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# The Washington State Supreme Court Renders a Decision Impacting Financial Institutions Doing Business in the State

By Larry Brant and Kyle Richard on 10.6.21 | Posted in Legislation, State and Local Tax, Tax Laws

***Prologue***

*Kyle N. Richard recently joined Foster Garvey. Kyle's practice is primarily focused on assisting our municipal clients in bond and tax matters. With his tax experience, however, he assists our tax practice group clients on broader federal, state and local tax matters. We are excited to have Kyle join our tax team, adding to our already robust bench strength.*

*The article below was authored by Kyle. Expect to see more of Kyle's contributions to Larry's Tax Law in the future.*

*Larry*

On September 30, 2021, the Washington State Supreme Court upheld the constitutionality of the additional 1.2 percent business and occupation (B&O) tax imposed by the 2019 Substitute House Bill 2167 ("SHB 2167") on "specified financial institutions"—financial institutions with annual net income of more than $1 billion. SHB 2167 increases the tax rate for these institutions from 1.5 percent (the rate generally applicable to financial institutions) to 2.7 percent.

The tax was codified in Section 82.04.29004 Revised Code of Washington ("RCW"). Like other B&O taxes in Washington, the amount of tax due is measured by the amount of the specified financial institution's gross revenues attributed to Washington State, which is generally based on an apportionment formula (contained in RCW 82.04.460-.462). The effect of this apportionment regime is that a certain percentage of a financial institution's total gross income for the year is treated as earned in Washington and taxed under Washington law.

The Washington Bankers Association and American Bankers Association (taxpayers) commenced a lawsuit, arguing that the tax violated the U.S. Constitution's Dormant Commerce Clause ("DCC"). At trial, the court concluded that the taxpayers had standing to challenge the tax under the Uniform Declaratory Judgments Act ("UDJA") and held that the additional graduated tax rate discriminated against out-of-state businesses, in violation of the DCC. The trial court denied reconsideration of its decision. The Washington Department of Revenue then

appealed directly to the Washington State Supreme Court.

The Washington Supreme Court agreed with the trial court regarding standing and accepted the case. Although the taxpayers argued that there was a disproportionate economic effect on large, out-of-state financial institutions, the court discussed prior DCC precedent (largely from the U.S. Supreme Court) holding that a disproportionate economic effect alone does not render a tax discriminatory. Ultimately, the Washington Supreme Court found that the tax was both facially neutral (the tax does not, by its terms, discriminate against out-of-state businesses) and not discriminatory in effect (the tax does not, in its application, nevertheless prejudice out of state taxpayers).

The Washington Supreme Court based this conclusion on the facial neutrality of the statute (all financial institutions are subject to the same $1 billion threshold) and the lack of burden on interstate commerce (the statute merely increases the rate of tax on specified financial institutions, it does not prevent them from doing business in Washington and does not burden the flow of interstate goods or distinguish between domestic and out-of-state financial institutions).

The Washington Supreme Court also considered the taxpayers' argument that the tax failed the "internal consistency test" under the DCC. As stated by the Washington Supreme Court, to pass that test, an individual "state tax [must be] consistent such that if it was applied by every jurisdiction, there would be no impermissible interference with free trade by means of multiple taxation." According to the Court, this tax passes that test through the apportionment formula—if each state were to implement a similar tax, apportioned based on income attributable to the state, it would not result in multiple taxation.

Finally, the Washington Supreme Court rejected the argument that the state legislature's intent in enacting the tax was discriminatory—finding that the express intent of the bill was to address Washington's regressive tax code and to raise revenue for essential services. The court also evaluated statements by legislators in considering the bill, and found that those statements indicated an intent to benefit the people of Washington, but not an intent to impose a tax that treated Washington State-specified financial institutions differently from out-of-state financial institutions. Together, the court held that this was enough to survive rational basis review.

However, it is unlikely that this case is over—the taxpayers are large organizations with significant tax liability at stake. It would not be surprising to see the taxpayers petition the U.S. Supreme Court for certiorari. Given the many questions about Washington State's tax code (including challenges to City income taxes and likely challenges to the State's recently passed capital gains tax), along with the U.S. Supreme Court's DCC jurisprudence, this will be an interesting case to follow. We will update you should this case progress further.

**Tags:** apportionment, financial institutions, Washington Business & Occupations Tax, Washington state, Washington Supreme Court