WASHINGTON STATE TAX STRUCTURE STUDY

Economic Neutrality/Efficiency

Issues

The primary questions addressed in this analysis are the following.

- Does Washington's tax structure cause companies to organize or conduct their business in any inefficient ways?
- What do businesses do to avoid taxes?
- What do individuals do to avoid taxes?

Findings

- Businesses are increasingly engaged in a variety of strategies to legally minimize their tax obligations in Washington. One contributing factor may be the reduced level of federal corporate income tax, making the Washington tax payment (primarily B&O) relatively more important.
- Most of these strategies are designed to reduce the level of taxable income, rather than to avoid tax altogether.
- Strategies to minimize tax are often inefficient and can be costly to implement. They also increase the complexity and level of effort necessary to review and fairly enforce Washington's tax.
- Business strategies to reduce their Washington tax levels include: creating wholly owned subsidiaries to receive a portion of the income in another state, conducting a portion of the manufacturing operation in another state, creating holding companies, and creating a purchasing agent relationship with customers.
- Individuals illegally avoid use tax by making purchases through the Internet, via catalogs of businesses with no taxable nexus in Washington, and making purchases in states with a lower or no (Oregon) sales tax.

Economic Inefficiencies - Business

Analysis

There is an increased willingness in recent years to develop strategies to decrease a business' tax base in Washington. One reason these strategies are more prevalent is the recent reduction in federal corporate income tax rates, which makes state business taxes relatively more significant. Another factor is the increased availability of tax consultation services. Also important is the growth of Washington's high technology sectors for which tax savings can be particularly significant, while their transfer of some operations can be accomplished with relative ease.

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This paper focuses primarily on the efforts businesses make to reduce their business and occupation (B&O) tax liability. There are also strategies to decrease a business' sales tax liability, but these strategies are common to many states with sales taxes.

Although business reorganizations and other strategies often reduce a business' tax liability, they are inefficient and often costly to implement. Time and money are required to form and maintain additional corporate entities and out-of-state offices. These strategies are also complex for tax administration agencies to review and enforce. Each scenario where a taxpayer asserts that a particular business or activity is exempt because of a complex corporate structure takes additional time and effort to verify.

<u>Examples</u>

Intellectual Property

A Washington corporation with intellectual property creates a subsidiary company that is not subject to federal corporate income taxes. The subsidiary moves to a state that does not tax corporate income (e.g. Nevada). The intellectual property rights are transferred to this out-of-state subsidiary company. The Nevada subsidiary receives all of the royalty income from use of the intellectual property and pays dividends to the remaining Washington business.

<u>Results</u>

- The Washington portion of the business no longer pays B&O tax on the income from use of the intellectual property because dividends paid by a subsidiary to a parent are exempt.

Manufacturing

A Washington manufacturing company wants to reduce its tax base. The company forms an out-of-state subsidiary to be the primary manufacturer. The out-of-state subsidiary brings its own goods into Washington and contracts with the Washington manufacturer as a processor for hire to finalize the manufacturing process. The Washington manufacturer pays B&O tax on the contract payments it receives as a processor for hire. The goods are then sold by the out-of-state subsidiary.

<u>Results</u>

- The processor for hire (in-state) pays tax only on the contract payments from the out-of-state manufacturer, which only cover the costs of labor and overhead. If the in-state manufacturer had manufactured its own goods, B&O tax would have been assessed on the full value of the goods.

Purchasing Agents

A Washington wholesaler wants to decrease its B&O tax liability. The wholesaler sets up contracts with its customers appointing the wholesaler as a purchasing agent. The purchasing agent buys goods from manufacturers on behalf of the retailers and passes the goods along to the retailers, receiving a commission for the service provided. The purchasing agent pays B&O tax on the commission income.

Results

- The purchasing agent pays tax only on the service income derived from providing purchasing services to retailers.
- The purchasing agent is no longer acting as a wholesaler and no longer pays B&O tax on the value of the goods sold to the retailers.
- The overall cost of the goods for the retailer is reduced because the final cost no longer includes tax on the full value of the goods, just tax on the commission income.

Real Estate Excise Tax

Real estate excise tax (REET) is assessed on the transfer of real property or of a controlling interest in an entity owning real property. REET is assessed when at least 50 percent of the interest in an entity owning real property is transferred within a 12-month period. In order to avoid REET on the transfer of controlling interest in an entity owning real property, a person may create several nominal transfers over the 12-month period (totaling less than 50 percent) with the larger transfers achieving controlling interest taking place beyond the 12-month period.

Results

- No REET is paid on these transfers of real property.

Relocations

In the age of remote commerce and electronic businesses, it is no longer necessary for all portions of a business to be co-located. Businesses are able to relocate parts of their enterprise, especially those that do not deal with tangible personal property, to other states with more favorable tax treatments for that business activity, or to states with less stringent regulatory requirements for that activity.

Results

- Businesses relocate portions of their enterprise and only pay tax on the remaining in-state activities.
- Businesses pay little or no tax on the relocated portion of the enterprise.

Sales Tax

Businesses (and individuals) that purchase large items such as planes or yachts may reduce their sales tax liability by creating separate holding companies. The holding company owns the plane and leases the plane to the original business on a daily basis a few times a month. Since the holding company has purchased the plane for resale, there is no sales tax due at the time of purchase. The business is only required to pay sales tax on the occasional daily lease payments.

Results

- Leasing arrangements with separate companies allows businesses or individuals to reduce their sales tax liability.

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Economic Inefficiencies - Individuals

Washington individuals change their behavior in two ways because of the sales tax. They shop more on the Internet and through catalogs, and they shop more in Oregon than they would if Washington did not have a sales tax.

Washington households spent an estimated $2.3 billion on remote sales in 2001. Out of that total, about 6 percent, or $147 million, was purchased because Washington has a higher than average sales tax. The avoidance estimate is based on a tax elasticity from Dr. Austan Goolsbee's paper "In a World without Borders: The Impact of Taxes on Internet Commerce."

Washington households purchased an estimated $808 million in Oregon in 2001 because of the tax differential. These estimates are based on result shown in "The Effects of Tax Rate Differences on Retail Trade in Washington Border Counties" by Dr. Lorrie Jo Brown.

Goods purchased through these means are subject to the Washington use tax at the point of first use in the state. In general collection of use tax from individuals is very difficult. . However, the department does collect use tax from individuals on items that must be licensed and from those who voluntarily report use tax on items they purchase via the Internet or in Oregon.