

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.

DRAFT