

# Taxation Section

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## IRS Issues Tenancy-in-Common Guidance for Like-Kind Exchange\*

By Ronald A. Shellan

In recent years, sponsors have created and marketed tenancy-in-common interests in real property as replacement property in tax-free exchanges. Tenancy-in-common interests have broad appeal as an investment because they allow taxpayers to purchase interests in larger, quality properties that can be professionally managed. But can such interests qualify as replacement property in a tax-free exchange? Yes. In Rev. Proc. 2002-22, 2002-14 IRB 733, the IRS provided definitive guidance to taxpayers and their legal counsel in structuring such transactions.

The issue is whether such interests are "real estate" that can qualify as replacement property in a tax-free exchange, or are interests in a partnership, which cannot. Partnership interests can never be the subject of a tax-free exchange. IRC § 1031(a)(2)(D). The distinctions between a tenancy-in-common interest in real estate and a partnership are not clear, but tenancy-in-common arrangements have on occasion been characterized as partnerships.<sup>1</sup> The danger, of course, is that an exchange involving a tenancy-in-common interest treated as a partnership would be a taxable sale.

Rev. Proc. 2002-22 provides the requirements for taxpayers who want to obtain a favorable ruling that a tenancy-in-common arrangement is a partnership for tax purposes. As a practical matter, however, most practitioners will use the Revenue Procedure as guidance for safely structuring a tenancy-in-common interest so that it will not be deemed to be a partnership. To obtain a favorable ruling, each of the Revenue Procedure's 15 requirements (discussed below) must be met.

As a preliminary matter, the Revenue Procedure provides some guidance on what constitutes a parcel of real property for purposes of the ruling. Each parcel constituting the property must be viewed together as a single business unit. The IRS will generally consider contiguous parcels as a single business unit. Noncontiguous parcels will also qualify as a single property "where there is a close connection between the business use of one parcel and the business use of another parcel." For example, an office building and a parking garage that services the office building could be considered a single parcel, even if they were not contiguous.

**1. Tenancy-in-Common Ownership.** Each co-owner must hold title to the property as a tenant in common under local law. Ownership through disregarded entities, such as single-member limited liability companies, is specifically allowed.<sup>2</sup>

**2. Number of Co-Owners.** The number of co-owners cannot exceed 35 persons. For this purpose, husband and wife are treated as a single person, as well as all persons who acquire interests from co-owners by inheritance. This should not be problematic as tenancy-in-common arrangements exceeding 35 persons are rare.

**3. No Treatment of Co-Ownership as an Entity.** The owners must not act like an entity. They cannot file a partnership or corporate tax return, conduct business under a common name, refer to themselves as partners, shareholders, or members of a business entity, or otherwise hold themselves out as conducting business as an entity.

Except for the requirement not to conduct business under a common name, these requirements should not present difficulties to taxpayers. Virtually every strip mall, office building, and apartment building in the country has a name, and using the name would appear to violate this requirement. This problem can be avoided if the co-owners lease the property to a single user, who may or may not sublease the property to other subtenants under that lease ("Master Lease"). A common Master Lease arrangement is to lease the property to the sponsor who created the tenancy-in-common interest on a long-term lease (often 20 years or more). The lease rents often increase slowly over time, allowing the tenant ("Master Lessee") to create income on the spread. As will be discussed below, a number of requirements of the Revenue Procedure promote using a Master Lease.

A ruling generally will not be issued if the property was held in an entity immediately prior to holding the property in tenancy-in-common ownership. This requirement is designed to prevent ruling requests for partnerships that want to liquidate in order to allow individual partners to exchange their interests in a tax free IRC § 1031 exchange (so-called "drop-and-swap transactions").

**4. Co-Ownership Agreement.** The Revenue Procedure specifically allows co-ownership agreements. This is good news because some practitioners believed, based on prior case law, that the very existence of a tenancy-in-common agreement might be evidence of a partnership. Such tenancy-in-common agreements may run with the land. The terms of such agreements, such as voting, granting rights of first offer, and restrictions on the right of partition, are discussed below.

**5. Voting.** The good news is that a tenancy-in-common agreement may include voting provisions. The Revenue Procedure implies that, at a minimum, co-owners holding no more than 50 percent of the undivided interests in the property must approve any specific action. The bad news is that most important decisions require unanimous approval: selling; leasing; borrowing funds secured by a blanket lien; hiring a manager; or approving, or even renewing, a management contract.

From a business point of view, requiring unanimous approval does not make good sense. For example, a single intransigent co-owner, no matter how small his or her interest, could block an action approved by every other co-owner. An intransigent co-owner thus has the power to blackmail the other co-owners. However, a Master Lease will allow the co-owners to avoid the unanimity requirement, at least for leasing and engaging a manager. The Master Lessee can make all leasing decisions regarding leases by entering into subleases, and can manage the property or hire a manager to manage it.

May the co-owners in the tenancy-in-common agreement agree to take an action in the future, such as refinancing the property? The unanimous voting requirement would appear to be defeated if the parties agreed in the tenancy-in-common agreement to refinance or sell the property in five years. Yet if the tenancy-in-common agreement contained the co-own-

ers' intention to obtain a permanent loan from XYZ Mortgage Company when the construction loan was due, it appears that such an action would be sufficiently contemporaneous to be acceptable under the revenue procedure. Once a co-owner has consented to an action, he or she can grant a power of attorney to allow another person to execute specific documents to carry out that action. But global powers of attorney are specifically prohibited.

**6. Restrictions on Alienation.** In general, there can be no restrictions on the right to transfer, partition, or encumber a co-owner's interest in the property. But certain restrictions are allowed, including restrictions on alienation contained in loan documents that are commercially customary. In addition, the co-owners, the sponsor or the lessee may have a right to make the first offer to buy a co-owner's interest when that co-owner wishes to transfer his or her interest in the property. A co-owner may also agree to offer the interest to other co-owners, the sponsor or the lessee prior to taking any partition action. In either case, the offer price must be at fair market value.

It seems odd that a right of first *offer* is allowed with respect to selling a tenancy-in-common interest, but the more common right of first *refusal* is not specifically allowed. Drawing a distinction between the two rights seems insupportable, at least based on prior cases, but how rights of first refusal will ultimately be treated remains unclear.

**7. Sharing Proceeds and Liabilities Upon Sale of Property.** If the property is sold, any debt secured by a blanket lien must first be satisfied before distributing the remaining proceeds to the co-owners. This requirement would arguably prohibit a sale in which the buyer assumed the secured debt since the lien must first be satisfied. The IRS can have no conceivable reason to object to a sale involving assumption of the underlying debt. In such a situation, perhaps a technical violation of the requirements in the final act of selling the property will not override previous compliance with all of the other requirements.

**8. Proportionate Sharing of Profits and Losses.** Each of the co-owners must share all profits and losses in proportion to their undivided interests in the property. This provision is perfectly logical and will not pose a problem to taxpayers structuring tenancy-in-common transactions.

The Revenue Procedure also requires that no co-owner, sponsor, or lessee may advance money to pay expenses for a period longer than 31 days. The logic behind this requirement is not at all clear. Perhaps the IRS wanted to discourage long-term advances, which are in effect debts owed by one co-owner to another that are disallowed in Section 6.14 of the Revenue Procedure.<sup>3</sup>

**9. Proportionate Sharing of Debt.** Co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests. Thus, any tenancy-in-common agreement should specifically provide that debt is shared in accordance with each co-owner's ownership percentage. Otherwise, the obligation of the co-owners to the mortgage

lender, which is usually joint and several, might not, under local law, allocate the debt obligation between the parties in proportion to their ownership interests in the property. A co-owner is not precluded from borrowing against his tenancy-in-common interest in the property, as long as it is not secured by a blanket lien on the property. Such a debt, for example, could theoretically be secured by the debtor co-owner's tenancy-in-common interest in the property, not the entire property.

**10. Options.** The Revenue Procedure allows call options to be issued by co-owners. A call option must be based on the fair market value of the property at the time the option is exercised. No minority or marketability discounts are allowed. This is achieved by requiring that the option price be the fair market value of the entire property multiplied by the co-owner's percentage interest in the property. Put options in favor of the co-owners, the sponsor, the lessee, the lender, or their affiliates are not allowed. This will prevent tenancy-in-common sponsors from guaranteeing a floor value of the property being purchased by co-owners. A put option in favor of an outside party is allowable. Again, the reasoning behind this requirement is unclear. In theory, there is no reason why a put option, even to the insiders, could not have been allowed as long as it was exercisable at fair market value and the put option and call options could not be exercised during the same period.

**11. No Business Activity.** The co-owners' activities "must be limited to those customarily performed in connection with the maintenance and repair of rental real property (customary activities)." The Revenue Procedure cites Rev. Rul. 75-374, 1975-2 CB 261, and the requirements for unrelated business taxable income found in IRC § 512(b)(3)(A). For example, the co-owners could not operate property that was a hotel, motel, nursing home, or car wash. Legal counsel will need to scrutinize carefully the proposed operation of the property. If such an operation is desired, the Master Lease can again come to the rescue. If the property is leased under a Master Lease, the co-owners can be insulated against issues as to whether the management activities are customary activities.

There is, however, at least one fly in this ointment. Activities of parties related to the co-owners (disregarded for a co-owner who owns an interest in the property for six months or less) will be imputed to the co-owners. For example, if the co-owners leased the property under a Master Lease to a nursing home operated through a limited liability company controlled by one of the co-owners, the co-ownership arrangement could be considered by the IRS to be a partnership.

To avoid this problem, properties such as hotels, motels, nursing homes, and car washes should not be the subject of a co-ownership arrangement unless a Master Lease is used and the Master Lessee either is not a co-owner or agrees to convey its interest in the property to an unrelated party within six months.<sup>4</sup> A Master Lessee should be very cautious about agreeing to sell its property within a six-month period because the Master Lessee could be forced to sell its interest at a bargain-basement price.

## **12. Management and Brokerage Agreements.**

Co-owners may not enter into management or brokerage agreements unless they are "renewable" annually. This can be problematic because the co-owners must, as discussed above, unanimously agree "to hire any manager" or agree to the "negotiation of any management contract." If every co-owner did not agree, who would manage the property? The answer to this problem is our old friend, the Master Lease.

The Revenue Procedure also provides that the manager may use a common bank account to operate the property. All net revenues must be disbursed to the co-owners every three months. There is no provision for reserves, but it is doubtful that reserve payments required under mortgages would be disallowed. The manager can also prepare statements showing each co-owner's share of revenue and costs. The manager may also be authorized to obtain or modify insurance, negotiate a lease, or negotiate a new mortgage (even though the co-owners must approve these actions by the required vote percentage). The fees paid to the manager must not be in excess of fair market value and cannot be based on income or profit. This latter requirement is to prevent the manager from in effect being a "manager" partner who receives an allocation of partnership income for services rendered to the partnership.

**13. Leasing Agreements.** All leases must be bona fide leases for federal tax purposes. Rents must be set at fair market value. No rent can be determined in whole or in part by net income, profit, cash flow, increases in equity, or similar arrangements, maintaining the principle that only the co-owners can share in the fruits of the operation of the property. But, fortunately, rent can include or be based on a percentage of gross sales in receipts.

**14. Loan Agreements.** No co-owner, sponsor, manager, or lessee may make a loan to acquire a tenancy-in-common interest in the property. This provision could be interpreted to prevent tenancy-in-common agreements from including mandated seller-financing provisions when a co-owner is exercising rights under a right-of-first-offer provision.

**15. Payment to Sponsor.** Any payment to a sponsor must reflect the fair market value of the services provided and may not be based on income or profit from the property.

## **Conclusion**

For the most part, the principles set forth in Rev. Proc. 2002-22 are reasonable. Although the IRS sought and received significant input from tax practitioners in formulating the revenue procedure (including significant input from the author), the Revenue Procedure's language reflects in places a lack of actual experience in structuring real estate transactions in the real world. It also reflects a failure to vet the actual language of the revenue procedure with tax practitioners before finalizing it. The most significant problems will be the requirement for unanimous consent to sell, lease, finance, or enter into a management contract with respect to the property. Most transactions will probably be structured under a long-term Master Lease to avoid the requirement for

unanimous consent for leasing or entering into a management contract.

The Revenue Procedure will now become the standard for structuring tenancy-in-common transactions. Sponsors of tenancy-in-common transactions will likely structure all of their transactions so that its requirements are met, and taxpayers can be fully assured that their tax-free exchange transactions will in fact be fully tax-free.

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## Footnotes:

<sup>1</sup> *Bergford v. Commissioner*, 12 F3d 166, 94-1 USTC ¶ 50,004 (9th Cir 1993) (unified audit procedures); *Madison Gas & Electric Co. v. Commissioner*, 72 TC 521 (1979) (start-up costs).

- <sup>2</sup> Will owning interests in real estate as tenants by the entirety or joint tenancy work? What about owning unusual interests in property such as a lessee's leasehold interests in a long-term lease or interests in ownership entities such as Illinois Land Trusts? Or even an undivided beneficial interest in a revocable living trust? Although it does not appear that the IRS intended to preclude such interests, they clearly do not meet the "letter" of the revenue procedure's requirements.
- <sup>3</sup> One commentator suggests that if a co-owner did not pay his share of expenses, the only remedy available would be to "sell the property or purchase the interest of the defaulting co-owner." Richard M. Lipton, *New Rules Likely to Increase Use of Tenancy-in-Common Ownership in Like-Kind Exchanges*, J Tax'n (vol. 96, May 2002). The author believes this approach to be overly conservative. The Revenue Procedure does not preclude traditional remedies such as bringing a legal action to specifically perform the obligations under the agreement.
- <sup>4</sup> Some commentators suggest that in all situations the transaction should be structured so that the Master Lessee co-owner must agree to sell its interest in the property within six months. See Lipton, *supra*. This seems incorrect. There is no need for the Master Lessee to sell his interest in the property if the property's management will require only customary activities.

# Understanding Washington's Business and Occupation Tax

By George C. Mastrodonato\*

This article addresses the Washington Business and Occupation ("B&O") Tax issues that an Oregon practitioner may encounter. The tax is especially confusing to businesses located outside of Washington, and because of the close ties between Washington and Oregon, Oregon businesses provide fertile ground for the Washington Department of Revenue to reach new tax revenues. This article will provide a broad overview of the tax and highlight some of the issues Oregon businesses may encounter in determining whether they are required to pay the tax.

## Gross Receipts Tax

The Washington B&O tax is often misunderstood precisely because it is a tax on gross, not net, income. Washington is one of only a handful of jurisdictions that still impose a tax on gross receipts. Neither federal nor state income tax concepts apply to the tax. So, for example, to the extent federal income tax rules apply to Oregon's net income tax, those rules will have no application in Washington for the B&O tax.

The B&O tax is "measured by the application of rates against value of products, gross proceeds of sales or gross income of the business, as the case may be." RCW 82.04.220.<sup>1</sup> The tax is also imposed at every stage of economic activity (extracting, manufacturing, wholesaling, retailing, etc.) and so the tax is said to "pyramid." The pyramiding nature of the B&O tax has been challenged and upheld numerous times.<sup>2</sup>

The terms "value of products," "gross proceeds of sales," and "gross income of the business" are all defined in the B&O tax statutes. See RCW 82.04.070, 82.04.450 and 82.04.080. In general, these terms mean the "value proceeding or accruing" from sales of tangible personal property or from performing services. Inasmuch as the B&O tax is a tax on gross receipts, there is no deduction allowed for the cost of goods sold or materials used, labor costs, interest, discount, delivery costs, taxes, "or any other expense whatsoever paid or accrued and without any deduction on account of losses." RCW 82.04.070, 82.04.080.

## Timing and Rate of Tax

The method of accounting regularly employed by a taxpayer generally determines when the B&O tax is to be paid. RCW 82.04.090. Thus, accrual method taxpayers generally are taxable in the period in which income accrues, while cash basis taxpayers generally report income as it is actually or constructively received. There are some important limitations as to accounting methodologies and these are described in the regulations. See WAC 458-20-197, 458-20-198 and 458-20-199.

B&O tax rates vary according to the nature of the business activity engaged in by the taxpayer. For example, manufacturing is a particular activity and the gross receipts from engaging in that activity are taxed at the rate of .484 percent. RCW 82.04.240. Extractors and wholesalers pay B&O tax at the rate of .484 percent on their gross proceeds of sales also. RCW 82.04.230; 82.04.270. Retailers pay at a slightly lower rate (.471 percent). RCW 82.04.250. Business

activities that are not otherwise specifically defined in the B&O tax statutes, including personal and professional services, pay the tax at the rate of 1.5 percent under the “service and other activities” classification. RCW 82.04.290(2).

A person who engages in more than one activity is subject to tax under each classification. The tax must be computed by multiplying the revenue from each activity times the B&O tax rate applicable to that activity.

## Who Is Subject to the Tax?

The B&O tax is an excise imposed on every “person... for the act or privilege of engaging in business activities” in Washington. RCW 82.04.220. It is not necessary for an Oregon business to have an office or other business location in Washington so long as it is “engaging in business activities” in the state within constitutionally prescribed limits. Thus, unless a deduction, exemption or constitutional prohibition applies, the B&O tax is imposed on virtually all business activities carried on in Washington.

The tax is also applied to every “person,” which is broadly defined to include any individual, business entity (corporation, partnership, LLC), trust, government or nonprofit entity, association, “or any group of individuals acting as a unit.” RCW 82.04.030. As a general proposition, every individual and every kind of formal or informal entity “engaging in business” in Washington is subject to the B&O tax. RCW 82.04.150.

Finally, the B&O tax does not have any counterpart to the federal income tax “consolidated return” that permits affiliated corporations to aggregate and report their income together. In fact, quite the contrary: Washington requires every separate “person” to register and file tax returns. RCW 82.04.030.

The B&O tax statutes define “business” very broadly to include “all activities engaged in with the object of gain, benefit, or advantage to the taxpayer, or to another person or class, directly or indirectly.” RCW 82.04.140. The object of monetary gain is not necessary for an activity to be taxed as a “business” under the B&O tax.<sup>3</sup> This means that the B&O tax is imposed on all business activities carried on within Washington, even when no profit is realized. The courts have consistently upheld this position.<sup>4</sup> However, exceptions exist for casual and isolated sales (RCW 82.04.080) and accommodation sales (WAC 458-20-208).

Moreover, charitable, benevolent, religious and other nonprofit organizations that are exempt from federal income taxes may nevertheless be subject to the B&O tax since Washington law does not provide any blanket or general exemption from tax for such entities. WAC 458-20-169. However, there are many exceptions from the B&O tax for various nonprofit and charitable organizations, but an organization is exempted from the B&O tax *only* when a specific deduction or exemption has been enacted.

Being an employee, as opposed to being an independent contractor, does not constitute engaging in business. RCW

82.04.360; WAC 458-20-105. Thus, employee salaries and wages are not business income subject to the B&O tax. WAC 458-20-105 provides the guidelines for distinguishing between employees (not taxable) and independent contractors (taxable).

**Interstate Business.** Transactions that involve interstate sales of goods or services raise particular problems in the application of any state tax, and the B&O tax is no exception. A state may collect a tax on nonresidents only if the tax passes muster under the Due Process Clause and Commerce Clause of the U.S. Constitution. Most state taxes will survive a due process challenge; it is usually fairly easy for the state to show the kind of “minimum contacts” necessary to meet due process concerns. Under the Commerce Clause, however, four requirements must be met to sustain a tax on interstate commerce: (1) the tax must be applied to an activity with a “substantial nexus” with the taxing state; (2) the tax must be fairly apportioned; (3) the tax must not discriminate against interstate commerce by giving local businesses an unfair advantage; and (4) the tax must be fairly related to the services provided by the state.<sup>5</sup> Under the Washington B&O tax, the third and fourth requirements are not problematic, but the first two are the subject of some controversy.

**Nexus.** In Washington, a taxpayer is subject to the B&O tax if the taxpayer carries on any activity that is “significantly associated with the . . . ability to establish or maintain a market for its products in Washington.” WAC 458-20-193(2)(f).

WAC 458-20-193 addresses “inbound” sales – e.g., sales made by an Oregon business to its Washington customers, which are most likely to generate nexus questions.<sup>6</sup> In this context, what constitutes “substantial nexus” continues to be the subject of significant disputes between taxpayers and the Washington Department of Revenue. Washington argues that *any* physical presence in the state is sufficient to establish substantial nexus pursuant to WAC 458-20-193(7)(c)(v), which provides that nexus is present where “[t]he out-of-state seller, either directly or by an agent or other representatives, performs significant services in relation to [the] establishment or maintenance of sales into the state [of Washington], even though the seller may not have formal sales offices in Washington or the agent or representative may not be formally characterized a ‘salesperson.’” Either an employee or independent contractor can establish nexus.<sup>7</sup> While taxpayers may argue that substantial nexus under *Quill*<sup>8</sup> requires an analysis of both the quality and quantity of the physical presence, they should not be surprised if the Washington Department of Revenue disagrees.<sup>9</sup>

**Apportionment.** Assuming that substantial nexus exists, then revenue from interstate commerce must be fairly apportioned. Under the administrative rules, sales of goods are treated quite differently from sales of services. Sales of goods are allocated (and taxable) based upon where the buyer receives the goods. See WAC 458-20-193(3) (outbound sales) and (7) (inbound sales). Sales of services, on the other hand,

are allocated either by separate accounting or apportioned based upon the cost of doing business. See RCW 82.04.460(1) and WAC 458-20-194.

For sales of goods, Washington uses allocation (not apportionment), meaning that the revenue from the sale is either entirely taxable in Washington or none of it is taxable in the state.<sup>10</sup> This results from the general rule that locates the situs of the sale to the place of delivery – i.e., where the buyer receives the goods.

When selling property to customers outside Washington (“outbound sales”), the controlling issue is where the sale takes place. By having the seller deliver and the buyer receive the goods outside of Washington, the B&O tax can be eliminated. For these outbound sales, the buyer will typically receive the goods at the buyer’s out-of-state location. This means that for most businesses located in Washington and selling goods to out-of-state customers, there will be no B&O tax on the sale.<sup>11</sup>

Of course, the corollary is that out-of-state sellers with nexus in Washington will be taxable in this state because the buyer will receive goods in Washington (“inbound sales”). But, by planning for an out-of-state delivery, the B&O tax on the inbound sale can be avoided, even if the seller has nexus. For example, if a Washington buyer goes to Oregon to pick up or receive delivery of the goods, then Washington could not assert its B&O tax on the sale. What if the buyer cannot go to Oregon to receive the goods? The rule recognizes this and allows for an agent to receive the goods, so long as the agent is given authority to, and actually does, physically inspect and accept or reject the goods at the out-of-state location. WAC 458-20-193(2)(e).

The sale of services is first allocated (if possible), to the state where the taxpayer earned the income. A taxpayer can have activities in more than one state, but if the activity in the other state or states is only incidental, the income is allocated to the state where the substantial activity (place of business) takes place. WAC 458-20-194. If substantial activities take place in more than one state, the income is apportioned based upon costs of doing business, but only when an office or other place of business is maintained in the other state. *Id.*

Certain services can be allocated rather than apportioned. For example, the Washington Department of Revenue holds that construction or repair services are inherently local to the location where the actual work is performed. WAC 458-20-193(5)(c). In most cases, however, services that are performed both within and outside Washington are apportioned and taxed based upon relative costs. WAC 458-20-194.

## B&O Tax Exemptions

Persons otherwise subject to the B&O tax may be exempt from the tax under one of numerous exemptions codified in RCW chapter 82.04. There are generally two major categories of exemptions. The first includes exemptions that could apply to various types of businesses, such as

the exemption from B&O tax for employees (RCW 82.04.360), or for the sale of real estate (RCW 82.04.390) or for operating commuter ride sharing (RCW 82.04.355). The second major category, and by far the most numerous, are various B&O tax exemptions granted to specific industries. For the most part, these are set forth in RCW 82.04.310 through RCW 82.04.327. A person granted a total exemption from B&O tax is generally required to register, even if the total income of the business is exempt (e.g., farmers). See RCW 82.32.030.

## B&O Tax Deductions

The B&O tax allows certain deductions from the measure of the tax. Unlike exemptions, however, taxpayers must theoretically report gross income and then take a deduction on the face of the tax return, but the general rules are the same for both exemptions and deductions – they are strictly and narrowly construed against the taxpayer.<sup>12</sup> As with exemptions, some B&O tax deductions have broad interest to a variety of taxpayers while others are applicable to certain industries.

## Credits Against the B&O Tax

Two credits would be of interest to persons in Oregon who engage in business in Washington.

**Small Business Credit.** Prior law allowed a gross income exemption threshold (\$1,000, \$3,000 or \$12,000 depending on the reporting frequency—monthly, quarterly or annual—assigned to the taxpayer) but this was repealed in 1994 (former RCW 82.04.300; RCW 82.04.4451; see WAC 458-20-104) in favor of a small business tax credit. The small business credit is now \$71 for monthly taxpayers, \$211 for quarterly and \$841 for annual reporting taxpayers. This credit is claimed after all other B&O credits have been claimed. RCW 82.04.4451(1).

**Multiple Activities Tax Credit (MATC).** Taxpayers engaged in multiple business activities and falling under two or more B&O tax classifications (e.g., manufacturing and wholesaling, manufacturing and retailing, extracting and wholesaling) are subject to B&O tax under each applicable classification. RCW 82.04.440. However, the law also grants B&O tax credits for more than one B&O tax paid on gross receipts to Washington and other taxing jurisdictions. The net result is that only one B&O tax is ultimately paid. The MATC can be broken into three categories:

1. Taxpayers subject to Washington B&O tax under the wholesaling or retailing classification are entitled to a credit for (a) manufacturing taxes paid to Washington or any other state with respect to manufacturing of products sold in Washington, and (b) extracting taxes paid to Washington or any other state with respect to extracted products or ingredients of products sold in Washington. However, the amount of credit allowed cannot exceed the taxpayer’s Washington B&O tax liability with respect to the sale of such products. RCW 82.04.440(2).

2. Taxpayers subject to B&O tax under the general manufacturing classification or the seafood products manufacturing classification are entitled to a credit for extracting taxes paid to Washington or any other state with respect to extracting the ingredients or the products manufactured in Washington. RCW 82.04.440(3).

3. Taxpayers subject to Washington B&O tax under the extracting classification, the general manufacturing classification or any of the special manufacturing classifications provided in RCW 82.04.260(2), (3), (4), (5) or (7), are entitled to a credit against the Washington tax otherwise due for any (a) gross receipts taxes paid to any other state on the sale of products extracted or manufactured in Washington, (b) manufacturing taxes paid to Washington or to any other state with respect to the manufacturing of products using ingredients extracted in Washington, and (c) manufacturing taxes paid with respect to manufacturing activities completed in another state for products manufactured in Washington. Again, the credit allowed may not exceed the taxpayer's Washington B&O tax liability with respect to the extraction or manufacturing of such products. RCW 82.04.440(4).

The MATC is also allowed for taxes paid to foreign countries or their political subdivisions. RCW 82.04.440(5)(b)(iv).

For purposes of the MATC, the tax sought to be credited must be similar to the Washington B&O tax. The term "gross receipts tax" means any tax imposed on or measured by the "gross volume of business," whether measured by gross receipts or by some other measure, which does not amount to an income tax or value added tax and is not separately stated from the sale price (such as a sales tax).

## Conclusion

The B&O tax is only one tax that could be imposed by the State of Washington on Oregon companies engaging in business in Washington. Other taxes include the retail sales tax, use tax and public utility tax. An examination of all Washington taxes is recommended for any Oregon company transacting any business with Washington customers.

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## Footnotes:

- <sup>1</sup> The B&O tax is a cost of doing business and is considered part of a business's operating overhead. RCW 82.04.500. It is not a pass-on tax like the retail sales tax. If a person does charge a customer or client for the amount of B&O tax, these funds become part of the person's gross receipts upon which the B&O tax is to be applied.
- <sup>2</sup> See *Supply Laundry Co. v. Jenner*, 178 Wash. 72, 34 P.2d 363 (1934); *Drury the Tailor v. Jenner*, 12 Wn.2d 508, 122 P.2d 493 (1942).
- <sup>3</sup> See *Young Men's Christian Ass'n v. State*, 62 Wn.2d 504, 383 P.2d 497 (1963)
- <sup>4</sup> See *Time Oil Co. v. State*, 79 Wn.2d 143, 483 P.2d 628 (1971).
- <sup>5</sup> *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279, 51 L. Ed. 2d 326, 97 S. Ct. 1076 (1977).
- <sup>6</sup> WAC 458-20-193 also addresses "outbound" sales . i.e., sales made by a Washington business to its customers in other states.
- <sup>7</sup> *Tyler Pipe Indus., Inc. v. Dep't of Revenue*, 483 U.S. 232, 97 L. Ed. 2d 199, 107 S. Ct. 2810 (1987).
- <sup>8</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298, 119 L. Ed. 91, 112 S. Ct. 1904 (1992), addressed a state's ability to impose on an out-of-state company the requirement to collect the state's use tax from in-state customers. *Quill* did not address a state's ability to impose a "doing business" tax – like the B&O tax – on the out-of-state company.
- <sup>9</sup> Out-of-state businesses with nexus in Washington cannot rely on P.L. 86-272 (15 U.S.C. § 381) because that federal act, by its terms, applies to net income taxes and does not apply to the Washington B&O tax, a tax on gross income. See Determination No. 87-286, 4 WTD 51, 61 (1987) (Washington Tax Decisions (WTD) are selected determinations published by the Department of Revenue), citing *Clairel, Incorporated v. Kingsley*, 57 N.J. 199, 270 A.2d 702 (1970).
- <sup>10</sup> See *Chicago Bridge & Iron Company v. Department of Revenue*, 98 Wn.2d 814, 659 P.2d 463 (1983), appeal dismissed, 464 U.S. 1013, 78 L. Ed. 2d 718, 104 S. Ct. 542 (1983).
- <sup>11</sup> This is true only if there are no extracting or manufacturing activities associated with the goods.
- <sup>12</sup> See *Group Health Cooperative of Puget Sound, Inc. v. State Tax Commission*, 72 Wn.2d 422, 429, 433 P.2d 201 (1967).

## Tax Humor

Why did the auditor cross the road?  
Because he looked in the file and that's  
what they did last year.

Where there's a will there's a tax  
shelter.

Whenever one tax goes down, another  
goes up.

The reward for saving your money is  
being able to pay your taxes without  
borrowing.

# Upcoming Tax Meetings

## **PORTLAND**

### ***Portland Luncheon Series***

Contact: Mark Huglin  
mark@draneaslaw.com

July 10, 2003  
Bankruptcy Tax Issues  
Speaker: Susan Ford

September 11, 2003  
In conjunction with Tax Institute Lunch  
Speaker: Judge Henry Breithaupt,  
Oregon Tax Court

### ***Portland Tax Forum***

Contact: Mark Golding  
mgolding@hhdglaw.com

Postponed to TBA  
Partnership Taxation  
Speaker: Blake D. Rubin  
Date TBA

Negotiating M & A Agreements  
Speaker: Glen A. Kohl

### ***Oregon Tax Institute***

September 11-12, 2003  
Pittock Mansion

### ***Broadbrush Taxation***

November 6, 2003

## **SALEM**

Mid-Valley Tax Forum  
Contact: Barbara Smith –  
bjsmith@mail.heltzel.com

July 15, 2003  
Tax Issues in Divorce  
Speaker: Kristin LaMont  
September 16, 2003  
Fiduciary Income Tax Issues  
Speaker: Steve Cyr

## **EUGENE**

### ***Eugene-Springfield Tax Association***

Contact: Jeffrey D Kirtner  
jkirtner@hershnerhunter.com

No meetings scheduled in June, July  
and August

September – TBA

### ***Eugene Estate Planning Council***

Contact: Howard Feinman  
hfeinman@rio.com

No meetings scheduled in June, July  
and August

September – TBA

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Taxation Section  
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