, for example:
  - Fund domicile in Washington
  - Asset management services performed in Washington on behalf of the fund
  - Fund distribution in Washington (advisors, wholesalers, etc.)
  - Fund shareholders residing in Washington
  - Fund income from securities of issuers headquartered in Washington, including public companies, municipalities, and private companies
- If funds are subject to tax, the portion of the fund's income that would be deemed attributable to Washington.

Washington's B&O tax is unique from other state taxes. Other states that impose tax on funds apply either a small minimum tax or determine taxable income by reference to the Federal tax law, which imposes no tax on funds that distribute all net income. Consequently, funds generally pay small amounts of state income tax, in states where they have substantial business operations or activities. The Washington B&O tax does not follow federal tax law. The tax base is gross income, not net income, so much more income is subject to tax. If a fund is subject to B&O tax in Washington, it incurs B&O tax on the portion of its investment income attributable to Washington.

The tax implications for members depends largely on whether Washington's Department of Revenue will pursue claims against taxpayers that had previously relied on the investment income exemption, and if so, whether it would do so prospectively (for tax years 2024 and after), or retroactively to prior years, and how broadly it interprets its taxing jurisdiction. The Department of Revenue could limit audits and enforcement to taxpayers similarly situated to the taxpayers who litigated this case (private debt funds and their investors), or it could attempt to audit and assess tax against funds registered under the Investment Company of 1940. It's unclear what basis the State could seek to audit funds with no direct presence in Washington, other than applying general concepts of "economic nexus" that are not easily adapted to funds. In a worst-case scenario, if the Department of Revenue successfully pursues the broadest interpretation of its taxing authority, our amicus brief estimated the annual cumulative B&O tax on ICI member mutual funds to be at least $300 million (estimate for 2022).[3] The amount of tax could vary significantly from year-to-year based on variations in investment income. Further, this estimate does not include income from ETFs, closed-end funds, private funds, or other types of funds that investment advisers

may sponsor. Members are encouraged to consult with state tax advisors to consider their fund's tax filing or non-filing position in Washington based on this ruling.

What's Next: Because the Court's decision rested entirely on an interpretation of state tax law, it does not appear that it can be appealed. However, the ICI is considering all options for additional advocacy on this issue, potentially including engagement with Washington's legislature and Department of Revenue. We'll reach out to Washington-based ICI member firms to assess their interest in additional advocacy. We also welcome feedback from all members and emphasize that Washington's Department of Revenue could potentially pursue claims against funds with no direct presence in Washington.

Please contact Mike Horn (michael.horn@ici.org) or Katie Sunderland (katie.sunderland@ici.org) if you have any questions or comments.

Mike Horn
Deputy General Counsel - Tax

Notes

[1] Antio, LLC v. Department of Revenue, docket no. 102223-9 (Wash. Sup. Ct., Oct 24, 2024), attached.

[2] The $300 million estimate assumes that all ICI member funds are subject to tax in Washington, using total distributions as a proxy for gross income ($774 million in 2022), attributing 2.33% of that amount to Washington, and applying a 1.75% tax rate. The $1.8 billion estimate assumes 6 years of tax, based on the statute of limitations.

[3] Assuming that all member funds are subject to tax in Washington, using total distributions as a proxy for gross income ($865 million in 2018, $756 million in 2019, $672 million in 2020, $1,138 million in 2021, and $774 million in 2022), attributing 2.33% of that amount to Washington, and applying a 1.75% tax rate.