



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.