**WAC 458-20-280 Introduction.** This rule is organized into eight parts, as follows:

- Purpose and general scope
- Transactions or arrangements specifically identified as potential tax avoidance
- Relevant factors in transactions deemed unfair tax avoidance
- Economic positions of participants
- Substantial nontax reasons for entering into an arrangement
- Results of unfair tax avoidance transactions
- Tax periods affected
- Penalty provisions

Other rules. There are three auxiliary rules that address the following three types of arrangements.

- WAC 458-20-28001 Construction joint ventures and similar arrangements described in RCW 82.32.655 (3)(a);
- WAC 458-20-28002 Disguised income arrangements described in RCW 82.32.655 (3)(b); and
- WAC 458-20-28003 Sales and use tax avoidance arrangements described in RCW 82.32.655 (3)(c).

(1) **Purpose and general scope.** Chapter 23, Laws of 2010 1st sp. sess., enacted as RCW 82.32.655 and 82.32.660, as well as amended RCW 82.32.090, to address unfair tax avoidance. Although taxpayers have the right to enter into arrangements or transactions that have lower tax consequences, the legislature recognized that certain arrangements and transactions are contrary to the intent of the taxation 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.

(a) **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 the taxpayer is entitled to any particular tax treatment or that the arrangement or transaction is approved by the department under other authority. It may still be disregarded or disapproved by the department under other statutory or common law authority.

In addition, each fact pattern in each example is self-contained (i.e., "stands on its own") unless otherwise indicated by reference to another example. Examples concluding that sales tax applies to the transaction assume that no exclusions or exemptions apply, and the sale is sourced to Washington.

(b) **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 subsection (2) of this rule.

(ii) "Unfair tax avoidance" means an arrangement or transaction that meets the elements of an arrangement or transaction described in subsection (2) of this rule, and that is also determined under all the

facts and circumstances to be unfair tax avoidance based on the factors identified in subsection (3) of this rule.

(iii) "Affiliated" means under common control.

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

(v) "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 an entity, whether through the ownership of voting shares, by contract, or otherwise. A person's power to cause the direction of management and policies includes power that is 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.

(vi) "Related" includes:

(A) An entity's parent, owner, subsidiary, or affiliate under common control;

(B) An individual person's spouse, grandparent, parent, sibling, child, or grandchild; and

(C) In the case of a trust, the trust or a related person as defined in (A) or (B) of this subsection that:

(I) Has a beneficial interest in the trust;

(II) Has control over the trust or trust property; or

(III) Is the settlor and has retained significant control over the trust.

(vii) "Moving" or "moves" is any act or series of acts to ensure that income is received by a person who 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 could be obtained in an arm's length transaction; and capital contributions and distributions from a capital account.

(viii) "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.

(ix) "Person" or "company" has the same meaning as provided in RCW 82.04.030.

(2) **Transactions or arrangements specifically identified as potential tax avoidance:** Under RCW 82.32.655(3), 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 WAC 458-20-28001 for more information.

(b) **Redirecting income.** Arrangements through which a taxpayer attempts to avoid business and occupation 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 WAC 458-20-28002 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 WAC 458-20-28003 for more information.

(3) **Factors in a specifically identified arrangement or transaction deemed unfair tax avoidance:** An arrangement or transaction identified in subsection (2) of this rule, is not "unfair tax avoidance" unless the arrangement or transaction is determined to be unfair tax avoidance under consideration of one or more of the factors in this subsection. These factors do not constitute a list of discrete elements that must be met for an arrangement or transaction to be unfair tax avoidance.

(a) Whether there has been a meaningful change in the economic positions of the participants in an arrangement or transaction, apart from its tax effects, when the arrangement is considered in its entirety;

(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[1]; and

[1] For apportionable activities, see WAC 458-20-19401 through 458-20-19404.

(f) Other relevant factors.

(g) Application of factors:

(i) To the extent relevant, the department may consider any or all factors listed in this subsection 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.

(ii) Right of rebuttal. If the department determines that the arrangement or transaction meets the elements identified in WAC 458-20-28001, 458-20-28002, or 458-20-28003 and that one or more of the factors identified in this subsection indicate unfair tax avoidance, the department presumes the arrangement or transaction is unfair tax avoidance. The taxpayer may rebut the presumption by proving that:

(A) 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

(B) One or more substantial nontax reasons were the taxpayer's primary reason for entering into the arrangement or transaction.

(4) **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 a bona fide and substantial 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. The reasonably expected profit from the arrangement or transaction must be substantial when compared to the reasonably expected tax benefits that would be allowed if the arrangement or transaction is to be respected.

(c) **Shifting profits insufficient.** An arrangement or transaction that merely shifts income or value between related persons does not result in a meaningful change in economic position.

(5) **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's decision to enter into the arrangement or transaction in this state. A bona fide nontax reason may include the purpose of obtaining tax benefits from another government, 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 under RCW 82.32.655, the department may treat stated nontax reasons as other than bona fide, if appropriate under all facts and circumstances.

(6) **Results of an unfair tax avoidance transaction:**

(a) **Determination of proper amount of tax.** For tax benefits received on or after January 1, 2006, the department must disregard the form of an unfair tax avoidance arrangement or transaction and determine the amount of tax based on the actual substance of the arrangement or transaction, except as provided in subsection (7) of this rule.

(b) **Amount of tax benefit defined.** The tax benefit of an unfair tax avoidance arrangement or transaction is the difference between the amount of tax due based on the actual substance of the arrangement or transaction and the amount of tax actually paid by the taxpayer based on the form of the arrangement or transaction. In determining the

amount of the tax benefit, the department will credit the tax previously paid by the taxpayer against total tax assessed on the revised transaction in accordance with customary department practice.

(c) **Actual substance.** The actual substance of an unfair tax avoidance arrangement or transaction is:

(i) For transactions or arrangements described in subsection (2)(a) of this rule and WAC 458-20-28001, a sale of construction services from the construction contractor to the developer or owner.

(ii) For transactions or arrangements described in subsection (2)(b) of this rule and WAC 458-20-28002, a sale of property or services by a person subject to Washington taxes on the arrangement or transaction.

(iii) For transactions or arrangements described in subsection (2)(c) of this rule and WAC 458-20-28003, direct ownership of the tangible personal property by the user.

(7) **Tax periods affected:** The legislation addressed in this rule applies to tax benefits received on or after January 1, 2006. The legislation also contains exceptions to an application based on when an arrangement or transaction is initiated. The relationship between when the tax benefit is received and when the arrangement or transaction is initiated is explained as follows:

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

(b) **When are tax benefits received?** For purposes of this rule, the timing of receipt of tax benefits is not dependent on the date on which the tax return is required to be filed, but instead:

(i) Business and occupation tax benefits are received on the date that, in the absence of tax avoidance, the taxpayer would have been subject to B&O tax under RCW 82.04.220.

(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) **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 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 (1)(b)(iii), and the taxpayer's arrangement or transaction does not differ materially from that addressed in the specific written instructions.

(ii) The taxpayer 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) **Arrangement or transaction initiated *before* May 1, 2010, and tax benefits received after April 30, 2010.** The department will not

deny tax benefits received by the taxpayer on or after May 1, 2010, if either of the following is 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 (1)(b)(iii) of this rule, 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) **Arrangement or transaction initiated *on or after* May 1, 2010.** For arrangements and transactions initiated on or after May 1, 2010, the department will not deny tax benefits received by the taxpayer if the taxpayer reports its tax liability in conformance with unrevoked specific written instructions issued to that taxpayer, and the taxpayer's arrangement or transaction does not materially differ from that addressed in the specific written instructions. Specific written instructions for this purpose do not include instructions provided to any other person. Further, 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 do transactions or arrangements materially differ from those addressed in written guidance?** An arrangement or transaction materially differs 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 1.** 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. The taxpayer's arrangement does not materially differ at any point in time 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 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 2.** Assume the same facts as Example 1, but the letter ruling was sought by and issued to a person affiliated with the taxpayer as defined under subsection (1)(b)(iii) of this rule. 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 3.** Assume the same facts as Example 1, but the letter ruling was not sought by or issued to either the taxpayer or an affiliate. 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 4.** The department conducts a field audit of a taxpayer for the period January 1, 2004, through December 31, 2008. The taxpay-

er 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 5.** Assume the same facts as Example 4, 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.

• 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 period prior to May 1, 2010.

• 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.

(8) **Unfair tax avoidance penalty.**

(a) **Penalty imposed.** Except as otherwise stated in this rule, the department must assess a penalty of thirty-five percent on the amount of the tax benefit denied because of the disregard of an unfair tax avoidance arrangement or transaction.

(i) **When the unfair tax avoidance penalty applies.** The thirty-five percent assessment penalty applies to the tax benefits from engaging in unfair tax avoidance and received on or after 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.

(iii) **Disclosure requirements.** The disclosure must be in writing, it must identify the taxpayer, and it must either request a ruling on the 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 (a)(ii) of this subsection 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) as 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 (a)(ii) of this subsection.

**Example 6.** 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 had not discovered the taxpayer's participation in the arrangement and had not notified the taxpayer of its intention to investigate or audit. If the department subsequently disregards the arrangement and denies the tax benefits, the department will not apply the thirty-five percent avoidance penalty to any denied tax benefit.

**Example 7.** Assume the same facts as in Example 6, 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 thirty-five percent avoidance penalty to any denied tax benefit.

**Example 8.** Assume the same facts as Example 7, but the taxpayer only requests a ruling on specific elements related to the tax avoidance arrangement, not the 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 thirty-five percent avoidance penalty to any denied tax benefit.

**Example 9.** 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 (a)(ii) of this subsection. If the department subsequently disregards the arrangement and denies the tax benefits, it must do so back to January 1, 2006, subject to the statute of limitations. The department must also apply the thirty-five percent 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.

**Example 10.** A construction contractor forms a joint venture with a developer. The venture was initiated, wound up its business, and was

dissolved on April 1, 2010. Assume the joint venture constituted 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 back to January 1, 2006. The department will not assess the thirty-five percent avoidance penalty, however, because no tax benefits were received on or after May 1, 2010.

**Example 11.** Assume the same facts as Example 5, for tax benefits received on or after May 1, 2010, the department must disregard the form of the arrangement and deny the tax benefits received. In addition, the department must assess the thirty-five percent tax avoidance penalty unless the taxpayer discloses its participation in the arrangement in accordance with this rule.

For further information refer to WAC 458-20-28001, 458-20-28002, and 458-20-28003.

[Statutory Authority: RCW 82.32.300 and 82.01.060(2). WSR 15-09-004, § 458-20-280, filed 4/2/15, effective 5/3/15.]