1. Introduction.

(a) Purpose. This section WAC 458-20- ____ ("rule") implements sections 201 through 203 of 2ESSB 6143 (ch. 23, 1st Sp. Sess, Laws 2010), effective May 1, 2010. Although taxpayers have the right to enter into arrangements or transactions in order to reduce taxes, the legislature has recognized that some arrangements and transactions are contrary to the intent of the taxing statutes. The legislation and this rule address certain identified arrangements and transactions that unfairly avoid taxes and prescribe specific remedial actions to be taken by the department in such cases. The legislation and this rule do not affect or apply to any other remedies available to the department by statute or common law, as these remedies are expressly preserved by the legislation.

(b) Rule examples. This rule 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. The department will evaluate each case on its particular facts and circumstances and apply both this rule and other statutory and common law authority. An example that concludes an arrangement or transaction is not unfair tax avoidance under this rule does not mean that arrangement or transaction is approved by the department under other authority.

(c) Definitions.

(i) "Potential tax avoidance" and "identified transaction" both refer to an arrangement or transaction that has the potential to be unfair tax avoidance because it meets the elements of an arrangement or transaction described in section 2.

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

(iii) "Related" includes an entity's parent, owner, subsidiary, or affiliate under common control, and where the person is an individual, such persons' spouse, parent, sibling, child, or grandchild. A trust is related to a taxpayer when the taxpayer or a related person has a beneficial interest in the trust, or the taxpayer or a related person has control over the trust as a trustee or a trustor with significant retained control.

(iv) "Specific written instructions" means tax reporting instructions that specifically 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. Specific written instructions will not be construed as revoked by operation of this rule or its statutory authority, but the department may revoke specific written instructions by written notice to the taxpayer.

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 section 6 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 on that income. See section 7 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 section 8 for more information.

3. When is a specifically identified arrangement or transaction unfair tax avoidance? An arrangement or transaction identified in section 2, above is not "unfair tax avoidance" unless the arrangement or transaction is determined to be unfair tax avoidance under one or more of the following factors:

(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.

These factors do not constitute a list of discrete elements that must be met for an arrangement or transaction to be unfair tax avoidance. Section 9 provides additional information on the factors.

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

(a) Denial of tax benefits. The department must disregard the form of an unfair tax avoidance arrangement or transaction and deny any tax benefits received on or after January 1, 2006, except as provided in section 5. The total tax due will be based on the substance of the arrangement or transaction. The department will credit tax previously paid against total tax assessed in accordance with customary department practice.

(b) Actual Substance. The department presumes the substance of an unfair tax avoidance arrangement or transaction to be:

(i) For transactions or arrangements described in subsection 2(a) and 6(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)and 7(a), 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) and 8(a), direct ownership of the tangible personal property by the user.

(c) Penalty. Except as otherwise stated in this rule, 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. The department will not apply the penalty to tax received and credited against total tax due in accordance with Subsection 4(a).

(i) Penalty 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 rule.

(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 provides notice of an investigation or audit of any kind or otherwise discovers the taxpayer's participation, whichever is earlier.

(A) Disclosure requirements. The disclosure must be in writing, it must identify the taxpayer, and it must either request a ruling on a specific arrangement or transaction, or it must provide sufficient information to allow the department to reasonably determine whether the arrangement or transaction is unfair tax avoidance. Disclosure under this subsection applies only to the specific arrangement or transaction addressed in the disclosure. The disclosure no longer qualifies for the safe harbor upon any material change to the arrangement or transaction, including a change in participants.

(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., retail sales, use, business and occupation) as the tax benefit obtained from the unfair tax avoidance arrangement or transaction.

(D) Audits. Taxpayers subject to an investigation or audit that was open as of May 1, 2010 shall be deemed to have provided disclosure to the department that satisfies the requirements of subsections 4(c)(ii)(A) - (C) with respect to any arrangement or transaction initiated prior to May 1, 2010 that results in a tax benefit of the same type (e.g., retail sales, use, business and occupation) covered in the open investigation or audit. If the department fails to discover the taxpayer's participation in a tax avoidance arrangement or transaction during an investigation or audit closed after May 1, 2010, the taxpayer may still apply for the safe harbor for future periods by disclosure in accordance with the requirements of subsection 4(b)(ii).

EXAMPLE 1. 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 rule. The taxpayer specifically requests that the department determine whether the arrangement is an identified transaction or unfair tax avoidance 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 2. Assume the same facts as in Example 1, but the taxpayer does not specifically request that the department determine whether the arrangement is an identified transaction or unfair tax avoidance. However, in the ruling request, the taxpayer provides sufficient information for the department to reasonably determine whether the arrangement is an identified transaction or unfair tax avoidance. 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 3. Assume the same facts as Example 2, 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 an identified transaction or unfair tax avoidance. 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 4. 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 rule. The taxpayer does not disclose the arrangement to the department in conformance with subsection (4)(c)(ii)(A). 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 rule.

5. What tax periods are affected? The legislation addressed in this rule applies retroactively to tax benefits received on or after January 1, 2006. The legislation also contains exceptions to retroactive application based on when an arrangement or transaction is initiated. The relationship between retroactive application and date an arrangement or transaction is initiated is addressed in the subsections identified the following chart:

Benefits received	**Arrangement or Transaction Initiated**	
	Before May 1, 2010 (retroactive period)	**On or after May 1, 2010 (prospective period)**
January 1, 2006 through April 30, 2010	See subsection 5(c)	N/A
On or after May 1, 2010	See subsection 5(d)	See subsection 5(e)

(a) When is an arrangement or transaction initiated? An arrangement or transaction is initiated as soon as the first tax benefits are received.

(b) When are tax benefits received? For purposes of this rule:

(i) Business and occupation tax benefits are received on the date that, in the absence of tax avoidance, the taxpayer would have been required to recognize income for B&O tax purposes.

(ii) Retail sales tax benefits are received on the date of the retail sale; and

(iii) Use tax benefits are received on the date of first use in Washington.

(c) Retroactive period: Tax benefits received January 1, 2006 through April 30, 2010. The department will not deny tax benefits received by a taxpayer during this period if any of the following are true:

(i) The taxpayer has reported its tax liability in conformance with unrevoked specific written instructions issued to that taxpayer or a person affiliated with the taxpayer as defined under subsection 7(a), and the taxpayer's arrangement or transaction does not differ materially from that addressed in the specific written instructions.

(ii) The taxpayer has reported its tax liability in conformance with a determination or other document made available by the department to the general public that specifically identifies and clearly approves the arrangement or transaction, and the taxpayer's arrangement or transaction does not differ materially from that addressed in the determination or document.

(iii) The department has completed a field audit of the taxpayer and the arrangement or transaction is covered by the audit. An arrangement or transaction is covered by an audit if the audit covered the same tax type (e.g., sales, use, business and occupation) as the tax benefit obtained by the taxpayer from the arrangement or transaction. An audit is complete when closed by the department.

(d) Prospective period: Arrangement or transaction initiated before May 1, 2010. The department will not deny tax benefits received by the taxpayer on or after May 1, 2010 if either of the following are true:

(i) The taxpayer has reported its tax liability in conformance with unrevoked specific written instructions issued to that taxpayer or a person affiliated with the taxpayer as defined under subsection 7(a), and the taxpayer's arrangement or transaction does not differ materially from that addressed in the specific written instructions.

(ii) The taxpayer has reported its tax liability in conformance with a determination or other document made available by the department to the general public that specifically identifies and clearly approves the arrangement or transaction, and the taxpayer's arrangement or transaction does not differ materially from that addressed in the determination or document.

(e) Prospective period: **Arrangement or transaction initiated after May 1, 2010.** The department will not deny tax benefits received by the taxpayer on or after May 1, 2010 if the taxpayer has reported its tax liability in conformance with unrevoked specific written instructions issued to that taxpayer, and the taxpayer's arrangement or transaction does not differ materially from that addressed in the specific written instructions. Taxpayers may not rely on instructions provided to any other person. Taxpayers may not rely on any determination or other document made available by the department to the general public prior to May 1, 2010, to the extent inconsistent with this rule.

(f) When does an arrangement or transaction differ materially from that addressed in written guidance? An arrangement or transaction differs materially from that addressed in written guidance when there is a material change in the form or substance of the arrangement or transaction, including without limitation, when there is a change of any participant identified in specific written instructions.

EXAMPLE 5. A construction contractor forms a joint venture with a developer. The venture was initiated, has wound up its business, and was dissolved on April 1, 2010. Assume the joint venture constitutes an unfair tax avoidance arrangement under this rule. Also assume that the venture has never been audited and did not report its tax liability in conformance with specific written instructions, or any other written authority that specifically identifies and clearly approves the arrangement. 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, however, because no tax benefits were received on or after May 1, 2010.

EXAMPLE 6. A taxpayer identifying itself obtains a letter ruling from the department that specifically identifies an arrangement that constitutes unfair tax avoidance under this rule. In its letter ruling, the department approves the arrangement as presented and does not rule that the arrangement must be disregarded or the tax benefits denied. Assume the taxpayer's arrangement does not materially differ at any point in time from the arrangement addressed in the letter ruling, and that the taxpayer reports its tax liability in accordance with the letter ruling. The department will not disregard the arrangement or deny the resulting tax benefits for that taxpayer for any tax period, unless and until the letter ruling is expressly revoked.

EXAMPLE 7. Assume the same facts as Example 6, but the letter ruling was sought by and issued to a person affiliated with the taxpayer as defined under subsection 7(a). If the arrangement was initiated and started to generate tax benefits prior to May 1, 2010, the department will not disregard the arrangement or deny the resulting tax benefits for that taxpayer for any tax period, unless and until the letter ruling is expressly revoked.

EXAMPLE 8. Assume the same facts as Example 6, but the letter ruling was not sought by or issued to either the taxpayer or an affiliate. However, many unrelated taxpayers have obtained letter rulings on nearly identical arrangements, and therefore, it is common practice for taxpayers to enter into the same type of arrangements without obtaining a separate letter ruling. Assume that the arrangement or transaction is not addressed in any published guidance made available to the public by the department. The department must disregard the arrangement and deny the tax benefits received on or after January 1, 2006.

EXAMPLE 9. 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 rule. The arrangement was initiated January 1, 2004. The audit is completed prior to May 1, 2010. In specific written instructions, the audit expressly approves the arrangement. The taxpayer's arrangement does not materially differ at any point in time from the arrangement addressed in the audit instructions, and the taxpayer reports its tax liability in accordance with the those instructions. The department will not disregard the form of the arrangement or deny the tax benefits received for any tax period, unless and until the audit instructions are expressly revoked.

EXAMPLE 10. Assume the same facts as Example 9, but the audit does not expressly approve the arrangement. Although the audit covers the same tax type as the benefits received under the arrangement, the arrangement is not specifically addressed in the audit's written reporting instructions. The taxpayer's arrangement does not differ at any point in time from the arrangement engaged in during the audit. Also assume that the arrangement or transaction is not addressed in any other published guidance made available by the department to the public.

A. The department will not disregard the form of the arrangement or deny the tax benefits received through December 31, 2008, because the period is included in a completed field audit and is wholly included in the retroactivity period (prior to May 1, 2010).

B. The department must disregard the form of the arrangement and deny tax benefits received after December 31, 2008 and prior to May 1, 2010, because the period is not included in a completed field audit but is wholly included in the retroactivity period.

C. The department must disregard the form of the arrangement and deny the tax benefits received on or after May 1, 2010. In addition, the department must assess the 35% tax avoidance penalty unless the taxpayer discloses its participation in the arrangement in accordance with subsection 4(b)(ii).

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

(a) Required elements. A construction joint venture or similar arrangement is a potential tax avoidance arrangement or transaction when it:

(i) Provides any substantially guaranteed payments to the construction contractor for contributed construction services;

(ii) Does not provide the construction contractor with the right to share substantial profits in the venture; or

(iii) Does not require the construction contractor to bear significant risks of loss in the venture.

The construction venture is considered a sale of construction services and unfair tax avoidance if one or more of these elements exists and the arrangement is also determined to be unfair tax avoidance under section 8. If none of these elements exist, then it is not potential tax avoidance and cannot be unfair tax avoidance.

(b) Form of the arrangement. A joint venture or similar arrangement includes a joint venture, partnership, limited liability company, or any similar arrangement between a construction contractor and an owner or developer. This rule applies even if the arrangement includes additional participants. The term "construction contractor" includes any person providing construction services or services in respect to construction. The term "owner or developer" includes, without limitation, a landowner, a project manager, or a 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. Except as provided in subsection (d) below, a "substantially guaranteed payment" is a payment that is guaranteed, secured, or otherwise protected so as to be substantially guaranteed to occur. The determination is based on all relevant facts and circumstances, including without limitation, the terms of an any operating agreement or other applicable instrument, common trade practice, and the course of dealing of the parties. The fact that a payment reduces the payee's capital account is not determinative. Whether or not a payment is a guaranteed payment for purposes of IRC §707(b) is not relevant.

(d) Safe harbor for certain guaranteed payments. The department will not treat certain distributions of loan proceeds as substantially guaranteed payments, even where such distributions are guaranteed, secured, or otherwise protected. This safe harbor applies only to distributions of loan proceeds that decrease capital account. To qualify for this safe harbor, value of the construction contractor's capital account contributions may include only actual costs (hard or soft) incurred by the construction contractor. These out-of-pocket expenses may include wages and benefits of employees performing construction labor on-site, but not personnel performing project or construction management services of any kind, including "services in respect to constructing" under RCW 82.04.051. The construction contractor's capital account may include direct overhead costs equal to a maximum of 3% all other allowable out-of-pocket expenses, but not gross margin or profit in any form; costs attributed to the depreciation or loss of use of equipment; or costs attributable to a loss of use of personnel.

(e) Substantial profits. A construction contractor is entitled to substantial profits only when it has a vested and unconditional right to receive income earned by the venture in the ordinary course of the venture's business to which the construction contractor's contributed property and/or services relate, after costs of the venture are paid in full or otherwise provided for. If the receipt of income is guaranteed, secured, or otherwise protected so as to be substantially guaranteed to occur, it is a guaranteed payment, not a right to share in substantial profits. For purposes of determining substantial profits, a right is unconditional even though dependent on venture profitability.

(f) Significant risks. A construction contractor bears significant risks when its right to substantial profit is not guaranteed, secured, or otherwise protected so as to be substantially guaranteed to occur.

EXAMPLE 11. A construction contractor and a developer create a joint venture under which the developer contributes land, and the construction contractor contributes labor and materials. All contributions and distributions are reflected in adjustments to the parties' capital accounts. The construction contractor's capital account contributions are valued at out-of-pocket cost of labor and materials plus 12% designated as overhead. The venture 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 terms of the construction loan require that construction loan proceeds be used to pay the construction contractor and remove applicable liens. Under this arrangement, payments to the construction contractor are substantially guaranteed to occur because the terms of the construction loan require payments to the construction contractor. The payments do not qualify for the safe harbor because the construction contractor's contributions are valued at more than out-of-pocket costs and allowed overhead. Because it provides for substantially guaranteed payments, this arrangement is a potential tax avoidance arrangement or transaction under subsection 6(a). However, it is not unfair tax avoidance unless it is determined to be tax avoidance in accordance with section 9.

EXAMPLE 12. Assume the same facts as in Example 11, but the construction contractor's contributions of labor and materials are credited to capital account at out-of-pocket cost plus 3% for overhead. Assume that none of the items prohibited under subsections 6(d) are credited to capital account. Under this arrangement, payments to the construction contractor are substantially guaranteed to occur because the terms of the construction loan require payments to the construction contractor. However, those payments qualify for the safe harbor because the construction contractor's capital account contributions include only out-of-pocket costs and allowed overhead. If the arrangement also provides the contractor with the right to share substantial profits and requires the contractor to bear significant risks of loss in the venture, then the arrangement is not a potential tax avoidance arrangement or transaction.

EXAMPLE 13. Assume the same facts as in Example 12, except that nothing in the loan documents require that any payments be made to the construction contractor. However, another member of the venture guarantees the construction contractor will receive regular payments to reduce its capital account. Payments from construction loan proceeds to pay down the construction contractor's capital account still qualify for the safe harbor because the construction contractor's contributions are valued at out-of-pocket costs and allowed overhead. If the arrangement also provides the contractor with the right to share substantial profits and requires the contractor to bear significant risks of loss in the venture, then the arrangement is not a potential tax avoidance arrangement or transaction.

EXAMPLE 14. A construction contractor and a developer create a joint venture under which the developer contributes land, and the construction contractor contributes labor and materials. All contributions and distributions are reflected in adjustments to the parties' capital accounts. The value of the construction contractor's capital account contributions include out-of-pocket costs of labor and materials plus 12% designated as overhead. The venture agreement authorizes distributions to the construction contractor upon approval of the members. If at any point, the construction contractor’s capital account exceeds a specified percentage of the total capital account balances of all members combined, and that percentage is not reduced within 30 days, the construction contractor has the right to require a buy-out by the venture (a "put option"). The purchase price of the put option is equal to the unpaid balance of the construction contractor’s capital account. The agreement requires the developer to guarantee the venture's payment obligation under the option. In this example, payments to the construction contractor are substantially guaranteed because the payments to the construction contractor are substantially likely to occur as a result of the put option and the developer guarantee. The substantially guaranteed payments do not qualify for the safe harbor, because the construction contractor's contributions are valued at more than out-of-pocket costs and allowed overhead. Therefore, the arrangement is a potential tax avoidance arrangement or transaction under subsection 6(a). However, it is not unfair tax avoidance unless it is determined to be tax avoidance in accordance with section 9.

EXAMPLE 15. Assume the same facts as Example 14, but the developer has the power under the joint venture agreement to issue a call option and buy all of the construction contractor's interest in the venture at any time prior to the sale of the house. Under this example, the construction contractor is also not entitled to a substantial share of the profits of the venture because the construction contractor's right can be terminated by unilateral act of the developer. It does not matter whether the developer's call right is discretionary or is limited to a termination "for cause." Because the arrangement provided for guaranteed payments and does not provide the construction contractor with a vested and unconditional right profits of the venture, the arrangement is a potential tax avoidance transaction. However, it is not unfair tax avoidance unless it is determined to be tax avoidance in accordance with section 9.

EXAMPLE 16. Assume the same facts as Example 14, but the value of the construction contractor's capital account contributions includes only allowable cost of labor and materials plus 3% overhead. However, the purchase price of the put option is equal to the unpaid balance of the construction contractor's capital account plus 8% of the profits of the venture, determined as of the date the put option is exercised. Even if distributions to the construction contractor qualify for the safe harbor and are not considered to be guaranteed payments, the arrangement is still a potential tax avoidance arrangement. In this example, the price under the put right is a guaranteed payment, because it includes amounts in excess of the permitted safe harbor value of the contractor's capital account and is guaranteed by the developer.

EXAMPLE 17. A construction contractor and a developer create a joint venture to build a house, under which the developer contributes land and the construction contractor contributes labor and materials. All contributions and distributions are reflected in adjustments to the parties' capital accounts. The venture allows distributions as approved by the members. Upon sale of the house, the venture will wind up its business, pay or provide for all debts of the venture, and distribute all funds in the following order: (i) a distribution to the construction contractor in an amount equal to its capital account; (ii) a distribution to the developer equal to the amount of its capital account; (iii) $X to the construction contractor; and (iv) all remaining funds to the developer. Assume the construction contractor's rights to receive the value of its capital account and the $X final distribution are vested and unconditional, but that neither of the payments are guaranteed, secured, or otherwise protected. In this example, the construction contractor is not entitled to any guaranteed payments. In addition, the construction contractor has a right to substantial profits that are at significant risk of loss. Because none of the elements identified in subsection 6(a) are present, this is not a potential tax avoidance transaction.

EXAMPLE 18. A construction contractor and a developer create a joint venture under which the developer contributes land and the construction contractor contributes labor and materials. Assume the construction contractor is not entitled to any guaranteed payments. Upon sale of the house, the venture will wind up its business, pay or provide for all debts of the venture, and distribute all funds X% to the developer and Y% to the construction contractor. Assume that the construction contractor's right to receive this Y% of venture profits is vested and unconditional and that the construction contractor is not entitled to any guaranteed payments. Under this example, the construction contractor is entitled to a substantial share of profits earned by the venture in the ordinary course of its business to which the construction contractor's contributions relate. This arrangement is not a potential tax avoidance arrangement or transaction because no payments, including payment of the Y% profit, are guaranteed. Therefore, the construction contractor also bears significant risk in the venture.

EXAMPLE 19. Assume the same facts as Example 18, but the developer and an affiliate of the construction contractor enter into a separate contract for project management services. The construction contractor will contribute only allowable labor and materials to the venture. The affiliate will provide all project management and similar services through the contract, under which payment for the services is substantially guaranteed. The arrangement is not potential tax avoidance under this subsection, however, the project management contract will be characterized as a retail sale, according to the substance of the arrangement as a whole.

(g) Related guidance. Nothing in this rule affects the application of WAC 458-20-170 or other department published guidance on differentiating between speculative builders and prime contractors. 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 potential or unfair tax avoidance under this rule.

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

(a) Required elements. An arrangement that moves income is a potential tax avoidance arrangement or transaction only when all of the following elements are met:

(i) The arrangement or transaction functions to move income to a person that is not taxable in Washington on that income;

(ii) The income is received by a participant in the arrangement, from a person not affiliated with the taxpayer, as consideration for property or services; and

(iii) The business activities of the taxpayer, or a person related to the taxpayer, are of the type taxable in Washington and are integral to providing the property or services. Mere administrative services, without more, will not be considered integral to providing property or services for purposes of this subsection.

The arrangement or transaction is unfair tax avoidance only if it meets all three of these elements and is also determined to be unfair tax avoidance under section 9. If the arrangement or transaction does not meet all three of these elements, then it cannot be unfair tax avoidance.

(b) Additional 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. A person's power to cause the direction of management and policies includes that held by:

(A) persons related to the taxpayer; and

(B) persons with whom the taxpayer acts in concert to direct the management or policies of the entity.

(iii) "Common control" means two or more entities controlled by the same person.

(iv) "Moving" or "moves" is any act or series of acts to ensure that the income is received by a person that is not taxable in Washington on that income; and that the taxpayer or a related person receives substantially all the benefit of the income. Such acts may include without limitation: an assignment, transfer, lease, or license of income-producing assets; the sale of property or services at less than market value; and capital contributions and distributions from capital account.

EXAMPLE 20. A Washington company ("Parent") forms a wholly-owned limited liability company in Nevada ("Subsidiary"). Subsidiary has one part-time employee in Nevada, rents shared office space, and has 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 potential tax avoidance 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. However, it is only an unfair tax avoidance transaction if it is also determined to be tax avoidance under section 9.

EXAMPLE 21. Assume the same facts as Example 20, but all customers of the Subsidiary (formerly customers of Parent) are affiliates of Parent. Assume the intangible personal property and consulting services that the customers purchase from Subsidiary are not integral to any property or services provided by the customers to non-affiliated persons. This arrangement is not potential tax avoidance, because the ultimate customers of the Subsidiary in this arrangement are affiliates, rather than persons not affiliated with the taxpayer.

EXAMPLE 22. 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 limits the number of agreements per subsidiary so that each subsidiary's annual gross income is less than $50,000. 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 (and otherwise taxable in Washington) is received by the subsidiaries. The arrangement further ensures that each subsidiary's gross income does not meet minimum nexus standards in Washington. However, it is only an unfair tax avoidance transaction if it is also determined to be tax avoidance under section 9.

EXAMPLE 23. A Washington parent company forms a Nevada subsidiary and contributes income-producing assets to it in exchange for ownership interests. The Nevada subsidiary is adequately capitalized, and uses its own employees to complete the activities necessary to sell property or services to customers. However, the parent company provides administrative services to the subsidiary at a below market cost. After paying all other costs, the Nevada subsidiary distributes its net income to the parent company. This is not a potential tax avoidance arrangement because the parent company's business activities are not integral to the subsidiary's ability to provide the property or services to its customers.

EXAMPLE 24. A Washington parent company forms a Delaware subsidiary that is adequately capitalized and carries on substantial business activities using its own property or employees. Sales representatives employed by the Washington parent company call on potential customers and enter into product sales contracts on behalf of the Washington parent. The Washington parent then transfers those contracts to the subsidiary, and the subsidiary fulfills the orders and receives the income. After paying its costs, the Nevada subsidiary distributes its net income to parent. This arrangement is a potential tax avoidance arrangement because the sales representatives' activities are integral to the to the subsidiary's ability to provide the property or services to its customers. However, it is only an unfair tax avoidance transaction if it is also determined to be tax avoidance under section 9.

EXAMPLE 25. A Washington manufacturer wholesales its products both within and without Washington. The Washington manufacturer forms an Idaho subsidiary company and transfers all of its wholesale contracts to it. The manufacturer causes the subsidiary to purchase and hold all raw materials necessary to manufacture the products. The subsidiary then hires the Washington manufacturer to act as a processor for hire. The subsidiary, as owner of the manufactured products, sells them under the transferred wholesale contracts. Assume the subsidiary has nexus with Washington. This arrangement is not a potential tax avoidance arrangement because it does not function to move income from the sale of goods or services from an entity taxable in Washington to a related entity that is not taxable in Washington on that income. The subsidiary is taxable on all sales in Washington in the same manner as was the manufacturer.

EXAMPLE 26. A Washington manufacturer sells its products both within and without Washington. The Washington manufacturer forms a Washington subsidiary company and transfers all of its sales contracts to it. The subsidiary purchases all of the products made by the manufacturer at a discount. The subsidiary then sells the products under the transferred contracts. This arrangement is not a potential tax avoidance arrangement because the subsidiary is taxable on all sales in Washington in the same manner as was the manufacturer. The arrangement does not function to move income from the sale of goods or services from an entity taxable in Washington to a related entity that is not taxable in Washington on that income.

EXAMPLE 27. Assume the same facts as Example 26, but the subsidiary is an Oregon company with no nexus with Washington. Assume that the products are not warehoused in Washington, but are immediately shipped upon production, and that the Oregon subsidiary has no other activities that create nexus with Washington. This arrangement is a potential tax avoidance arrangement because it functions to move income from the sale of the product from the manufacturer to the Oregon subsidiary. However, it is only an unfair tax avoidance transaction if it is also determined to be tax avoidance under section 9.

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

An arrangement or transaction under which property is owned by a controlled entity is unfair tax avoidance only if it meets all three of these elements and is also determined to be unfair tax avoidance under section 9. If the arrangement or transaction does not meet all three of these elements, then it cannot be unfair tax avoidance.

(b) Control of the entity. A taxpayer controls an entity when the taxpayer possesses, directly or indirectly, more than fifty percent 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 also includes the voting or management authority held by, or for the benefit of:

(i) persons related to the taxpayer; and

(ii) persons with whom the taxpayer acts in concert to direct the management or 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) Safe harbors.

(i) Certain leasing arrangements. The department will not disregard leasing arrangements under which:

(A) At least ninety-five percent (95%) of all use as a consumer of the property by the taxpayer and related persons is for bona fide business purposes under a fair market lease rate with the retail sales tax or use tax sourced to Washington.

(B) At least ninety-five percent (95%) of all use as a consumer of the property by the taxpayer and related persons is for bona fide business purposes under a fair market lease rate with the retail sales or use tax sourced anywhere, where the lessee is a substantive operating business that is adequately capitalized and carries on substantial business activities using its own property or employees.

(C) At least ninety-five percent (95%) of all use as a consumer of the property is under a fair market lease rate by persons that are not related to the entity that owns the property.

(D) All use as a consumer of the property occurs through a leasing or shared use arrangement under which retail sales and/or use tax is collected and paid to the department at regular intervals and will, within five (5) years from the date of purchase or first use in Washington, reach at least one hundred percent (100%) of the full retail sales or use tax amount applicable to the property. The "full retail sales or use tax amount" is the retail sales or use tax amount that would have been due upon the date and at the location of purchase or first use, whichever is earlier. To be eligible for this safe harbor, the owning entity and each person with control over the property must consent to extend the nonclaim statute under RCW 82.32.060 to five (5) years.

(ii) Use tax exceptions. The department will not disregard an arrangement or transaction where no use tax is due on the use of the tangible personal property in Washington. For example, an arrangement will not be disregarded if use or retail sales tax has been paid in full by the user of the tangible personal property or by the user's bailor or donor.

(e) Bona fide business purposes. Use of tangible personal property serves a bona fide business purpose only when the use, in nature and quantity, is ordinary and necessary for the business of the user. Use for entertainment purposes must be directly related or associated with substantial business activities of the user. For purposes of this subsection, investing in tangible personal property or holding such property for use by related persons is not a substantial business activity. A bona fide business purpose may include providing employee or director benefits when the business pays the lease rate, the employee or director is required to report the value of the benefit as compensation for state or federal tax purposes; and the benefit is not ordinary and necessary in nature or quantity for the business. *See* RCW 82.04.360 for the taxability of director's compensation.

(f) Retail sales and use tax-exemptions. If property ownership by an entity is determined to be unfair tax avoidance under this rule, 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.

EXAMPLE 28. 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 any formal arrangement and 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 and none of the safe harbors apply. However, it is only unfair tax avoidance if it is also determined to be tax avoidance under section 9.

EXAMPLE 29. Assume the same facts as Example 28, but MT, LLC is owned by a husband and wife, with each having a fifty percent ownership interest. This is still a potential tax avoidance transaction, because either spouse's ownership interest in MT, LLC may be attributable to the other. Therefore, both spouses have effective control over the motorhome.

EXAMPLE 30. Three Washington residents form a Washington limited liability company (the "Company") with each having a one-third ownership interest. The Company purchases an aircraft in Washington for the purpose of leasing to its members and does not pay retail sales tax on the purchase. The aircraft is stored in Washington. All use of the aircraft is by Company members at a fair market rate, and the Company collects retail sales tax on all lease payments. This is a potential tax avoidance arrangement, because the individuals act in concert to control the entity and the aircraft. However, it is only unfair tax avoidance if none of the safe harbors under subsection 8(d) are met, and the arrangement is also determined to be tax avoidance under section 9.

EXAMPLE 31. Assume the same facts as Example 30, but the aircraft is stored at a hangar in Oregon. The Company does not collect retail sales tax on the lease payments, because any sales tax due under the lease is sourced Oregon. This is a potential tax avoidance arrangement, because it does not meet any of the safe harbors. However, it is only unfair tax avoidance if none of the safe harbors under subsection 8(d) are met, and the arrangement is also determined to be tax avoidance under section 9.

EXAMPLE 32. A parent company forms a subsidiary, "Y," to purchase and hold a yacht for lease (resale) to the parent company for use in Washington. All leases of the yacht are as bareboat charters at a fair market lease rate. The parent company leases the yacht to provide benefits to its directors, to entertain business clients, and for company celebrations. Assume no other use of the yacht, and that the directors report the value of yacht benefit as compensation for B&O and federal income tax purposes. This arrangement meets the safe harbor under subsection 8(d)(i)(A), provided that the described uses by the parent are quantitatively ordinary and necessary for the business of the parent.

EXAMPLE 33. Assume the same facts as in Example 32, but that the company only provides the yacht benefit to one of its directors. Assume the benefit allows the director to use the yacht for three full months of the year, and that the addition of the yacht benefit makes the director's compensation inconsistent with similarly situated directors. This arrangement does not meet the safe harbor under subsection 8(d)(i)(A), because it is not ordinary or necessary for a business to provide a single director with such liberal benefits. However, it is only unfair tax avoidance if the arrangement is determined to be tax avoidance under section 9.

EXAMPLE 34. Assume the same facts as in Example 32, and that the parent's annual gross income is $50,000. Assume that the total annual payments by the parent for its use of the yacht is $25,000. This arrangement does not meet the safe harbor under subsection 8(d)(i)(A), because it is not ordinary or necessary for a business to spend the equivalent of half of its annual gross income on the use of a yacht. This is true even if the parent obtains loans or additional capital contributions to fund its use of the yacht. However, it is only unfair tax avoidance if the arrangement is determined to be tax avoidance under section 9.

EXAMPLE 35. A Washington resident forms a Washington limited liability company (the "Company") to hold and lease tangible personal property back to the resident at a fair market lease rate. The resident's first use of the property in Washington occurs on June 1, 2012. The Company collects and remits retail sales tax on all lease payments. As of December 31, 2016, the total amount of retail sales collected and paid to the department is eighty percent (80%) of the retail sales or use tax amount that would have been due on the sale or use of the aircraft in Washington on June 1, 2012, in the absence of this arrangement. This arrangement meets the safe harbor requirements of subsection 8(d)(i)(D).

EXAMPLE 36. Company S owns tangible personal property purchased in a retail sale under which all retail sales taxes were paid. Company B, a Washington resident, wants to purchase the property from Company S. Company S forms a subsidiary entity and transfers the property to the subsidiary in exchange for all ownership interests in the entity. Company S then sells all ownership interests in the subsidiary to Company B. Company B is now the parent company of the subsidiary entity. Company B uses the property in its Washington business activities without any formal arrangement or payments to its subsidiary. This is a potential tax avoidance arrangement because Company B uses tangible personal property in Washington that is owned by an entity over which Company B has complete control. However, it is only unfair tax avoidance if none of the safe harbors under subsection 8(d) are met, and the arrangement is also determined to be tax avoidance under section 9.

EXAMPLE 37. Assume the same facts as Example 36, but Company B obtains the use of its subsidiary's assets under a fair market rate lease arrangement. Assume all use of the property is for bona-fide business purposes. This is not a potential tax avoidance arrangement because Company B's use of the property qualifies for the safe harbor under subsection 8(d)(i)(A).

EXAMPLE 38. Company O, an Oregon company, is wholly owned by an Oregon resident. Company O purchases an aircraft for lease to the Oregon resident. The Oregon resident uses the aircraft in Washington for personal purposes, for periods not in excess of 59 days. The aircraft lease is for less than fair market rate. This is a potential tax avoidance arrangement, but the department will not disregard the arrangement because no use tax is due on the Oregon resident's use of the tangible personal property in Washington. This qualifies for the safe harbor under subsection 8(d)(ii).

(9) How are the factors applied?

(a) Relevant factors. To the extent relevant, the department may consider any or all factors listed in section 3 as part of an analysis of whether an arrangement or transaction has sufficient substance to be respected for tax purposes. 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) Right of rebuttal. If the department determines that the arrangement or transaction meets the elements identified in subsections 6(a), 7(a), or 8(a) and that one or more of the factors identified in section 3 indicate unfair tax avoidance, the department presumes the arrangement or transaction is unfair tax avoidance. The taxpayer may rebut the presumption by proving 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) One or more substantial nontax reasons were the taxpayer's primary reason for entering into the arrangement or transaction.

(10) 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, apart from its tax benefits, a bona fide and substantial increase in profit or profit potential, or reduction in costs or expenses, between the form of the arrangement or transaction chosen by the taxpayer and the actual substance of the arrangement or transaction. If the tax benefits available under the arrangement or transaction substantially exceed the value of potential change in economic position, the change in economic position is not bona fide and substantial. The department will consider all relevant facts and circumstances, including the likelihood of change, to determine the value of a potential change in economic position.

EXAMPLE 39. 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. If all elements identified in subsection 7(a) are met, this would be 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 40. 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. Company W will lease the yacht to the Washington resident. Both leases are 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. Assume that all the elements of subsection 8(a) are met, and that none of the safe harbors in subsection 8(d) apply. This arrangement 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 when the arrangement is viewed as a whole. The Washington resident is in the same financial position as if the resident was the direct owner of the yacht, the substance of the arrangement.

EXAMPLE 41. A construction contractor and a developer create a joint venture under which the developer contributes land, and the construction contractor contributes labor and materials. All contributions and distributions are reflected in adjustments to the parties' capital accounts at actual cost. The venture agreement prohibits distributions until the house is sold. Upon sale of the house, the venture will wind up its business, pay or provide for all debts of the venture, and distribute all remaining funds 99% to the developer and 1% to the construction contractor. However, the developer has the power under the joint venture agreement to issue a call option and buy all of the construction contractor's interest in the venture at any time prior to the sale of the house. The purchased interest includes the construction contractor's 1% right to profits of the venture. The total purchase price for the interest is set at 115% of the value of the construction contractor's capital account. Assume the arrangement meets the elements of a potential tax avoidance arrangement under subsection 6(a). This is an unfair tax avoidance arrangement, because the participants are in the same economic position as under a sale of construction services, the substance of this arrangement.

(11) When do substantial nontax reasons or purposes exist for entering into an arrangement or transaction?

(a) Subjective purpose. In evaluating whether a taxpayer had a substantial nontax reason or purpose for an arrangement or transaction, the department will consider all facts and circumstances that are relevant to determining the taxpayer's subjective intent. However, 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 other relevant factors.

(b) Substantial nontax reason defined. A substantial nontax reason is a bona fide nontax reason that is a substantial motivating factor to the taxpayer decision to enter into the arrangement or transaction. A bona fide nontax reason may include the purpose of obtaining a state, local, federal or foreign tax benefits, provided the benefits are not the same type, kind, or nature of any substantial Washington state tax benefit obtained under the arrangement or transaction.

(c) Partial safe harbor. For purposes of applying this rule, the department will treat a stated nontax purpose as a bona fide reason where all participants in an arrangement or transaction are substantive operating businesses, adequately capitalized, and carrying on substantial business activities using their own property or employees. For purposes of applying common law or statutory remedies other than those provided in this rule or the legislation addressed by this rule, the department may treat a stated non-tax reason as other than bona-fide if appropriate under all the facts and circumstances.