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## Washington's 2010 B&O Tax Law Changes

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This year, the State of Washington made several significant changes to the business and occupation ("B&O") tax in an effort to raise revenue and ease compliance. The following changes were all enacted by Second Engrossed Substitute Senate Bill 6143, which was signed into law on April 23, 2010, by Governor Christine Gregoire and is expected to raise approximately $318 million in taxes for fiscal year 2011.

### Economic Nexus

According to the Washington Legislature, out-of-state businesses without a physical presence in the state earn significant income from in-state residents by providing services or collecting royalties on the use of intangible property in the state.[1] The economic nexus provisions, which apply to "apportionable activities," including activities falling under the "services and other activities" category and receiving income from intangible property, are an attempt to extend the B&O tax to such businesses.[2] Effective June 1, 2010, an out-of-state business is deemed to have substantial nexus with the state if the business has (1) more than $50,000 of property (including intangible property) in the state; (2) more than $50,000 of payroll in the state; (3) more than $250,000 of receipts from the state; or (4) 25 percent or more of its

[1] 2ESSB 6143, § 101(1).

[2] *Id.* §§ 104(6), 1702. "Apportionable activities" also include activities subject to the following classifications: (i) travel agents and tour operators; (ii) international steamship agents, customs house brokers, freight forwarders, vessel and/or cargo charter brokers in foreign commerce, and/or international air cargo agents; (iii) stevedoring; (iv) disposing of low-level waste; (v) title insurance producers or agents, or surplus line brokers, (vi) public or nonprofit hospitals; (vii) real estate brokers; (viii) research and development performed by nonprofits; (ix) inspecting, testing, labeling, and storing canned salmon owned by another person; (x) representing and performing services for fire or casualty insurance companies as an independent resident managing general agent; (xi) contests of chance; (xii) horse races; (xiii) international investment management services, (xiv) room and domiciliary care to boarding-home residents; (xv) aerospace product development; (xvi) printing or publishing a newspaper (but only for advertising income); (xvii) printing materials other than newspapers and publishing periodicals or magazines (but only for advertising income); and (xviii) cleaning up radioactive waste and other byproducts of weapons production and nuclear research and development, but only for activities that would be taxable as an "apportionable activity" under any of the tax classifications listed above. WAC § 458-20-19401(2).

total property, total payroll, or total receipts from the state.[3] The minimum nexus thresholds are determined on a tax-year basis, which is generally based on the calendar year.[4]

For 2010, the minimum nexus thresholds are based on the entire 2010 calendar year, but taxes are due under the new thresholds only from June 1, 2010, forward.[5] The Department of Revenue will review the nexus threshold amounts each year and adjust the amounts based on changes of 5 percent or more in the consumer price index.[6] Once economic nexus has been established, substantial nexus is deemed to exist not only for the current year but also for the following tax year.[7]

Property used to determine the property threshold is "tangible, intangible, and real property owned or rented and used in [Washington] during the calendar year."[8] Property does not however, include ownership of or rights in computer software.[9] The value of the property is determined by averaging the values at the beginning and end of the tax year.[10] The Department of Revenue may require the averaging of monthly values if reasonably required to properly reflect the average value of the taxpayer's property.[11] Property other than loans and credit card receivables is valued at its original cost basis.[12]

Payroll counting toward the threshold is the total amount paid by the taxpayer for employee compensation in Washington during the tax year plus nonemployee compensation paid to representative third parties in Washington.[13] Employee compensation is considered in Washington if the compensation is properly reportable to the state for unemployment compensation tax purposes, regardless of whether the compensation was actually reported in the

[3] 2ESSB 6143, § 104(1)(c). For taxes imposed on other activities, a person has substantial nexus "if the person has a physical presence in this state, which need only be demonstrably more than a slightest presence." *Id.* § 104(b). "[A] person is physically present in this state if the person has property or employees in this state" or "either directly or through an agent or other representative, engages in activities in this state that are significantly associated with the person's ability to establish or maintain a market for its products in this state." *Id.*

[4] WAC § 458-20-19401(1)(a) (Emergency regulation effective June 2, 2010, until Sept. 30, 2010, unless the Department of Revenue adopts a permanent rule prior to that date).

[5] *Id.*

[6] 2ESSB 6143, § 104(5)(a).

[7] *Id.* § 102(2).

[8] WAC § 458-20-19401(2)(c)(i).

[9] *Id.* § 458-20-19401(2)(c)(ii).

[10] 2ESSB 6143, § 104(2)(c).

[11] *Id.*

[12] *Id.* § 104(2)(b)(i).

[13] *Id.* § 104(3)(a).

state.[14] Nonemployee compensation is considered in Washington if the service performed by the representative occurs entirely or primarily in Washington.[15]

The receipts threshold includes only those amounts included in the numerator of the taxpayer's receipts factor—only those related to apportionable income from apportionable activities.[16] The 25 percent threshold is determined by dividing the value of property located in Washington by the total value of the taxpayer's property, the payroll located in Washington by the taxpayer's total payroll, or the receipts attributed to Washington by the taxpayer's total receipts.[17]

**Single Receipts Factor Apportionment Replaces Complicated Cost Apportionment Method**

The new Washington B&O law abandons the complicated cost apportionment method used for the "services and other activities" category and adopts a more common single receipts factor apportionment method.[18] The legislature attributed the switch to the difficulty in assigning certain costs of doing business under the prior cost method, the dissimilarity of the cost method to methods used in other states, the relative ease and commonality of the single receipts factor, and the potential for increased business in the state due to the absence of a property or payroll factor.[19]

Effective June 1, 2010, the new single receipts factor applies to the "services and other activities" category and to receiving income from intangible property, among others, but does not apply to activities falling under the retailing, wholesaling, or manufacturing categories, to name a few.[20] The receipts apportionment factor is determined by dividing gross income from engaging in an apportionable activity in Washington into gross income from engaging in an apportionable activity worldwide.[21] An "apportionable activity" includes, for example, an activity under the "services and other activities" category or receiving income from intangible property, and a separate receipts factor must be calculated for each apportionable activity.[22]

**Receipts Sourced by Benefit Location With "Throw-Out" Rule**

Income for B&O purposes is sourced to Washington for purposes of the numerator of the receipts factor if the benefit of the service was received in Washington or if the customer used

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[14] *Id.* § 104(3)(b).

[15] *Id.* § 104(3)(c).

[16] *Id.* § 104(4).

[17] WAC § 458-20-19401(7).

[18] *See* 2ESSB 6143, § 105.

[19] *Id.* § 101(2)(a), (b).

[20] *Id.* §§ 105(1), 1709. *See supra* note 2 for the other activities using single receipts factor apportionment.

[21] *Id.* § 105(3)(a).

[22] *Id.* §§ 105(1), 108(4)(a).

the intangible property in Washington.[23] If the benefit was received or the intangible property was used in more than one state, gross income is attributed to Washington if the benefit of the service was received primarily in Washington or the intangible property was used primarily in Washington.[24]

A series of alternative attribution rules apply where the taxpayer is unable to attribute the receipts to a determinable benefit location. The alternative rules include the location (i) from which a royalty agreement was negotiated, (ii) to which invoices are sent, (iii) from which the customer sends payment, (iv) of the customer's address in the taxpayer's business records maintained in the ordinary course of the taxpayer's business, or (v) of the customer's commercial domicile.[25] The new apportionment formula also includes a "throw-out" rule, in which income is excluded from the denominator if the income is attributed to a state where the taxpayer is not taxable.[26] A taxpayer is generally considered not taxable in a state where the taxpayer is not subject to a business activities tax by that state; however, a taxpayer is considered taxable in the state in which it is organized or commercially domiciled, or where it meets the new economic nexus standards, regardless of whether such state imposes a business activities tax.[27]

**Special Single Receipts Factor for Financial Institutions**

It should be noted that the new apportionment rules do not apply to financial institutions; however, the Washington Legislature directed the Department of Revenue to create rules for the apportionment of income of financial institutions that provide for a single receipts factor.[28] An emergency rule, effective from June 2, 2010, until September 30, 2010, provides that any financial institution that is

> organized under the laws of a foreign country, the Commonwealth of Puerto Rico, or a territory or possession of the United States, except such institutions that are exempt under RCW 82.04.315, whose effectively connected income (as defined under the Federal Internal Revenue Code) is taxable both in this state and another state, other than the state in which it is organized, must allocate and apportion its gross income as provided in this rule.[29]

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[23] *Id.* § 105(b)(i).

[24] *Id.* § 105(b)(ii). If the taxpayer is unable to attribute gross income based on the benefit of the service or the use of intangible property, the section provides a hierarchical list of ways to attribute the income. *See id.* §§ 105(b)(iii)–(b)(vii).

[25] 2ESSB Sec. 105(3)(b)(iii)-(vii).

[26] *Id.* § 105(c).

[27] *Id.*

[28] *Id.* §§ 105(d), 108(2).

[29] WAC § 458-20-19404(2)(a).

The rule goes on to provide for a single receipts factor and enumerates the specific types of gross income included in the numerator.[30] For example, interest, fees, and penalties in the nature of interest from loans secured by real property are in the numerator if the property is located in Washington.[31]

Taxpayers required to use receipts factor apportionment, including financial institutions, may report their apportionable income for the most recent calendar year for which the taxpayer has information.[32] If the taxpayer does not use the most recent calendar year for which it has information, the taxpayer must use current-year information.[33] Under either method, when the taxpayer has the information from which to determine receipts for a calendar year, it must file a reconciliation and either obtain a refund or pay additional tax.[34]

**Temporary Rate and Small Business Credit Increases**

From May 1, 2010, to June 30, 2013, the tax rate for real estate brokers, "contests of chance," and business activities falling under the "services and other activities" category was temporarily increased from 1.5 percent to 1.8 percent.[35] The rate increase, however, does not apply to hospitals or to persons engaged in scientific research and development.[36]

For businesses that report at least 50 percent of their taxable income under the "services and other activities" category, the legislature correspondingly increased the small business credit from $420 per year ($35 per month) to $900 per year ($75 per month).[37]

**Corporate Directors Are Subject to the B&O**

The B&O tax applies to independent contractors but not to employees. Previously, many corporate directors considered themselves employees of the corporation and thus exempt from the B&O tax. The new legislation makes clear that corporate directors are considered independent contractors and are subject to tax.[38]

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 taxed under the "services and other activities" category.[39] However, if an individual is serving a corporation

[30] *Id.* § 458-20-19404(4)(b)–(4)(l).

[31] *Id.* § 458-20-19404(4)(b).

[32] 2ESSB 6143, § 105(4), WAC § 458-20-19404(2)(c).

[33] 2ESSB 6143, § 105(4), WAC § 458-20-19404(2)(c).

[34] WAC §§ 458-20-19402(6)(b), 458-20-19404(2)(c).

[35] 2ESSB 6143, § 1101(1).

[36] *Id.* § 1101(2)(a), (b).

[37] *Id.* § 1102(1).

[38] *Id.* § 701.

[39] *Id.* § 702(2).

in the role of director and as an employee, nothing in the new provisions implies that the individual would be taxed on the income received as an employee. Further, out-of-state corporate directors of Washington corporations may be subject to the B&O tax if the directors have substantial nexus with Washington under the new economic nexus rules.[40] The most likely situation would be that the out-of-state director will have received 25 percent or more of his or her income from the Washington corporation, thus subjecting the director to Washington B&O tax.

**Tax-Avoidance Transactions**

In order to ensure that all taxpayers pay their fair share and to stop transactions and arrangements that are designed to unfairly avoid taxes, the Washington State legislature enacted provisions requiring the Department of Revenue to disregard certain tax-avoidance transactions and to deny any tax benefits that would result from such transactions.[41] As a further deterrent, a 35 percent penalty must be added to any deficiency in tax that results from engaging in a tax-avoidance transaction.[42] Included in the disregarded transactions are

> [a]rrangements through which a taxpayer attempts to avoid tax under [the 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.[43]

In determining whether such a transaction must be disregarded as a tax-avoidance scheme, the Department of Revenue can consider several factors, including: (1) 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; (2) whether substantial nontax reasons exist for entering into an arrangement or transaction; (3) whether an arrangement or transaction is a reasonable means of accomplishing a substantial nontax purpose; (4) an entity's relative contributions to the work that generates the income; (5) the location where the work is performed; and (6) any other relevant factors.[44]

The Department of Revenue provided the following example of a B&O tax transaction that will be disregarded under the new provisions

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[40] *See id.* § 104(1)(c).

[41] *Id.* § 201(1), (2).

[42] *Id.* 203(6). The tax will not be assessed if the taxpayer discloses its participation in a prohibited transaction before the Department of Revenue discovers the participation. *Id.*

[43] *Id.* § 201(3)(b). The other transactions that are prohibited involve joint ventures between contractors and developers and arrangements to avoid sales and use taxes. *See id.* § 201(3)(a), (c). For purposes of applying this section, "affiliated" means under common control. *Id.* 201(7). "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." *Id.*

[44] *Id.* § 201(2).

> A Washington company with its only place of business in Washington provides online services subject to B&O tax to Washington customers. The Washington company forms a LLC in another state. The Washington company causes the out-of-state LLC to contract with its Washington customers to provide the online services. The out-of-state LLC hires the Washington company as a subcontractor to provide the online services to customers. The out-of-state LLC has no employees or other property and pays only a nominal fee to the Washington company for the services. The out-of-state LLC collects customer payments and makes distributions to the Washington company. The Washington company claims the distributions are from its capital account with the out-of-state LLC and exempt from B&O tax under RCW 82.04.4281.
>
> The Department will disregard the transactions between the Washington company and the LLC and assess the Washington company for tax on the income collected by the out-of-state LLC.[45]

The tax-avoidance provisions are effective for tax periods beginning January 1, 2006.[46] Thus, these provisions have a retroactive effect.

There are a couple of safe-harbor provisions where the legislation will not be applied retroactively. A transaction will not be disregarded if the transaction or arrangement was initiated before May 1, 2010, and the taxpayer reported its tax liability in conformance with either: (1) specific written instructions provided by the Department of Revenue to the taxpayer; (2) a determination published under the authority of RCW 82.32.410; or (3) other documents made available by the Department to the general public.[47] This provision applies as long as the transaction or arrangement does not differ materially from the transaction or arrangement that was addressed in the specific written instructions, published determination, or other document made available by the Department to the general public.[48] Also, the provision does not apply to tax periods beginning before May 1, 2010, if the periods were "included in a completed field audit conducted by the department."[49]



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[45] Washington Department of Revenue Special Notice (May 27, 2010).

[46] 2ESSB 6143, § 1703.

[47] *Id.* § 202(1)(a). "Specific written instructions" means "tax reporting instructions provided to the taxpayer and which specifically identify the taxpayer to whom the instructions apply." *Id.* § 202(3). The instructions "may be provided as part of an audit, tax assessment, determination, closing agreement, or in response to a binding ruling request." *Id.*

[48] *Id.* § 202(1)(b).

[49] *Id.* § 202(2).