Tax Avoidance Rule Overview -- October 27, 2010

Rule Objectives

The Department's objectives in implementing Part II of 2ESSB 6143 are:

- Present a straightforward explanation of the legislation that provides as much certainty for Washington businesses as is possible.
- Address the arrangements and transactions intended by the legislation without overreaching.
- Balance ease of enforcement with fair burdens of proof and evidentiary standards.
- Provide safe harbors consistent with established business norms.
- Provide clear examples to provide guidance and accommodate innovative business planning and operations.

General Overview of Proposed Rule

(current draft)

The following is a general outline of the operation of the proposed tax avoidance rule:

1. The Department must show that:
   a. The arrangement or transaction fits within one of the three specified transaction types because it meet all elements specified by Legislature; and
   b. One or more of the interrelated factors identified by the legislature is present and indicates unfair tax avoidance.

2. The taxpayer may prove that an arrangement or transaction is not tax avoidance by proving that:
   a. There is a substantial nontax reason for the arrangement or transaction; and
   b. The arrangement or transaction results in a meaningful change in the economic positions of the participants.

3. If the taxpayer is unable to prove both of these factors, the arrangement or transaction is unfair tax avoidance. The Department will:
   a. Disregard the arrangement or transaction;
   b. Deny any tax benefits;
   c. Assess tax according to the substance of the transaction; and
   d. Assess applicable penalties, including the 35% tax avoidance penalty.

Stakeholder Comments

The Department has held several stakeholder meetings and received numerous comments on the proposed draft rule. The Department is revising the rule to incorporate many of the comments. Other comments are currently under consideration and may require additional research and/or stakeholder work.

Comments: **"Moving" income to another entity that would not be taxable in Washington.**

Moving income

Section 201 3(b) of 2ESSB 6143 provides that the following specified arrangement may be considered unfair tax avoidance:

> Arrangements through which a taxpayer attempts to avoid tax … [on income] … that would be taxable in Washington by *moving* that income to another entity that *would not be taxable in Washington*. (Emphasis added).

Stakeholder comment #1:

- The term "moving" requires that the taxpayer have a pre-existing stream of income in Washington that is moved to another entity. Therefore, *only* business reorganizations -- *not* newly created arrangements -- are covered by the legislation.

The Department's response:

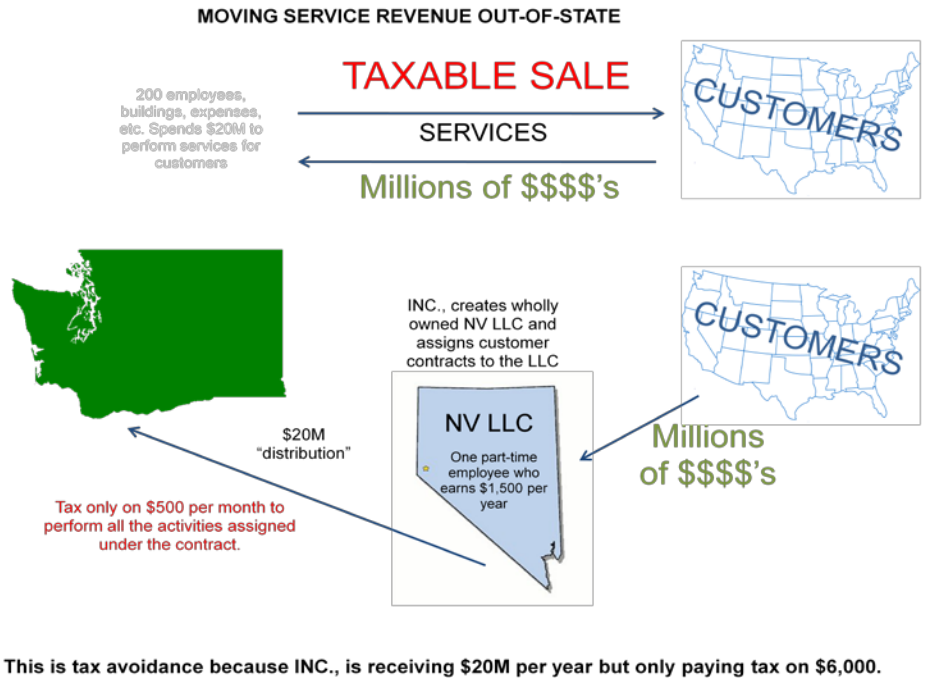
- There is nothing in the statute that requires a pre-existing stream of income followed by a reorganization or change in business operations for an arrangement to be considered unfair tax avoidance.
  - Income from business activities that would be taxable in Washington but for being moved to another entity encompasses all income that would be taxable in Washington in the absence of the tax avoidance arrangement or transaction.
  - This section covers arrangements that are initiated in the form of unfair tax avoidance, as well as arrangements that are only changed to the form of unfair tax avoidance at a later time.

Stakeholder comment #2:

- The phrase "would not be taxable in Washington" refers only to entities that have no nexus with Washington and are, therefore, not taxable in any way in Washington. Accordingly, the legislation does not apply to entities that have nexus with Washington and pay some amount of tax here.

The Department's response:

- The legislation was intended to apply even where the income is moved to entities that have nexus with Washington. In the specific example provided to the Legislature (reproduced below), the Nevada LLC has nexus with Washington, but only pays tax on a small portion of its income due to apportionment rules.



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

Comments

Conjunctive Factors

Focus on two of the identified factors and taxpayer's conjunctive burden of proof.

1. Under the proposed rule draft, taxpayers may prove that an arrangement or transaction is not tax avoidance by proving that:
   a. There is a substantial nontax reason for the arrangement or transaction; and
   b. The arrangement or transaction results in a meaningful change in the economic positions of the participants.

Stakeholder Comment #1:

The rule should not require the taxpayer to show both of these factors.

Department Response:

These factors are the same as stated in the recently codified federal economic substance doctrine. The Department believes that the selected two factors together are dispositive as to whether a transaction is tax avoidance. If the transaction is one of the three specified types and the taxpayer is unable to show both of these factors, then the arrangement should be deemed tax avoidance.

Stakeholder Comment #2:

The rule should allow a taxpayer to show one of the following factors instead as proof that the arrangement or transaction is not tax avoidance:

(i) Whether the chosen form of the arrangement or transaction is a reasonable means of accomplishing a substantial nontax purpose;
(ii) An entity's relative contributions to the work generating income;

(iii) The location where work is performed; or
(iv) Other relevant factors.

Department Response:

While these factors may be relevant, they are derived from or otherwise integrally related to the two dispositive factors selected by the Department. The taxpayer will have the ability to present proof on any of these factors, but must prove the two selected factors, above, as a minimum burden of proof.

Stakeholder Comment #3:

The requirement of proof of these factors should be restated in the form of a safe harbor, not in the form of a burden of proof.

Department Response:

The Department believes this would provide greater certainty for innovative business planning and is currently considering this comment.

Comments

Defining nontax reason as one that is not related to "federal, state, or local state, local, federal, or foreign taxes of any kind or nature."

Nontax Reason – All tax types

Stakeholder comment:

This definition is too broad. Arrangements or transactions structured to avoid or reduce federal, foreign, and other taxes should not be deemed to be tax avoidance except when the tax type and benefit are similar.

Department response:

The Department agrees that the definition should be rewritten. We are currently reviewing alternative language, including a potential option based on the codified federal economic substance doctrine:

> [A nontax reason is] a reason that is not related to any Washington state or local tax effect. A reason is presumed to be related to a Washington state or local tax effect when the arrangement or transaction results in or seeks to result in a tax effect of any kind or nature that is the same as or related to a Washington state or local tax effect.

Tax Avoidance Rule Outline - October 27, 2010

Sections 1-3: Legislative overview.
Section 4: What is the result of an unfair tax avoidance transaction?
- (a) Disregard the form, deny tax benefits.
- (b) Retroactive application.
- (c) Retroactivity Exception: Written instructions.
- (d) Retroactivity Exception: Completed Field Audits.

Examples 1-4.
- (e) Penalty.
  - (i) Not retroactive.
  - (ii) Penalty safe harbor - disclosure.

Examples 5-9.
5. When is a construction venture a potential tax avoidance arrangement or transaction?
- (a) Required elements.
- (b) Form of the arrangement.
- (c) Substantially guaranteed payments explained.

Examples 10-14.
- (d) "Substantial profits" and "significant risk of loss" explained.

Examples 15-17.
6. When is redirecting income a potential tax avoidance arrangement or transaction?
- (a) Definitions.
- (b) Required elements.

Examples 18-20.
7. When is property ownership by a controlled entity a potential tax avoidance arrangement?
- (a) Required elements.
- (b) Control of the entity explained.
- (c) Effective control of tangible personal property explained.
- (d) Other sales and use tax exemptions.

Examples 21-23.
8. How are the factors applied?
- (a) All relevant factors used.
- (b) Safe harbor: Taxpayer proof of meaningful economic change and substantial nontax reason.

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.
- (b) Meaningful change defined.
- (c) Actual Substance.
- (d) De minimis effects insufficient.
- (e) Safe harbors.
  - (i) Moving income - All participants are substantive operating businesses.
  - (ii) Certain leasing activities – Lessee is substantive operating business.

Examples 24-27.
10. When do substantial nontax reasons exist for entering into an arrangement or transaction?
- (a) All relevant facts and circumstances.
- (b) Substantial nontax reason defined.
- (c) De minimis effects insufficient.

Examples 28-29