

## Washington State Adopts Budget/Tax Legislation

April 23, 2010

### Overview

Earlier today, Washington Governor Christine Gregoire signed Second Engrossed Substitute Senate Bill 6143 (“2ESSB 6143”) into law, adopting the following significant business tax law changes as part of a broad set of revenue raising measures:

- An “economic nexus” standard and single receipts factor apportionment for business and occupation (“B&O”) tax purposes applicable to “income ... generated from engaging in apportionable activities,” which include specified services and the business of receiving income from royalties.
- A temporary B&O tax surcharge on certain service businesses, “contests of chance,” and real estate brokers.
- A tax avoidance provision with potential retroactive application and a 35% penalty.

This tax alert summarizes these changes and highlights some of the other provisions of the new law.

### Economic Nexus Standard

Effective June 1, 2010, Washington will impose for B&O tax purposes an economic nexus standard on “income ... generated from engaging in apportionable activities,” which includes income from various specified services and the business of receiving income from royalties.<sup>1</sup> Under the new law, businesses domiciled outside the state will be subject to the B&O tax if they meet any of the following thresholds: more than \$50,000 of property in the state; more than \$50,000 of payroll in the state; more than \$250,000 of receipts from the state; or if at least 25% of the taxpayer’s total property, payroll, or receipts are in the state.<sup>2</sup>

### Single Receipts Factor Apportionment

Also, effective June 1, 2010, “income ... generated from engaging in apportionable activities,” must be apportioned to Washington using a single factor receipts methodology.<sup>3</sup> Under the new law, the following sourcing rules apply for purposes of determining the receipts factor numerator:

- Apportionable receipts are sourced to where the customer received the benefit of the services, or in the case of royalties, where the customer used the intangible property.
- If the location of the customer’s benefit or use, as applicable, cannot be ascertained, default rules source the receipts in the following order:
  1. To the location from which the customer ordered the service or, in the case of royalties, the customer’s office from which the royalty agreement was negotiated;
  2. To the location to which the billing statements are sent to the customer;
  3. To the location from which the customer sends payment to the taxpayer;

<sup>1</sup> 2ESSB 6143, Section 104. 2ESSB 6143, Section 104(6) provides that the new economic nexus provisions apply only to “taxes imposed under this chapter on apportionable activities as defined in RCW 82.04.460.” The term “apportionable activities” is defined in Wash. Rev. Code § 82.04.460(4)(a) (as amended by 2ESSB 6143, Section 108) as various specified services and the business of receiving income from royalties.

<sup>2</sup> 2ESSB 6143, Section 104(1).

<sup>3</sup> 2ESSB 6143, Section 105(1). As noted previously, Wash. Rev. Code § 82.04.460(4)(a), as amended by 2ESSB 6143, Section 108), defines “apportionable activities” as various specified services and the business of receiving income from royalties.

4. To the customer's business address as shown in the taxpayer's business records or as otherwise obtained as part of the consummation or negotiation of the underlying contract; and
5. To the commercial domicile of the taxpayer.<sup>4</sup>

2ESSB 6143 provides that income attributable to a state in which the taxpayer is "not taxable" will be excluded from the receipts factor denominator.<sup>5</sup>

The new law also provides that the foregoing sourcing rules do not apply to "financial institutions."<sup>6</sup> Instead, the Department of Revenue ("Department") is directed to adopt by rule a method that, "to the extent feasible, [is] consistent with the multistate tax commission's recommended formula for the apportionment and allocation of net income of financial institutions."<sup>7</sup> This rule also "must provide for a single factor apportionment method based on the receipts factor."<sup>8</sup>

### Temporary B&O Tax Surcharge on Certain Service Businesses, Realtors, and Contests of Chance

From May 1, 2010 to June 30, 2013, an additional tax rate of 0.3% is added to the 1.5% B&O tax on real estate brokers (Wash. Rev. Code § 82.04.255), contests of chance (Wash. Rev. Code § 82.04.285), and all service and other businesses currently taxed under the catchall provisions of Wash. Rev. Code § 82.04.290(2).<sup>9</sup> This change does not apply to certain hospitals and to those performing specified scientific research and development services.<sup>10</sup>

### Tax Avoidance Transactions or Arrangements

2ESSB 6143 provides that the Department "must disregard" specified "tax avoidance transactions or arrangements" and deny the tax benefit that would otherwise result.<sup>11</sup> The specified transactions and arrangements (also referred in this bill as "disregarded transactions") are:

- Certain joint ventures between a construction contractor and a project owner or developer that are, "in substance, substantially guaranteed payments for the purchase of construction services...."
- Arrangements in which a taxpayer seeks 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."
- Arrangements through which a taxpayer attempts to avoid 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."<sup>12</sup>

In determining whether this new provision applies, the Department may consider, among other relevant factors, the following:

- Whether the transaction or arrangement changes in a meaningful way, apart from tax effects, the economic positions of the participants.

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<sup>4</sup> 2ESSB 6143, Section 105(3)(b).

<sup>5</sup> 2ESSB 6143, Section 105(3)(c). Section 105(3)(c) defines "not taxable" in a state to mean "that the taxpayer is not subject to a business activities tax by that state, except that a taxpayer is taxable in a state in which it would be deemed to have a substantial nexus with that state under the standards in section 104(1) of this act regardless of whether that state imposes such a tax."

<sup>6</sup> 2ESSB 6143, Section 105(3)(d).

<sup>7</sup> 2ESSB 6143, Section 105(2); and 2ESSB 6143, Section 108, amending Wash. Rev. Code § 82.04.460(2). Note also that an existing rule, Wash. Admin. Code § 458-20-14601, already provides such a method of apportionment for financial institutions.

<sup>8</sup> See, Wash. Rev. Code § 82.04.460(2)(a), as added by 2ESSB 6143, Section 108.

<sup>9</sup> 2ESSB 6143, Section 1101(1).

<sup>10</sup> 2ESSB 6143, Section 1101(2). Section 1102 of the bill also increases the small business tax credit for the affected "service businesses" from \$35 per month to \$70 per month.

<sup>11</sup> 2ESSB 6143, Section 201(2).

<sup>12</sup> 2ESSB 6143, Section 201(3).

- Whether substantial nontax reasons exist for entering into the transaction or arrangement.
- Whether an arrangement or transaction is a reasonable means for accomplishing a nontax purpose.<sup>13</sup>

The new law specifies that this change applies to “tax periods beginning January 1, 2006.”<sup>14</sup> However, the following exceptions apply:

- The provision does not apply to any transaction or arrangement initiated before May 1, 2010, provided that the transaction or arrangement was reported by the taxpayer in conformance with and does not materially differ from the Department’s written instructions to the taxpayer, a precedential written determination specified in Rev. Code Wash § 82.32.410, or other authority publically issued by the Department.<sup>15</sup>
- The provision would also not apply to tax periods ending before May 1, 2010, that were included in a completed field audit of the taxpayer that was conducted by the Department.<sup>16</sup>

Adding further consequence to the use of “tax avoidance transactions or arrangements,” 2ESSB 6143 includes a penalty provision. If the Department finds that any part of a tax deficiency resulted from a “disregarded transaction,” the Department is required to assess a 35% penalty on the applicable tax deficiency.<sup>17</sup> The Department is precluded from imposing this penalty if prior to the Department’s discovery of the taxpayer’s participation in the transaction, the taxpayer discloses such participation to the Department.<sup>18</sup>

The tax avoidance section of 2ESSB 6143<sup>19</sup> also includes a number of statutory fixes that eliminate other specific approaches apparently viewed by the Legislature as designed to unfairly avoid taxes, including the ability to use a “drop down” strategy with a subsidiary entity to sell assets without incurring use tax on the tangible personal property acquired in the transaction.<sup>20</sup>

### Other Changes Contained in 2ESSB 6143

Among the other changes included in the bill are the following:

- *First Mortgage Deduction Modified* – Effective June 1, 2010,<sup>21</sup> certain amounts that are received for servicing loans no longer qualify for the B&O tax deduction under Wash. Rev. Code § 82.04.4292 applicable to interest on investments or loans secured by first mortgages or deeds of trust except when such amounts are received by the originator of the loans or certain affiliates and successors.<sup>22</sup> The law also clarifies that certain other types of fees and charges are not deductible.
- *Direct Sellers Exemption Eliminated* – Effective May 1, 2010,<sup>23</sup> the B&O tax exemption for firms that sell into Washington using a direct seller’s representative is eliminated.<sup>24</sup> For periods prior to May 1, 2010, the exemption is narrowed retroactively to apply only to persons that sell exclusively consumer products where such products are also not ultimately sold at retail in a permanent retail establishment.<sup>25</sup>
- *Modifying B&O Tax Preferences for Manufacturers of Products Derived from Certain Agricultural Products* – In response to the Washington Supreme Court’s decision in *Agrilink Foods, Inc. v. Department of Revenue*, 153 Wn.2d 392 (2005), effective June, 1 2010,<sup>26</sup> 2ESSB 6143 narrows the application of the preferential 0.138% B&O tax rate for persons

<sup>13</sup> 2ESSB 6143, Section 201(2).

<sup>14</sup> 2ESSB 6143, Section 1703.

<sup>15</sup> 2ESSB 6143, Sections 202(1) and 1708.

<sup>16</sup> 2ESSB 6143, Section 202(2).

<sup>17</sup> 2ESSB 6143, Section 203, amending Wash. Rev. Code § 82.32.090, by adding new subsection (6).

<sup>18</sup> *Id.*

<sup>19</sup> 2ESSB 6143, Part II, which includes bill Sections 201-213.

<sup>20</sup> 2ESSB 6143, Section 206, amending Wash. Rev. Code § 82.12.020.

<sup>21</sup> 2ESSB 6143, Section 1709.

<sup>22</sup> 2ESSB 6143, Section 301.

<sup>23</sup> 2ESSB 6143, Section 1708.

<sup>24</sup> 2ESSB 6143, Section 401.

<sup>25</sup> 2ESSB 6143, Sections 402 and 1704.

<sup>26</sup> 2ESSB 6143, Section 1709.

qualifying for the B&O classification of slaughtering, breaking, or processing of perishable meat.<sup>27</sup> The new law also provides that the definition of “fruit or vegetable products” is limited to products consisting of at least 50% fruit and vegetables.<sup>28</sup>

- *B&O Tax on Corporate Board of Director Fees* – Effective July 1, 2010, amounts received by an individual from a corporation as compensation for serving as a member of that corporation’s board of directors are taxable under the Service and Other Activities B&O tax classification.<sup>29</sup>
- *“Responsible Individual” Liability for Sales Tax Debts* – Effective May 1, 2010, the definition of “responsible individual” is expanded to include chief executives and chief financial officers of terminated, dissolved, abandoned, or insolvent limited liability businesses. Under the amended law, the Department may seek payment of collected and unremitted sales taxes (including applicable interest and penalties) of such businesses from the applicable chief executive or chief financial officer, regardless of fault or whether the individual was or should have been aware of the unpaid sales tax liability.<sup>30</sup>
- *Sales and Use Tax Exemptions for Bottled Water and Candy Eliminated* – Beginning June 1, 2010, candy is subject to sales and use tax.<sup>31</sup> From June 1, 2010 to June 30, 2013, bottled water is subject to sales and use tax.<sup>32</sup> However, certain exemptions apply, including an exemption for bottled water “dispensed to patients pursuant to a prescription,” and one applicable to sales of bottled water to persons without potable water.<sup>33</sup>
- *PUD Privilege Tax Clarification* – Effective May 1, 2010, PUD Privilege tax, which previously applied to charges for electric energy, is expanded to apply to “any recurring charge” billed to consumers as a condition of receiving the electricity.<sup>34</sup>
- *Property Management Salaries B&O Tax Exemption Modified* – Effective June 1, 2010, the exemption for amounts received by a property management company for on-site personnel is limited to nonprofit property management companies and property management companies that contract with a housing authority.<sup>35</sup>
- *Temporary Beer Tax Increase* – From June 1, 2010 to June 30, 2013, the Beer Tax is temporarily increased by 50 cents per gallon. The temporary increase does not apply to the first 60,000 barrels produced by small brewers.<sup>36</sup>
- *Temporary Carbonated Beverages Tax Imposed* – From July 1, 2010 to June 30, 2013, a new temporary tax is imposed at the rate of 2 cents per 12 ounces of carbonated beverages sold in the state.<sup>37</sup> This tax does not apply on successive sales of any previously taxed beverage or on a bottler’s first \$10 million of sales.<sup>38</sup>
- *Sales and Use Tax Bad Debt Deduction Limited* – Applicable to claims for refund filed after June 30, 2010, debts sold or assigned are specifically excluded from the bad debt deduction.<sup>39</sup>

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<sup>27</sup> 2ESSB 6143, Section 502.

<sup>28</sup> 2ESSB 6143, Sections 503-506. Note that this definitional change is relevant for purposes of the exemption for processing and selling fruit and vegetable products applicable through June 30, 2012; and for purposes of the preferential B&O tax rate of 0.138% for processing and selling fruit and vegetable products effective July 1, 2012.

<sup>29</sup> 2ESSB 6143, Sections 702(2) and 1713.

<sup>30</sup> 2ESSB 6143, Sections 801 and 1708. Note that any other “responsible individual” is liable for these taxes “only if he or she willfully fails to pay or cause to be paid . . . the sales tax due from the limited liability business entity.” See 2ESSB 6143, Section 801, amending Wash. Rev. Code § 82.32.145(3)(b), (4)(b).

<sup>31</sup> 2ESSB 6143, Sections 901-903, 1709, and 1713.

<sup>32</sup> 2ESSB 6143, Sections 901-903, 1709, and 1713. Note that Engrossed House Bill 2561 (pending) would appear to make taxation of bottled water permanent.

<sup>33</sup> 2ESSB 6143, Sections 904-907.

<sup>34</sup> 2ESSB 6143, Sections 1001 and 1708.

<sup>35</sup> 2ESSB 6143, Sections 1201, 1202, 1709, and 1713.

<sup>36</sup> 2ESSB 6143, Sections 1301 and 1709.

<sup>37</sup> 2ESSB 6143, Sections 1401, 1402, and 1713.

<sup>38</sup> 2ESSB 6143, Sections 1403 and 1404.

<sup>39</sup> 2ESSB 6143, Sections 1502, 1503, and 1719.

- *Other Sales and Use Tax Changes* – 2ESSB 1643 also makes technical changes to the recently passed sales and use tax exemption for data centers;<sup>40</sup> and suspends from July 1, 2010 to June 30, 2013, the sales and use tax exemption for livestock nutrient equipment and facilities.<sup>41</sup>

## Contacts

If you have questions regarding these tax law changes or other Washington tax matters, please contact either of the following Deloitte professionals or your Lead Multistate Executive:

Andy Colson  
Senior Manager  
Deloitte Tax LLP, Seattle  
[acolson@deloitte.com](mailto:acolson@deloitte.com)  
(206) 716-7618

Eric Ng  
Manager  
Deloitte Tax LLP, Seattle  
[ericng@deloitte.com](mailto:ericng@deloitte.com)  
(206) 716-7006

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<sup>40</sup> 2ESSB 6143, Section 1601.

<sup>41</sup> 2ESSB 6143, Sections 601, 602, and 1713.