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Previous newsletters are posted on the Taxation Section website.

The Oregon Residential Energy Tax Credit Program

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The Oregon Residential Energy Tax Credit Program (ORS 469.160 through ORS 469.180; OAR 330-070-0010 through OAR 330-070-0097) provides taxpayers with tax credits for alternate energy devices ("AEDs") which include certified energy efficient appliances, energy efficient heating, ventilation and air conditioning systems, premium efficiency water heaters, hybrid and alternative fuel vehicles, ground-source heat pump systems, and solar and wind systems.

In order to qualify for these tax credits, the taxpayer must (i) have an Oregon income tax liability, (ii) purchase, construct, install and certify an AED in accordance with the rules set forth in OAR 330-070-0010 through OAR 330-070-0097, and (iii) be the owner or contract buyer of an Oregon dwelling served by the AED, or be a tenant of the dwelling owner, and either (a) use the dwelling as a primary or secondary residence, or (b) rent or lease the dwelling to a tenant who uses the dwelling as a principal or secondary residence. The amount of the tax credit for an AED depends on the type of the AED, but in general may not exceed the net cost of the AED to the taxpayer. The amount of tax credit taken in a particular tax year may not exceed the taxpayer's tax liability, but unused tax credits may be carried forward for up to 5 years. A taxpayer can transfer the tax credit to an individual or business with an Oregon tax liability in exchange for a lump-sum payment. With a few exceptions, the amount of the lump-sum payment must be equal to 95% of the tax credit amount.

Appliances

An appliance must be certified by the Oregon Department of Energy to qualify for a tax credit. The Oregon Department of Energy provides a list of clothes washers, dishwashers, refrigerators, water heaters, wastewater heat recovery systems, and heat recovery and energy recovery whole-house ventilation systems that it certifies as energy efficient and therefore eligible for the tax credit. Appliances labeled as energy efficient by the federal Energy Star ™ program are not always eligible for the Oregon tax credit. In many cases, Oregon has higher standards than those of the Energy Star ™ program. A current list of certified appliances can be found at the Oregon Department of Energy's Web site at www.oregon.gov/energy.

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The appliance must be new and located in an Oregon dwelling that is either the taxpayer's primary or secondary residence or rented to a tenant who uses the dwelling as a principal or secondary residence. Motor homes or recreational vehicles do not qualify as dwellings. The maximum tax credit is the lesser of the amount listed on the Oregon Department of Energy qualifying list or 25% of the eligible net purchase cost. Shipping and delivery expenses and installation and space modification costs are not included as part of the net purchase cost. Multiple credits may be claimed in the same tax year for multiple energy-saving appliances.

Heating and Cooling Systems

A taxpayer can get a tax credit for a well-designed and sealed duct system in a new home or for sealing ductwork in the taxpayer's existing home. The work must be performed by a technician who is tax-credit certified by the Oregon Department of Energy. A list of eligible technicians can be found on the Department of Energy Web site listed above. The tax credit is 25% of the eligible cost, up to $250.

Qualified premium efficiency heat pumps and air conditioning systems installed by a technician who is tax-credit certified by the Oregon Department of Energy also qualify for a tax credit. A taxpayer can also get a tax credit for having the taxpayer's current heat pump or air conditioning system serviced and tested by a technician who is tax-credit certified by the Oregon Department of Energy.

Hybrid Electric and Alternative Fuel Vehicles

There is a tax credit for buying a new hybrid electric-gasoline vehicle, converting a vehicle to run on a qualifying alternative fuel, and buying a charging or alternative-fuel fueling system. Most hybrid vehicles qualify for both a $750 vehicle tax credit and a $750 on-board charging system credit. Check the Oregon Department of Energy Web site to see the list of qualifying hybrid vehicles.

Alternative fuel vehicles that use electricity, natural gas, E-85 (or higher) blend, methanol, propane, hydrogen and other fuels approved by the Oregon Department of Energy qualify for a tax credit, however, new "flex-fuel" vehicles that run on either E-85 or gasoline are not eligible for a tax credit. The tax credit for new alternative-fuel vehicles is based on the incremental difference between the base price of the alternative-fuel vehicle and the base price of the gasoline-only version of the same make and model vehicle. The tax credit is the lesser of 25% of the incremental difference or $750. The tax credit for vehicle conversions and charging/fueling systems is the lesser of $750 or 25% of the cost.

Solar AEDs

There are tax credits for solar water heating systems, solar pool heating systems, solar electric generation systems, and active and passive solar heating systems. Most of these systems must be installed or verified by a technician who is tax-credit certified by the Oregon Department of Energy. The guidelines for solar tax credits are beyond the scope of this article and can be found in OAR 330-070-0059 through 330-070-0064.

How to Apply for Residential Energy Tax Credits

The tax credit applications are available on the Oregon Department of Energy Web site. The Department will provide a certificate with the tax credit amount to qualified applicants. The taxpayer can then claim the credit on the taxpayer's Oregon income tax return. The taxpayer does not need to file the certificate, application or supporting documents with the taxpayer's return, but should retain them with the taxpayer's tax records in the event of an audit. The applications must be received by the Oregon Department of Revenue no later than April 1 of the year following the purchase, but the Department recommends filing the application as soon as possible to allow for the orderly processing of applications throughout the year. Much of the information in this article is from the Department of Energy Web site.

OSB TAXATION SECTION
Events Calendar

Tax Section CLEs – held at noon at the University Club, Portland

December 20 Washington Update
by Mark Prater

The Oregon Department of Revenue Pushes Nexus Arguments in Attempt to Bring More "Out-of-State" Taxpayers into Oregon

By Larry J. Brant,
Scott M. Schiefelbein[1]

A. Introduction

The State of Oregon recently received good news. Local economists forecast a $152 million increase in its revenues over the next two years.[2] This good news, however, has not sated the government's hunger for additional revenues. For better or worse, it appears our state government subscribes to the philosophy of fictional entrepreneur C. Montgomery Burns: "It's great being rich, but I'd trade it all for a little more."

This hunger for additional cash stems in part from the rise of electronic commerce – recent estimates indicate that electronic commerce costs states and localities as much as $14 billion per year in tax revenue.[3] States like Oregon that are so dependent upon income taxes (regarded as unstable revenue sources) must constantly strive to find additional revenue.

The State of Oregon, like other states, subscribes to the fundamental political fact – it is easier to raise revenue from non-voters than from voters. In this environment, the Oregon Department of Revenue (the "DOR") is advancing aggressive interpretations of constitutional and tax law in order to subject more out-of-state businesses ("Foreign Taxpayers") to Oregon's corporate income tax regime.[4]

This Article provides a brief overview of the constitutional and federal statutory hurdles a state must clear in order to impose its income tax on a Foreign Taxpayer. This Article also addresses three interesting arguments the DOR recently made in an attempt to clear these hurdles. These arguments are:

1. A Foreign Taxpayer has nexus with Oregon through its manufacturer's warranty;
2. A Foreign Taxpayer has "attributional nexus" with Oregon through its in-state agent, the local dealer; and
3. A Foreign Taxpayer has nexus with Oregon because a local dealer uses the Foreign Taxpayer's intangible property (e.g., trademarks, logos, etc.).

B. Overview of Nexus.

1. General Principles.

Under the Due Process and Commerce Clauses of the United States Constitution, a state must establish that there is a sufficient link between a taxpayer and the state before the state may subject that taxpayer to the state's tax regime.[5] This concept is distilled into the term "nexus." The primary question in state tax examinations involving Foreign Taxpayers is whether the taxpayer has established a sufficient nexus with the taxing state to subject it to state taxes.

Once nexus is established, the state may levy its full range of applicable taxes against the taxpayer and the taxpayer's in-state business activities. There is no distinction for nexus purposes between a taxpayer who has nexus as a result of its factory and thousands of employees located in the state, and a taxpayer who has nexus because it provides $5,000 of consulting services through a single two-week in-state engagement inside the state. Either the taxpayer has nexus or does not have nexus, – and if the taxpayer has nexus, the state can tax.

The only exception to this rule is Public Law 86-272 ("P.L. 86-272"), which prohibits states from imposing taxes measured by net income on taxpayers whose only activity in the state is the solicitation of sales of tangible personal property (discussed in greater detail below).[6] P.L. 86-272 does not eliminate the taxpayer's nexus – it only prevents the state from imposing net income taxes on that taxpayer.

A state cannot tax a taxpayer without satisfying both the Commerce Clause and the Due Process Clause of the U.S. Constitution. Historically, the Due Process Clause has been the easier test to satisfy, and accordingly most cases focus on the Commerce Clause inquiry.

a. The Due Process Clause.

A state may not impose a tax upon any taxpayer in violation of the Due Process Clause. Due process demands

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that there be "some definite link, some minimum connection, between a state and the person, property, or transaction it seeks to tax."[7] A taxpayer that purposefully directs its sales activities to a given state – even where the taxpayer has no physical presence in that state – will generally be considered as having sufficient connections with the taxing state to satisfy the Due Process Clause.[8] The Due Process Clause test is a *quid pro quo*: the "test is whether property was taken without due process of law, or, if paraphrase we must, whether the taxing power of the state bears fiscal relation to protection, opportunities, and benefits given by the state."[9]

b. The Commerce Clause.

The Commerce Clause mandates that a state's attempt to tax the taxpayer cannot impose an undue burden on interstate commerce.[10] Among other requirements, the Commerce Clause denies any state the right to tax individuals and businesses who have no nexus with that state.[11] The United States Supreme Court has never explicitly held that a different nexus standard applies to income taxes than to sales and use taxes. Some state courts, however, have taken the position that while the Quill decision,[12] a use tax case, affirms that the taxpayer's in-state physical presence is required to establish nexus for sales and use tax purposes, there is no similar physical presence requirement for state income and franchise taxes.[13] The United States Supreme Court recently denied petitions for writs of certiorari in cases from New Jersey and West Virginia where the state courts had upheld findings that Foreign Taxpayers had nexus solely due to their in-state economic presence – neither taxpayer had any in-state physical presence.[14] These denials of certiorari may encourage other states to adopt similar economic presence standards, thereby dramatically expanding their ability to impose income taxes on Foreign Taxpayers. Congress, however, may step into the void left by these denials: on June 28, 2007, Senators Charles Schumer (D-NY) and Mike Crapo (R-Idaho) introduced the Business Activity Tax Simplification Act that would codify the rule that no state could impose business activity taxes on a company unless it had a physical presence in the state.[15]

c. Physical Presence is a Key Nexus Standard, but Perhaps Not in Oregon.

The Quill decision upheld the Bellas Hess rule that established "bright-line" physical presence component of nexus under the Commerce Clause. This "bright line" test provides that if a taxpayer is not physically present in a state (in a more than de minimis capacity), then the state cannot subject that taxpayer to its tax regime.

The physical presence standard can be satisfied in any number of ways. If a taxpayer maintains an office, has inventory, owns or leases real property, or has employees working in a state, the taxpayer will be considered to have a sufficient physical presence in that state to be subject to tax.[16] This physical presence standard can also be satisfied by having independent contractors performing services on behalf of the taxpayer in that state.[17] A state may also subject a Foreign Taxpayer to the state's tax regime if the taxpayer uses an agent to further its business in that state.[18]

A taxpayer's physical presence in a state must be more than de minimis, but not necessarily substantial. In Quill, the United States Supreme Court concluded that the presence needed to be more than de minimis (a few floppy disks containing software was de minimis). In a commonly-cited decision, the New York Court of Appeals concluded that while "a physical presence of the [taxpayer] is required, it need not be substantial. Rather, it must be demonstrably more than a 'slightest presence' . . . ."[19]

The Oregon Supreme Court has taken a different tack regarding the physical presence requirement. In American Refrigerator Transit Company (which predated Bellas Hess, Complete Auto, and Quill), the Oregon Supreme Court did not find it necessary to show that the taxpayer has a physical presence in Oregon in order to establish nexus:

> [I]t is necessary to show that the taxpayer has, in the conduct of his business, taken advantage of the economy of the taxing state to produce the income which is subjected to tax. This is readily seen where, as in the instant case, the taxpayer's property itself is employed in the taxing state to produce income. Nexus may be found even when neither property nor personnel of the taxpayer is employed within the taxing state if it can be said that the state substantially contributes to the production of the taxpayer's income.[20]

Notwithstanding this decision, Oregon courts have not specifically concluded that the physical presence test articulated in Quill or Bellas Hess does not apply to Oregon's ability to impose its income tax on nonresident taxpayers who lack a physical presence in Oregon. Accordingly, the Oregon courts' position on the physical presence test appears to be unsettled, but cannot be construed as explicitly requiring a physical presence to establish nexus.

The Oregon Senate considered legislation in 2007 that was consistent with the analysis found in American Refrigerator Transit Company and would have subjected nonresident businesses and individuals to Oregon's tax regime if, inter alia, the business or individual has sales in Oregon in excess of $500,000 in a given year, even if the taxpayer has no physical presence in Oregon. Following

a public hearing that demonstrated substantial opposition to the legislation, the bill "died" in committee when the legislative session adjourned on June 28, 2007. S. 177, 74th Leg. (Or. 2007). Notwithstanding the apparent defeat of SB 177 and perhaps emboldened by the recent denial of certiorari by the United States Supreme Court in the New Jersey and West Virginia cases discussed above, the DOR is considering a change to the state's income tax rules (proposed OAR 150-317.010(4)) that would create an "economic nexus" standard. It is unclear whether an "economic nexus" standard for nexus adopted by either the Oregon legislature or the DOR would withstand constitutional scrutiny, but these recent developments indicate that both the legislature and the DOR are focused on expanding Oregon's ability to tax Foreign Taxpayers.

2. Public Law 86-272.

P.L. 86-272 provides that a state cannot impose a tax measured by **net income** on a Foreign Taxpayer doing business in that state if the Foreign Taxpayer's business activity is limited to the solicitation of interstate sales of tangible personal property or activities directly ancillary thereto. In substance, for state income tax purposes, P.L. 86-272 provides an exception to the "physical presence" requirement for taxable nexus with a state. P.L. 86-272 does not apply to tax regimes which are not based on **net income**, such as sales, use, or gross receipts tax systems (i.e., Washington State's business and occupation tax).

The landmark case interpreting P.L. 86-272 is Wisconsin Dep't of Revenue v. Wrigley Co.[21] The Supreme Court concluded that Wrigley fell outside the scope of P.L. 86-272 due to the activities of Wrigley's in-state sales force, even though the Court found that many of the activities were protected by P.L. 86-272. The Court narrowly construed the protection offered by P.L. 86-272 as the solicitation of orders for interstate sales of tangible personal property and "those activities that are entirely ancillary to requests for purchases - those that serve no independent business function apart from their connection to the solicitation of sales . . . ."[22] In other words, "it is not enough that the activity facilitate sales; it must facilitate the requesting of sales . . . ."[23]

The Court concluded that the in-state activity went beyond P.L. 86-272's protection when the sales people replaced stale gum that they found at retail outlets, even though Wrigley argued that the removal of stale gum is a logical promotional activity. The Court observed that any ongoing business would enter into this activity regardless of solicitation of sales. Wrigley also argued that this activity was de minimis, but the Court rejected this argument, noting that Wrigley maintained an inventory of gum "worth several thousand dollars" in Wisconsin for this purpose. The key for making the de minimis inquiry is examining "whether that activity establishes a nontrivial additional connection with the taxing state."[24] This narrow scope of the protection offered by P.L. 86-272 has held firm since Wrigley.[25]

Oregon's courts have followed P.L. 86-272 closely. The Oregon Tax Court in Estee Lauder found that while solicitation of sales and maintaining promotional samples is protected by P.L. 86-272, such activities as inventory management, forecasting, measuring brand loyalty, and long-term inventory planning are not solicitation or ancillary to solicitation.[26]

C. Recent Noteworthy Nexus Arguments Raised by the DOR.

The foregoing discussion sets the stage for the DOR's recent arguments relative to nexus. Many businesses generate revenue from Oregon, but have taken the position that they are exempt from Oregon's tax regime because they have no physical presence in Oregon. The DOR is now aggressively pursuing these taxpayers. Following is a brief examination of three recent arguments the DOR has made to conclude Foreign Taxpayers have nexus with Oregon.

1. Warranty Service Provided for Out-of-State Business.

The DOR currently argues that a Foreign Taxpayer establishes nexus through the warranty on its products sold in Oregon. This argument has some merit, and the DOR appears to be pushing it more aggressively than ever before.

The DOR raises the argument under the following circumstances. A corporation has no physical presence in Oregon, but sells products to residents of Oregon which are shipped into Oregon via a common carrier. Once in Oregon, the products are sold by a local dealer who is a separate business entity with no common ownership with the corporation. A manufacturer's warranty accompanies each product. Under the warranty, the customer may bring the defective product to the local dealer for warranty service. The dealer has a contract with the corporation to service any and all warranty claims. The dealer repairs the defective product, and the corporation pays the dealer for those services.

The DOR takes the position that this relationship between the corporation and the local dealer is sufficient to create nexus with Oregon. The argument relies on the DOR's characterization of the local dealer as an independent contractor providing repair services in Oregon that are outside the protections offered by P.L. 86-272.[27]

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Oregon courts have not yet specifically addressed the question of whether such a warranty creates nexus for Foreign Taxpayers. The DOR's position follows a Washington state court decision, General Motors Corporation v. City of Seattle.[28] In that case, the city of Seattle argued that out-of-state car manufacturers were subject to the city's B&O tax by virtue of nexus created in part by the services provided by local dealers under the warranties provided by the out-of-state manufacturer.[29] The court noted that these "warranties serve an important marketing function because customers are unlikely to purchase a new vehicle without a warranty."[30] The court also noted that the out-of-state car manufacturers sent representatives into Seattle to train dealers in sales and management techniques, to speak with dissatisfied customers, and to discuss other business matters. The court did not conclude that any one factor was more important than another, or if any one factor alone would be sufficient to establish nexus. It concluded, that these factors taken together, established nexus with Seattle because the "automakers certainly exploit the market in the City, regardless of where they are physically located."[31]

The DOR's current focus on warranty services as a nexus-generating activity is not entirely the same as the court's focus in General Motors. The primary distinction between the DOR's position and the court's analysis in General Motors is that the DOR contends that the in-state warranty service provider is an independent contractor of the Foreign Taxpayer. The court in General Motors did not explicitly make such a finding, likely due to the (hotly disputed) argument that the bright-line physical presence test in Quill does not apply to B&O taxes. The DOR takes its position wisely: (i) the performance of services by an independent contractor on behalf of an out-of-state manufacturer in Oregon creates the physical presence in Oregon; and (ii) a substantial in-state physical presence creates nexus.[32] This position allows the DOR to avoid the question of whether the out-of-state manufacturer's employees ever entered Oregon, as well as the need to make complex or unsettled nexus arguments based upon a mere economic presence.

Under the DOR's argument, if an out-of-state manufacturer has only a few products serviced in Oregon under warranties, then all of the out-of-state manufacturer's income from sales to Oregon would be subject to Oregon's income tax regime. It is unclear how many products would have to be serviced under warranties to create a "substantial nexus," but we presume that the DOR would set a fairly low standard.

The DOR's argument creates substantial dangers for manufacturers that have never filed an income tax return in Oregon under the belief they have no nexus with the state. In such cases, the DOR is not limited by the statute of limitations. It can examine as many tax years as it likes. When combined with interest and penalties, this unlimited exam period could trigger massive tax assessments. These wide-ranging examinations may also extend back to years for which the taxpayer may have difficulty locating the evidence necessary to mount a vigorous defense.

An additional problem these unlucky Foreign Taxpayers will face is closed tax years in other jurisdictions. Once Oregon establishes nexus with a Foreign Taxpayer, the "apportionment" system prevents other states from "double-taxing" that income – each state may tax only its share of the taxpayer's total taxable income. In an audit reaching back several years, the income Oregon seeks to tax has already been taxed by other states, and many of the tax years will likely be closed in those other states. Accordingly, the Foreign Taxpayer could be "double-taxed" on its Oregon income for many of the years under examination. Advisors must be aware of this argument and review with clients any warranties that are extended to customers in Oregon.

Through restructuring, the Foreign Taxpayer might eliminate the nexus created with Oregon through the warranty. One possible step might be to stop providing manufacturer's warranties, but instead allow the local customer to purchase a warranty contract directly from the in-state service provider that does not involve the Foreign Taxpayer. Another possibility would be to set up a separate company that has as its sole purpose the sale and administration of warranties. Careful planning would be required in order to ensure that the out-of-state manufacturer is properly "disconnected" from the Oregon warranty service provider.

2. Affiliate Nexus Created by Local Dealers.

The DOR has raised a related nexus argument: a Foreign Taxpayer has nexus if it uses a local dealer to sell its products. The DOR characterizes local dealers as "agents," and a local dealer creates "attributional nexus" for the Foreign Taxpayer – the dealer's Oregon nexus is "attributed" to the Foreign Taxpayer.

Attributional nexus is usually broken down into two kinds of relationships: the alter ego theory and the agency theory. The alter ego theory applies where the two taxpayers are so thoroughly linked that their separate existence is ignored. This often occurs in a parent-subsidiary relationship, particularly where the parent and subsidiary have common officers and directors.

The DOR is currently pushing the agency theory, and Oregon courts have recognized the agency theory. In Estee

Lauder, the court found that a "captive service corporation" was the in-state agent of out-of-state manufacturing corporations. The court noted that although "the court agrees . . . that an automatic right of attribution does not exist solely based on the common ownership of the entities, the activities of affiliates may be attributable despite the form of corporate organization utilized."[33] The court specifically noted that all of the in-state corporation's "activities were undertaken solely to generate sales for [the out-of-state manufacturers]. . . . The sales operations of the [in-state corporation] were 'so inextricably connected' to the [out-of-state manufacturers] that to state that the profits of one were not dictated by the operations of the other would be inconceivable."[34]

The DOR is advancing this argument to assert attributional nexus for a local dealer who sells products exclusively for one Foreign Taxpayer. An advisor whose client utilizes such a local dealer system should carefully review the relationship between the two entities. Can the local dealer make any material decision independent of the Foreign Taxpayer? How separate is the local dealer's ownership and management from the Foreign Taxpayer? Does the Foreign Taxpayer have any actual control over the local dealer's operations (e.g., sales and marketing practices, hiring policies, inventory management, etc.)? Can the operations be restructured to increase the local dealer's independence? Documentation of the independence of the local dealer prior to the outset of an examination is highly recommended.

3. Royalty-Free Use of Intangible Personal Property in Oregon.

The DOR has made an even more aggressive assertion: intangible personal property used in Oregon creates nexus for Foreign Taxpayers that lack a physical presence in Oregon. The argument is summarized as follows. The Foreign Taxpayer has a contract with a local dealer to sell the Foreign Taxpayer's products in Oregon. The Foreign Taxpayer allows the dealer to post the Foreign Taxpayer's trademarks, signs and logos free of charge to advertise the dealer's sale of the Foreign Taxpayer's products. The DOR argues, apparently relying on Geoffrey, that this intangible property in Oregon creates nexus for the Foreign Taxpayer.

Geoffrey, Inc. ("Geoffrey") was the wholly-owned subsidiary of Toys R Us, Inc. ("Toys R Us"). Geoffrey, a Delaware corporation, had no employees, offices, or tangible personal property in South Carolina. Geoffrey owned Toys R Us trademarks and licensed them to Toys R Us for one percent of its net sales. South Carolina asserted that Geoffrey had nexus with South Carolina and taxed the royalties generated by South Carolina sales. The South Carolina Supreme Court upheld the state's position: "[B]y licensing intangibles for use in this state and deriving income from their use here, Geoffrey has a 'substantial nexus' with South Carolina."[35]

The DOR ignores both the significant criticism that has been leveled at Geoffrey and the second prong of the Geoffrey "test" (deriving income from the use of intangibles in the state).[36] While it may be no surprise that a state agency ignores scholarly comment when revenue dollars are at stake, it is surprising that the DOR ignores the basic fact in Geoffrey that the Foreign Taxpayer generated income from the intangibles in South Carolina. The DOR instead argues that the local dealer's royalty-free use of the intangibles creates nexus for the Foreign Taxpayer merely because the dealer's use of the intangibles increases sales.

This is a mind-boggling extension of Geoffrey. Essentially, the DOR argues that if intangible property provides an indirect aid or boost to an out-of-state manufacturer's sales, nexus has been created. Imagine the consequences to a manufacturer if this argument finds acceptance in every state. The manufacturer would be subject to tax in any jurisdiction where its advertisements appear on the radio, television, or Internet, in every state where the manufacturer's logo appears on a T-shirt or jacket in a positive manner, or even in every state where the manufacturer's product is used – presuming that the manufacturer's logo can be seen on the product itself.

While the DOR may be over-reaching by pursuing this argument, advisors should review their clients' operations and determine if any of those clients are generating income from the use of intangibles in Oregon. The DOR appears eager to pursue the Geoffrey argument, and the Supreme Court's recent refusal to hear the two economic nexus cases may embolden the DOR to pursue it even more aggressively. Prompt and thorough reviews of operations may allow advisors to help clients structure their affairs accordingly and minimize exposure to such arguments.

D. Conclusion.

The field of state and local taxation continues to evolve as state and local governments seek new sources of revenue. State revenue departments and even state courts have proven willing to stray from strict adherence to the constitutional guidelines set down by the Supreme Court regarding taxable nexus – and the Supreme Court's reluctance to review nexus cases will likely embolden the states to adopt even more aggressive positions. Oregon is no exception to this trend, as shown by the recent aggressive arguments raised by the DOR. Advisors must stay informed and monitor their clients' activities to minimize the risk that a client may suddenly and surprisingly find itself admitted to the growing society of Oregon taxpayers.

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Endnotes

1 Larry J. Brant is a Shareholder in Garvey Schubert Barer, P.C. and is Chair of the firm's Tax Department. Scott M. Schiefelbein is an Associate in Garvey Schubert Barer, P.C.

2 "Oregon Expects an Extra $152 Million," by Betsy Hammond, The Oregonian (Wednesday, May 16, 2007) (retrieved via www.oregonlive.com).

3 "Comment: Marching to the Beat of the Itinerant Drummer: States Increasingly Refuse to Get Physical Before Finding Nexus," by Mark. A McGinnis, 32 Cap. U.L. Rev. 149 (2003), citing, Christopher Swope, "States Approve Sales-Tax Pact," 16 GOVERNING MAGAZINE 44 (Jan. 2003), available at WL 19784730.

4 Chapter 317 of the Oregon Revised Statutes imposes a corporate excise tax of 6.6% on corporations "doing business" in Oregon, but it is possible for a corporation to be doing business in Oregon and yet not have taxable nexus with Oregon.

5 See, e.g., Allied Signal, Inc. v. Director, Division of Taxation, 504 U.S. 768 (1992).

6 P.L. 86-272 is codified at 15 USCS § 381, but it is still commonly referred to as P.L. 86-272.

7 Miller Bros. Co. v. Maryland, 347 U.S. 340, 344-345 (1954).

8 Quill Corp. v. North Dakota, 504 U.S. 298 (1992).

9 Wisconsin v. J.C. Penney Co., 311 U.S. 435 (1940).

10 See, e.g., National Bellas Hess, Inc. v. Dep't of Revenue, 386 U.S. 753 (1967); Quill, supra, note 8.

11 The United States Supreme Court established a four-prong test to determine if a State tax statute violates the Commerce Clause – such a tax will only be sustained if (1) it is applied to an activity with a substantial nexus with the taxing state; (2) it is fairly apportioned; (3) it does not discriminate against interstate commerce; and (4) it is fairly related to the services provided by the state. Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977).

12 Supra note 8.

13 See, e.g., Geoffrey, Inc. v. South Carolina Tax Comm'n, 437 S.E.2d 13 (S.C. 1993) (South Carolina Supreme Court concluded that the taxpayer had established nexus with South Carolina solely by virtue of generating royalty income through licensing a trademark to South Carolina Toys "R" Us stores; the court focused on language in the Quill decision that Quill only applied to sales and use taxes).

14 Lanco, Inc. v. Director, 908 A.2d 176 (N.J. 2006), cert. denied, No. 06-1236 (U.S. June 18, 2007); FIA Card Services, N.A. f.k.a. MBNA America Bank N.A. v. Tax Com'r, 640 S.E.2d 226 (W. Va. 2006), cert. denied, No. 06-1228 (U.S. June 18, 2007).

15 S. 1726.

16 See, e.g., Quill, supra, note 8.

17 Tyler Pipe Indus., Inc. v. Washington Dep't of Revenue, 483 U.S. 232 (1987); Scripto v. Carson, 362 U.S. 207 (1960) (maintaining sales force of independent contractors in Florida was sufficient to subject Georgia corporation to Florida use tax).

18 See, e.g., Estee Lauder Services, Inc. v. Oregon Department of Revenue, 16 OTR-MD 279 (2000); Borders Online, LLC v. State Board of Equalization, 129 Cal. App. 4th (2005).

19 Orvis Co. v. Tax Tribunal, 86 N.Y.2d 165, 178 (1995).

20 American Refrigerator Transit Company v. State Tax Comm'n, 238 Or. 340, 347 (1964).

21 505 U.S. 214 (1992).

22 Id., at 228-229.

23 Id., at 233.

24 Id., at 232.

25 See, e.g., Asher v. Director, Division of Taxation, 22 N.J. Tax 582 (2006) (New Jersey Tax Court concluded that where a foreign corporation used its deliverymen to deliver products to New Jersey from out-of-state, and those deliverymen collect payment and occasionally accept returned product, the foreign corporation was subject to New Jersey's state income tax because the delivery of product, collection of payment, and acceptance of returned product were not within the scope of solicitation of orders).

26 Estee Lauder, supra, note 16.

27 The DOR bases its position on Oregon Administrative Rule 150-317.010(4)(5).

28 107 Wn. App. 42 (Wash. 2001).

29 Cities are generally subject to the same constitutional limitations on their ability to tax as are states.

30 Id., at 52.

31 Id., at 55. The Washington appellate court's decision is unclear as to whether it relies on the manufacturers' physical presence in Seattle. The opinion cites several specific instances where employees of the manufacturers are present in Seattle for business purposes, and yet the court also concluded that a physical presence was not necessary under the rationale of South Carolina's Geoffrey decision: "We decline to extend Quill's physical presence requirement [to the B&O tax]." General Motors, supra, note 27, at 55. Even though the court had established a physical presence for the taxpayers at issue in the jurisdiction, the court appears to go out of its way to refrain from establishing a physical presence standard for the B&O tax.

32 See, Scripto, supra, note 15.

33 Estee Lauder, supra, note 16, at 288.

34 Id., at 288-89 (citations omitted).

35 Geoffrey, supra, note 12, at 23-24 (emphasis added).

36 For a polite example of the criticism of Geoffrey, see Hellerstein, J. and Walter Hellerstein, STATE TAXATION, Volume I, 6.11[2] (3rd ed. 2005). For a less-reserved analysis of the decision, see McGinnis, supra, note 3 ("The court announced its shocking assertion that there is really no difference between real and intangible

property." Id., n. 273.). The DOR also ignores several state courts and state administrative law judges that have explicitly recognized that the physical presence analysis in Quill should not be limited to sales and use taxes and have held that a corporation can only be subject to a state's corporate income tax if it is physically present in that state. See, e.g., Kevin Associates, L.L.C. v. Crawford, No. 460-981 (La. 19th Jud. Dist. (Aug. 20, 2001); SYL, Inc. v. Comptroller, No. 24-C-99-002389 AA (Cir. Ct. Baltimore City Mar. 17, 2000) (appeal pending), aff'g No. C-96-0154-01, 1999 Md. Tax LEXIS 3 (Md. T.C. Apr. 26, 1999); Crown Cork & Seal (Del.) Inc. v. Comptroller, No. 24-C-99-002388 (Cir. Ct. Baltimore City Mar. 17, 2000); MCT Telecomms, Corp. v. Comptroller, No. 24-C-99-002387 (Cir. Ct. Baltimore City Mar. 17, 2000); Rylander v. Bandag Licensing Corp., No. 03-99-00472-CV (Tenn. May 8, 2000); Dial Bank, Nos. INC. 95-289, F.95-308, 1998 Ala. Tax LEXIS 196 (Ala. Dep't of Revenue Aug. 10, 1998); Cerro Copper Products, Inc., No. F-94-444, 1995 Ala. Tax LEXIS 211 (Ala. Dep't of Revenue Dec. 11, 1995), reh'g denied, 1996 Ala. Tax LEXIS 17 (Ala. Dep't of Revenue Jan. 29, 1996).

Select Tax Legislative Highlights

By Robert T. Manicke, Stoel Rives LLP *and C. Jeffrey Abbott,* Abbott & Munns LLC

The following is a brief synopsis of select tax legislation. The purpose of this article is to alert practitioners of various legislation in summary form. Please refer to the bill language for particulars where an issue should be addressed. The authors have used editorial privilege in selecting which tax bills are addressed in this article based in part on anticipated interest by the general readers and believed breadth of application.

Withholding on Real Estate Sales by Nonresidents and Out-of-State Corporations

HB 2592 (ch 864) requires withholding of Oregon income tax when Oregon real property is transferred by a nonresident individual or by a corporation that is not qualified to do business in Oregon and has no permanent place of business in Oregon. The withholding amount is 4% of the consideration, 4% of the net proceeds, or 10% of the taxable gain, whichever is least. Certain transfers of stock of a corporation that holds real property also may be subject to withholding. Transfers by S corporations or by entities taxed as partnerships are not subject to withholding because those entities already are subject to composite return reporting and withholding. Other exemptions and requirements may apply, including exemptions for certain tax-free or tax-deferred transfers. The Department of Revenue, which did not request the legislation, is proposing an administrative rule that will become final late this year that will clarify certain points. The withholding requirement applies to conveyances on or after January 1, 2008.

Deduction Doubled for Oregon College Savings Plan Contributions

HB 3201 doubles the amount that can be subtracted for contributions to the Oregon College Savings Plan, a Section 529 plan. Starting with the 2008 tax year, the subtraction will increase from $2,000 to $4,000 in the case of a joint return. For later years, the ceilings will be indexed for inflation.

High-Income Taxpayers May Have Reduced Personal Exemption Credit

For 2007 and later years, HB 3201 will require a partial phase-out of the personal exemption credit for taxpayers with federal adjusted gross income exceeding $117,300 (single taxpayers) or $234,600 (joint returns).

Property Tax Exemption Can Apply to Sublessees

Under former ORS 307.112, it was not clear that a charity or other organization eligible for property tax exemption could claim the exemption if the charity was a sublessee (or sub-sublessee), and the ultimate owner was a taxable person. SB 653 allows the exemption, but the sublessee is required to file an application. The new law extends the normal April 1 deadline to December 31, 2007, for the 2007-08 property tax year.

Income Tax Kicker; Small Corporation Tax Credit

HB 2031 creates a one-time credit for C corporations against income and excise taxes that is equal to 67% of the taxes that would otherwise be due for the 2007 tax year. The credit was designed to allow small corporations to keep their portion of the 2005-07 kicker that is mostly being directed to the Oregon Rainy Day Fund by HB 2707. Qualified corporations include those corporations with Oregon sales for the year of less than $5,000,000. Special rules apply for those corporations that apportion sales.

HB 2031 took effect on September 27, 2007.

Corporate Kicker Changes

HB 3048 modifies the way in which the corporate "kicker" credit is calculated. The "kicker" is the common name for the requirement that the state return to taxpayers all state income tax revenues that exceed projections for the biennium by more than 2%. HB 3048 changes the base year that is used to apportion the amount of kicker credit that any corporate taxpayer will receive, from the tax year during which the kicker credit is determined to the prior tax year. This change conforms the method for corporate taxpayers to the method already in place for personal income taxpayers. The legislation also allows carry-forward of any unused kicker credit to any later year. HB 3048, §1 (amending ORS 291.349). The changes are effective for the 2005-07 biennium and later biennia. HB 3048, §2. See the discussion of HB 2041 and SB 819.

HB 3048 took effect on September 27, 2007.

Internal Revenue Code Reconnection

Oregon's laws contained many references to the Internal Revenue Code as the code was in effect on December 31, 2004. HB 2235 updates these references to December 31, 2006. As a consequence, the Oregon law references will now incorporate the amendments made to the IRC during 2005 and 2006. The changes are retroactive to January 1, 2007. However, any refunds applicable to the changes and references do not carry interest. In addition, any deficiencies attributable to the retroactive amendments will not carry interest or penalties that might be assessed under the tax laws. The bill also provides that if a taxpayer fails to file an amended return by reason of the changes made by the bill, the Department of Revenue is authorized to make the necessary changes to the taxpayer's tax return. HB 2235, §15.

HB 2235 took effect on September 27, 2007.

Exempt Charitable Organizations; Reporting

Under current law, charitable organizations must file reports with the Department of Justice. Along with the report, the organization must pay a fee that is based in part on the total amount of the organization's income and receipts during the time covered by the report, and in part on the organization's fund balance. SB 109 repeals these fees and replaces them with a fee that will be established by the Department of Justice in accordance with certain guidelines. The minimum fee is $10.00, and the maximum fee is $400.00. In addition, the bill authorizes the Department of Justice to impose a delinquent fee based on the length of time a payment or report remains delinquent. Civil penalties of not more than a $1,000 may also be imposed if a charitable organization fails to file a report, or pay a fee within 90 days after receiving a notice of the delinquency. The Department of Justice can order the charitable organization to cease soliciting contributions until the organization has paid all required fees. SB 109, §1 (amending ORS 128.670).

In general, the amendments become operative on January 1, 2008, although some of the amendments apply to fees paid or penalties imposed on or after the June 25, 2007 (the effective date of the bill). SB 109, §§8–9. If the Department of Justice has not established a fee schedule by December 31, 2007, the old fee schedule remains in effect until such time as the new fee schedule is adopted. SB 109, §11.

SB 109 took effect on June 25, 2007.

Failure to File; Penalties and Notices

SB 175 reduces the period of time the Department of Revenue must wait before demanding a taxpayer file a tax report or return and imposing the failure-to-file penalty. Generally, for reports other than those required to be filed annually, the time period is reduced from three months to one month after the filing or payment is due. In cases in which a taxpayer is required to file a federal income tax return for a period of less than 12 months, the current waiting period of three months is retained. The statutory penalties start at 20% of the amount of the tax due. The penalty period has not been changed for tax returns that are required to be filed annually or for a one-year period. SB 175, §1 (amending ORS 314.400). The amendments apply to reports or returns required to be filed on or after January 1, 2008, or to tax years beginning on or after January 1, 2008, as the case may be. SB 175, §2.

Transferee Liability for "Reorganized" Business Entities

SB 176 grants broad power to the Department of Revenue to transfer the outstanding liability for taxes, penalties, or interest of a business entity that dissolves to a reorganized entity that is substantially the same business. In effect, the bill allows the Department of Revenue to breach the "corporate veil" of a new entity. The Department of Revenue may transfer liability to a new reorganized entity based on factors including, but not limited to:

(1) Operating from the same physical location;

(2) Providing the same services or manufacturing the same products; and

(3) Having one or more of the same corporate directors or officers, owners, or holders of direct or indirect interest in the business entity. SB 176, §2(3).

The bill attempts to carve out and exempt certain business entities that have converted to a different form or changed ownership solely because of a transfer of assets, or because of a transfer of an interest of an investor who has no right to manage the business entity, such as: (1) a minority shareholder in a corporation; (2) a member of a manager-managed limited liability company; or (3) a limited partner of a limited partnership who does not participate in the control of the business of the limited partnership. SB 176, §2(1)(b).

Practice Tip: Lawyers should be cautioned to watch for regulations proposed by the Department of Revenue concerning the application of SB 176. If a new business falls under the bill's definition of a *reorganized business entity* the bill will allow the department to impose the liabilities of a previous business entity on the new business. Questions exist regarding whether an unrelated buyer of a business's assets could be subject to this law's application.

SB 176 took effect on September 27, 2007.

Tax Shelters; Listed and Reportable Transactions

SB 39 establishes reporting requirements and enhanced penalties for persons who use certain transactions to underpay tax liability. The bill defines *reportable transactions* and *listed transaction* primarily by incorporating the definitions of those terms in Internal Revenue Code §6707A. (Specific Oregon taxable transactions are also included in the definitions.) SB 39, §2. The bill also defines the persons who are associated with a reportable transaction. These include any person who engages in a reportable transaction as a buyer or who acquires interest in a property as a result of a reportable transaction. SB 39, §3. Persons who are engaged in or associated with a reportable transaction must make the report in a form described by the department by rule. Penalties are imposed on taxpayers who as a result of a listed transaction have an underpayment of tax. The penalty is equal to 60% of the amount of any understatement of a tax liability as a result of a listed transaction. SB 39, §8.

The time for filing a notice of deficiency for a listed transaction is extended to nine years, allowing audits for tax years as far back as 1999. SB 39, §18 (amending ORS 314.410).

If a taxpayer fails to report a reportable transaction to the Department of Revenue, the department adds to a tax liability a penalty for individual taxpayers of $3,300 and corporate taxpayers of $16,700. If the reportable transaction is also a listed transaction, the penalty is $33,000 for individual taxpayers and $66,000 for corporate taxpayers. Additional severe penalties apply to promoters of certain abusive tax shelters, as defined under Section 6700 of the Internal Revenue Code. SB 39, §§9, 12.

SB 39 took effect on September 27, 2007.

Domestic Partnerships

HB 2007 authorizes the creation of domestic partnerships. Under the bill, same-sex couples who enter into domestic partnerships are to be treated similarly to married couples for Oregon tax purposes. As a result, tax lawyers must consider filing joint returns for domestic partners and must consider other tax consequences arising out of domestic partnerships. A lawyer must be aware that federal law and laws of other states may be interpreted differently. Those laws may require domestic partners to file separate returns as single taxpayers, as opposed to a married-filing-jointly return filed under Oregon law. The bill may require domestic partners to file for Oregon income tax purposes as "married filing separately" if joint filing is not elected. Other tax impacts, such as surviving spouse rules for Oregon inheritance taxes, should be considered. Again, federal tax law and laws of other states could treat domestic partners as single, whereas Oregon tax laws will treat them as though they were married.

Disclosure of Tax Information

SB 173 expands the scope of entities to which the Department of Revenue may disclose income tax information. Prior law allowed disclosure only to another state or the District of Columbia. ORS 314.840(2)(c). The legislation adds cities, counties, or other political subdivisions of a state, as well as associations established exclusively to provide services to federal, state, or local taxing authorities. In all cases, the entity receiving the tax information must satisfy the requirements of federal law regarding confidentiality, and the Department of Revenue may disclose the information only for tax administration and compliance purposes.

Definition of *Unitary Business*

SB 178 changes the unitary business test to lower the threshold for businesses to be considered unitary. Prior law required all of three factors to be present to support a conclusion that a "single trade or business" existed: centralized management, centralized administrative services resulting in economies of scale, and functional integration. *Former* ORS 317.705(3)(a). The legislation changes this conjunctive test to a disjunctive test, so that only one of the three factors need be present to support a conclusion

that a unitary business exists. SB 178, §1. The legislation applies to tax years beginning on or after January 1, 2007. SB 178, §3.

SB 178 took effect on September 27, 2007.

Expanded Use of Tax Exempt Revenue Conduit Bonds

HB 3482 has expanded the use of tax free interest financing. Before this bill, ORS 289 et. seq. permitted bonds to be issued through the Oregon Facilities Authorities for construction of facilities of certain nonprofit entities or "institutions." This allowed certain entities to obtain financing generally at lower interest rates because the interest was tax free to the buyer of the bonds. The institution list formerly only included an institution for housing, higher education or pre-kindergarten through grade 12 education, a school for the handicapped, a health care institution, or a cultural institution within Oregon. The list has been expanded to include all IRC section 501(c)(3) organizations in Oregon. In the case of a participating institution that is a nonprofit not formerly specified before this bill, eligible projects include construction costs for structure or structures suitable for its purposes, including facilities or structures essential or convenient for the orderly operations of the nonprofit. It shall also include acquisition of interests in land, landscaping, site preparation, furniture, equipment and machinery and other similar items necessary or convenient for the nonprofit, whether or not the items are related to a particular facility or structure financed under this chapter, including borrowings needed to alleviate interim cash flow deficits of the nonprofit.

Notification Regarding Updated Web Site:

The Taxation Section has updated its web site, which can be found at **http://osbtaxation.homestead.com/Index.html**. The Web site has the past issues of the Taxation Newsletter along with other helpful resources. Please take a moment to review it. If you would like to see anything added to the site, please contact one of the Executive Committee members.

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