Close B&O tax loophole that allows companies to create shell corporations outside the state in order to reduce their WA tax liability

Description

- Some Washington-based manufacturers are exploiting a loophole that allows an in-state manufacturer to reduce its B&O tax obligation by creating an out-of-state affiliate to own the raw materials used in the Washington manufacturing operation. As a result:
  - The in-state entity owes substantially less tax as a processor-for-hire rather than a manufacturer, and
  - The out-of-state affiliated entity is not subject to any B&O tax unless it sells the end products in this state.
- Under this proposal, the out-of-state affiliate would be taxed just like any other manufacturer.
- This proposal would still allow a B&O tax exemption for an out-of-state owner of raw materials processed in this state when the out-of-state owner is not affiliated with the in-state processor for hire.

Current Law

Manufacturing B&O taxation

- Manufacturers are generally taxed on the entire value of the product manufactured in this state.
- This value is usually determined by the gross proceeds of sales of the end product.

Processing for hire B&O taxation

- In contrast, firms that manufacture products for other firms, using raw materials provided by the customer, are taxed as processors-for-hire on the gross income received from the customer.
- Gross income generally reflects the value of the services supplied by the processor-for-hire. This is less than the value of the end product, which also includes the value of the raw materials.

Continued on next page

Close B&O tax loophole that allows companies to create shell corporations outside the state in order to reduce their WA tax liability, Continued

Current Law (continued)

Who is a "manufacturer?"

- For B&O tax purposes, the firm that owns the raw materials used in a manufacturing operation is considered the manufacturer of the end products.
- In most cases, the owner of the raw materials will be considered the manufacturer regardless of whether it performs the manufacturing work itself or contracts with another firm (i.e., a processor-for-hire) to perform the manufacturing work.
- However, an exception is made for a nonresident owner of raw materials processed in this state by a separate entity. In this case, the nonresident owner is not considered to be a manufacturer.
  - This exception was intended to remove a disincentive for out-of-state owners of raw materials to use Washington processors-for-hire.

How does the loophole work?

- A Washington manufacturer will establish an affiliate domiciled outside Washington to own the raw material used in the manufacturing operation.
- The out-of-state affiliate contracts with the Washington parent to perform the manufacturing.
- This arrangement allows the Washington parent entity to be taxed on the reduced amount received for processing the end product instead of being taxed on the entire value of the end product.
- The out-of-state affiliate is not subject to B&O tax as a manufacturer.

Revenue Impact

General Fund Impacts ($ millions):

Fiscal Year 2012	Fiscal Year 2013	2011-2013 Biennium
$0	$ 3.5	$3.5

Notes:

- *Estimate assumes a July 1, 2012, effective date, representing 11 months of collections for FY 2013.*
- *Estimate reflects the November 2011 Economic & Revenue Forecast Council revenue forecast.*

Continued on next page

Close B&O tax loophole that allows companies to create shell corporations outside the state in order to reduce their WA tax liability, Continued

Expenditure Impact

Fiscal Year 2012	Fiscal Year 2013	2011-2013 Biennium
$21,500	$15,400	$36,900