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Washington State: Additional B&O tax imposed on financial institutions violates Commerce Clause

A Washington State superior court granted summary judgment for banking associations, holding that the state's additional 1.2% business and occupation (B&O) tax imposed on certain financial institutions violates the "Commerce Clause" of the U.S. Constitution because it discriminates against out-of-state financial institutions.

Additional B&O tax for "specified financial institutions"

Effective January 1, 2020, an additional B&O tax is imposed on "specified financial institutions." These are defined as financial institutions that are members of a consolidated financial institution group that reported on its consolidated financial statement for the previous calendar year annual net income of at least \$1 billion. The additional tax is imposed at a rate of 1.2% of gross income taxable under the "Service and Other Activities" classification, thus making the effective B&O tax rate for these institutions 2.7%.

Lawsuit challenging the additional B&O tax

A lawsuit challenging the constitutionality of the additional tax was filed in November 2019. The plaintiffs, two associations representing financial institutions, argued that the additional tax violated the Commerce Clause because the \$1 billion threshold effectively limits the application of the tax to certain out-of-state banks only. The additional tax, the banking associations also alleged, directly discriminates against interstate commerce because liability is tied to a financial institution's net income from all operations, including interstate and foreign operations that the state has no legitimate power to tax. Finally, the banking associations asserted that the additional tax fails the internal consistency test because if every state imposed a similar tax, the burden on interstate commerce would be significantly greater than on intrastate commerce.

The Washington State Department of Revenue countered that the additional tax did not discriminate against interstate commerce because it applied evenly to any financial institution that met the \$1 billion threshold and applied only to income apportioned to Washington State.

A state superior court judge at a virtual hearing on May 8, 2020, granted summary judgment for the banking associations on the basis that the additional 1.2% tax discriminated against out-of-state financial institutions. There is no written opinion at this point.

What's next?

It is not yet known whether this grant of summary judgment will be appealed. It has been reported that the Department may seek direct review before the Washington State Supreme Court.

KPMG observation

The additional B&O tax is reported on the monthly excise tax report, meaning taxpayers need to consider whether to continue to remit the additional tax and seek a refund if the additional tax is ultimately held to be unconstitutional. If a taxpayer decides to no longer remit the additional tax, and the tax is later declared constitutional, the taxpayer will owe the tax plus interest.

For more information, contact a KPMG State and Local Tax professional:

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