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"Hit the Road, Jack—And Don't You Pay [Oregon] Tax No More?"

By Alan Pasternack and Neil Kimmelfield¹

While Oregon residents are taxed at a 9% rate on their taxable income, including capital gain income, Washington imposes no personal income tax. Not surprisingly, Oregon residents who expect to recognize substantial income in the future often ask whether they can avoid Oregon tax on the income by moving to Washington before the income is recognized. This article discusses the impact of such a move on the Oregon income tax treatment of different types of income.

Determining Resident Status

A critical step in determining whether an individual can avoid Oregon tax by moving out of Oregon is understanding what it means to be a "resident" for Oregon tax purposes.

Oregon income tax law generally defines an Oregon "resident" as someone "domiciled" in Oregon. ORS 316.027(1)(a)(A). Domicile is generally the place an individual considers his permanent home, the one to which he intends to return when he is away. OAR 150-316.027(1) states: "A person can only have one domicile at a given time. It continues as the domicile until the person demonstrates an intent to abandon it, to acquire a new domicile, and actually resides in the new domicile. Factors that contribute to determining domicile include family, business activities and social connections."

An individual *not* domiciled in Oregon still will be treated as an Oregon resident if he maintains a "permanent place of abode" in Oregon *and* "spends" a total of more than 200 days in Oregon during a taxable year, *unless* he proves that he is in Oregon only for a "temporary or transitory" purpose. ORS 316.027(1)(a)(B). Under OAR 150-316.027(1)(b)(B), owning residential property in Oregon is not considered maintaining a "permanent place of abode" *if* the individual and his family *never* use that property as a dwelling. However, use of the property by the individual during the tax year, even for one day, may be sufficient for it to be considered a "permanent place of abode" if it is also used by the individual's family "for a sufficient period of time to create a well-settled physical connection."

An Oregon resident moving out of Oregon will be treated as domiciled in Oregon until he has a specific intent to abandon the old domicile, intent to acquire a new domicile, *and* actual physical presence in the new domicile. OAR 150-316.027(1)(a); *see also Davis v. Dept. of Rev.*, 13 OTR 260, 264 (1995). A taxpayer's intent to abandon one domicile and acquire a new one is subjective, and Oregon courts have placed the burden

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on the taxpayer to establish his intent by all the facts and circumstances. When determining the taxpayer's intent, the Oregon Tax Court relies heavily on overt actions. *See, e.g., Ott v. Dept. of Rev.*, 16 OTR 102, 111 (2002).

Thus, in order for an Oregon resident to sever connections with Oregon sufficiently to be considered a nonresident, actions must be taken to show an intent to establish a domicile outside Oregon. This may be difficult if the individual or the individual's family maintains contacts with Oregon after the move, as any apparent ambiguity in the individual's intent will make a determination of nonresidence uncertain.

Determining the Portion of Income Subject to Oregon Income Tax

Oregon imposes a personal income tax on residents based on all taxable income regardless of the source. ORS 316.007(3). By contrast, for a full-year nonresident, Oregon imposes a tax only on taxable income "derived from sources within this state." ORS 316.037(3). In the case of a taxpayer who is a part-year resident, the Oregon income tax is equal to the tax that would be imposed on the taxpayer if he were an Oregon resident, multiplied by a fraction determined by dividing the taxpayer's federal adjusted gross income from Oregon sources by the taxpayer's federal adjusted gross income from all sources. ORS 316.037(2); ORS 316.117. In order to determine the income of a nonresident or a part-year resident that is subject to Oregon tax, it is essential to determine whether each item of income is derived from an Oregon source.

A. Employment-Related Income

1. Compensation for Services; Unemployment Insurance Benefits; Severance Pay

In general a nonresident's employment-related income Oregon-source income if it is attributable to services performed in Oregon, regardless of whether the income is regular wages, unemployment compensation, or severance pay. OAR 150-316.127-(A)(1)(a), -(A)(3)(e), and -(A)(3)(f). Compensation for personal services provided by a nonresident outside Oregon and not connected with the conduct of business in Oregon is not Oregon source income. OAR 150-316.127-(A)(1)(b).

Assume Oregon resident Jack B. Nimble is the regional manager of a company with operations in Oregon and Washington and spends half his time working in each state. As an Oregon resident, Jack is taxed by Oregon on all of his compensation, regardless of how much time he spends working in Washington. If Jack were a Washington resident, he would pay no Oregon tax on the portion of his income attributable to services performed in Washington.

Now assume that Jack establishes residency in Washington on October 1, 2009. Assume further that Jack's employment is terminated on March 31, 2010, that he receives a severance payment equal to three months' salary, and that he receives unemployment insurance benefits. Finally, assume that the severance payment is paid pursuant to a written agreement between Jack and his former employer under which the payment is determined according to a formula taking into account Jack's final salary and length of service *and* that the payment is in consideration of his agreement to waive a potential claim for age discrimination and enter into a confidentiality agreement.

Under OAR 150-316.127-(A)(3)(e), a nonresident's gross income for Oregon purposes includes unemployment insurance benefits to the extent they "pertain to" the individual's employment in Oregon, regardless of where the taxpayer resides when he receives the benefits. Thus, Jack's unemployment compensation received prior to October 1, 2009, will be taxed by Oregon in full, but his unemployment compensation received on or after after October 1, 2009, will be taxed by Oregon only to the extent it "pertains" to services performed in Oregon. Any reasonable apportionment method may be used to determine whether unemployment benefits pertain to Oregon services.

A nonresident's Oregon income also includes severance pay to the extent that such pay is attributable to services performed in Oregon. OAR 150-316.127-(A)(3)(f). Any reasonable method may be used to apportion severance pay to Oregon services. "Severance pay" is defined as "compensation payable upon voluntary or involuntary termination or employment based on length of service, a percentage of final salary, a contract between the employer and employee or some other method." While this definition is broad, a payment is considered severance pay only if it relates to *services* performed in the state of Oregon. In *Dept. of Revenue v. Wheeler*, 18 OTR 129, 133 (Oct. 14, 2004), the Tax Court held that a payment in exchange for a nonresident employee's agreement to terminate his employment by a specified date, release the employer from any actual or potential claims, and enter into a confidentiality agreement was not Oregon-source income.

In Jack's case, if he can establish that his severance payment was made as consideration for his waiver of the potential age discrimination claim, as a nonresident he will avoid Oregon tax on the payment.

2. Deferred Compensation

a. Retirement Benefit Plans.

After looking for a new job without success, Jack decides to retire. In retirement, Jack will receive distributions from both a qualified employer retirement benefit

plan, i.e., a “pension” plan, and a qualified employee retirement benefit plan, in his case a 401(k) account.

Federal law prohibits a state from taxing retirement income received by individuals who are *neither residents of nor domiciled in* the state. 4 U.S.C. § 114. For this purpose, “retirement income” includes income from a qualified trust described in Code section 401(a) and several other categories of income. An individual who maintains an Oregon domicile is taxed on his Oregon source retirement income even if he is a nonresident. ORS 316.127(9)(a), OAR 150-316.127-(9)(1)(c), and OAR 150-316.127-(B)(2)(a).

Thus, if Jack ceases to reside or be domiciled in Oregon, his retirement income—even the portion attributable to services performed in Oregon—will not be subject to Oregon tax. If Jack maintains an Oregon domicile, he will be taxed by Oregon on his Oregon source retirement income, even if he otherwise qualifies to be taxed as a nonresident.

b. Nonqualified Stock Options.

Assume that Jack’s former employer granted him nonqualified stock options as part of his compensation. Assume further that, at the time of the grant, the value of the options was not readily ascertainable. Jack decides to exercise the options in 2010.

Under Code section 83(a) and Treasury Regulations Section 1.83-7(a), an employee who receives a nonqualified stock option with a readily ascertainable value recognizes income at the time the recipient’s rights to the option are freely transferable or no longer subject to substantial risk of forfeiture. If the option does not have a readily ascertainable value at the time of the grant, no income is recognized until the option is exercised or otherwise disposed of.

Under OAR 150-316.127-(A)(3)(d)(A), an employee’s income from the grant of a nonqualified stock option *with* an ascertainable fair market value is treated as Oregon source income based on the portion of the taxable year that the employee worked in Oregon during the year of the grant.

Under OAR 150-316.127-(A)(3)(d)(B), an employee’s income from the grant of a nonqualified stock option *without* an ascertainable fair market value is treated as Oregon source income based on a fraction of which the numerator is the number of days the taxpayer worked in Oregon from the date of the grant to the date income from the option is recognized for federal tax purposes, and the denominator equals the total days worked everywhere from the date of the grant to the date of federal income recognition.²

² The bound volumes of the Oregon Administrative Rules do not include this formula. The formula may be found on the Department of Revenue’s website under “permanent administrative rules.”

Jack is a nonresident for the entire year in which he exercises his option. Because Jack worked in Oregon during the year in which the option was granted, he must include in Oregon taxable income the amount included in federal taxable income multiplied by the fraction described in the preceding paragraph. The fact that Jack was an Oregon resident at the time the option was granted is irrelevant to this determination.

Now suppose Jack received additional options in 2010 before his termination and that those options had a readily ascertainable value. Under Code section 83, Jack must include the value of the options in taxable income in the year in which the options become transferable or are no longer subject to a substantial risk of forfeiture. For Oregon purposes, Jack must include in taxable income a fraction of that value, based on the ratio of days worked in Oregon to days worked everywhere *during the year of the grant*. OAR 150-316.127-(A)(3)(d)(A).

B. Income Derived from Real or Tangible Personal Property

1. Income From Ownership or Disposition of Tangible Property

Income from the rental by a nonresident of real or tangible personal property located in Oregon is included in Oregon taxable income. ORS 316.127(2)(a); OAR 150-316.127-(C)(2). Likewise, gain from any sale or other disposition by a nonresident of real or tangible personal property located in Oregon is included in Oregon taxable income. OAR 150-316.127-(D)(2)(a).

Suppose Jack owns one rental building in Oregon and another in Washington. If Jack were an Oregon resident, he would be taxed by Oregon on his rental income from both buildings and on gain from the sale of either building. As a Washington resident, Jack will be taxed by Oregon on his rental income and gain from the Oregon building but not the Washington building.

2. Deferred Recognition Under Code section 1031 or 1033

Under Code sections 1031 and 1033, a taxpayer may defer recognition of gain realized in a like-kind exchange or from a condemnation or involuntary conversion. Deferral of gain under those provisions requires the acquisition of “replacement” property, the basis of which is reduced by the amount of the deferred gain. The deferred

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gain is recognized when the replacement property is sold or exchanged in a taxable transaction.

Jack wonders if he can avoid Oregon income tax on gain from the sale of his Oregon building by entering into a section 1031 exchange in which he and replaces the Oregon building with a building in Washington. Jack reasons that he will no longer own Oregon property, so if he later sells the new building, he will not have to pay Oregon tax on the gain.

ORS 316.738 appears to be designed to prevent a taxpayer from benefiting from the kind of plan Jack is contemplating. Under ORS 316.738, if a taxpayer receives out-of-state property in exchange for Oregon property and later disposes of the replacement property in a taxable transaction in which the gain “is not taken into account in computing federal taxable income for Oregon tax purposes,” the taxpayer must increase “federal taxable income” by an amount equal to the lesser of the recognized gain or the deferred gain. Presumably, the purpose of this provision appears to be to include the recognized deferred gain in a nonresident taxpayer’s *Oregon taxable income*, but nothing in the statute clearly causes this result. It can be argued that, by reason of ORS 316.127(2)(a), the increase to federal taxable income under ORS 316.738 is Oregon source income on the ground that it is “attributable to . . . [t]he ownership or disposition of any interest in real or tangible personal property in this state,” but the same could have been said of the federal gain recognized on the sale of the out-of-state replacement property even without ORS 316.738. In any event, assuming ORS 316.738 operates as it is apparently intended to, if Jack disposes of his Oregon building in a section 1031 exchange and replaces it with Washington property, he will be taxed by Oregon on the lesser of the recognized gain and the deferred gain if he sells the Washington property after leaving Oregon.

What if, after closing the section 1031 exchange, Jack contributes the replacement property to a partnership (a so-called “swap and drop” transaction), and the partnership later sells the property in a taxable transaction? What if, instead of the partnership selling the property, Jack sells his interest in the partnership? These questions are addressed in Sections B.3 and C.1 below.

3. Income From a Partnership, Limited Liability Company, or S Corporation

Under ORS 316.124(1) and 316.127(1)(a)(A), Oregon taxes a nonresident partner on his distributive share of partnership income only to the extent it is derived from Oregon sources. If Jack owns an interest in a partnership that operates a business in both Oregon and Washington, Oregon will tax Jack’s share of the partnership’s income

while he is an Oregon resident. Once he has moved to Washington and is no longer an Oregon resident, only the partnership’s income from its Oregon business activities will be taxed by Oregon. The result would be the same if the partnership were an S corporation. ORS 316.127(5)(a).

How do these rules apply to Jack’s share of the gain recognized by a partnership when the partnership sells non-Oregon property acquired in a “swap and drop” transaction described in the preceding section? ORS 316.124(3) provides: “Any modification to federal taxable income described in this chapter that relates to an item of partnership income, gain, loss or deduction (or item thereof) shall be made in accordance with the partner’s distributive share, for federal income tax purposes of the item to which the modification relates, but limited to the portion of such item derived from or connected with sources in this state.” As noted above, ORS 316.738 apparently is intended to require an addition to Oregon taxable income in the event of a sale of out-of-state replacement property acquired in a section 1031 exchange for Oregon property. Moreover, there is nothing in ORS 316.738 that prevents this adjustment from occurring merely because the person disposing of the replacement property is not the same as the person who exchanged the Oregon property. Although ORS 316.124(3) is not a model of clarity, it appears to be intended to provide that a modification described in ORS Chapter 316 to an “item” relating to the computation of a partnership’s federal taxable income must be allocated to its partners in the same manner as the item to which the modification relates. Since any built-in gain from Jack’s contributed property will be allocated to Jack when the property is sold,³ presumably the addition to the partnership’s income under ORS 316.738 also must be allocated to Jack.

C. Income and Gain Derived From or Connected With Intangible Personal Property

1. Gain from the Sale of a Partnership or Limited Liability Company Interest.

Gain from the sale by a nonresident of a general partnership interest in an “Oregon partnership” is treated as Oregon source income based on the percentage of the partnership’s tangible property in Oregon (measured by original cost).⁴ OAR 150-316.127-(D)(2)(d); ORS

³ See Code section 704(c).

⁴ Application of this rule does not appear to depend on whether the partnership is organized under the laws of Oregon. See ORS 316.082(7)(b), which defines “Oregon partnership” to mean “an entity that is treated as a partnership for Oregon excise and income tax purposes” for purposes of ORS 316.082.

314.635. A nonresident's gain or loss from the sale of an interest in a limited liability partnership is taxed in the same manner. OAR 150-316.127-(D)(2)(g).

Gain from the sale by a nonresident of a limited partnership interest is not taxable by Oregon unless the limited partnership interest is "used in the conduct of the taxpayer's business, trade, or profession in Oregon." OAR 150-316.127-(D)(1)(a); 150-316.127-(D)(2)(e).

A nonresident's gain from the sale of an interest in an LLC operating in Oregon depends on whether the selling member has a right to participate in management as a member-manager. If the member has that right, the sale is treated the same as the sale of a general partnership interest; if not, the sale is treated the same as the sale of a limited partnership interest. OAR 150-316.127-(D)(2)(f).

Suppose Jack disposes of his Oregon building in a section 1031 exchange, contributes the replacement property to an LLC in exchange for a nonmanaging member interest, and, after becoming a Washington resident, sells his interest in the LLC in a taxable transaction. The treatment of Jack's gain is not readily apparent on the face of the applicable statute and rules, and no published authority addresses such a transaction. It appears that, under OAR 150-316.127-(D)(2)(e) and (f), Jack's sale of his nonmanaging member interest in the LLC does not give Oregon a basis for taxing his gain, because those provisions specifically provide that a sale of a limited partnership interest does not result in gain taxable by Oregon unless the limited partnership interest has acquired an Oregon situs. OAR 150-316.127-(D)(1)(a), which addresses "business situs," does not appear to provide any basis for treating Jack's interest in the LLC as having an Oregon situs.

ORS 316.127(2)(a) provides that gain attributable to the ownership or disposition of an interest in real property in the state is treated as derived from an Oregon source. Because Jack's basis in the LLC, determined under Code section 722 and ORS 314.716, equals his adjusted basis in the replacement property, and his adjusted basis in the replacement property reflects the deferred gain from sale of the Oregon property, his gain from the sale of his LLC interest could be viewed as "attributable to" his ownership of the Oregon property. That reading of ORS 316.127(2)(a), however, would render ORS 316.738 superfluous. On balance, there appears to be a good argument that Jack's gain from the sale of his LLC interest is not subject to tax by Oregon.

2. Gain From the Sale or Exchange of Stock, Bonds, or Other Securities

Gain from a nonresident's sale or exchange of stock in a C corporation or an S corporation, bonds, or other securities generally is not taxable by Oregon unless the securities are "used in the conduct of the taxpayer's business, trade, or profession in Oregon." OAR 150-316.127-(D)(1)(a), -(D)(2)(b), and -(D)(2)(c). Thus, if Jack conducts a business through a C corporation or S corporation and sells the stock in the corporation after moving to Washington and ceasing to be an Oregon resident, he generally will not be subject to Oregon tax on gain from the sale, even if the business operates exclusively in Oregon. Note, however, that he will be subject to Oregon tax on the gain if he has employed the stock in any business in Oregon (for instance, by pledging them as security for the liability of an Oregon business).⁵

Conclusion

The Oregon Tax Court has stated that Oregon residents are subject to Oregon taxation based on the State's jurisdiction over their person, and nonresidents are subject to Oregon taxation based on the State's jurisdiction over the source of their income. *Dept. of Revenue v. Glass*, 15 OTR 117 (Mar. 24, 2000), *aff'd*, *Dept. of Revenue v. Glass*, 333 Or. 1 (Nov. 16, 2001). Thus, Oregon generally retains jurisdiction to tax a taxpayer's income from Oregon sources even if the income is received after the taxpayer has ceased to be an Oregon resident.

By moving to Washington, an Oregon resident may expect to reduce his or her Oregon income tax liability with respect to *future taxable income not derived from Oregon sources*. Effecting a move from Oregon with a view to minimizing Oregon taxable income must be done with proper attention to the rules applicable to various types of income and the steps necessary to establish residence outside Oregon.

⁵ If Jack conducts a business through an S corporation and liquidates the corporation after becoming a Washington resident, he will be subject on the corporate-level liquidation gain that flows through to him if the corporation has a commercial domicile in Oregon. OAR 150-316.127-(C)(3). "Commercial domicile" is defined in OAR 150-316.871(3).

IRS Offers in Compromise: A Process in Decline

By Marc K. Sellers

Tax practitioners frequently receive inquiries from delinquent taxpayers concerning Offers in Compromise (“OICs”). With infomercials advertising that the IRS has “new programs” in which it will settle for “pennies on the dollar,” this increased interest is both natural and foreseeable; however, those representations are not supported by reality.

Conventional wisdom indicates that five principal administrative mechanisms are potentially available to resolve tax collection matters: (1) payment in full; (2) bankruptcy; (3) suspension of tax collection activity as “currently not collectible”; (4) installment payment arrangements; and (5) OICs. Of these, OICs are potentially the most useful, because it offers the taxpayer a “fresh start,” on a relatively prompt basis, on ascertainable terms concerning both the amount of the offer and requirements for future tax reporting and tax payment compliance. The goals of the program are to achieve collection of what is reasonably collectible at the least cost and at the earliest possible time, and to promote future taxpayer compliance.

Prior to 1998, the IRS considered OICs only if they were based on doubt as to the taxpayer’s liability or doubt as to collectibility. Regs. § 301.7122-1(b). In 1998 Congress amended Section 7122, and encouraged the IRS to be more flexible in its use of OICs. “[T]he conferees expect that the present regulations will be expanded so as to permit the IRS, in certain circumstances, to consider additional factors (i.e., factors other than doubt as to liability or collectibility) in determining whether to compromise the income tax liabilities of individual taxpayers.”¹ Simultaneously, Congress granted the IRS authority to accept an OIC based on “Effective Tax Administration.” “For example, the conferees anticipate that the IRS will take into account factors such as equity, hardship, and public policy where a compromise of an individual taxpayer’s income tax liability would promote effective tax administration.”²

Thus, in theory, the OIC program is a useful mechanism for the IRS and taxpayers in situation in which the taxpayer is unable to pay in full, and particularly for taxpayers that are experiencing financial hardships in these difficult economic times.

In practice, however, recent statistics indicate that the IRS has severely restricted the acceptance of OICs. The number of accepted OICs declined by over 72 percent from 2001 to 2008. The number of levies issued by the IRS increased by 1,608 percent from 2000 to 2007. More recently, tax lien foreclosures increased by 71 percent in the third quarter of 2008 compared to the same period in 2007.³ Accordingly, rather than expanding the use of the OIC as a mechanism for effective resolution of delinquent accounts, the IRS appears to have placed a heightened emphasis on maximizing the use of enforcement tools, such as seizure and sale.

The National Taxpayer Advocate has for several years expressed concern over these developments in her annual report to Congress, stating that she is “concerned that IRS’s response to the current economic downturn in regards to collection does not adequately consider the taxpayer’s perception of IRS collection practices. Failing to take the appropriate steps to address this economic crisis could result in the perception of the IRS using “harsh” collection tactics in troubled times, thereby, discouraging taxpayers from trying to work things out with the IRS. Conversely, the perception of a more reasonable and flexible IRS is likely to encourage more taxpayers to try.”⁴

The IRS “centralized” its OIC program in 2001. Whereas offers used to be processed in local IRS offices, OIC consideration now takes place in Memphis, TN and Holtsville, NY. Additionally, the IRS has introduced many strict procedural requirements, aimed at greater “efficiencies.” Among the barriers to filing an OIC are its costs, which now include (1) a \$150 processing fee; (2) a *non-refundable* deposit in the sum of 20 percent of the amount offered⁵; and (3) an extension to the 10-year statute of limitation for collection of the tax (26 USC § 6502(a) (1)) during the period the offer is “pending,” regardless of whether the OIC is ultimately accepted, rejected, or returned to the taxpayer as “non-processable.” In light of these substantial costs, coupled with the low probability

1 See Internal Revenue Service Restructuring and Reform Act, Pub. L. No. 105-206, § 3462 (1998)

2 H.R. Rep. No. 105-599, at 289 (1998) (Conf. Rep.).

3 Taxpayer Advocate Service – 2008 Annual Report to Congress, Vol. 1, p. 16

4 Taxpayer Advocate Service – 2008 Annual Report to Congress, Vol. 1, p. 35

5 A bill (HR 2343) was introduced into the House of Representatives on May 13, 2009 that would repeal the 20 percent down payment requirement. While removal of the down payment requirement may increase the number of Offers in Compromise filed, it will not necessarily have any effect upon the number of Offers accepted by the Internal Revenue Service.

of acceptance by the IRS, tax practitioners nationwide indicate that they have abandoned the OIC as a potential collection solution for their clients.

As more and more taxpayers find themselves struggling to make ends meet, pragmatism would indicate that the IRS should take into account current economic realities in determining the best methods of resolving tax delinquencies. As things currently stand, however, prudence indicates that there are currently four, not five, available administrative mechanisms to resolution of tax collection disputes.

Employment Taxes and Disregarded Entities after January 1, 2009

By Joshua E. Husbands

As of January 1, 2009, the rules governing federal employment taxes for disregarded entities changed in a very important manner. Prior to January 1, 2009, a disregarded entity, such as a single member limited liability company (LLC) or a qualified S subsidiary (QSub), had two options for meeting employment tax obligations: 1) the single member / owner could calculate, report and pay all employment tax obligations with respect to the employees of the disregarded entity as though the employees were employed directly by the owner; or 2) the entity could separately calculate, report and pay all employment tax obligations with respect to its employees under its own name and taxpayer identification number. See Notice 99-6, 1999-3 IRB 12. Effective January 1, 2009, the final regulations disseminated in Internal Revenue Bulletin 2007-39 allow a disregarded entity only the second option.

Under the final regulations, a disregarded entity such as a single member LLC or QSub will be treated as a corporation for purposes of employment taxes and must separately account for all of its employment tax obligations at the subsidiary level, rather than the single member or parent level. Treas. Reg. §§ 1.1361-4(a)(7)(i) and 301.7701-2(c)(2)(iv)(B). The entity, be it an LLC or QSub, continues to be disregarded for all other federal tax purposes.

It is important to note that an individual (i.e. human) owner of a disregarded entity (e.g., a single member of an LLC) will continue to be treated as self-employed for self-employment tax purposes, and not as an employee of

the entity. An implied effect of these new rules will be the necessity of obtaining a separate taxpayer identification number (TIN) for the disregarded entity that will only be used to report employment taxes. Taxable income or loss will continue to pass through to the owner and be reported on the appropriate form for that individual or entity. A string of multi-tier single member LLCs could end up reporting under multiple TINs for employment tax purposes but a single TIN (at the common or ultimate parent level) for income tax purposes.

An interesting issue arises in the context of a wholly-owned foreign entity (WFOE) formed under the laws of a foreign jurisdiction that has “checked the box” to be disregarded as separate from its US parent for income tax purposes. Under the new rules, the WFOE is *not* disregarded from its parent and is considered its own corporate taxpayer for employment tax purposes. If the WFOE employs US taxpayers who provide all of their services in the foreign jurisdiction, the WFOE is not required to withhold or report to the IRS for US employment taxes because it is a foreign entity with no employees performing services in the US. It is uncertain whether Treasury intended this result so it is yet to be seen whether they attempt to alter the rule, but for now that is the proper employment tax treatment for a WFOE.

Other than in the WFOE context, the impact of the final regulations is really only administrative. That said, they cannot be ignored and could prove to be a trap to the unwary.

Oregon Department of Revenue Adopts New “Costs of Performance” Standard for Apportionment of Sales Factor

By Scott M. Schiefelbein and Katherine Kruse¹

Just in time for the tax industry’s busiest compliance season, Oregon has made a small but important change to the state’s apportionment rules. Taxpayers must now include indirect costs in the calculation of “costs of performance” when determining their sales factor for purposes of apportioning sales of items other than tangible personal property. While Oregon is the first state to adopt this standard, other states are considering a similar change.²

Apportionment in General

There may be no more Byzantine set of rules than those governing multistate apportionment. Accordingly, this article will provide a brief overview of the apportionment system before examining the new Oregon rule in detail.

When a taxpayer’s business activities touch upon more than one state and are sufficient to create constitutional nexus upon which various states can assert jurisdiction to tax the “business income” generated from those activities, the taxpayer must apportion that income amongst those states.³ Generally speaking, taxpayers apportion business income to individual states based on a combination of factors (e.g., property, wages, receipts) intended to measure the taxpayer’s business activity in each state.

After a taxpayer determines its state taxable business income, which is derived from the taxpayer’s federal taxable income,⁴ the taxpayer calculates an apportionment percentage for each state in which it does business. To determine a state’s apportionment percentage, the taxpayer calculates a ratio for each of the factors included in a state’s apportionment formula.⁵ Each ratio compares the level of the taxpayer’s applicable business factor (e.g., sales) within a state to the taxpayer’s total business factor everywhere.⁶ The ratios are then appropriately weighted and summed to determine the taxpayer’s total apportionment percentage for each state, which is then applied to the taxpayer’s state taxable income to calculate each state’s respective “share” of that income.

Ultimately, the apportionment system attempts to allow each state to tax its fair share of a taxpayer’s business income, as measured by the apportionment percentages, without allowing multiple states to tax the same dollar of income. As a matter of course, apportionment does not always provide a uniform division of a taxpayer’s income

among the states. Each state is free to choose the factors it will use and the weighting of those factors in computing the amount of in-state business activity conducted, and some disparity naturally ensues.

Oregon’s Apportionment Formula – Single Sales Factor

Oregon uses an apportionment formula based on a single sales factor.⁷ Oregon defines “sales” broadly to include virtually all gross receipts that are not allocable income.⁸ The state’s ratio is calculated by taking the total sales of a taxpayer in Oregon during a given tax period and dividing that number by the total sales of a taxpayer everywhere during that same tax period.⁹

For purposes of assigning sales to a specific location, Oregon divides sales receipts into those derived from two types of transactions: the sale of tangible personal property (“TPP”) and the sale of other than TPP (e.g., sales resulting from the provision of services).

Receipts From Services Apportioned Using Costs of Performance

While the rules assigning receipts from the sale of TPP to respective states are fairly straightforward,¹⁰ the rules for assigning receipts from sales other than sales of TPP give even the most intrepid practitioners pause. The states have codified various methods for assigning such receipts, the most common method being “the greater costs of performance” (“COP”), which generally assigns sales to the state in which the taxpayer incurred the greatest proportion of COP for each service sold. The theory underlying this factor presumes that the state in which the taxpayer incurs the greatest expense in providing the service has the best claim to the income generated by that service. Oregon subscribes to this standard, which is based on Model Regulations drafted by the Uniformity Committee of the Multistate Tax Commission (“MTC”) in the late 1970s.¹¹

The MTC Model Regulations provide a highly detailed scheme – adopted by Oregon – for the calculation of COP. Originally, only direct costs incurred by the taxpayer were included in the calculation of COP; payments made by the taxpayer to independent contractors and agents were excluded. This exclusion, perhaps in part based on the belief that a taxpayer’s apportionment should not be

based on the actions of an independent party, eventually drew criticism as potentially distortive of a taxpayer's apportionment, particularly where a taxpayer heavily relied on agents or independent contractors. Accordingly, the most recent amendments to the MTC Model Regulations reverse this position and specifically include payments to agents and independent contractors who perform services on behalf of a taxpayer that give rise to a particular item of income.¹²

One of the initial reasons the MTC excluded indirect costs from the COP calculation was the perceived taxpayer difficulty in assigning these payments to specific states. In an attempt to reduce this difficulty, the MTC Model Regulation adds "cascading rules" that create a tiered hierarchy for sourcing the payments to the independent contractor/agent. The rules prescribe that services performed on behalf of a taxpayer are performed in a given state if any of the following apply:

The taxpayer can reasonably determine that the work was actually performed in a single state by the agent or independent contractor; or

If the taxpayer cannot reasonably determine that the work was actually performed in a single state, then the taxpayer must check the contract between the taxpayer and the taxpayer's customer to determine if the contract defines where the work is to be performed and identifies a portion of the payment to be associated with that work; or

If the taxpayer cannot allocate all or a portion of the payment based on the taxpayer's contract with the customer, then the taxpayer must perform the same inquiry with the taxpayer's contract with its agent or independent contractor for the unallocated amount; or

If the taxpayer cannot allocate all or a portion of the payment based on the taxpayer's contracts with either its customer or its agent/independent contractor, then any remaining unallocated portion of the payment is allocated to the state of the taxpayer's domicile (commercial domicile for corporate taxpayers).¹³

If none of the foregoing criteria results in a determination of where all or a portion of the payment to the agent/independent contractor will be sourced, or if the state of the activity is determinable but the taxpayer is not taxable in that state, then such income-producing activity shall be disregarded.¹⁴

Effective August 31, 2008, and applicable to tax years beginning on or after January 1, 2008, Oregon has adopted the provisions of the MTC Model Regulation discussed above.¹⁵ As the Oregon regulation adopting the new rules is fairly recent, its wider-reaching effects are not yet known. However, in an era where taxpayers are

often looking to reduce the perceived expense of full-time employees by out-sourcing projects and responsibilities to agents and independent contractors, we anticipate that this amendment will affect a significant number of Oregon taxpayers. Furthermore, due to Oregon's relatively early adoption of this rule compared to other states, practitioners and taxpayers should familiarize themselves with the changes and seek to ascertain the potential benefits and burdens that may arise from Oregon's new regime.

Endnotes

- 1 Scott Schiefelbein (Manager) and Katherine Kruse (Senior Associate) both work in Deloitte Tax LLP's Multistate Tax Practice in Portland, Oregon. Copyright © 2009 Deloitte Development LLC. All rights reserved.
- 2 For example, Idaho has adopted a rule providing that payments to independent contractors and agents are included in the costs of performance calculation. IAC 35.01.01.550.03. Other states are in various stages of considering similar changes. California is considering a similar draft regulation (Cal. Code Regs. tit. 18, § 25136) that also includes several examples of how the new rules will function. However, it is unclear whether this draft rule will receive a public hearing now that California will replace its "costs of performance" sourcing rules with "market-based" sourcing rules for tax years beginning on or after January 1, 2011. S.B. 15, 2009-10 Leg., 3rd. Extraordinary Sess. (Cal. 2009) (signed by Gov. Schwarzenegger on Feb. 20, 2009). In addition, the Supreme Court of Virginia has concluded that indirect costs cannot be excluded from the sales factor calculation for sales of items other than tangible personal property. See *General Motors Corp. v. Commonwealth of Virginia*, 268 Va. 289, 602 S.E.2d 123 (2004) (analyzing rules similar to Oregon's former rules; Virginia is not a member of the Multistate Tax Compact). The Virginia Department of Taxation effectively allows taxpayers to elect whether to include indirect costs. See *Ruling of Comm'r*, P.D. 07-57 (May 10, 2007).
- 3 For apportionment purposes, Oregon defines the term "business income" as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, the management, use or rental, and the disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." ORS 314.610(1). "Nonbusiness income," defined as "income other than business income," is not apportioned but is, instead, subject to "allocation" in accordance with ORS 314.625 through ORS 314.645. Oregon's allocation system (applicable to nonbusiness income), while a fascinating topic in its own right, is beyond the scope of this article.
- 4 In the calculation of state taxable income, federal taxable income is subjected to several state-specific adjustments to additions or deductions allowed on the federal income tax return, but allowed or disallowed for purposes of the state's calculation of its income tax (e.g., the state tax addback, depreciation adjustments, etc.).
- 5 An increasing number of states use a single sales factor. However, most states use a three factor formula consisting of property, payroll, and sales factors, either applying equal weighting to each of the three factors or some degree of increased weighting to the sales factor (e.g., double or greater weighting applied to the sales factor).
- 6 For example, if wages paid in the state are \$100,000 and wages paid in total are \$1,000,000, then the taxpayer's payroll ratio is 10%. The determination of what is included in the everywhere numbers also varies according to the state involved and/or elections made by the taxpayer. The "everywhere" numbers for a particular

state may include only domestic U.S. numbers or may include worldwide numbers.

- 7 ORS 314.650. Oregon has used the single-sales factor since July 1, 2005. Oregon's apportionment ratio has evolved over time from an equally weighted three-factor apportionment ratio to an apportionment ratio based solely on the sales factor.
- 8 OAR 150-314.665(1)-(A)(1).
- 9 ORS 314.665(1).
- 10 Sales of TPP are generally sourced to place of delivery.
- 11 The MTC Model Regulation is found at MTC Art. IV.17. Regarding Oregon, sales other than sales of TPP are considered sales in the state when "(a) the income-producing activity is performed in this state; or (b) the income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance." ORS 314.665(4).

- 12 See MTC Regulation IV.17.(4)(C), added in 2007 to the MTC's Allocation and Apportionment Regulations; adopted in Oregon at OAR 150-314.665(4).
- 13 MTC Model Regulations IV.17.(C).
- 14 *Id.*
- 15 OAR 150-314.665(4)(5)(c).

Message From the Chair

By Katherine O. VanZanten, Chair, OSB Taxation Section Executive Committee

The members of the Oregon State Bar Taxation Section (the "Section") have been very productive this year and look forward to a busy 2010.

The legislative subcommittee met regularly this session to comment on proposed legislation and administrative rules. It was a busy session and now that it has ended, the legislative subcommittee is commenting on proposed administrative rules and preparing for the next legislative session. Robert Manicke, chair of the legislative subcommittee, will be speaking to Section members about the amnesty bill, SB 880, on September 3, 2009 at the Stoel Rives law firm. Given the short window for compliance and the ramifications of this bill, I encourage you to attend.

In June the Section sponsored the Ninth Annual Oregon Tax Institute ("OTI"). The OTI's local and national speakers spoke on a variety of tax subjects over a period of two days. We hope that those of you who attended the OTI found it helpful in your practice and welcome any suggestions you have for next year's OTI seminar.

The Section will sponsor the Broadbrush Taxation CLE on November 15, 2009. The Broadbrush CLE is held every other year and is designed to provide important tax information to attorneys whose practices do not primarily focus on tax law. Information regarding this CLE is posted on the Section's website as well as on the Oregon State Bar CLE calendar.

The Executive Committee of the Section encourages you to become involved. With your involvement, our

Section will better serve its members. Please consider writing an article for the newsletter, volunteering to work on a subcommittee, or volunteering to organize or speak at a CLE. The Section's subcommittees include: the legislative subcommittee, which addresses pending and current legislation as well as proposed Oregon Administrative Rules; the CLE subcommittee, which plans the OTI and the Broadbrush Taxation CLEs; the Portland luncheon subcommittee, which conducts monthly CLE lunch topics in Portland; the Salem luncheon subcommittee, which conducts monthly CLE lunch topics in Salem; and the newsletter subcommittee, which publishes three to four newsletters each year.

As summer comes to a close and the seersucker suits are put away, we hope you will consider becoming involved in the Section this fall and in 2010.

UPCOMING EVENTS CALENDAR

- **Amnesty Program Brown Bag**
September 3, 2009
Stoel Rives (Portland)
- **IRS Practitioner Forum (Bad Debt, Independent Contractor, Administration, CID and Collections)**
October 30, 2009
Portland Airport Embassy Suites Hotel
- **Broadbrush Taxation**
November 15, 2009
Double Tree Hotel Portland
- **Portland Luncheon Speaker Series**
University Club, Portland:
 - September 10, 2009*
David C. Culpepper, TBA
 - October 8, 2009*
Vincent P. Cacciottoli, Cash Balance and Other Innovative Qualified Plan Designs
 - November 12, 2009*
Neil D. Kimmelfield, Tax Return Preparer Penalties and Circular 230 – Current State of the Law
 - December 29, 2009*
Mark A. Prater, Washington, DC Tax Update
- **Salem Luncheon Speaker Series**
Roth's West Salem:
 - September 22, 2009*
Jeff Wong, Discharge of Indebtedness Income
 - October 20, 2009*
Debra Buchanan, New State Tax Law Legislation
 - November 17, 2009*
TBA
- **10th Annual Oregon Tax Institute**
June 3 and 4, 2010
Multnomah Athletic Club, Portland

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