

Report of the

Joint Tax Avoidance Review Committee

To the Fiscal Committees of the House of Representatives and the Senate

October 2010



Joint Committee Members:

Deborah Eddy, State Representative, Chair of Committee

Phil Rockefeller, State Senator, Vice Chair of Committee

Adam Kline , State Senator

Ed Orcutt, State Representative

Dean Takko, State Representative

Joseph Zarelli, State Senator

Joint Committee Alternates:

Cary Condotta, State Representative

Mike Hewitt, State Senator

Ross Hunter, State Representative

Jeanne Kohl-Welles, State Senator

Introduction

The Legislature created the Joint Tax Avoidance Review Committee in Section 204 of 2ESSB 6143 (Chapter 23, 2010 Laws 1st Special Session). The committee consists of six members - three each from the House and the Senate. Two are members of the majority caucus and one from the minority caucus. Each caucus also appointed an alternate member. The Committee chose Representative Eddy as Chair and Senator Rockefeller as Vice-Chair.

2ESSB 6143 set out the Committee's tasks as follows:

1. Generally monitor the Department of Revenue's (DOR) implementation of the tax avoidance provisions of 2ESSB 6143;
2. Provide timely advice to the DOR on rule making related to tax avoidance;
3. Seek input from stakeholders and legislators;
4. Review other cases of tax avoidance, as identified by DOR, not covered by the tax avoidance provisions of 2EESB 6143;
5. Consider the need for an explicit statutory construction standard to provide direction to the courts on the interpretation of the tax avoidance provisions of 2ESSB 6143; and
6. Provide a report to the fiscal committees of the legislature by December 31, 2011 that includes:
 - a. Recommendations on legislation, including amendments to sections of 2ESSB 6143 related to tax avoidance; and
 - b. Recommendations on future legislative oversight of the DOR implementation of the tax avoidance provisions of 2ESSB 6143.

Background on Tax Avoidance

2ESSB 6143 authorized the DOR to disregard, for tax purposes, certain tax avoidance arrangements. In adopting these provisions, the legislature's intent is to require all taxpayers to pay their fair share of taxes by stopping arrangements that are designed to unfairly avoid tax.

The arrangements specifically mentioned in 2ESSB 6143 are:

1. Joint ventures between construction contractors and developers that are substantially guaranteed payments for construction services;
2. Arrangements that attempt to avoid business and occupation tax by disguising income from a person not affiliated with the Washington taxpayer by moving that income to another entity that is not taxable in Washington; and
3. Arrangements that attempt to avoid sales and use tax on the purchase or use of tangible personal property by vesting ownership in another non-taxable entity such that the taxpayer retains control of the property.

When determining whether to disregard the tax benefits of an arrangement DOR may consider:

1. Whether the arrangement changes in a meaningful way the economic position of the participants apart from the tax effects;
2. Whether substantial nontax reasons exist for entering into the arrangement;
3. Whether the arrangement is a reasonable means of accomplishing a substantial nontax purpose;
4. An entities' relative contribution to the work that generates income;
5. The location where work is performed; and
6. Other relevant factors.

Committee Activities

Meetings of the Committee covered the following:

1. Committee staff briefings on:
 - a. The tax avoidance provisions of 2ESSB 6143; and
 - b. The Joint Tax Avoidance Review Committee study language.
2. Briefings by the Department of Revenue on the implementation of the tax avoidance provisions including:
 - a. Communications with taxpayers,
 - b. Development of an administrative rule on tax avoidance, and
 - c. The plan for stakeholder engagement in the rule making process.
3. A briefing by Helen Hecht, Tax Counsel, Federation of Tax Administrators, on the codification of common law economic substance doctrine at the state and federal levels.

Public comments were solicited at each meeting.

Video coverage of Committee meetings are available on TVW (www.tvw.org) under media archives/audio video archives see July 22, 2010, September 20, 2010, and October 27, 2010.

Recommendations of the Committee:

Recommendations on legislation including amendments to sections of 2ESSB 6143 related to tax avoidance;

Place holder for recommendations.

Recommendations on future legislative oversight of DOR implementation of the tax avoidance provision of 2ESSB 6143;

Place holder for recommendations.

Appendices

1. July 22, 2010 Committee meeting agenda;
2. Tax Avoidance Provision of 2ESSB 6143;
3. Presentation on Joint Tax Avoidance Committee provisions of 2ESSB 6143 - briefing by Committee Staff;
4. Tax Avoidance Provisions of 2ESSB 6143 - briefing by Committee Staff;
5. Special Notice on Tax Avoidance Transactions - Department of Revenue;
6. September 20, 2010 Committee meeting agenda;
7. Overview of the codification of the common law economic substance doctrine at the state and federal levels - briefing by Helen Hecht, Tax Counsel, Federation of Tax Administrators;
8. Draft Tax Avoidance Rule – DOR; and
9. Draft Tax Avoidance Rule Flow Chart - DOR



Washington State Legislature

Tax Avoidance Review Committee, Joint Full Committee

Thursday
July 22, 2010
12:30 p.m.

Senate Hearing Rm 3
J.A. Cherberg Building
Olympia, WA

Agenda:

1. Selection of a Chair & Vice Chair.
2. Overview of Section 201, 202, and 203 of 2ESSB 6143.
3. Overview of the Study Language in Section 204 of 2ESSB 6143.
4. Presentation by the Department of Revenue (DOR) on implementation activities.
5. Other items.
6. Planning for future meetings.

Members:

Senator Rockefeller
Senator Kline
Senator Zarelli

Representative Eddy
Representative Takko
Representative Orcutt

Alternates:

Senator Kohl-Welles
Senator Hewitt
Representative Hunter
Representative Condotta

Tax Avoidance Provisions
(§§ 201-204, 2ESSB 6143)

1 NEW SECTION. **Sec. 201.** A new section is added to chapter 82.32
2 RCW to read as follows:

3 (1) It is the legislature's intent to require all taxpayers to pay
4 their fair share of taxes. To accomplish this purpose, it is the
5 legislature's intent to stop transactions or arrangements that are
6 designed to unfairly avoid taxes.

7 (2) The department must disregard, for tax purposes, the tax
8 avoidance transactions or arrangements that are described in subsection
9 (3) of this section. The department must deny the tax benefit that
10 would otherwise result from the tax avoidance transaction or
11 arrangement. In determining whether the department must disregard a
12 transaction or arrangement described under subsection (3) of this
13 section, the department may consider:

14 (a) Whether an arrangement or transaction changes in a meaningful
15 way, apart from its tax effects, the economic positions of the
16 participants in the arrangement when considered as a whole;

17 (b) Whether substantial nontax reasons exist for entering into an
18 arrangement or transaction;

19 (c) Whether an arrangement or transaction is a reasonable means of
20 accomplishing a substantial nontax purpose;

21 (d) An entities' relative contributions to the work that generates
22 income;

23 (e) The location where work is performed; and

24 (f) Other relevant factors.

25 (3) This section applies only to the following transactions or
26 arrangements:

27 (a) Arrangements that are, in form, a joint venture or similar
28 arrangement between a construction contractor and the owner or
29 developer of a construction project but that are, in substance,
30 substantially guaranteed payments for the purchase of construction
31 services characterized by a failure of the parties' agreement to
32 provide for the contractor to share substantial profits and bear
33 significant risk of loss in the venture;

34 (b) Arrangements through which a taxpayer attempts to avoid tax
35 under chapter 82.04 RCW by disguising income received, or otherwise
36 avoiding tax on income, from a person that is not affiliated with the
37 taxpayer from business activities that would be taxable in Washington

1 by moving that income to another entity that would not be taxable in
2 Washington; and

3 (c) Arrangements through which a taxpayer attempts to avoid tax
4 under chapter 82.08 or 82.12 RCW by engaging in a transaction to
5 disguise its purchase or use of tangible personal property by vesting
6 legal title or other ownership interest in another entity over which
7 the taxpayer exercises control in such a manner as to effectively
8 retain control of the tangible personal property.

9 (4) In determining whether a transaction or arrangement comes
10 within the scope of subsection (3) of this section, the department is
11 not required to prove a taxpayer's subjective intent in engaging in the
12 transaction or arrangement.

13 (5) The department must adopt rules to assist in determining
14 whether a transaction or arrangement is within the scope of subsection
15 (3) of this section. The adoption of a rule as required under this
16 subsection is not a condition precedent for the department's exercise
17 of the authority provided in this section. Any rules adopted under
18 this section must include examples of transactions that the department
19 will disregard for tax purposes.

20 (6) This section does not affect the department's authority to
21 apply any other remedies available under statutory or common law.

22 (7) For purposes of this section, "affiliated" means under common
23 control. "Control" means the possession, directly or indirectly, of
24 more than fifty percent of the power to direct or cause the direction
25 of the management and policies of a person, whether through the
26 ownership of voting shares, by contract, or otherwise.

27 NEW SECTION. **Sec. 202.** A new section is added to chapter 82.32
28 RCW to read as follows:

29 (1)(a) The department may not use section 201 of this act to
30 disregard any transaction or arrangement initiated before the effective
31 date of this section, if, in respect to such transaction or
32 arrangement, the taxpayer had reported its tax liability in conformance
33 with either specific written instructions provided by the department to
34 the taxpayer, a determination published under the authority of RCW
35 82.32.410, or other document made available by the department to the
36 general public.

1 (b) This section does not apply if the transaction or arrangement
2 engaged in by the taxpayer differs materially from the transaction or
3 arrangement that was addressed in the specific written instructions,
4 published determination, or other document made available by the
5 department to the general public.

6 (2) Section 201 of this act does not apply to any tax periods
7 ending before May 1, 2010, that were included in a completed field
8 audit conducted by the department.

9 (3) For purposes of this section, "specific written instructions"
10 means tax reporting instructions provided to a taxpayer and which
11 specifically identify the taxpayer to whom the instructions apply.
12 Specific written instructions may be provided as part of an audit, tax
13 assessment, determination, closing agreement, or in response to a
14 binding ruling request.

15 **Sec. 203.** RCW 82.32.090 and 2006 c 256 s 6 are each amended to
16 read as follows:

17 (1) If payment of any tax due on a return to be filed by a taxpayer
18 is not received by the department of revenue by the due date, there
19 (~~shall be~~) is assessed a penalty of five percent of the amount of the
20 tax; and if the tax is not received on or before the last day of the
21 month following the due date, there (~~shall be~~) is assessed a total
22 penalty of fifteen percent of the amount of the tax under this
23 subsection; and if the tax is not received on or before the last day of
24 the second month following the due date, there (~~shall be~~) is assessed
25 a total penalty of twenty-five percent of the amount of the tax under
26 this subsection. No penalty so added shall be less than five dollars.

27 (2) If the department of revenue determines that any tax has been
28 substantially underpaid, there (~~shall be~~) is assessed a penalty of
29 five percent of the amount of the tax determined by the department to
30 be due. If payment of any tax determined by the department to be due
31 is not received by the department by the due date specified in the
32 notice, or any extension thereof, there (~~shall be~~) is assessed a
33 total penalty of fifteen percent of the amount of the tax under this
34 subsection; and if payment of any tax determined by the department to
35 be due is not received on or before the thirtieth day following the due
36 date specified in the notice of tax due, or any extension thereof,
37 there (~~shall be~~) is assessed a total penalty of twenty-five percent

1 of the amount of the tax under this subsection. No penalty so added
2 (~~shall~~) may be less than five dollars. As used in this section,
3 "substantially underpaid" means that the taxpayer has paid less than
4 eighty percent of the amount of tax determined by the department to be
5 due for all of the types of taxes included in, and for the entire
6 period of time covered by, the department's examination, and the amount
7 of underpayment is at least one thousand dollars.

8 (3) If a warrant (~~be~~) is issued by the department of revenue for
9 the collection of taxes, increases, and penalties, there (~~shall-be~~)
10 is added thereto a penalty of ten percent of the amount of the tax, but
11 not less than ten dollars.

12 (4) If the department finds that a person has engaged in any
13 business or performed any act upon which a tax is imposed under this
14 title and that person has not obtained from the department a
15 registration certificate as required by RCW 82.32.030, the department
16 (~~shall~~) must impose a penalty of five percent of the amount of tax
17 due from that person for the period that the person was not registered
18 as required by RCW 82.32.030. The department (~~shall~~) may not impose
19 the penalty under this subsection (4) if a person who has engaged in
20 business taxable under this title without first having registered as
21 required by RCW 82.32.030, prior to any notification by the department
22 of the need to register, obtains a registration certificate from the
23 department.

24 (5) If the department finds that all or any part of a deficiency
25 resulted from the disregard of specific written instructions as to
26 reporting or tax liabilities, the department (~~shall~~) must add a
27 penalty of ten percent of the amount of the additional tax found due
28 because of the failure to follow the instructions. A taxpayer
29 disregards specific written instructions when the department (~~of~~
30 ~~revenue~~) has informed the taxpayer in writing of the taxpayer's tax
31 obligations and the taxpayer fails to act in accordance with those
32 instructions unless the department has not issued final instructions
33 because the matter is under appeal pursuant to this chapter or
34 departmental regulations. The department (~~shall~~) may not assess the
35 penalty under this section upon any taxpayer who has made a good faith
36 effort to comply with the specific written instructions provided by the
37 department to that taxpayer. Specific written instructions may be
38 given as a part of a tax assessment, audit, determination, or closing

1 agreement, provided that such specific written instructions (~~shall~~)
2 apply only to the taxpayer addressed or referenced on such documents.
3 Any specific written instructions by the department (~~of revenue~~
4 ~~shall~~) must be clearly identified as such and (~~shall~~) must inform
5 the taxpayer that failure to follow the instructions may subject the
6 taxpayer to the penalties imposed by this subsection.

7 (6) If the department finds that all or any part of a deficiency
8 resulted from engaging in a disregarded transaction, as described in
9 section 201(3) of this act, the department must assess a penalty of
10 thirty-five percent of the additional tax found to be due as a result
11 of engaging in a transaction disregarded by the department under
12 section 201(2) of this act. The penalty provided in this subsection
13 may be assessed together with any other applicable penalties provided
14 in this section on the same tax found to be due, except for the evasion
15 penalty provided in subsection (7) of this section. The department may
16 not assess the penalty under this subsection if, before the department
17 discovers the taxpayer's use of a transaction described under section
18 201(3) of this act, the taxpayer discloses its participation in the
19 transaction to the department.

20 (7) If the department finds that all or any part of the deficiency
21 resulted from an intent to evade the tax payable hereunder, a further
22 penalty of fifty percent of the additional tax found to be due
23 (~~shall~~) must be added.

24 ~~((+7))~~ (8) The penalties imposed under subsections (1) through (4)
25 of this section can each be imposed on the same tax found to be due.
26 This subsection does not prohibit or restrict the application of other
27 penalties authorized by law.

28 ~~((+8))~~ (9) The department (~~of revenue~~) may not impose (~~both~~)
29 the evasion penalty (~~and~~) in combination with the penalty for
30 disregarding specific written instructions or the penalty provided in
31 subsection (6) of this section on the same tax found to be due.

32 ~~((+9))~~ (10) For the purposes of this section, "return" means any
33 document a person is required by the state of Washington to file to
34 satisfy or establish a tax or fee obligation that is administered or
35 collected by the department (~~of revenue~~), and that has a statutorily
36 defined due date.

1 NEW SECTION. **Sec. 204.** A new section is added to chapter 82.32
2 RCW to read as follows:

3 There is hereby created a joint tax avoidance review committee
4 which is a bipartisan committee consisting of three members of the
5 senate, two from the majority caucus and one from the minority caucus,
6 and three members of the house of representatives, two from the
7 majority caucus and one from the minority caucus. The senate members
8 of the committee must be appointed by the majority leader of the
9 senate, and the house members of the committee must be appointed by the
10 speaker of the house. The appointing authorities must also appoint one
11 alternate member from each of the two largest caucuses of each
12 legislative chamber.

13 (1) (a) Members and alternates must be appointed as soon as possible
14 after the effective date of this section, and their terms continue
15 until such persons no longer wish to serve on the committee or no
16 longer serve in the legislature, whichever occurs first.

17 (b) A vacancy must be filled by the appointment of a legislator
18 from the same legislative chamber and caucus as the original
19 appointment. The appropriate appointing authority must make the
20 appointment within thirty days of the vacancy occurring. Former
21 committee members and alternates may be reappointed to the committee.

22 (2) The committee must choose its chair and vice-chair from among
23 its membership. The committee meets at the call of the chair. The
24 chair of the committee must cause all meeting notices and committee
25 documents to be sent to the committee members and alternates.

26 (3) Staff support for the committee must be provided by the senate
27 committee services and the house of representatives office of program
28 research.

29 (4) The committee must:

30 (a) Generally monitor the department's implementation of Part II of
31 this act, providing timely advice to the department in any rule making
32 undertaken pursuant to the authority granted under section 201 of this
33 act;

34 (b) Seek input from stakeholders and other legislators as the
35 committee may determine is desirable and useful in the furtherance of
36 its mission herein described;

37 (c) Review other cases, identified by the department, of tax

1 avoidance transactions not described in section 201 of this act that
2 may represent examples of arrangements that circumvent the policies of
3 this state and thus unfairly avoid taxes;

4 (d) Consider the need for an explicit statutory construction
5 standard to provide direction to the courts on the interpretation of
6 Part II of this act; and

7 (e) Provide a report to the fiscal committees of the house of
8 representatives and senate by December 31, 2010, which must include:

9 (i) Recommended legislation on any matters that the committee deems
10 advisable, including amendments to sections 201, 202, and 203 of this
11 act; and

12 (ii) Recommendations for future legislative oversight of the
13 department's implementation of sections 201, 202, and 203 of this act.

14 (5) For the purposes of this section, the disclosure of otherwise
15 confidential tax information to the members of the committee is deemed
16 to fall within the exception provided by RCW 82.32.330(3)(d).

17 (6) This section expires July 1, 2011.

Joint Tax Avoidance Review Committee

Section 204 2ESSB 6143

Committee Structure

- 3 members each from House and Senate (2 from the majority, 1 from the minority) plus 2 alternate members from each caucus.
- Committee selects a Chair and Vice Chair.
- Committee meets at call of Chair.
- Committee staffed by Senate Committee Services and Office of Program Research.

Committee Tasks

- Monitor Department of Revenue's (DOR) implementation of tax avoidance provisions of 2ESSB 6143.
- Provide advise to DOR in rule making related to tax avoidance under section 201.
- Seek input from stakeholders and other legislators.
- Review other cases of tax avoidance transactions not covered by Section 201 of 2EESB 6143.

Committee Tasks (continued)

- Consider need for an explicit statutory construction standard to provide direction to courts on the interpretation of Part 2 of 2ESSB 6143.
- Provide report to fiscal committees by December 31, 2010 that:
 - Recommends legislation on any matter including amendments to sections 201, 202, and 203 of 2ESSB 6143
 - Recommendations related to future legislative oversight of Department of Revenue implementation.

Protection of Tax Information

- The Secrecy Clause (RCW 82.32.330) is the law that prohibits disclosure of tax information about specific taxpayers to unauthorized persons.
- All tax information is confidential, without the taxpayer's permission or other statutory authorization to disclose.
- 2022 ESSB 6143, s. 204(5) provides a statutory exception to the confidentiality of tax information for JTARC members .

Unauthorized Disclosure

- DOR employees or persons receiving authorized tax information who then disclose that information to unauthorized parties are guilty of a misdemeanor.
- If the person guilty of such violation is an officer or employee of the state, such person must forfeit such office or employment and is incapable of holding any public office or employment in this state for a period of two years thereafter.

Website and Staff Contacts

JTARC Website:

- <http://www.leg.wa.gov/jointcommittees/tarc/>

Staff Contacts:

Rick Peterson

- (360) 786-7150; Peterson.Rick@leg.wa.gov

Jeff Mitchell

- (360) 786-7139; Mitchell.Jeffrey@leg.wa.gov

Dean Carlson

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Dianne Criswell

- (360) 786-7433; Criswell.Dianne@leg.wa.gov

Tax Avoidance Provisions 201- 203

2ESSB 6143 & Chapter 23, Laws of 2010

Joint Tax Avoidance Review Committee

- **JTARC Purpose:** Address implementation, oversight, and other issues related to sections 201 through 203 of 2ESSB 6143
- **General Nature: Sections 201 through 203**
 - Section 201: Tax Avoidance Transactions
 - Section 202: Safe Harbor for Certain Prior Tax Avoidance Transactions
 - Section 203: Penalty for Engaging in a Tax Avoidance Transaction

Intent

“It is the legislature's intent to require all taxpayers to pay their fair share of taxes. To accomplish this purpose, it is the legislature's intent to stop transactions or arrangements that are designed to unfairly avoid taxes.”

Section 201(1)

Section 201 - Tax Avoidance

- **Tax Avoidance:** Can be generally described as engaging in a particular transaction or arrangement for the primary purpose of avoiding state taxation.
- **Factors that may be considered:**
 - “ . . . [T]he department may consider:
 - (a) *Whether an arrangement or transaction changes in a meaningful way, apart from its tax effects, the economic positions of the participants in the arrangement when considered as a whole;*
 - (b) *Whether substantial nontax reasons exist for entering into an arrangement or transaction;*
 - (c) *Whether an arrangement or transaction is a reasonable means of accomplishing a substantial nontax purpose;*
 - (d) *An entities' relative contributions to the work that generates income;*
 - (e) *The location where work is performed; and*
 - (f) *Other relevant factors.”*

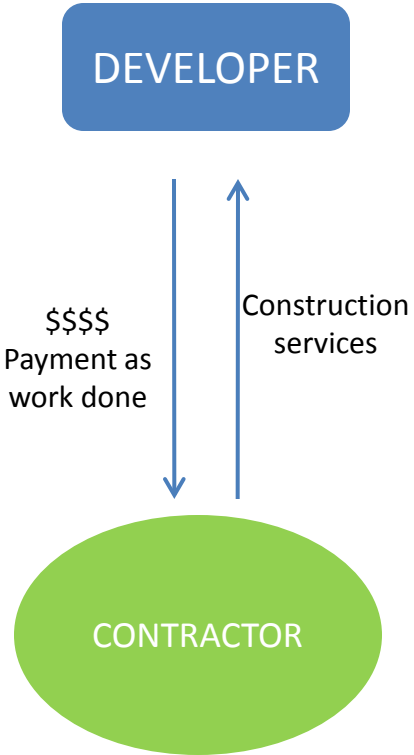
Section 201 - Tax Avoidance

- **Three Specific Types of Arrangements or Transactions:**
 - **Arrangements to Avoid Sales & B&O Taxes on Construction Services:** A contractor and developer form an LLC where the contractor has minimal risk and does not share in the profits. Distributions from the LLC to the contractor are tax free.
 - **Arrangements to Avoid B&O Taxes:** A WA taxpayer creates an out-of-state subsidiary and assigns customer contracts to the subsidiary. Distributions to the WA company from the subsidiary are tax free.
 - **Arrangements to Avoid Sales/Use Taxes on TPP:** A WA taxpayer vests legal title in tangible personal property to a business entity such as an LLC, but maintains control over the use of property. Sales and use taxes are avoided.

Arrangements to Avoid Sales & B&O Taxes on Construction Services

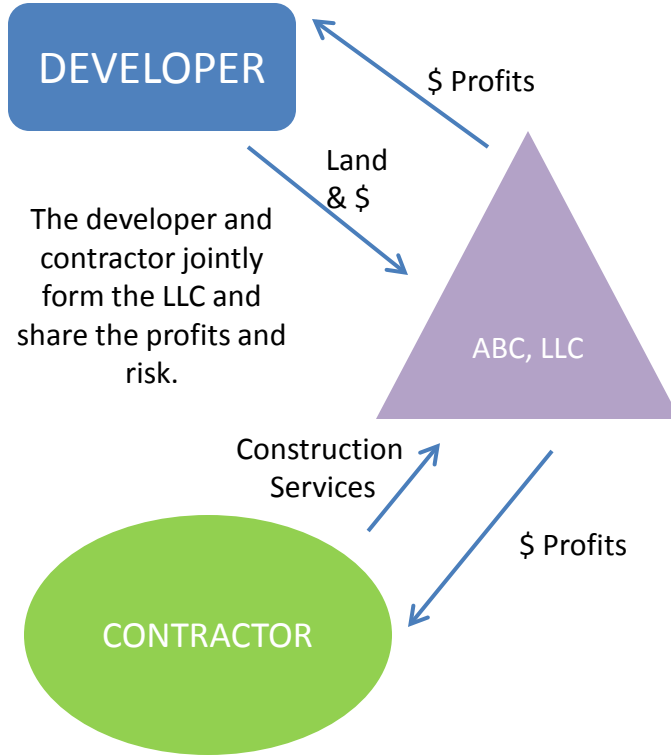
Scenario One

TAXABLE STANDARD
CONSTRUCTION CONTRACT



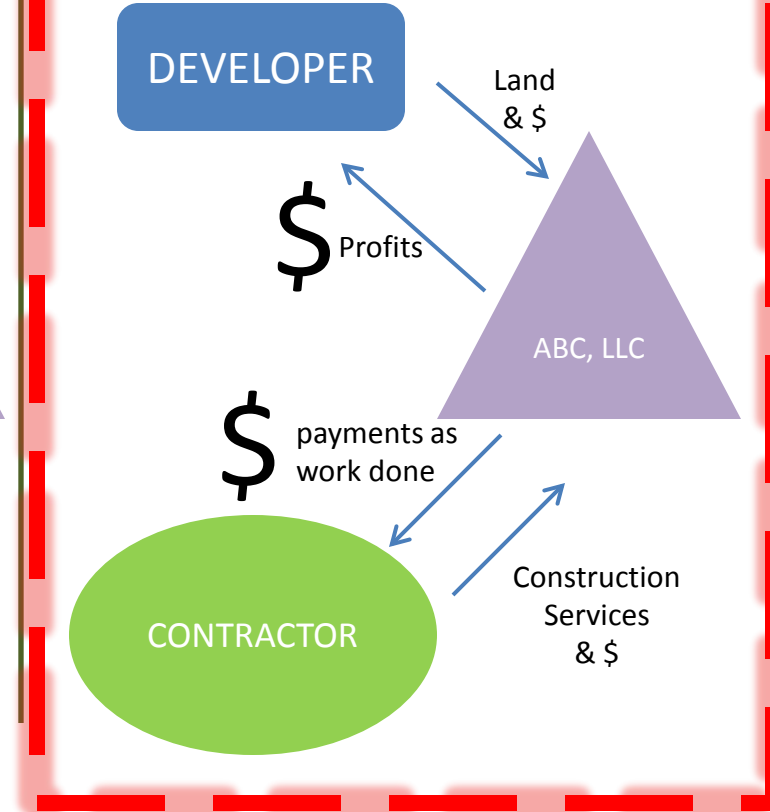
Scenario Two

TAX FREE DISTRIBUTION UNDER RCW
82.04.4281



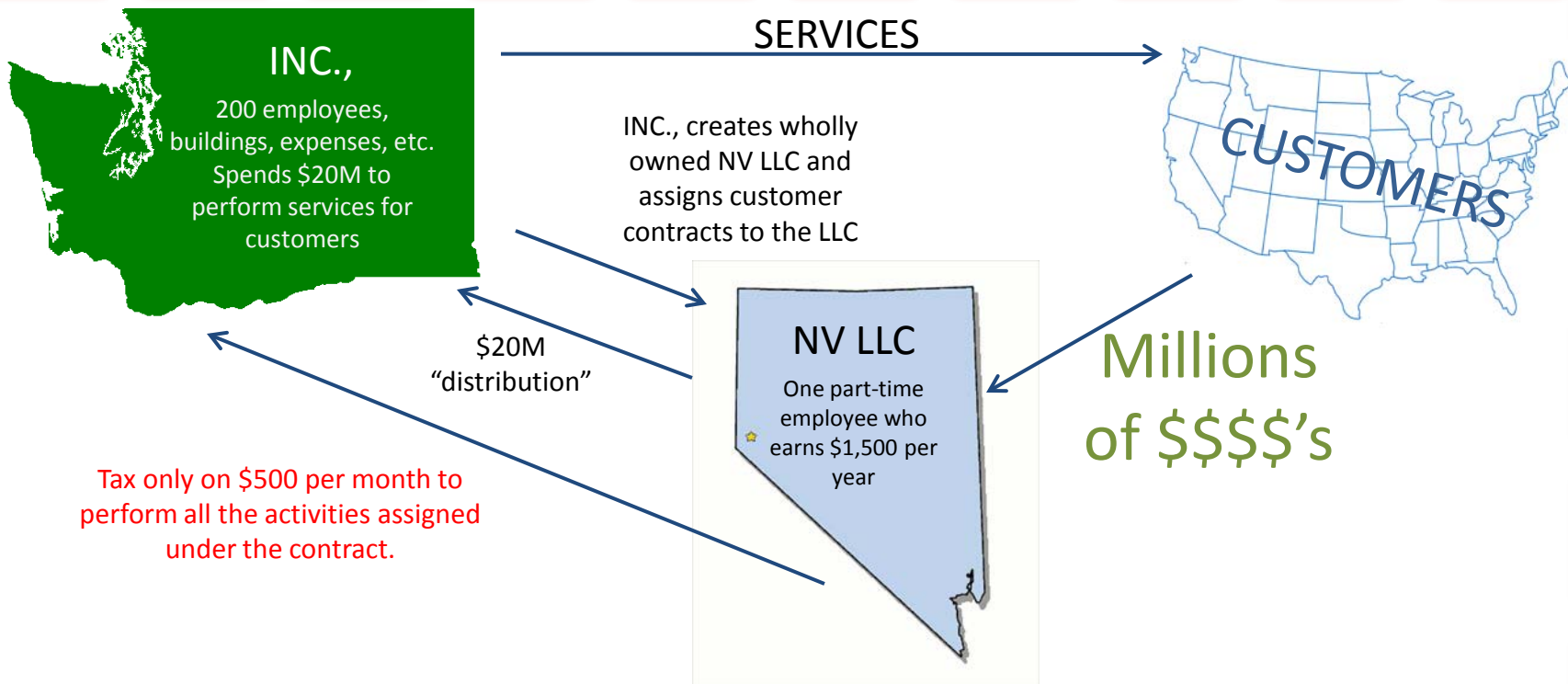
Scenario Three

TAXABLE SALE UNDER BILL



Avoidance occurs in Scenario Three because the Contractor's "distributions" are essentially guaranteed payments for the construction services; the Contractor does not share substantial profits and has little to no risk in the venture.

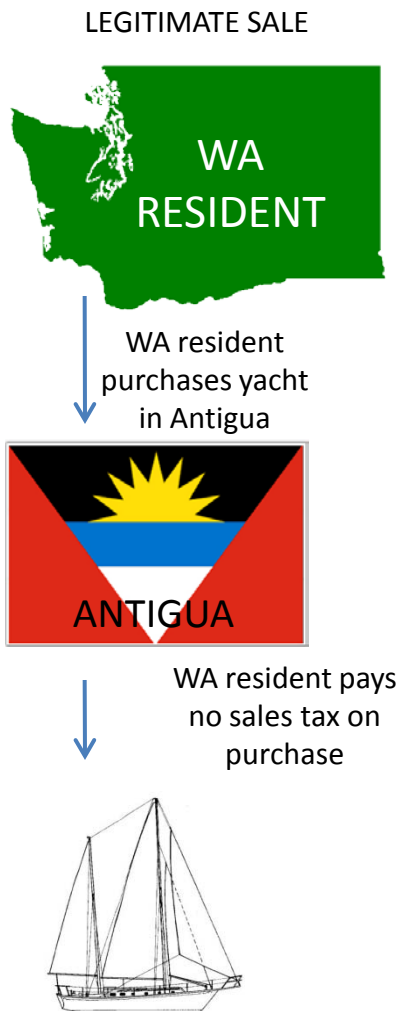
Arrangements to Avoid B&O Taxes



This is tax avoidance because INC., is receiving \$20M per year but only paying tax on \$6,000.

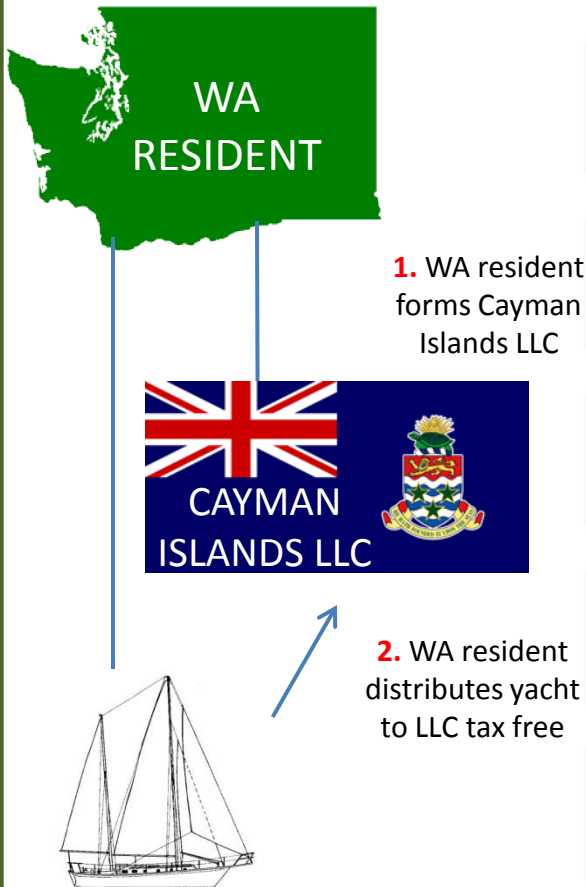
Arrangements to Avoid Sales/Use Taxes on TPP

Scenario 1- Traditional Out-of-State Yacht Purchase



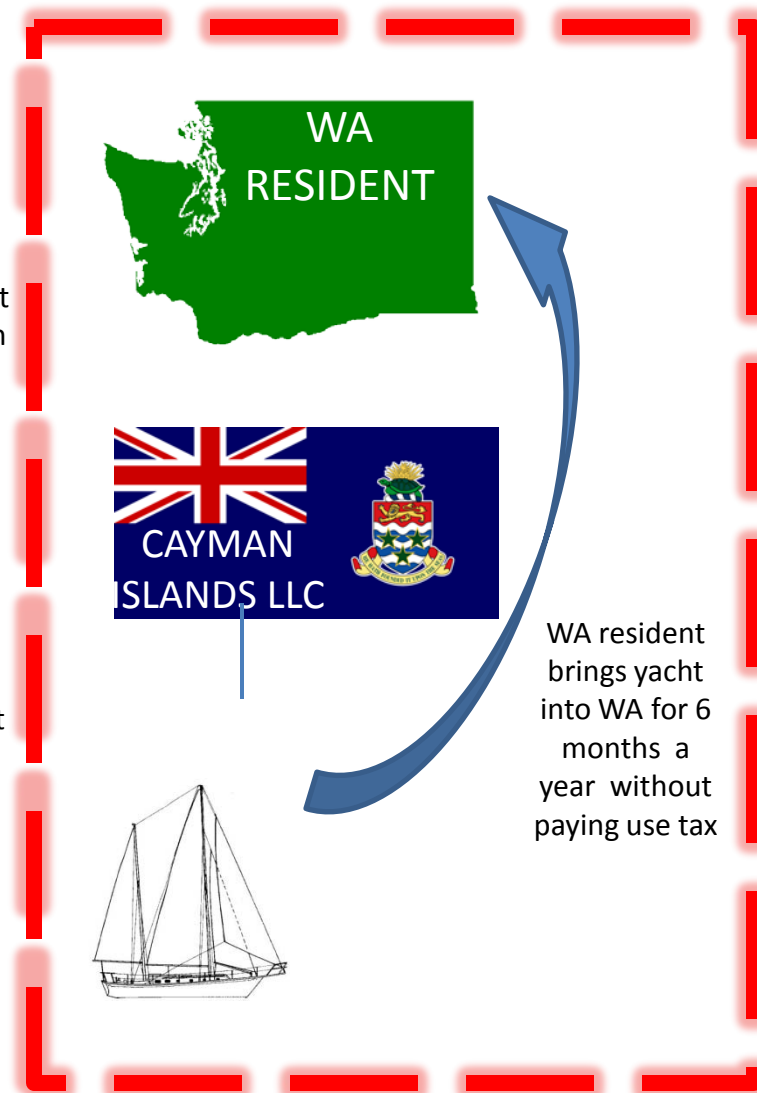
Scenario 2 - LLC Created

WA RESIDENT FORMS FOREIGN LLC;
CONTRIBUTES YACHT TAX FREE UNDER RCW
82.04.4281



Scenario 2 -Yacht Used in WA

WA RESIDENT DOES NOT PAY USE TAX ON YACHT



Section 202 - Safe Harbor Provisions

- **General Rule:** DOR may pursue transactions or arrangements that would have been taxable in tax periods on or after January 1, 2006.
- **Exceptions to retroactive application:**
 - Specific Written Instructions
 - Published Department Determinations
 - Any other document made available to the public

Section 203 - Tax Avoidance Penalty

- 35% Penalty on Additional Tax
- Exception:
 - *“The department may not assess the penalty under this subsection if, before the department discovers the taxpayer's use of a transaction described under section 201(3) of this act, the taxpayer discloses its participation in the transaction to the department.”*



Special Notice

WASHINGTON STATE DEPARTMENT OF REVENUE

MAY 27, 2010

Department Authority to Disregard Tax Avoidance Transactions

Purpose

Second Engrossed Substitute Senate Bill (2ESSB) 6143 Sections §§ 201-203 (Part II) Chapter 23, Laws of 2010, 1st Special Session directs the Department to disregard, for tax purposes, transactions or arrangements that are designed to unfairly avoid taxes.

Not included in this Notice: Part II also addresses tax loopholes related to the use tax (§ 206) and the real estate excise tax on transfers of a controlling interest of an entity that owns real property in Washington (§§ 207-213). The closure of loopholes for use tax and real estate excise tax will be addressed in separate Special Notices.

Effective date

This legislation takes effect on May 1, 2010 and applies to tax periods beginning January 1, 2006.

What will be disregarded

The Department will disregard the following transactions or arrangements:

- Arrangements that are, in form, a joint venture or similar arrangement between a construction contractor and the owner or developer of a construction project but that are, in substance, substantially guaranteed payments for the purchase of construction services. These arrangements are characterized by a failure of the parties' agreement to provide for the contractor to share substantial profits or bear significant risk of loss in the venture.
- Arrangements through which a taxpayer attempts to avoid business and occupation (B&O) tax by disguising income received, or otherwise avoiding tax on income, from a person that is not affiliated¹ with the taxpayer from business activities that would otherwise be taxable in Washington by moving the income to an affiliated entity that is not subject to tax.
- Arrangements through which a taxpayer attempts to avoid retail sales or use tax by engaging in a transaction to disguise its purchase or use of tangible personal property in Washington by vesting title or ownership to another entity over which the taxpayer exercises control in such manner as to effectively retain control of the tangible personal property.

¹ For purposes of applying 2ESSB 6143, "affiliated" means under common control. "Control" means the possession, directly or indirectly, of more than fifty percent (50%) of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting shares, by contract, or otherwise.

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Examples

The following examples illustrate transactions or arrangements that will be disregarded by the Department. These examples identify a number of facts and then state a conclusion. These examples should be used only as a general guide. The tax consequences of other arrangements must be determined based on all the facts and circumstances.

Example: Disguised sale of construction services

A real estate developer and a construction company form a joint venture. The developer contributes land to the venture, and the construction company contributes labor and materials. The construction company's "capital account" is credited for the value of labor and materials provided. Under the terms of the joint venture agreement, the construction company is entitled to monthly distributions equaling the value of that construction labor and materials provided each month. If the construction company does not receive payment in full, it has the right to require an immediate buy-out of its interests in the joint venture. Upon liquidation of the joint venture, the construction company is only entitled to a nominal payment, not a proportionate share of the value of the assets of the joint venture.

The construction company claims the payments are distributions from capital account and exempt from B&O tax under RCW 82.04.4281. However, the construction company is not entitled to substantial profits and does not bear significant risk of loss under the venture.

The Department will disregard the joint venture arrangement and consider the payments received by the contractor as payment for providing retail construction services, subject to retail sales tax and taxable under the Retailing B&O tax classification.

Example: B&O tax transaction

A Washington company with its only place of business in Washington provides online services subject to B&O tax to Washington customers. The Washington company forms a LLC in another state. The Washington company causes the out-of-state LLC to contract with its Washington customers to provide the online services. The out-of-state LLC hires the Washington company as a subcontractor to provide the online services to customers. The out-of-state LLC has no employees or other property and pays only a nominal fee to the Washington company for the services. The out-of-state LLC collects customer payments and makes distributions to the Washington company. The Washington company claims the distributions are from its capital account with the out-of-state LLC and exempt from B&O tax under RCW 82.04.4281.

The Department will disregard the transactions between the Washington company and the LLC and assess the Washington company for tax on the income collected by the out-of-state LLC.

Example: Sales/use tax avoidance transaction

A Washington resident purchases a yacht in Antigua and does not pay sales tax. The Washington resident then forms a foreign LLC and contributes the yacht to the LLC in exchange for 100% of the LLC ownership interests. The Washington resident retains effective control over the yacht, and uses the yacht in Washington.

The Department will disregard the transaction and assess use tax against the Washington resident on the value of the yacht.

Safe harbor

This legislation will not be applied:

- For any period ending before May 1, 2010 if the transaction is included in a completed field audit;
- Where the tax was reported and paid in conformance with:
 1. Specific written instructions² provided by the department to the taxpayer, or
 2. A determination published under the authority of RCW 82.32.410, or
 3. Other documents made available by the Department to the general public; **and**
- Where the facts do not differ materially from the specific written instructions, published determination, or other document made available by the Department to the general public.

² **Specific written instructions** means tax reporting instructions provided to the taxpayer and which specifically identify the taxpayer to whom the instructions apply. The instructions may be provided as part of an audit, tax assessment, determination, closing agreement, or in response to a binding ruling request.

Penalties and interest

Any tax deficiency resulting from engaging in a disregarded transaction is subject to a penalty of thirty-five percent (35%). This penalty applies in addition to any other applicable penalties, except the evasion penalty of fifty percent (50%) provided in RCW 82.32.090.

The Department will not apply the penalty if, before the Department discovers it, the taxpayer discloses its participation in a disregarded transaction to the Department in writing.

For more information

To learn more about this legislation, visit our website at dor.wa.gov/newlegislation and click on tax avoidance. You may contact the Department by sending an email to communications@dor.wa.gov or by calling the Department's Telephone Information Center at 1-800-647-7706.



Washington State Legislature

Tax Avoidance Review Committee, Joint Full Committee

Thursday
September 20, 2010
1:30 p.m.

Senate Hearing Rm 2
J.A. Cherberg Building
Olympia, WA

Agenda:

1. Overview of the codification of common law economic substance doctrines at the state and federal levels.
 - Helen Hecht, *Federation of Tax Administrators*
2. Review of rule-making and implementation of tax avoidance provisions in 2ESSB 6143.
 - Gil Brewer and Drew Shirk, *Department of Revenue*
3. Review of framework for tax avoidance disputes.
 - Gil Brewer and Drew Shirk, *Department of Revenue*
4. Stakeholder and legislator feedback.
5. Description of process for closed meetings when confidential tax information may be discussed.
 - Rick Peterson, *Office of Program Research*
6. Identification of agenda for October meeting.

Members:

Senator Rockefeller
Senator Kline
Senator Zarelli

Representative Eddy
Representative Takko
Representative Orcutt

Alternates:

Senator Kohl-Welles
Senator Hewitt
Representative Hunter
Representative Condotta



Presentation for the
Washington Joint Tax Avoidance Review Committee

**Overview of the codification of the
common law economic substance
doctrine at the state and federal levels.**

By Helen Hecht, Tax Counsel
Federation of Tax Administrators

Introduction:

The Federation of Tax Administrators is a Washington, D.C. based membership organization made up of the state tax agencies from all 50 states, D.C. and New York City and certain other associate members.

The FTA monitors Congressional actions that may affect the state tax agencies and represents the interests of those agencies. It also provides the agencies with a means for working together on a number of projects including information sharing, electronic filing, research and training.



Summary of presentation:

This presentation is intended to provide an overview of the economic substance doctrine and to answer the following questions:

- What exactly is the economic substance doctrine?
- How does it interact with principles of statutory construction?
- How has that doctrine been applied at the federal level?
- What is the effect of the recent codification of the federal economic substance framework?
- How has the doctrine been applied at the state level, especially in the non-income tax area?
- Have other states codified the doctrine?



What exactly is the economic substance doctrine (ESD)?

- A judicially created doctrine – first applied by the federal courts.
 - Judicially created doctrines are different by nature from rules made by legislatures or tax agencies.
 - Because judicially created doctrines develop on a case-by-case basis, extra care must be taken in extrapolating the reasoning or result in one case to other cases, or in assuming that a result would differ just because the reasoning is slightly different.
 - Judicially created doctrines can generally be applied by administrative agencies as well as by courts.

- As the name implies – the ESD is concerned with substance, but it can be distinguished from other similar doctrines and principles that may also be concerned with substance, including the following:
 - Specific precedent-based common law rules –
 - Judicially created doctrines, sometimes very old, that govern how particular actions or circumstances may be characterized for legal purposes.
 - Examples – rules defining property (“real property” or “intangible property”), rules defining transactions (a “gift” or a “lease”), rules specifying the attributes of a particular arrangement (“joint venture,” “debtor-creditor” or “employee” relationship), etc.

 - Fraud (common law, civil, and criminal) –
 - Typically involves misrepresentation of a material fact with knowledge and intent to defraud another party. Tax fraud is typically prosecuted as a criminal matter (although civil type penalties may be imposed in some cases).
 - Example – filing fraudulent tax refund claims with fictitious names and addresses.



- “Sham transaction” doctrine –
 - Very closely related to the ESD (and to fraud). If the transaction is “made up” but there is insufficient proof of fraudulent intent, the tax agency might argue that the transaction is a sham and should be disregarded.
 - Example – calling a gift made to a relative a “loan” even though there was no intent that the gift would be repaid.

- “Step transaction” doctrine –
 - Also very similar to the ESC, but narrower. Allows a series of related transactions to be recast for tax purposes, where they are undertaken merely to avoid the tax that would otherwise be due. The court generally must find that the parties committed to undertake all the transactions, as part of a single plan, and there must generally be no non-tax purpose for the intervening steps.
 - Example – certain corporate reorganizations that would otherwise trigger gains if accomplished without also undertaking intermediate transactions.

- Anti-assignment doctrine –
 - Prevents one taxpayer from assigning earned income to another taxpayer for tax purposes.
 - Example – a father who has taxable income cannot avoid paying tax at his higher tax rate by assigning the income to a child, even if the assignment is legally binding.

- Imputation of income doctrine –
 - Allows tax to be applied to related-party transactions where the parties may not have designated any consideration to be paid but where benefits are otherwise given and received.
 - Example – constructive dividends.



- Arms-length pricing rules (statutory in many cases now)
 - Require that transactions between related-parties be priced at rates which would be applied to unrelated parties.
 - Example – transactions with foreign affiliates not part of the consolidated return.

- These doctrines tend to be narrower than the ESD and even where they overlap with the ESD, courts historically have tended to apply these doctrines first, rather than resorting to the more general ESD framework.

- Depending on the jurisdiction, the basic ESD framework involves the application of two tests – applied together or separately, which ask whether the transaction or arrangement in question:
 - Produces an economic effect or impact (apart from the tax effect), and/or.
 - Is undertaken for a non-tax purpose.

- What the ESD and all these other doctrines have in common is that they are all based on the recognition that, in the area of tax law, substance prevails over form (except when it doesn't).
 - In fact, *this is the crux of the issue – whether a particular tax rule intended to be form-driven or substance-driven?*
 - Opponents of the ESD criticize both tests – the economic effect test and non-tax purpose test. They defend transactions which are legally binding and properly executed, arguing that this is all the substance that tax rules should require. They also argue that the non-tax purpose test will preclude tax benefits which are intended to be provided to taxpayers who structure their activities a certain way. What these arguments assume, however, is that all tax rules are form driven, or that courts cannot properly distinguish between form-driven and substance-driven rules. This is an argument that courts have rejected for years, with the implicit approval of lawmakers.



How does the ESD interact with principles of statutory construction?

- The intersection of ESD and the rules of statutory construction is in the determination of legislative intent – particularly – whether a tax rule is intended to be form-driven or substance-driven.
 - The single over-arching goal of statutory construction is to give effect to legislative intent.
 - There are dozens of rules of statutory construction, but courts will be bound to follow the language of the statute unless it is ambiguous or conflicting or leads to an absurd result.
 - In giving effect to statutory language, however, a court will generally not take a strictly literal or “textualist” view of statutes without considering if this is a reasonable view in light of the context and the apparent legislative purpose.

- One of the first cases to apply the substance-over-form doctrine in a tax case was *Gregory v. Helvering* –
 - In which the U.S. Supreme Court found that a tax rule designed to allow a tax-free business reorganization was obviously intended to be applied only where a taxpayer had a business purpose for the reorganization and not where the reorganization was done solely as a “device” to avoid taxes. To hold otherwise, the court concluded, would be an absurd result and not in accordance with Congressional intent.

- An informal (non-scientific) survey of the treatment of different tax rules reveals some differences in attributes between form-driven and substance-driven rules.
 - Attributes of form-driven rules
 - Few operative terms
 - Terms are clear and definite
 - May appear somewhat arbitrary or the purpose may not be apparent from the rule itself



- Are they type of rule that historically has been applied strictly
 - Generally do not require extensive administrative regulations or explanations.
 - Examples:
 - Statute of limitations on refund claims
 - Interest imposed on over/underpayments
 - Certain filing elections
 - Other rules which specify a particular form
 - Attributes of substance-driven rules
 - May have more operative terms
 - Terms may be less clear and definite
 - Will often appear to be less arbitrary, more rational
 - Generally require more administrative regulations and explanations
 - Examples
 - General business expense deductions
 - Charitable gift deductions
 - Treatment of a worker as an employee
 - Rules that do not specify a particular form
- One tax rule can be made up of form-driven and substance-driven parts. Example, a deduction for “the value of charitable gifts made to organizations granted status as 501(c)(3) organizations under the Internal Revenue Code,” has both form and substance-driven parts.
- It is not accurate to imply that the distinction between form-driven or substance driven rules is always easy or that there are not transactions that fall somewhere in between.
 - Example – IRC Section 1031 exchanges – which allow deferral of taxable gains if property is exchanged for other property in a particular way. Here, it could be argued, that both form and substance are important and it would be incorrect to assume that transactions which do not follow the required form lack substance. It is merely that in addition to having substance, the transactions must also, and probably more importantly, follow a particular form.



How has the ESD been applied at the federal level?

- As noted above, the doctrine itself has evolved to contain two parts – sometimes applied together and sometimes applied separately.
 - The transaction or arrangement must have actual substantive economic effect on the parties, and/or
 - The transaction or arrangement must be undertaken for a non-tax purpose.
- The number of cases has grown over the years as has the complexity in these cases. That complexity has been increased due to:
 - The nature of the federal income tax – which is an extremely complicated tax (especially when compared to most state taxes), and includes very targeted tax incentives and special deductions;
 - The use of exotic transactions in tax planning;
 - The use of foreign entities in tax planning;
 - The use of multiple transactions, undertaken over an extended period of time;
 - The involvement of tax professionals in the creation and marketing of tax strategies; and
 - Activity by the IRS in designating tax planning strategies as “listed transactions” or tax shelters and the application of penalties to these transactions. (So that it is not only necessary for courts to determine if the transaction lacks economic substance, but also whether it is the same or similar to a listed transaction.)
- It does not appear feasible for Congress or the IRS to act to shut down every possible tax planning strategy where non-substantive arrangements are undertaken to skirt the tax law. Instead, there is a clear need at the federal level for the ESD.



What is the effect of the recent codification of the federal doctrine?

- First, it should be noted, the federal law imposes new mandatory penalties for engaging in transactions that lack economic substance. This may be as important as the codification of the doctrine itself.
- The codification of the EDS is found in IRC 7701(o) (new section) contains the following formulation of the test:
 - In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if—
 - the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position, and
 - the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.”
 - Furthermore, the potential for pretax profits is the primary indicator of substance.
- *Critically, the law does not specify which transactions the codified ESD will apply to—leaving this important determination to the courts.* The comments on the bill by the Joint Committee on Taxation make clear that transactions which have long been held to be permissible, even though they are chosen for tax purposes (i.e. form-driven rules), are not effected by the codification of the ESD.
- Also, in evaluating whether the transaction has an economic effect or is undertaken for a non-tax purpose, state taxes are to be treated in the same manner as federal taxes.
- The codified ESD applies only to activities of the type which are entered into to produce revenue and would therefore not apply to charitable gifts or to the estate tax (when and if there is one).



How has the ESD been applied by state courts, especially in the non-income tax area?

- The most common application of the ESD at the state level is in the corporate income tax area. Many states have adopted statutory rules which give authority to the tax agency to cure “distortion” in reported corporate income where the reported income does not fairly reflect income derived from the state. (Example, UDITPA Section 18 authority.) Therefore, the ESD has a natural fit in this area. (A few states lack this authority and the result in those states may be that courts are reluctant to apply the ESD in cases in those states.)
- While examples of the use of the ESD in the state income tax area are becoming more and more plentiful, examples of the application of the ESD in non-income tax cases are rare for a number of reasons:
 - Non-income taxes are typically much simpler.
 - Non-income taxes are often somewhat more form-driven.
 - Taxpayers may not have incentives to plan around less costly excise taxes or taxes which they merely pass on to their customer.
 - There may be limited ways to plan around simpler excise taxes.
 - Courts may be able to resolve the issue by applying specific precedent-based rules or other tax doctrines without resorting to ESD.
- Examples, however, can sometimes be found, including the following recent matters involving sales and use taxes:
 - Indiana Department of Revenue Letter of Findings 10-0111 – holding that the use and storage of an RV in the state was not affected by the fact that the purchasers had used an out-of-state LLC to take title to the RV.
 - Indiana Department of Revenue Letter of Findings 08-0656 – holding that an arrangement between two affiliated entities



lacked the necessary substance to qualify for a sales tax public transportation exemption.

- Texas Comptroller Public Ruling 09022523, August 6, 2009 – ruling that a transaction involving use tax must be found by the agency to have economic substance and citing authority under Texas case law.



- New York Tax Appeals Tribunal Determination DTA No. 821342 – holding that the ESD was not relevant where a statute applied tax to entities doing business in the state and the entity in question was simply not doing business in the state.
- Tennessee Court of Appeals – *CAO Holdings Inc. v. Chumley* – holding that a sale for resale (or in this case, re-lease) exemption applies so long as the requirements of the statute are satisfied and that since it is not required under the exemption that the lessor give up beneficial use of the item resold, an ESD argument based on this fact is irrelevant. (Similar to a recent Washington case.)
- Florida Department of Revenue Technical Assistance Advisement 03A-002 – holding that certain payments made to a landlord but treated as non-taxable payments for intangibles must reflect economic substance and citing state case law.
- Illinois Appeals Court, *JJ Aviation, Inc. v. Department of Revenue* – holding that the Department had incorrectly elevated *form* of a transaction over its substance when applying an isolated and occasional sales exemption citing a prior case for the proposition that the Department “should not hold a taxpayer to the technical form of its transactions” in situations where there will never be conflicting claims (that is, claims asserting substance over form).



Have other states codified the doctrine?

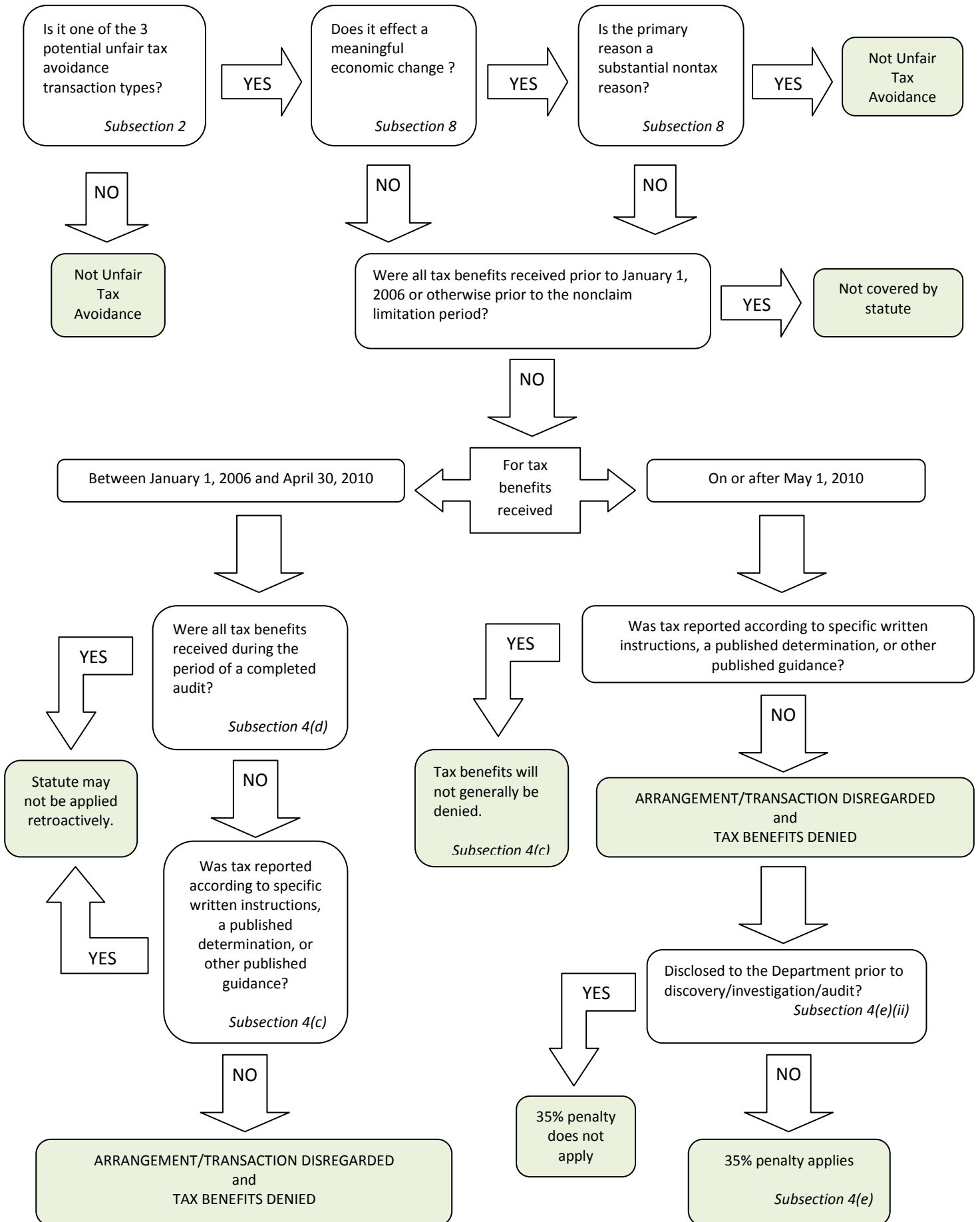
Yes, including the following:

- Alabama – requiring substantial business purpose and economic substance to avoid having to add back inter-company transactions.
- Massachusetts – to make clear that the taxpayer must prove economic substance that that the transaction must have a purpose other than tax avoidance.
- California – for the purpose of imposing additional penalties only (otherwise relying on the common law doctrine).
- Ohio – defining “sham transactions” as those without economic substance.
- Oregon – for the purpose of certain transactions involving real estate investment trusts.
- Wisconsin – defining economic substance as a meaningful change in economic position apart from any tax effects and requiring a non-tax purpose and a showing that the transaction is a reasonable means to accomplish the purpose.



Draft Tax Avoidance Rule Flow Chart

Department of Revenue



Draft Tax Avoidance Rule

Department of Revenue

1. Introduction.

(a) Purpose of the section. This section implements sections 201 through 203 of 2ESSB 6143 (ch. 23, 1st Sp. Sess, Laws 2010), effective May 1, 2010. The legislation and this section address certain specific transactions or arrangements that are designed to unfairly avoid taxes, and prescribe specific remedial actions to be taken by the department in such cases. The legislation and this section do not apply to any other remedies available by statute or common law, as these remedies are expressly preserved by the legislation.

(b) Section examples. This section includes a number of examples that identify a set of facts and then state a conclusion. The examples should be used only as a general guide. Each taxpayer's case will be evaluated based on its particular facts and circumstances.

(c) Definitions.

(i) "Potential tax avoidance" means an arrangement or transaction that meets the elements of an arrangement or transaction described in subsection 2.

(ii) "Unfair tax avoidance" means an arrangement or transaction that meets the elements of an arrangement or transaction described in subsection 2, and that is determined under all the facts and circumstances to be unfair tax avoidance based on the factors identified in subsection 3.

(iii) For purposes of this section, "specific written instructions" means tax reporting instructions that address an arrangement or transaction and specifically identify the taxpayer to whom the instructions apply. Specific written instructions may be provided as part of an audit, tax assessment, determination, closing agreement, or in response to a binding ruling request.

2. What arrangements or transactions are specifically identified as potential tax avoidance? Under RCW 82.32.655, the following arrangements or transactions are specifically identified as potential tax avoidance:

(a) Certain construction ventures. Arrangements that are, in form, a joint venture or similar arrangement between a construction contractor and the owner or developer of a construction project but that are, in substance, substantially guaranteed payments for the purchase of construction services and that are characterized by a failure of the parties' agreement to provide for the contractor to share substantial profits and bear significant risk of loss in the venture. See subsection 5 for more information.

(b) Redirecting income. Arrangements through which a taxpayer attempts to avoid B&O tax by disguising income received, or otherwise avoiding tax on income, from a person that is not affiliated with the taxpayer from business activities that would be taxable in Washington by moving that income to another entity that would not be taxable in Washington. See subsection 6 for more information.

(c) Property ownership by controlled entity. Arrangements through which a taxpayer attempts to avoid retail sales or use tax by engaging in a transaction to disguise its purchase or use of tangible personal property by vesting legal title or other ownership interest in another entity over which the taxpayer exercises control in such a manner as to effectively retain control of the tangible personal property. See subsection 7 for more information.

3. When is a specifically identified arrangement or transaction unfair tax avoidance? The department may evaluate any or all of the following factors to determine if an arrangement or transaction that is specifically identified in subsection 2 is unfair tax avoidance:

(a) Whether an arrangement or transaction changes in a meaningful way, apart from its tax effects, the economic positions of the participants in the arrangement when considered as a whole;

(b) Whether substantial nontax reasons exist for entering into an arrangement or transaction;

(c) Whether an arrangement or transaction is a reasonable means of accomplishing a substantial nontax purpose;

(d) An entity's relative contributions to the work that generates income;

(e) The location where work is performed; and

(f) Other relevant factors.

Subsection 8 provides additional information on these factors.

4. What is the result of an unfair tax avoidance transaction?

(a) Disregard the form. The department must disregard the form of an unfair tax avoidance arrangement or transaction and deny any tax benefits arising from that form. The department will assess tax according to the substance of the arrangement or transaction.

(b) Retroactive application. Subsection 4(a) applies to tax periods beginning January 1, 2006 and thereafter, except as provided in subsections 4(c) and 4(d), below. The department must disregard unfair tax avoidance arrangements or transactions and deny any tax benefits received on or after January 1, 2006. For purposes of this section, Business and Occupation (B&O) tax benefits are received by the taxpayer on the date the taxpayer avoided receipt of income or received disguised income; use and retail sales tax benefits are received on the date the tax would be due in the absence of unfair tax avoidance.

(c) Written instructions. The department may not disregard the form or deny the tax benefits of any arrangement or transaction initiated before May 1, 2010 if, with respect to such

arrangement or transaction, the taxpayer reported its tax liability in conformance with specific written instructions, a determination published under the authority of RCW 82.32.410, or other document made available by the department to the general public, when the instructions, determination, or other document was provided or published prior to May 1, 2010. This exception will be strictly construed, and does not apply if:

(i) the arrangement or transaction engaged differs materially from the arrangement or transaction that was addressed in the specific written instructions, published determination, or other document made available by the department to the general public;

(ii) the specific written instructions addressing the arrangement or transaction were issued by the department in reliance on a material misstatement of fact or a material omission of the taxpayer; or

(iii) the specific written instructions address only certain specific elements related to the tax avoidance arrangement or transaction, rather than all or substantially all of the elements or the arrangement or transaction as a whole.

(d) Completed Field Audits. Subsection 4(a) does not apply to any tax periods ending before May 1, 2010 that were included in a completed field audit conducted by the department. A field audit is complete when closed by the department. An arrangement or transaction is included in a field audit if the field audit covers the same tax type (e.g., sales, use, business and occupation) as the tax benefit obtained from the arrangement or transaction. However, an audit will not be deemed to contain specific written instructions addressing an arrangement or transaction based solely on the tax type covered by the audit.

EXAMPLE 1. A taxpayer identifying itself and disclosing all relevant facts, obtains a letter ruling from the department on an arrangement that constitutes unfair tax avoidance under this section. In its letter ruling, dated December 31, 2005, the department approves the arrangement as presented and does not rule that the arrangement must be disregarded or the tax benefits denied. The taxpayer's arrangement does not materially differ from the arrangement addressed in the letter ruling, and the taxpayer reports its tax liability in accordance with the letter ruling. The department will not disregard or deny the tax benefits of the arrangement.

EXAMPLE 2. A taxpayer engages in an arrangement that constitutes unfair tax avoidance under this section. The first step in the transaction was initiated on December 31, 2005. The final step in the arrangement was completed on January 31, 2006. The taxpayer does not report its tax liability in conformance with specific written instructions provided by the department, a published determination, or any other document made available to the public by the department. The department must disregard the tax benefits of the unfair tax avoidance arrangement to the extent received on or after January 1, 2006.

EXAMPLE 3. The department conducts a field audit of a taxpayer for the period January 1, 2004 through December 31, 2008. The taxpayer has engaged in an arrangement that constitutes unfair tax avoidance under this section since January 1, 2007. In specific written instructions, the audit approves the arrangement and does not determine that the arrangement must be disregarded or the tax benefits denied. For all periods subsequent to the audit period, the taxpayer's arrangement does not materially differ from the arrangement addressed in the audit, and the taxpayer reports its tax liability in accordance with the specific written instructions. The department will not disregard the form of the arrangement or deny the tax benefits received through December 31, 2008 because those periods are covered by a completed audit. The department will not disregard the form of the arrangement or deny the tax benefits received on or after January 1, 2009 because the taxpayer is reporting in accordance with specific written and unrevoked instructions.

EXAMPLE 4. Assume the same facts as Example 3, except the taxpayer did not receive any specific written instructions. The department will not disregard the form or deny the tax benefits of the arrangement to the extent received during the audit period. The department must disregard the form and deny the tax benefits of the arrangement to the extent received after the audit period (on or after January 1, 2009).

(e) Penalty. Except as otherwise provided, the department must assess a penalty of thirty-five percent (35%) on the portion of any assessment resulting from the disregard of an unfair tax avoidance arrangement or transaction and the denial of tax benefits.

(i) Not retroactive. The 35% assessment penalty is not retroactive. The department will not apply the penalty to any portion of an assessment that results from tax benefits received prior to May 1, 2010 and denied under this section.

(ii) Penalty safe harbor. The department will not apply the tax avoidance penalty if the taxpayer discloses its participation in the tax avoidance arrangement or transaction to the department before the department discovers the taxpayer's participation or provides notice of an investigation or audit, whichever is earlier.

(A) Disclosure requirements. The disclosure must be in writing, it must identify the taxpayer, and it must either specifically request a ruling on whether an arrangement or transaction is unfair tax avoidance in fact, or it must provide sufficient information to allow the department to reasonably determine whether the arrangement or transaction or unfair tax avoidance in fact.

(B) Discovery. The department discovers a taxpayer's participation in an unfair tax avoidance arrangement when the department obtains any evidence of the participation from any source.

(C) Notice. The department provides notice of an investigation or audit when it provides either oral or written notice to the taxpayer of the investigation or audit, regardless of whether

the audit covers the same tax type (e.g., sales, use, business and occupation) as the tax benefit obtained from the unfair tax avoidance arrangement or transaction. Notice of an investigation or audit only precludes a taxpayer from qualifying for the safe harbor until the investigation or audit is concluded.

EXAMPLE 5. On or after May 1, 2010, A taxpayer identifying itself requests a letter ruling on its participation in an arrangement that constitutes unfair tax avoidance under this section. The taxpayer specifically requests that the department determine whether the arrangement is a potential or unfair tax avoidance arrangement and provides all information requested by the department. As of the date the letter ruling request is received by the department, the department has not discovered the taxpayer's participation in the arrangement and has not notified the taxpayer of an intent to investigate or audit. If the department subsequently disregards the arrangement and denies the tax benefits, the department will not apply the 35% avoidance penalty to any resulting assessment.

EXAMPLE 6. Assume the same facts as in Example 5, but the taxpayer does not specifically request that the department determine whether the arrangement is a potential or unfair tax avoidance arrangement. However, the taxpayer provides sufficient information for the department to reasonably determine whether the arrangement is a potential or unfair tax avoidance arrangement. If the department subsequently disregards the arrangement and denies the tax benefits, the department will not apply the 35% avoidance penalty to any resulting assessment.

EXAMPLE 7. Assume the same facts as Example 6, but the taxpayer only requests a ruling on specific elements related to the tax avoidance arrangement, not the tax avoidance arrangement as a whole. The ruling request therefore does not contain information sufficient for the department to reasonably determine whether the arrangement is a potential or unfair tax avoidance arrangement. If the department subsequently disregards the arrangement and denies the tax benefits, the department must apply the 35% avoidance penalty to any resulting assessment.

EXAMPLE 8. A taxpayer engages in an arrangement or transaction from January 1, 2005 through December 31, 2010. Assume the arrangement constitutes an unfair tax avoidance arrangement under this section. The taxpayer does not disclose the arrangement to the department in conformance with subsection (4)(e)(ii). If the department subsequently disregards the arrangement and denies the tax benefits, it must do so retroactively back to January 1, 2006. The department must also apply the 35% avoidance penalty, but only to the portion of the assessment that results from tax benefits received on or after May 1, 2010 and denied under this section.

EXAMPLE 9. A construction contractor forms a joint venture with a developer. The formation date of the venture is January 1, 2006. The venture winds up its business and dissolves on April 30, 2010. Assume the joint venture constitutes an unfair tax avoidance arrangement under this section, and that the taxpayer did not report its tax liability in

conformance with any written authority identified in subsection 4(c) above. If the department subsequently disregards the arrangement and denies the tax benefits, it must do so retroactively back to January 1, 2006. The department will not assess the 35% avoidance penalty because no part of the arrangement or transaction occurred on or after May 1, 2010.

5. When is a construction venture a potential tax avoidance arrangement or transaction?

(a) **Required Elements.** A construction venture is a potential tax avoidance arrangement or transaction only when it:

- (i) Is in the form of a joint venture or similar arrangement;
- (ii) Provides any substantially guaranteed payments to a construction contractor;
- (iii) Does not provide the contractor with a substantial share of the profits; and
- (iv) Does not require the contractor to bear significant risks of the venture.

The construction venture is unfair tax avoidance only if it meets all four of these elements and is also determined to be unfair tax avoidance under subsection 8. If the construction venture does not meet all four of these elements, then it is not potential tax avoidance and cannot be unfair tax avoidance.

(b) **Form of the arrangement.** The arrangement may be in the form of a joint venture, partnership, limited liability company, or similar arrangement between a construction contractor and an owner or developer, and may include additional participants. A construction contractor includes, without limitation, a construction manager, or general, prime, or sub-contractor. An owner or developer includes, without limitation, a landowner or project or construction manager. An arrangement that fails to meet all elements of a joint venture at common law may still be an arrangement that is similar to a joint venture under this subsection.

(c) **Substantially guaranteed payments.** A “substantially guaranteed payment” does not include a distribution of income earned by the venture in the ordinary course of the venture’s business to which the payee’s contributed property and/or services relate, unless the distribution is guaranteed by any person. The fact that a payment reduces the payee’s capital account, or that an operating agreement or other instrument identifies the payment as something other than a guaranteed payment under IRC §707(c) are not determinative.

EXAMPLE 10. A construction contractor and a developer create a joint venture for the purpose of constructing a house to be sold after completion. The joint venture agreement requires the developer to contribute land to the joint venture, and the construction contractor to contribute the labor and materials to build the house. All contributions and distributions are reflected in adjustments to the parties’ capital accounts. Under the joint venture agreement,

the venture will sell the house upon completion and distribute the proceeds or share the losses equally. Distributions to the construction contractor upon the sale of the house are not substantially guaranteed payments. The venture does not meet all elements of a potential tax avoidance arrangement or transaction and therefore is not unfair tax avoidance.

EXAMPLE 11. Assume the same facts as in Example 10, but the construction contractor is entitled to receive distributions during construction of the house. However, the only funds available to make the distributions are those contributed to the venture by the developer. Under this arrangement, distributions to the construction contractor are substantially guaranteed because the payments are made from contributions, not from income earned by the venture in the ordinary course of its business to which the construction contractor's contributed services relate. The venture meets the first two elements of a potential tax avoidance arrangement or transaction in subsection 5(a). If it meets the other two elements, then the venture is a potential tax avoidance arrangement or transaction. If the venture is a potential tax avoidance arrangement or transaction and the taxpayer is unable to prove the factors identified in subsection 8(b) (meaningful economic change and substantial nontax purpose), the venture will be considered unfair tax avoidance.

EXAMPLE 12. Assume the same facts as in Example 10, but the agreement provides that the venture may make periodic distributions to one or both members, upon the request of any member and upon approval of the manager. These distributions are to be made from income earned by the joint venture through the sale of houses previously completed by the same venture and venture members. Under this arrangement the distributions are not guaranteed payments, because they are made from income earned in the ordinary course of business to which the construction contractor's property and/or service contributions relate. The venture does not meet all elements of a potential tax avoidance arrangement or transaction and is therefore not unfair tax avoidance.

EXAMPLE 13. Assume the same facts as in Example 10, but the agreement provides that the venture will obtain a bank construction loan and will use the construction draws to periodically pay down the construction contractor's capital account. The agreement also states that the payments to the construction contractor are not guaranteed payments under IRC §707(c). Under this arrangement, the payments to the construction contractor are substantially guaranteed because the payments are made from loan proceeds, not from income earned by the venture in the ordinary course of its business to which the construction contractor's contributed services relate. The venture meets the first two elements of a potential tax avoidance arrangement or transaction in subsection 5(a). If it meets the other two elements, then the venture is a potential tax avoidance arrangement or transaction. If the venture is a potential tax avoidance arrangement or transaction and the taxpayer is unable to prove the factors identified in subsection 8(b) (meaningful economic change and substantial nontax purpose), the venture will be considered unfair tax avoidance.

EXAMPLE 14. Assume the same facts as in Example 12, except that if any distribution is not paid in full within 30 days of the request, the requesting member has the right to require a buy-

out by the company (a “put option”). The purchase price for the put option is the full remaining value of the requesting member’s capital account, plus interest at 12% per annum. The agreement requires the remaining member to guarantee the company’s payment obligation under the option. In this example, payments to the construction contractor are substantially guaranteed because although the payments are made from income earned in the ordinary course of business to which the construction contractor’s contributions relate, the construction contractor has the right to receive these payments on demand, backed by a put option guaranteed by the other member. The venture meets the first two elements of a potential tax avoidance arrangement or transaction in subsection 5(a). If it meets the other two elements, then the venture is a potential tax avoidance arrangement or transaction. If the venture is a potential tax avoidance arrangement or transaction and the taxpayer is unable to prove the factors identified in subsection 8(b) (meaningful economic change and substantial nontax purpose), the venture will be considered unfair tax avoidance. See example 17.

(d) Profits and risks. “Substantial profits” and “significant risk of loss” are determined based on all the facts and circumstances, including without limitation:

- (i) the value of income or other compensation received in relation to the value of property or services provided;
- (ii) the real value of any rights to income or profit considering limitations, risk, security, control, or other relevant issues; and
- (iii) the likelihood and extent of any risk of loss;

EXAMPLE 15. Assume the same facts as in Example 13. The agreed value of the construction contractor’s contribution is the costs for materials and subcontractor labor, plus a nominal overhead amount. After the house is sold and expenses of the venture paid, the joint venture agreement provides that the developer is to receive a preferred distribution of an amount equal to the value of the land contributed as of the distribution date. All remaining profits and losses of the venture are divided equally between the construction contractor and the developer. In this example, although the periodic distributions to the construction contractor are substantially guaranteed payments, the contractor is entitled to a substantial share of the profits and bears a significant risk of loss in the venture. This is not a potential tax avoidance transaction.

EXAMPLE 16. Assume the same facts as in Example 13. The agreed value of the construction contractor’s contribution is the costs for materials and subcontractor labor, the contractor’s customary overhead and profit percentage. After the house is sold and expenses of the venture paid, the contractor is entitled to a nominal share of the profits of the venture. The remaining profits are distributed 100% to the developer. In this example, the payments to the construction contractor are substantially guaranteed. In addition, the contractor is not entitled to a substantial share of the profits in excess of amounts a construction contractor is typically paid for construction services. The venture meets three of the elements of a potential

tax avoidance arrangement or transaction in subsection 5(a). If it meets the last element, then the venture is a potential tax avoidance arrangement or transaction. If the venture is a potential tax avoidance arrangement or transaction and the taxpayer is unable to prove the factors identified in subsection 8(b) (meaningful economic change and substantial nontax purpose), the venture will be considered unfair tax avoidance.

EXAMPLE 17. Assume the same facts as in Example 14. The contractor member does not bear significant risk of loss in the venture, due to the developer's guarantee and because the contractor's risk of loss is not significantly greater than under an ordinary construction contract. The venture meets three of the elements of a potential tax avoidance arrangement or transaction in subsection 5(a). If it meets the last element, then the venture is a potential tax avoidance arrangement or transaction. If the venture is a potential tax avoidance arrangement or transaction and the taxpayer is unable to prove the factors identified in subsection 8(b)(meaningful economic change and substantial nontax purpose), the venture will be considered unfair tax avoidance.

(e) Other department authority. Nothing in this section affects the application of WAC 458-20-170 or other department published guidance involving construction contractors or construction joint ventures. Therefore, an arrangement or transaction may be considered the sale of construction services under WAC 458-20-170 or other guidance, irrespective of whether the arrangement or transaction is a potential or unfair tax avoidance under this section.

(6) When is redirecting income a potential tax avoidance arrangement or transaction?

(a) Definitions.

(i) "Affiliated" means under common control.

(ii) "Control" means the possession, directly or indirectly, of more than fifty percent of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting shares, by contract, or otherwise.

(iii) "Moving" or "moves" income is any act by any person that ensures that income from a person not affiliated with the taxpayer is received by an entity that is not taxable in Washington on that income. It includes, without limitation, an assignment, the transfer, lease, or license of income-producing assets, the sale or provision of goods or services that are not at arm's length, or other mechanisms to redirect income.

(b) Required elements. Redirecting income is a potential tax avoidance arrangement or transaction only when the income:

(i) arises from business activities that would be taxable in Washington but for the arrangement or transaction that moves the income to an entity that is not taxable in Washington on that income; and

(ii) is ultimately derived from a person that is not affiliated with the taxpayer.

The redirecting income transaction or arrangement may be unfair tax avoidance only if it meets both of these elements and is also determined to be unfair tax avoidance under subsection 8. Whether the income is actually received by the taxpayer is not relevant.

EXAMPLE 18. A Washington company (“Parent”) forms a wholly-owned limited liability company in Nevada (“Subsidiary”). Subsidiary has one part-time employee in Nevada, renting shared office space, and the same corporate officers as Parent. Parent causes Subsidiary to enter into sales and service contracts with customers both within and without Washington for the sale of intangible personal property and consulting services. Subsidiary hires Parent to provide all services necessary to create and support the intangible personal property, and to provide the consulting services to Subsidiary’s customers. Subsidiary pays Parent a nominal amount for these services. Subsidiary transfers its remaining profits to Parent through ownership distributions. This arrangement is a potential tax avoidance transaction because the arrangement ensures that income received from customers for the services performed by Parent, which income would otherwise be taxable in Washington, is received by Subsidiary, not Parent. If the arrangement does not meet the requirements under subsection 8(b) (meaningful economic change and substantial nontax purpose), it may be considered unfair tax avoidance.

EXAMPLE 19. A Delaware S-corporation (“Parent”) is the sole owner of a Washington S-corporation (“Subsidiary”). Parent’s only employees are its corporate officers, who are also corporate officers or board members of Subsidiary. Parent engages in the sale of tangible personal property to customers both within and without Washington. Parent hires Subsidiary to manufacture the tangible personal property for a nominal amount per unit. The amount does not cover Subsidiary’s operating costs. Parent makes ownership contributions or loans to Subsidiary in the amount necessary to allow Subsidiary to meet its costs. This arrangement is a potential tax avoidance transaction. If the arrangement does not meet the requirements under subsection 8(b) (meaningful economic change and substantial nontax purpose), it may be considered unfair tax avoidance.

EXAMPLE 20. A Washington company (“Parent”) forms unlimited separate wholly-owned Nevada subsidiaries (“S-1,” “S-2,” “S-3,” etc.). Parent, as agent of the Nevada subsidiaries, enters into contracts with customers for services to be provided both within and without Washington. Parent enters into a maximum of ten agreements per subsidiary. Each Subsidiary hires Parent to provide all services necessary for the Subsidiary to meet its contract obligations. Each Subsidiary pays Parent only a nominal amount for these services. Each subsidiary transfers its remaining profits to Parent through ownership distributions. This arrangement is a potential tax avoidance transaction because the arrangement ensures that income received from customers for the services performed by Parent, which income would otherwise be taxable in Washington, is received the Subsidiaries. The arrangement further ensures that each subsidiary does not meet minimum nexus standards. If the arrangement does not meet the requirements under subsection 8(b) (meaningful economic change and substantial nontax purpose), it may be considered unfair tax avoidance.

(7) When is property ownership by a controlled entity a potential tax avoidance arrangement?

(a) Required elements. All three of the following elements must be met for property ownership by a controlled entity to be a potential tax avoidance arrangement:

- (i) The taxpayer has control over the entity owning the tangible personal property;
- (ii) The taxpayer effectively controls the tangible personal property; and
- (iii) The tangible personal property is either:

(A) Purchased in Washington by an entity, without payment of Washington retail sales or use tax on its full value and used by the taxpayer as a consumer; or

(B) Owned by an entity and used in Washington, without payment of Washington retail sales or use tax on its full value and used by the taxpayer as a consumer.

The arrangement or transaction may be unfair tax avoidance only if it meets all three of these elements and is also determined to be unfair tax avoidance under subsection 8.

(b) Control of the entity. A taxpayer is presumed to have control over an entity when the taxpayer possesses fifty percent or more of the voting power or the power to direct or cause the direction of the management and policies of the entity, whether through ownership, by contract, or otherwise. A taxpayer's total percentage of voting or management authority over an entity includes the voting or management authority held by, or for the benefit of:

(i) the taxpayers' parent, subsidiary, or affiliate under common control, and where the person is an individual, such person's spouse, parent, sibling, child, or grandchild; and

(ii) any other persons with whom the taxpayer acts in concert, collectively possessing fifty percent or more of the voting power or power to direct or cause the direction of the management and policies of the entity.

(c) Effective control of tangible personal property. A person is presumed to have effective control over the tangible personal property when the person has control over the entity.

(d) Sales and use tax exemptions. If property ownership by an entity is determined to be unfair tax avoidance under this section, the department will disregard the entity and for the purpose of determining whether any retail sales or use tax exemptions apply, attribute ownership to any person or persons with effective control over tangible personal property. *See, e.g., WAC 458-20-238 (use of watercraft by nonresidents).*

EXAMPLE 21. A Washington resident taxpayer forms a wholly-owned Montana limited liability company (MT, LLC). The Washington resident causes MT, LLC to obtain a new motorhome, purchased and registered in Montana. MT, LLC pays no retail sales tax on the purchase. The Washington resident stores the motorhome in Washington and uses it in Washington without paying use tax. This is a potential tax avoidance arrangement. The motorhome is owned by an entity and used in Washington by the taxpayer. The taxpayer has complete control over MT, LLC and effective control over the motorhome. If the taxpayer is unable to prove the factors identified in subsection 8(b) (meaningful economic change and substantial nontax purpose), the arrangement will be considered unfair tax avoidance.

EXAMPLE 22. Assume the same facts as Example 21, but MT, LLC is owned by a husband and wife, with each having a fifty percent ownership interest. This is a potential tax avoidance transaction. Because either spouse's ownership interest in MT, LLC may be attributable to the other, both spouses have effective control over the motorhome. If the taxpayers are unable to prove the factors identified in subsection 8(b) (meaningful economic change and substantial nontax purpose), the arrangement will be considered unfair tax avoidance.

EXAMPLE 23. A Washington resident, and two Oregon residents form an Oregon limited liability company (the "Company"), each having a one-third ownership interest. The owners cause the Company to purchase an aircraft in Oregon. No retail sales or use tax is paid. The Company operating agreement establishes the schedule of use for the owners and all rules for use that each owner must follow. The schedule and rules may not be changed except by unanimous approval of the owners. The Washington resident uses the aircraft in Washington during his scheduled use time, without paying use tax. This is a potential tax avoidance arrangement. The Washington resident acts in concert with the other owners and is presumed to have control over the entity and control over the aircraft. If the Washington resident is unable to rebut these presumptions, then the arrangement will be deemed a potential tax avoidance transaction. If the Washington resident is unable to prove the factors identified in subsection 8(b) (meaningful economic change and substantial nontax purpose), the arrangement will be considered unfair tax avoidance.

(8) How are the factors applied?

(a) Relevant factors. All relevant factors listed in subsection 3 may be part of the analysis of whether the arrangement or transaction has substance to be respected for tax purposes. The factors are interrelated inquiries, not a multi-factor test. To the extent relevant, the department may consider evidence of a taxpayer's actual subjective intent, but the department is not required to prove that tax avoidance was the subjective intent of any particular arrangement or transaction.

(b) Burden of proof. The taxpayer bears the burden of proving that an arrangement or transaction is not unfair tax avoidance, including that:

(i) The arrangement or transaction changes in a meaningful way, apart from its tax effects, the economic positions of the participants in the arrangement when considered as a whole; and

(ii) A substantial nontax reason is the primary reason for entering into the arrangement or transaction.

(9) When does an arrangement or transaction change in a meaningful way, apart from its tax effects, the economic positions of the participants in the arrangement when considered as a whole?

(a) Whole transaction. In evaluating any change to the economic positions of the participants, the department considers all facts and circumstances relevant to the individual economic position of each participant in the arrangement or transaction as a whole.

(b) Meaningful change defined. Meaningful change in economic position means a real and substantial increase in profit or profit potential, or reduction in risk or loss, between the form of the arrangement or transaction chosen by the taxpayer and its substance. If there is no meaningful difference in the economic position of the participants under the two alternatives, the department may treat the taxpayer's arrangement or transaction as unfair tax avoidance.

(c) Actual Substance. The department may consider the substance of the arrangement or transaction chosen by the taxpayer to be:

(i) For transactions or arrangements described in subsection 2(a), a sale of construction services from the construction contractor to the developer or owner.

(ii) For transactions or arrangements described in subsection 2(b), a sale of property or services by the Washington participant to a person that is not affiliated with the taxpayer.

(iii) For transactions or arrangements described in subsection 2(c), direct ownership of the tangible personal property by the user.

(d) De minimis effects insufficient. De minimis economic effects, such as accumulating small amounts of cash or avoiding marginal risks are not considered a substantial change in economic position.

(e) Safe harbors.

(i) Certain redirected Income. A potential tax avoidance arrangement or transaction described in subsection 2(b) is presumed to effect a meaningful change in the economic positions of the participants where each participant is a substantive operating business that is adequately capitalized and that carries on substantial business activities using its own property or employees.

(ii) Certain leasing activities. A potential tax avoidance arrangement or transaction described in subsection 2(c) that includes a leasing arrangement is presumed to effect a meaningful change in the economic positions of the participants when the lessee:

(A) is a substantive operating business that is adequately capitalized and that carries on substantial business activities using its own property or employees; and

(B) pays use tax on the fair market lease value of the tangible personal property when used in Washington.

EXAMPLE 24. A Washington business (Washco, Inc.) owns a copyright that generates royalty income under a variety of licensing agreements with unrelated, out-of-state persons. Washco, Inc. contributes the copyright to a newly formed Delaware subsidiary, Newco, LLC, in exchange for 100% of the ownership interests. Washco, Inc. also assigns all its rights in the licensing to agreements to Newco, LLC. Newco, LLC contracts with Washco, Inc. for management and administration services, which covers all activities necessary to manage Newco, LLC, to service the licensing agreements, and to handle all activities necessary to protect the copyrights. Newco, LLC pays Washco, Inc. a nominal amount, based on a percentage of the total royalty income. Newco, LLC makes regular tax exempt distributions of profits to its parent, Washco, Inc. This is an unfair tax avoidance arrangement because there is no meaningful change in economic position to Washco, Inc. under this arrangement than if Washco, Inc. retained ownership of the copyright and contracted directly with the licensees.

EXAMPLE 25. An individual that resides in Washington forms two wholly-owned limited liability companies, one in the Cayman Islands ("Company C") and one in Washington ("Company W"). Company C purchases a yacht outside of Washington State. Company C then leases the yacht full-time to Company W. The annual lease rate is ten percent (10%) of the value of the yacht. Company W will lease the yacht to the Washington resident at fair market rate. Company W has no other substantial business activities other than its leasing activities. Company W is responsible for all maintenance and moorage costs for the yacht. Any expenses beyond Company W's earnings will be covered by additional capital contributions by the Washington resident. Company C and Company W each make an annual distribution of all profits to the Washington resident. This is an unfair tax avoidance arrangement. Although the lease payments are at fair market value, there is no meaningful change in the economic position of the participants in this case when the arrangement is viewed as a whole. The Washington resident is in the same financial position, and has the same benefits and burdens, as if the resident was the direct owner of the yacht.

EXAMPLE 26. A Washington company ("WaCo") needs new equipment for its business. In order to obtain a loan to purchase the equipment, the bank requires WaCo to create a single purpose bankruptcy remote entity to purchase and own the equipment. WaCo forms Washington single purpose bankruptcy remote entity (WSPRE, LLC) and purchases the equipment without paying sales tax. WSPRE, LLC leases the equipment to WaCo at fair market rate. WSPRE, LLC uses the lease income to make payments on the bank loan and to store,

maintain, and insure the equipment. Because WSPRE, LLC is a bankruptcy remote entity, the arrangement results in a meaningful economic change for WaCo. This is not an unfair tax avoidance transaction.

EXAMPLE 27. A Washington construction company (“Construction”) performing construction in Washington and Oregon forms an Oregon limited liability company (OrCo) to purchase and hold a new construction crane. Construction causes OrCo to purchase and store the crane in Oregon, without paying sales tax. OrCo leases the crane to Construction for periodic use in Washington. Construction pays use tax on the fair market value lease value of the crane for each use in Washington. Assume that Construction has clear and convincing proof that holding the crane in a separate entity will substantially lower its risk of loss (see subsection 10(c)). This is not an unfair tax avoidance arrangement, because it meets the requirements for the special safe harbor in subsection 9(e), above.

10. When do substantial nontax reasons or purposes exist for entering into an arrangement or transaction?

(a) All relevant facts and circumstances. In evaluating whether a taxpayer has a substantial nontax reason or purpose for an arrangement or transaction, the department considers all relevant facts and circumstances, including without limitation, the benefits and burdens of the purported nontax reason relative to the tax savings. The Department is not required to prove that tax avoidance was the subjective intent of any particular arrangement or transaction, but may presume such intent from the presence of relevant factors. A taxpayer may prove that its subjective intent was not tax avoidance only by a showing of clear and convincing evidence.

(b) Substantial nontax reason defined. A substantial nontax reason or purpose is a reason or purpose that:

- (i) is the primary purpose or reason for an arrangement or transaction;
- (ii) is not related to state, local, federal, or foreign taxes of any kind or nature: and
- (iii) has the significant potential of:
 - (A) substantially increasing profit (apart from the tax benefits);
 - (B) substantially increasing efficiency;
 - (C) substantially lowering risk; or
 - (D) providing other substantial business benefits.

The phrase “significant potential” means a potential that is reasonably likely, not illusory or remote. Whether a potential benefit is of substantial value is evaluated based on all facts and circumstances, including without limitation the relative burden incurred a participant.

(c) De minimis effects. In evaluating whether a significant potential effect is substantial, the department presumes that avoiding regulatory burdens or inconveniences and segregating or shifting risk to a separate entity are of only de minimis value and not substantial. The taxpayer may overcome the presumptions only by a showing of clear and convincing evidence.

EXAMPLE 28. An individual that resides in Washington forms two wholly-owned limited liability companies, A and B. Company A will purchase a yacht, taking delivery outside of Washington State, and will bareboat lease the yacht full time to Company B, with annual lease rate of 1% of the value of the yacht. Company B will sublease the yacht to the Washington resident owner of the companies and his relatives, and to unrelated members of the public. Leases to the Washington resident owner and his family members are at a below market rate. Company B will be responsible for mooring costs and general upkeep of the yacht. Any expenses beyond Company B’s earnings will be covered by additional capital contributions by the Washington resident owner. In the first year, ninety-five percent (95%) of the use is by the Washington resident. Company B does not engage in any substantial marketing efforts to lease the yacht to the public. Assume that this arrangement meets the requirements of a potential tax avoidance transaction under subsection 7. This is an unfair tax avoidance transaction because there is no substantial nontax reason for the arrangement.

EXAMPLE 29. A closely-held, Washington business (Washco, Inc.) owns valuable intangibles that generate royalty income under a variety of licensing agreements with unrelated customers. Washco, Inc. has several offices and many employees in Washington. Washco, Inc.’s owners undertake a corporate reorganization creating three sister subsidiaries: Washco, Inc., located in Washington; Calco, Inc., located in the California; and Delco, Inc., located in Delaware. All three sister companies are owned by Parentco, Inc., and have the same officers and shareholders. As reorganized, Delco, Inc. is the owner of and licenses the intangibles to Washco’s former customers. Delco, Inc. hires Calco, Inc. to provide all services necessary to manage Delco, Inc., to service the licensing agreements, and to safeguard the intangibles. Calco, Inc., which has no offices or employees other than its officers, hires Washco, Inc. as an independent subcontractor to provide those services. Calco, Inc. pays Washco an amount that is not sufficient for Washco to pay its expenses. Every night, the bank accounts of Washco, Inc., Calco, Inc., and Delco, Inc. are swept into Parentco Inc.’s bank account, and transferred back from Parentco Inc.’s account, if necessary, to cover the subsidiaries expenditures. Assume this arrangement meets the requirements of a potential tax avoidance transaction under subsection 6. In the absence of economic nexus, this would be an unfair tax avoidance transaction because there is no substantial nontax reason for the arrangement.

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