Washington State
House of Representatives
Office of Program Research

BILL ANALYSIS

Finance Committee

HB 2970

Brief Description: Addressing tax avoidance.

Sponsors: Representatives Hunter and Conway; by request of Department of Revenue.

Brief Summary of Bill
• Allows the Department of Revenue to disregard abusive tax avoidance transactions. • Closes loopholes used to avoid use taxes and real estate excise taxes.

Hearing Date: 1/28/10

Staff: Jeffrey Mitchell (786-7139).

Background:

Economic Substance Doctrine.
The economic substance doctrine states that a transaction's tax benefits will not be allowed if the transaction does not have economic substance. This common law doctrine is an effort by the courts to enforce legislative intent in situations in which a literal reading of statutory code would allow a taxpayer to circumvent this intent. The doctrine is used frequently at the federal level to determine whether tax shelters or strategies used to reduce tax liability are considered "abusive" by the Internal Revenue Service. Washington courts have not used the economic substance doctrine to interpret tax statutes, but instead have relied on traditional methods of statutory construction that include: (1) looking to the plain language of a statute to determine whether the language is ambiguous; (2) giving words their common and ordinary meaning if the words are not ambiguous; (3) evaluating other evidence if language is determined to be ambiguous to ascertain legislative intent; and (4) construing tax exemptions, credits, and deductions narrowly.

Washington law provides a statute of limitations on the Department of Revenue's (DOR) ability to reach back in time to assess taxes and applicable interest and penalties for tax deficiencies. If the DOR determines that additional taxes are owed on a particular transaction, the DOR must formally assess the additional taxes plus any interest and penalties during the calendar year in

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which the transaction occurred or the following four calendar years. Beyond this time limitation, the DOR is prohibited from assessing additional taxes, interest, and penalties. However, the DOR may exceed this limitation if: the taxpayer failed to register with the DOR, the taxpayer engaged in a fraud or misrepresentation, or the taxpayer has authorized a waiver of the limitation.

Use Tax.
The use tax applies to the acquisition of tangible personal property (TPP), digital products, and some services that were not subject to sales tax. The use tax statute is very specific as to which TPP acquisitions it applies to: any article of TPP purchased at retail, or TPP acquired by lease, gift, repossession, or bailment, or TPP extracted or produced by the person using the TPP. The tax is measured by the value of the item at the time of first use within the state. Use tax rates are equivalent to retail sales tax rates. The DOR rules state that "[a] transfer of capital assets to or by a business is deemed not taxable to the extent the transfer is accomplished through an adjustment of beneficial interest of the business."

Real Estate Excise Tax.
The sale of real estate is subject to the state real estate excise tax (REET). The tax is measured by the full selling price, including the amount of any liens, mortgages, or other debts multiplied by the rate of 1.28 percent. State law also authorizes several local REETs.

The REET also applies to transfers of controlling interests in entities that own property in the state. In order for the REET to apply to the sale of a controlling interest in an entity that owns real property, the following must have occurred: (1) The transfer or acquisition of the controlling interest occurred within a twelve-month period; (2) the controlling interest was transferred in a single transaction or series of transactions by a single person or acquired by a single person or a group of persons acting in concert; (3) the entity has an interest in real property located in this state; (4) the transfer is not otherwise exempt from tax under state law; and (5) the transfer was made for valuable consideration. A program established in 2005 requires transfers of controlling interests in an entity that owns real property to be reported to the Secretary of State. Failure to report a transfer of a controlling interest to the Secretary of State can result in interest and penalties, including a 50 percent tax evasion penalty.

The REET is a legal obligation of the seller. Additionally, a statutory lien is placed on the property until the tax is paid. If REET is not properly paid, the DOR may enforce the obligation in an action of debt against the seller, enforce the lien in the same manner as a mortgage foreclosure, or some combination of the two. A buyer may also be liable for the REET unless the buyer notifies the DOR in writing within 30 days following the sale.

Summary of Bill:

Economic Substance Doctrine.
The economic substance doctrine is adopted. Accordingly, the Department of Revenue (DOR) may disregard abusive tax avoidance transactions for tax periods on or after January 1, 2006. An "abusive tax avoidance transaction" is defined to mean a transaction, plan, or arrangement that lacks economic substance. A transaction will be deemed to have economic substance only if: (1) the transaction changes the taxpayer's economic position in a meaningful way, apart from the transaction's tax effects; (2) the taxpayer has a substantial nontax purpose for entering into the

transaction; and (3) the transaction is an objectively reasonable means of accomplishing the substantial nontax purpose.

A taxpayer has the burden of establishing that a transaction has economic substance.

If the DOR determines that a transaction lacks economic substance, the DOR may take reasonable steps necessary to deny the tax benefit resulting from the abusive tax avoidance transaction. These steps may include: re-characterizing the nature of income; disregarding the form of a corporate or other business entity; treating a transaction according to its underlying economic substance rather than form; treating a series of formally separate steps as a single transaction; and imputing income to a taxpayer who provides services to a related person and the consideration does not reflect the fair market value of the service.

If a tax deficiency is deemed to be a result of an abusive tax avoidance transaction, the DOR may assess a 35 percent penalty; however, the DOR may not assess the penalty if the taxpayer discloses its participation in an abusive tax avoidance transaction before the DOR discovers it.

In a negligence action against a tax practitioner in connection with an abusive tax avoidance transaction, evidence may be introduced that shows that the practitioner failed to request a ruling from the DOR on whether the transaction would be construed as an abusive tax avoidance transaction.

The DOR is authorized to assess taxes, interest, and penalties beyond the time-frame in the statute of limitations for tax deficiencies related to abusive tax avoidance transactions.

<u>Use Tax</u>.
The statutory language describing how the acquisition of tangible personal property (TPP) occurs (lease, gift, bailment, etc.) is eliminated. Therefore, the acquisition of TPP in any manner is subject to use tax unless some other provision specifically exempts the transaction.

<u>Real Estate Excise Tax</u>.
For the purpose of determining whether the sale of a controlling interest has occurred within a 12 month period, an option to purchase real estate is also included in the determination. The date the option agreement is executed is used as the relevant date.

The DOR may, at its option, enforce the collection of real estate excise tax (REET) for the sale of a controlling interest in a business by pursuing the buyer of a controlling interest, seller of a controlling interest, or the business entity itself of which a controlling interest is transferred.

The law is clarified that a lien for payment of REET attaches to each parcel of property owned by an entity in which a controlling interest has been transferred.

A parent corporation of a wholly owned subsidiary is responsible for REET if the subsidiary transfers real property to a third party and then dissolves before payment of the tax.

Buyers are no longer absolved from REET liability by simply providing notice of a real estate sale to the DOR.

Appropriation: None.

Fiscal Note: Available.

Effective Date: The bill takes effect on July 1, 2010.