

Seattle Rule 5-046

Valuing the measure of the tax for business activities between related, controlled or affiliated persons.

(1) **Introduction.** In instances where the relationship between related, controlled or affiliated persons is such that the gross income from business activities between such persons is not indicative of the market value of the activities or transactions, the Director shall determine the market value upon which the Seattle business license tax shall be levied.

The purpose of this rule is to ensure taxpayers clearly reflect their true gross income attributable to business activities or transactions between related, controlled or affiliated persons, and to prevent the avoidance of taxes in regards to such activities or transactions. Business activities or transactions between one related, controlled or affiliated person and another will be subject to special scrutiny by the Director to ascertain whether common control is being used to reduce, avoid, or escape taxes. The authority of the Director to determine true taxable income extends to any case in which either by inadvertence, sham, or design the taxable income of a related, controlled or affiliated person is other than it would have been had the person, in the conduct of its affairs, been dealing at arm's length with an unrelated, uncontrolled or unaffiliated person. The Director will consider whether the persons are motivated by business purposes other than tax avoidance or are principally motivated by tax avoidance purposes.

- (2) **Definitions.** The following definitions apply when used within this rule.
- a. **"Market value" or "arms length consideration"** is the amount that would be paid or received for similar activities or transactions of like quantity, quality, or character under similar circumstances and conditions by other persons where no common interest exists between the persons involved in the activities or transactions.
 - b. **"Related, controlled or affiliated person"** means a person or entity that controls, or is controlled as the case may be, through common ownership. "Related," "controlled" and "affiliated" are used interchangeably when describing a subsidiary, however, related and affiliated can also mean the parent entity. The degree of ownership is unimportant, however the ability to control or influence the related, controlled or affiliated person is important in establishing whether

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relationships and transactions serve a business purpose, produce income, or merely avoid taxes.

- (3) Examples of business activities or transactions between related, controlled or affiliated taxpayers that will be scrutinized by the Director. The following are examples of business activities or transactions in which the Director will determine market value because the related, controlled or affiliated entities have not valued the activities or transactions at a reasonable price.
- a. A person performs services for another related, controlled, or affiliated person without charge, or at a charge which does not reflect the market value, or dividends are paid by a subsidiary to a parent as remuneration for services provided by the parent. However, a parent corporation providing supervisory services (also known as stewardship or overseeing functions) to a subsidiary need not charge the subsidiary for those services, which are regarded as providing the parent corporation with a benefit relating to the conservation and protection of its investment. Parent corporations often coordinate and oversee major policy decisions and set strategic direction for their subsidiaries. An arm's length consideration should be determined for managerial services that would have provided the subsidiary with a benefit had they been provided by a third party.
 - b. A person leases, sells, bails, or transfers tangible property to another related, controlled, or affiliated person without a charge or at a charge that is below market value.
 - c. A person licenses, transfers, bails, or sells intangible property to another related, controlled, or affiliated person for no fee or a fee that is below market value.
 - d. A related, controlled, or affiliated person provides services for the parent or controlling entity for which no charge is made, or for a charge below market value.
 - e. Any other transaction between related, controlled or affiliated persons or entities which results in an improper or inaccurate reflection of the business activity or income of those persons or entities.
- (4) Determining whether an improper or inaccurate valuation of activity exists. The director will consider the following to determine whether an arrangement between related, controlled, or affiliated persons results in an improper or inaccurate valuation of the activity.
- a. Whether the persons are motivated by business purposes other than tax avoidance or are principally motivated by tax avoidance. In no case shall

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the mere evasion or avoidance of taxation be regarded as a business purpose.

- b. Whether the separate businesses of the related, controlled or affiliated persons have economic substance because a reasonable possibility of obtaining a profit exists, apart from achieving tax benefits.
- c. Whether one person has a significant amount of capital gains, interest, dividend or similar income, but minimal capital, activity, or expenses, because essential business functions are performed for the person by another without arm's length consideration.
- d. In determining whether the related persons or entities are motivated by tax avoidance or whether they possess economic substance, the director shall also look to the following.
 - i. The related person has an identifiable place of business with supporting business records.
 - ii. The related person maintains books and related accounting records.
 - iii. The related person has a staff of employees or has engaged contractors adequate in number and with sufficient expertise to conduct its business affairs.
 - iv. The controlling person so controls and dominates the finances, policy and business activities of the related person that the related person has virtually no separate existence.
 - v. The form employed for conducting business is a sham.

(5) **Valuing the measure of the tax.** The Director will use the following methods to assign a value to business activities or transactions between related, controlled, or affiliated persons when the Director feels that a true or market value has not been determined.

- a. **Fair market valuation.** A value determined by comparing charges made for similar goods or services of like quality and character, in similar quantities, under comparable conditions of sale, to comparable unrelated party purchasers, including subsidies and bonuses.
- b. **Cost basis.** If no comparable goods or services can guide the Director in ascertaining the value, then such value may be determined upon a cost plus margin basis. All costs -- including direct and indirect overhead costs -- attributable to the particular article, good or service shall be included. An appropriate profit margin shall also be added to the costs.
- c. **Amount of dividends or loans received.** If a parent corporation or controlling person provides services that are more than general oversight duties to a subsidiary or controlled person and receives no payments, or

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such payments are not at market value, but then receives dividends or loans from the subsidiary or controlled person for the services rendered, the Director shall deem the dividends or loans received to be fair market value compensation for the services rendered. If the amount of dividends or loans can be shown to be higher than the market value of the services then the market value will be used. General oversight duties of a parent corporation include high level management direction, strategic planning, stewardship duties or assisting in the financing of the controlled persons. These duties can be provided without taxation of the dividends, loans or compensation from subsidiaries or controlled persons. However, providing services for a subsidiary's or controlled person's customers, or providing accounting and administrative services, or providing marketing services, or providing other lower level management duties for a subsidiary or controlled person, or any similar activities will be subject to a market value determination and taxation.

- (6) **Separate reporting required.** Every legal entity shall file a separate tax return and include therein the tax liability accruing to each. This applies to every person in a related, controlled or affiliated group, as the law makes no provision for filing of consolidated returns by related, controlled, or affiliated persons or for the elimination of inter-company activities from the measure of tax.
- (7) Examples. The following represent examples of situations where a person is engaged in a non-arms length transaction with another related, controlled, or affiliated person and how the Director will assess tax in the situation.
- a. Company Y is an internet service provider with their only office within the City of Seattle. Company Y provides their internet services to a related and controlled Company Z, which is located in Delaware, and Company Z in turn bills their customers for the internet service. Company Z has one or two employees. All of the services provided to Company Z's customers are actually provided by Company Y's Seattle office and Company Y's employees. Company Y bills Company Z a small management fee for their services which represents only 5% of the costs for their Seattle office. This example represents a non-market valued transaction between related, controlled or affiliated entities. It is unlikely that there will be comparable charges made for similar goods or services of like quality and character, in similar quantities, under comparable conditions of sale, to comparable purchasers. In this case, the Director will value the transactions between Company Y and the related Company Z based upon the costs of Company Y's operations in Seattle and add to those costs a profit margin for that type of industry.

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- b. Company XYZ, located in Seattle, is a research and development company that enters into a \$10 million contract to conduct research on behalf of Company A. XYZ sets up affiliate ZZZ in Nevada and immediately assigns the Company A Contract to ZZZ. ZZZ then in turn contracts with Company XYZ to actually perform the research work for company A for \$100,000. ZZZ recognizes the \$10 million under the contract as its income, and the \$100,000 paid to XYZ as its expense. ZZZ then distributes its net income back to XYZ, its parent company, by declaring a dividend. ZZZ's income resulted from transactions by its parent and there was no other income generated. The subsidiary relied entirely on its parent for performance of ordinary business operations. The transactions at issue were simply the receipt of significant contract payments by a subsidiary followed by a substantial repayment by the subsidiary to the parent in the form of a dividend. The subsidiary lacked real economic substance as a separate business entity and the activities of the subsidiary had to be viewed through the activities conducted by its operating parent. Under these circumstances, the Director will declare ZZZ a sham corporation if the corporation has no substance and tax the whole \$10 million dollar contract, or if ZZZ has substance, characterize the dividend received from ZZZ as compensation for services rendered. The latter would be an example of a payment for services disguised as a dividend.
- c. Company 123 is a manufacturer located in Seattle. Company 123 sells its manufactured products to a related or affiliated Company XYZ, who in turn sells the products to their customers. Company XYZ is also located in Seattle and has no assets or employees of their own. All employees are those of Company 123. All sales of Company XYZ to the consumer occur over the internet and 95% are interstate or foreign sales. The internet site is maintained by the employees of Company 123. The two entities have an intercompany wholesale sales agreement with the price set at 2% of the normal retail price. In reviewing the normal wholesale market for this product, it is determined that there are some similar wholesale sales to unrelated parties at 40% of the normal retail price. This is an example of a company selling property to another related, controlled, or affiliated person at a sales price that is not a "market value" price. The Director will value this business activity based on comparable charges made for similar goods in the Seattle market to comparable wholesale entities. If no similar wholesale sales were available then the Director would use a cost basis for the manufactured products and added a profit margin to the costs.

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- d. Person A owns land and wants to develop the land by constructing a 22 floor building on the land. Person A and a general contractor enter into an agreement to form a limited liability company to hold the land while the building is being constructed. After construction is completed the LLC is dissolved and the building and the land revert back to Person A. This LLC arrangement allows the building to be constructed as a spec building thereby eliminating the sales tax on the labor portion of the construction activity, and also eliminating the business license tax on the entire contract between the LLC and the general contractor. This is an example of an entity being formed for no economic reason other than avoiding taxation. Person A obviously created, and has control over the LLC to merely avoid taxes. In this case, the director will ignore the temporary LLC arrangement and treat the construction contract between the LLC and the general contractor as a contract between Person A and the general contractor. The entire contract (labor, materials, overhead, and applicable profit) would be subjected to the retailing business license tax.

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