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Paying the Cost of Certainty: ORS 316.032(2).

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This article discusses the legislative history of ORS 316.032(2), its application, and finally a suggestion for its amendment.

As a general rule Oregon income tax law incorporates and mirrors Federal income tax law.[1] However, due to the flexibility of Circuit Courts of Appeal to interpret statutes independently, Federal tax law can vary from circuit to circuit. That diversity between federal courts is not limited to the various Courts of Appeal. The United States District Courts, the United States Tax Court, the Court of Claims, the Bankruptcy Courts, and Bankruptcy Appellate Panels all have jurisdiction to decide tax matters. Moreover, the Internal Revenue Service may have an official position that differs from that of the circuit in which a particular taxpayer resides.

In the vast majority of tax decisions, there is consistency between the various federal courts and the Internal Revenue Service. However, there remains potential for disagreement. The Oregon Tax Court has framed the problem in those rare cases as follows:

> "It is clear from a study of the cases and Revenue Rulings cited by counsel… that there is no single federal rule applicable to the facts in the present case…. This is not uncommon under our federal judicial system in which many courts, over a wide area, have jurisdiction. The Commissioner of Internal Revenue seeks resolution from these difficulties through his acquiescence and nonacquiescence to particular decisions, often forcing an issue to the U.S. Supreme Court for resolution. This is accomplished only after the expenditure of much time and effort."[2]

Under these circumstances Oregon law, namely the conflicts provision of ORS 316.032(2), requires the Oregon Department of Revenue (the Department) to follow the position of the Commissioner of Internal Revenue (the Commissioner).[3]

On issues where there is a split in federal case law, predictability is indeed a worthwhile goal; however, the conflicts provision fails to achieve that goal. For instance, the Internal Revenue Service could change position on an issue while a parallel case is in front of the Oregon Tax Court.[4] The conflicts provision would

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1 ORS 316.007. All references to the Oregon Revised Statutes (ORS) are to 2011.

2 *Scouten v. DOR* 5 OTR 390, 394 (1974).

3 ORS 316.032(2) states:

> "Insofar as is practicable in the administration of this chapter, the department shall apply and follow the administrative and judicial interpretations of the federal income tax law. When a provision of the federal income tax law is the subject of conflicting opinions by two or more federal courts, the department shall follow the rule observed by the United States Commissioner of Internal Revenue until the conflict is resolved. Nothing contained in this section limits the right or duty of the department to audit the return of the tax liability of any taxpayer."

(Emphasis added).

4 As an example, the Internal Revenue Service abruptly changed positions on the statute of limitations on claims for innocent spouse equitable relief in Notice 2011-70 despite successes in the 7th, 3rd, and 4th Circuit Courts of Appeal. That notice acted as a concession on numerous pending cases, including a case where the author had already submitted memoranda to the United States Tax Court and prepared briefs as a certified law student while working with Professor Jan Pierce at the Lewis & Clark Legal Clinic.

then compel the Department to follow that position. In those cases ORS 316.032(2) creates uncertainty, unnecessary complexity, and increased litigation costs for the Department and Oregon taxpayers.

This article discusses the legislative history of ORS 316.032(2) including the theory behind incorporation of Federal income tax law, Oregon case law confronting the application of the conflicts provision of ORS 316.032(2), and finally a discussion of the inherent difficulties of applying the conflicts provision and whether alternatives exist to achieve integration at a lower cost and greater predictability to the Department and Oregon taxpayers.

Legislative Background: Efficiency, Simplification, Unity.

In 1969 the Oregon Legislature passed HB 1206 (1969), codifying ORS 316.032(2) and adopting federal income tax law as the basis for Oregon income tax law.[5] However, the non-delegation doctrine prohibited a statute from binding Oregon to all subsequent changes made by Congress.[6] Therefore, the legislature simultaneously offered HJR 3 to amend the Oregon Constitution and allow Oregon to mirror future federal changes.[7] Oregon voters subsequently approved Measure 2 on November 3, 1970,[8] officially tying Oregon to Federal tax law.[9]

Proponents of the change argued that a move to a federally based system would provide simplification, lower administrative costs, and lower compliance costs.[10] They argued that tying Oregon to federal law would allow, "both the taxpayer and [the] state administration" to take advantage of numerous "administrative and court interpretations, rulings and decisions."[11] Indeed, Oregon tax practitioners and the Oregon Tax Commission had already been citing federal decisions interpreting provisions of the Internal Revenue Code in Oregon controversies.[12]

5 OR Laws 1969 c. 493 (§10). The law was modeled after a provision passed by the State of Vermont. See Carl N. Byers, Memorandum to Carlisle B. Roberts, (February 8, 1967).

6 A point brought by Carl N. Byers, Memorandum to Carlisle B. Roberts, February 8, 1967. Also, Art.. I Sec. 21 which states, "…nor shall any law be passed, the taking effect of which shall be made to depend upon any authority, except as provided in this Constitution…"

7 HJR 3 (1969), Minutes of the House Taxation Committee, March 3, 1969 (p. 2).

8 Or Const., Art. IV, Section 32.

9 State of Oregon Secretary of State, Official Voters' Pamphlet for the Regular General Election, November 3, 1970 , 10.

10 Carlisle B. Roberts, State Tax Commission, Memorandum to Commissioner Charles H. Mack, 2 (August 19, 1968).

11 Voter's Pamphlet, 11.

12 Roberts Memorandum, Supra n. 9. (citing *Ruth Realty Co. v. State Tax Commission*, 222 Or. 290, 294 (1960)).

The sheer volume of Federal administrative and court interpretations available after incorporation provided the drafters of the statutes with a "paradox."[13] When Federal courts disagree, which federal or administrative interpretation should apply? The answer is found in the conflicts provision of ORS 316.032(2): the Department must follow the position of the Commissioner of Internal Revenue until the conflict is resolved. The provision provides no explanation of what the drafters intended by the phrase "position of the Commissioner of Internal Revenue." The House and Senate Committees did not discuss the provision in the committee hearings. [14] Our only real clue is language of the statute: that when federal courts disagree, the Department must follow the position of the Commissioner. The true impact of that statutory command remained a mystery for to the courts to unravel.

ORS 316.032(2) Case Law: The Department is Bound.

Oregon courts have applied ORS 316.032(2) in a variety of contexts.[15] In the first case to discuss the conflicts provision, ***Scouten v. Dep't of Rev.***, the taxpayer had received a lump sum distribution from a qualified 401(a) profit sharing plan, which the taxpayer contended was subject to capital gains treatment.[16] The Department disagreed, contending the distribution was ordinary income, and assessed a deficiency.[17] The Court determined, first, that there was indeed a conflict between various Federal courts, and second, that the Commissioner of Internal Revenue had voiced a position through two Revenue Rulings.[18] The Court held that the Commissioner's position was binding on the Department and ordered the Department to abate the deficiency.[19]

Deductibility of Travel Expenses Cases.

In a series of cases relating to the deductibility of business travel expenses, the Oregon Supreme Court and Oregon Tax Court confirmed that the conflicts provision requires the Department to follow the Commissioner's position on issues where federal courts are in disagreement.[20] In ***Deblock***, the

13 *Id.* at 7.

14 House Taxation Committee Minutes, HB 1206, 1969 (January 17, March 3, March 5, March 7). Senate Taxation Committee Minutes, HB 1206, 1969 (March 14, April 24, May 13).

15 ORS 316.032(2) is often cited in cases imposing tax on tax protesters, see e.g. *Baisch v. Dept. of Rev.,* 316 Or. 202, 209-10, 850 P.2d 1109 (1993).

16 5 OTR at 390.

17 *Id.*

18 5 OTR at 395.

19 *Id.*

20 *Deblock v. Dep't of Rev.,* 286 Or. 735, 596 P.2d 560, 563 (1979).

Department disallowed two taxpayers' deductions for commuting expenses to various construction sites.[21] The Department contended that the Commissioner's position was inconsistent with the Internal Revenue Code, legislative history, and Treasury Regulations.[22] The Oregon Supreme Court stated that the intent of the Oregon legislature in enacting the conflicts provision was not to delve into a lengthy argument in every case about which position the Commissioner observes, but more to, "maintain parallel rules of tax administration," and the Department was ordered to follow that position.[23]

Continuing the travel expenses line of cases, the Oregon Tax Court looked at the application of the conflict provision in ***Finn v. Dept. of Rev.***, ***Harding v. Dept. of Rev.***, and ***Hintz v. Dept. of Rev***. In ***Finn***, the taxpayer had purchased a home in Tahiti, yet returned to Oregon in a subsequent year to wind up a construction business.[24] In ***Harding***, the taxpayer deducted travel expenses connected to his work as a traveling certified public accountant.[25] Finally, in ***Hintz***, the taxpayer had deducted expenses connected to travel to sites for construction work.[26] In all three cases the Court stated unequivocally that when Federal courts are in disagreement, ORS 316.032(2) binds the Department to the position of the Commissioner of Internal Revenue.[27]

These decisions all held that in determining whether travel expenses were deductible, the test was that laid out in ***Rev Rul 83-82***, 1931-1 CB 45,[28] and the department was bound by the Commissioner's interpretation of that test, not the position adopted by the 9th Circuit Court of Appeals.[29] To be clear, the statute does not bind the Department of Revenue to factual determinations made by the Commissioner, but does bind the Department to the standards for making those determinations.[30]

The Courts are not Bound by the Position of the Commissioner

Clearly the conflicts provision of ORS 316.032(2) by its express language binds the hands of the ***Department***.[31] Whether the provision binds the Courts of the State of Oregon is a less settled question. In ***Hintz***, the Oregon Tax Court intimated it believed that *it* was bound to the position of the Commissioner.[32] However, in the most recent case to discuss the provision, the Court merely reaffirmed that the statute ties the Department to "the legal position taken by the Commissioner[.]"[33]

Although the Court did not expressly address whether the Court is similarly bound, the Court's use of the phrase "legal position of the Commissioner," leads to the construction that the statute cannot bind the Court. No tax may be imposed in Oregon except by law.[34] Indeed, Article IV, Section 32 explicitly limits the application of incorporation of Federal law to, "any provision **of the laws of the United States** as may be or become effective."[35] The conflicts provision of ORS 316.032(2) ties the Department to a legal ***position*** of the Commissioner, not to the laws of the United States or the state of Oregon.

In areas of ambiguity, statutory analysis compels us to look at the context of the statute to find clarity.[36] An analysis of the statute and the Oregon Constitution confirms that the legislature had divided the powers between the Department and the Tax Court. The Oregon Constitution vests the judicial power of the State of Oregon in the Oregon Supreme Court and other courts established by law.[37] Subject to review by the Oregon Supreme Court, the Oregon Tax Court is the sole and exclusive authority for the determination of all questions of law and fact arising under the tax laws of this state.[38] In cases within that authority, the Oregon Tax Court is a court of general jurisdiction, and has the power of a circuit court.[39]

The Legislature described and limited the power of the Tax Court in chapter 305, not chapter 316. Among those powers is the power to determine whether a law

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21 286 Or. at 737.

22 *Id* at 739-40.

23 *Id* at 741.

24 10 OTR 393, 395 (1987).

25 13 OTR 454, 455 (1996).

26 13 OTR 462 (1996).

27 *Finn*, 10 OTR at 383; *Harding*, 13 OTR at 459; *Hintz*, 13 OTR at 466.

28 Per Rev Rul 83-82 travel expenses are deductible if they satisfy three conditions, "(1) they must be ordinary and necessary, (2) they must be incurred while away from home, and (3) they must be incurred in pursuit of a trade or business."

29 13 OTR at 466.

30 *Id.*

31 ORS 316.032(2).

32 "Therefore, because there is a conflict among the federal courts, this court must follow the rule observed by the United States Commissioner of Internal Revenue Service." 13 OTR at 466.

33 *Department of Revenue v. Washington Federal, Inc., and Subsidiaries*, __ OTR __, (June 29, 2012) (slip op at Fn 8.) (citing *Department of Revenue v. Marks*, __ OTR __, (Nov 3, 2009) (slip op at 8.).

34 Or Const., Art. IX, Section 3.

35 Or Const., Art. IV, Section 32 (emphasis added).

36 *State v. Gaines*,346 OR 160, 171-173, 206 P3d 1042 (2009), modifying the analytical framework given in *PGE v. Bureau of Labor and Industries*, 317 OR 606, 610-12, 859 P2d 1143 (1993).

37 Or Const., Art. VI, Section 1

38 ORS 305.410(1).

39 ORS 305.405(1) and (2); *Sanok v. Grimes*, 294 Or. 684, 690-97, 662 P.2d 693 (1983).

violates the Constitution of the State of Oregon. Given that division of powers, an analysis of the context and legislative history of the provision lead to the understanding that ORS 316.032(2) cannot bind the courts of the State of Oregon to a legal position of the Commissioner.

Accepting the alternative, if the Court were bound, the provision would pose serious questions of delegation of legislative and rulemaking authority.[40] That very issue nearly ended incorporation before it began, and it was the foresight of Carl N. Byers in his memorandum to Carlisle B. Roberts,[41] and the passing of Article IV, Section 32 that allowed the Legislature to adopt incorporation.

The Golsen Rule and Inherent Conflict?

Accepting that the conflict provision binds the hands of the Department, and recognizing that Oregon taxpayers must at some point take a reporting position on any given transaction, taxpayers must be aware of the potential for a circuit split or a shift in the position of the Commissioner of Internal Revenue. Under the rule of ***Golsen v. Commissioner***, the United States Tax Court applies the law of the Circuit to which the taxpayer would appeal, without regard to the position of the Commissioner of Internal Revenue.[42] Thus a position of the commissioner such as a revenue ruling may be valid in the 9th Circuit Court of Appeals, but invalid in other circuits, thus creating different federal law in different circuits.[43]

In those instances, Oregon taxpayers are stuck between Scylla and Charybdis, are they to prepare their Oregon tax returns consistent with their federal returns (and applicable decisions of the 9th Circuit Court of Appeals) and face audit, or should they deviate from those positions on their Oregon returns based on the position of the Commissioner of Internal Revenue only to find that position potentially change? The latter adds compliance cost and difficult explanations during an audit, the former could lead to expensive (and potentially fruitless) controversy costs.

In 2010, the Taxation Section of the Oregon State Bar proposed a legislative concept that would have amended ORS 316.032(2) and its companion corporate excise tax statute, ORS 317.013(2), to remove the conflicts provision from the statutes. In the section's view at the time, removal of the provision would provide the Department more flexibility in litigation. Removal would also benefit Oregon taxpayers who already spend substantial time and effort reviewing Federal law to determine reporting positions on their Federal returns. Removing the conflicts provision would not add additional compliance costs to Oregon taxpayers. After discussions with the Department, the Section withdrew the concept, in favor of promoting further research on the background of the issue and publication of one or more articles on the subject.

Indeed, in the author's view, removing the conflicts provision could potentially achieve the goal of providing more predictability and harmony between the Federal and Oregon tax regimes as it would no longer tie the Department to the whim of the Commissioner. It would remove doubts about delegation of legislative and judicial powers and would provide taxpayers and tax practitioners more predictability, all while maintaining integration of the Federal and Oregon tax systems—the stated goal of Measure 2 and the drafters of ORS 316.032(2).

Conclusion

ORS 316.032(2) was enacted as part of sweeping legislation designed to align Oregon tax law to federal tax law in order to create efficiency, simplification, and unity. In the rare instances in which federal tax law is subject to multiple interpretations by various federal courts, the conflicts provision of ORS 316.032(2) has the potential of creating the opposite result. Practitioners should be aware of the effect of the provision, and its potential application.

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40 See e.g. *Seale v. McKennon*, 215 Or 562, 572, 336 P.2d 340 (1959) or *MacPherson v. Department of Administrative Services*, 340 Or 117, 130 P.3d 308 (2006).

41 Supra n. 6.

42 *Golsen*, 54 T.C. 742 (1970).

43 This is the result in *Trinova v. Commissioner of Internal Revenue*, 108 TC 68, 77 (1997). In *Trinova*, the United States Tax Court held Rev. Rul. 82-20 invalid, citing Treas. Reg. .150-3(f)(2) despite rulings of the 2nd and 9th Circuit Courts of Appeals.

US Tax Implications of Real Property Investments by Non-US Investors[1]

By Masataka Yamaguchi, Perkins & Co.

Overview

The US real estate markets continue to see strong demand from foreign investors on the back of the notion that they offer attractive investment alternatives to what's available in their home countries. However, US real property investments could bring foreign investors a number of unintended consequences without proper planning. In this edition of Perkins Bulletin, we explore some advantages and disadvantages of the typical US real estate holding structures involving foreign investors. We also discuss some noteworthy items that could affect foreign investors' financial goals.

What are your goals for your US real estate investment?

The ultimate goals of acquiring US real property would be different for a foreign investor looking for a single, personal-use vacation house in Palm Springs and a foreign investor who is about to acquire a number of properties in multiple locations for resale in the expectation of future gains. The former investor may hold on to his property without ever disposing of it during his lifetime while the latter investor may repeat a purchase and sale in a relatively short time span when the gain can be realized.

Long-term holding – US estate tax issues

The US federal government imposes the estate tax on the value of assets included in a decedent's taxable estate in excess of a prescribed threshold. A typical non-resident foreign investor in US real property would be subject to US estate tax on their US real property holdings. Assets which could give rise to the US estate tax for a non-resident foreign investor include, but are not limited to, real property and certain personal property located in the US as well as stock in corporations incorporated in the US. Therefore, a foreign investor who owns real estate in the US without any intention of disposing of it needs to be concerned about his potential exposure to the US estate tax. A different set of rules may apply to any person who is a former US citizen or long-term US resident.

If a foreign investor's home country imposes a similar kind of tax upon a death, and that country has an effective tax treaty with the US which provides a tax credit for the estate tax paid to the US government, his ownership of the US real property may not create any additional concern, as it is unlikely to materially change the worldwide estate tax exposure. However, countries which have been sending many investors to the US to scoop up real property in recent years (such as Canada, China and Australia) do not generally impose tax by reason of taxpayers' death in addition to the regular income tax. For investors from such countries, the US estate tax could be a significant and unexpected cost.

The highest US estate tax rate was 35% until December 31, 2012, but it has just been raised to 40%. The US tax treaties with certain countries provide an estate tax exclusion linked to the exclusion available to US citizens. For foreign nationals of such countries, the exclusion amount available is prorated based on the ratio of their US asset holdings to their worldwide asset holdings. The exclusion amount available to US citizens is currently $5.25 million and it continues to be indexed for inflation in future years. Foreign nationals residing in a country which does not receive any such US treaty benefits, or which does not have an effective tax treaty with the US, receive an exclusion amount of only $60,000. The magnitude of the estate tax can be overwhelming as the tax is assessed on the value of assets unlike the income tax that is assessed on the amount of net income or net gain after applicable deductions.

Possible solution: Corporate ownership structure

US estate tax exposure can be relatively easily eliminated for a foreign investor by having a foreign corporation directly hold the investor's US real estate. This way, the investor then owns shares in the foreign corporation, rather than a piece of real property located in the US. Shares in a corporation incorporated outside of the US are generally not subject to the US estate tax.

The most notable downside about the corporate ownership structure is that the gain on disposition of US real property will be taxed at the corporate income tax rate, which could be as high as 35% (federal) plus state taxes, while the applicable federal rate to individual taxpayers is still limited to 20% after being raised from 15% if the property is held over 12 months. The 3.8% "ObamaCare" surcharge will also apply in 2013. The 20% rate is applicable to individuals whose taxable income is over $400,000 ($450,000 for individuals filing jointly with their spouses) and individuals who do not reach the threshold continue to be taxed at 15%.

Branch Profits Tax

While exposure to US estate tax can be shielded with a foreign corporation holding US real property, that foreign corporation will also be subject to the US Branch Profits Tax ("BPT") rules. The BPT can be avoided by inserting a US corporation to directly hold the US real property as opposed to having a foreign corpora-

1 Originally published in Perkins & Co. "Tax Impacts Bulletin," January 2013; reprinted here with permission.

tion directly hold the property. A full explanation of the BPT regime is beyond the scope of this article, but it is a way to determine what amount of the US earnings in a given year is deemed to have been distributed to the home office of the foreign corporation. Such a mechanism is necessary to put a US branch of a foreign corporation on equal footing with a US wholly-owned subsidiary corporation of a foreign corporation with respect to the repatriation of the US earnings. Without the BPT, a US branch of a foreign corporation would be exempt from any US federal tax on distributions of US earnings to its home office whereas the actual dividend distributions made by a US wholly-owned subsidiary corporation to a foreign parent corporation would be generally subject to the US withholding tax.

The BPT could be problematic for the following reasons:

- A foreign corporation could be subject to the BPT whether or not any money was actually distributed to it by its US operations.
- The tax is assessed on the amount called the Dividend Equivalent Amount ("DEA") which is artificially computed based on the amounts of US earnings as well as US net worth.
- It is difficult to predict the BPT effect whereas a foreign parent can directly control tax associated with a US subsidiary.

Whether the existence of the BPT dampens the overall tax efficiency depends on some factors, including:

- Whether a tax treaty exists between the US and a foreign country.
- Whether the treaty eliminates the BPT or provides a partial exemption.
- Whether the treaty reduces the branch profits tax rate, which would be 30% of DEA without any treaty benefits.

A structure in which a foreign corporation owns an interest in a US corporation that in turn directly holds a US real property interest allows you to eliminate exposure to both the US estate tax and BPT.

US Real Property Holding Corporations ("USRPHC")

When shares in a US corporation are disposed of by a non-US person for a gain, the gain is generally not subject to the US federal income tax. This is true only if the US corporation is not a USRPHC. Shares in a US corporation that is a USRPHC are considered to be a US real property interest ("USPRPI"). The gain on disposition of them by a non-US person is subject to the US federal income tax because it is considered to be income effectively connected with a US trade or business.

A corporation is a USRPHC if 50% or more of the corporation's certain tested assets consists of USRPI. The tested assets refer to real property and other assets used in a trade or business and therefore investment assets other than real property are generally excluded from the analysis.

In a structure where the USRPI is held by a US corporation which is in turn owned by a foreign corporation, the foreign corporation's disposition of its shares in the US corporation would trigger a US federal tax filing obligation and, if any gain results, a US federal tax payment obligation as the shares in a USRPHC are considered USRPI. If the US corporation were not a USRPHC, the gain of a foreign investor would not be subject to the US federal income tax.

US Real Property Holding for Gains – Capital Gain v. Ordinary Income

As briefly discussed, gains on sales of real property held more than one year ("long-term capital gains") in the US are generally taxed at 20% or 15% (depending on the amount of taxable income) for individual taxpayers while the applicable tax rate could be as high as 35% for corporate taxpayers. This tax rate differential may be the main focus for investors whose intention is to sell the properties for future gains, as the differential is quite substantial. Rental income generated by real properties is treated as ordinary income, which is currently taxed at the maximum rate of 35% for corporate taxpayers and 39.6% for individual taxpayers whose taxable income is over \$400,000 (\$450,000 if filing jointly).

Aside from the changes affecting the individual taxpayers, we may see a corporate income tax rate reduction in 2013 or later so that the maximum rate would be lower than 35% (to align the US corporate tax rates to those of other developed countries). All of these changes that have occurred and that may occur along with the ones related to the US estate tax mentioned earlier will likely influence investors' decisions as to how they should hold the US real property. Also, they could trigger an opportunity to review current structures and possibly restructure the US real property holdings for some investors who have already invested in the US real property market.

Lower current US rate v. foreign tax deferral

Consideration should be given to how the gain is taxed in the home country, as the eventual overall tax costs of the gain would be primarily decided by the tax rate in the higher tax jurisdiction (as long as the home country allows the foreign investor to claim a credit for the amount of US taxes). For example, if the ultimate tax cost of the gain in the home country is lower than 35%, the foreign investor may be motivated to have the gain taxed at 20% rather than 35% in the US, to directly lower the overall tax costs of the gain. Having the gain taxed at 20% in the US will generally subject the gain to an immediate tax in the home country. On the other hand, if the ultimate tax cost in the home country is higher than 35%, the foreign investor is less likely to be concerned about the tax rate differential in the US and may be more motivated to have the home country tax on the gain deferred to the extent possible.

Many foreign countries do not tax corporate earnings resulting from the active conduct of an overseas business by foreign subsidiaries. If the home country does not tax the US gain recognized by a US subsidiary until the gain is distributed to the ultimate individual foreign investor in the form of dividends, the home country is unlikely to grant a credit for the US tax paid on the gain by the US subsidiary corporation. Where the US gain is not treated by a foreign country as income arising from the active conduct of a business, it is more likely to be subject to the immediate tax in that foreign country possibly with a tax credit for the amount of US taxes paid.

Disadvantages of personal holding

In addition to the US estate tax exposure, liability issues can arise from the personal holding structure especially when there are multiple properties through which active businesses are conducted. The liability issues can be mitigated or eliminated by the purchase of insurance contracts even with the personal holding structure. If the property is a vacation house the use of which is limited to the owner and his family, the liability issues may not be much of a concern.

What if your goals can change? Want more flexibility?

In the real world, investment goals can change over time as investors' priorities may change. Also, investment decisions are often dictated by changes in investment climate including legislative changes. The use of a partnership structure may make the most sense for foreign investors whose priorities may change in the future as the structure gives more flexibility.

Use of Partnerships

Preferential capital gain treatment

Having a flow-through entity, such as a limited partnership, hold US real estate ensures that the ultimate foreign non-corporate investors will receive preferential capital gain treatment for US tax purposes, as all the tax attributes, including income, deductions, and credits of the partnership, will be passed through to each partner. Limited partners of a limited partnership may also obtain adequate liability protection, as compared with a corporate structure, as the limited partners' risk is generally limited to the amount they contributed to the partnership.

US estate tax implications

Although there has been much debate as to what determines the situs of a partnership interest in the cross-border tax community, there has not been clear IRS guidance on this topic. It is possible that the situs of a partnership interest should be determined by where the majority of the partners reside, unless there is a statute to the contrary. Factors such as whether the partnership was formed inside or outside the US, whether the partnership survives the death of the partner, and where the majority of business activities are conducted through the partnership may contribute to the determination of the partnership interest situs under certain circumstances.

It is possible that an interest in a partnership that owns US real property can be gifted by a non-US owner of the partnership interest without triggering US gift tax. US gift tax is imposed only on real property and personal tangible property located in the US when the donor is a non-US person according to the applicable provision under US tax law. While the provision makes reference to corporate stock and debt obligations as intangible property, it makes no such reference to other types of intangible property such as partnership interests. Although it has generally been assumed that partnership interests should be treated in the same manner as corporate stock, it is not entirely clear that the IRS would never look through the partnership to subject US real property interests held by the partnership to US gift tax when the partnership interest is gifted by a non-US person. The gift tax rule mentioned above may not apply to certain non-US donors who are former US citizens or long-term US residents.

US check-the-box election

Those who seek more certainty in an attempt to eliminate the US estate tax exposure can still opt for the partnership structure to enjoy preferential capital gain treatment on sales of US real property while they are alive. For an unexpected sudden death of the partner, the deceased partner's executor can make an election to treat the partnership as a corporation for US federal tax purposes provided that all the other partners consent to the election. Such an election must be made by a date no later than 75 days following the death to make sure that the election was retroactively valid at the time of the death. There is currently nothing explicit to suggest that the post-mortem election is invalid. With the proper election in place, the decedent partner should be treated for US tax purposes as having owned as of the date of death an interest in a foreign entity which is not subject to the US estate tax, while the preferential capital gain treatment is no longer available on disposition of US real property under what has now become corporate ownership.

The election described above is widely referred to as Check-the-Box election, and it basically allows the foreign investors to keep more options alive for a longer period of time in the context of the US real estate investments.

US tax filing obligations

Unlike the corporate or personal ownership structures, in which only the direct owner of US real property interest is generally required to file a US federal income tax return, both a partnership and each partner are required to file a US federal income tax return. This may translate into substantial tax compliance costs especially if there are a number of foreign partners who invest in US real property interest.

Limited Liability Companies ("LLC")

The use of an LLC has been a popular choice in the US as a vehicle through which a business is carried on. It has the same US tax results as a partnership. However, it can create some unintended consequences in the cross-border context: some foreign jurisdictions treat it as a corporation, while the US either treats it as a pass-through entity or disregards it as a separate entity from its owner. Such inconsistencies can lead to a complete denial of or severe reduction in foreign tax credit in the home country. You should consult an experienced tax advisor before you implement an LLC in the US real property investment projects.

Other miscellaneous considerations

US Federal Tax Withholding Requirements

Generally, a payor of a US source income to a foreign payee is required to withhold US federal income tax at the time of the payment. The rate at which the US tax is withheld on the payment is determined by the type of income under the applicable tax treaty between the US and the applicable foreign country.

Foreign Investment in Real Property Tax Act ("FIRPTA")

The US Federal income tax withholding on sale of real property located in the US is governed by FIRPTA. When a seller/transferor is a non-US person, the general rule is that a purchaser/transferee of the real property being sold/transferred is required to withhold 10% of the gross sale proceeds (or the fair market value at the time of transfer) and remit the amount to the IRS within a certain period after the sale. This means that the 10% withholding needs to be done even if there is no gain to recognize, or even with a loss on the sale, absent any exemptions provided under FIRPTA. The tax withheld under FIRPTA can be recovered by claiming a refund on a tax return to the extent that the amount withheld exceeds the actual tax liability which arose from the gain for the seller. One of the FIRPTA withholding exemptions applies when the gross sale price is less than $300,000 and the purchaser is prepared to confirm that they intend to use the property for personal use for a period of two years or longer.

Where a foreign investor participates in a real estate project where a number of divided lots are separately sold, the FIRPTA withholding requirements can be extremely problematic as each transaction needs to have 10% of the gross sale proceeds withheld and remitted to the IRS. Such a situation can occur when the real property interest is directly held by a non-US person/entity, which includes foreign corporations, foreign partnerships and foreign nationals. Where the FIRPTA withholding could be problematic, the US real property interest should be directly owned by a US entity so that the sales of the interest would not be subject to the FIRPTA withholding.

Complications in connection with partnership structures

Aside from the FIRPTA withholding, a foreign partner's distributive share of income earned by a partnership is subject to the US tax withholding under a separate provision (Internal Revenue Code "Section 1446 tax"). Section 1446 tax is typically withheld at the highest rate of tax that is applicable to each foreign partner on a quarterly basis. Thus, it varies depending on whether a foreign partner is a corporate or non-corporate partner. The withheld tax can be recovered to the extent that it exceeds the amount of the final tax liability at the time of filing a US federal income tax return. There is a provision which relieves a US partnership from the FIRPTA withholding requirements when the S.1446 withholding is satisfied, but the same relief is not explicitly made available to a non-US partnership. A foreign partnership can be subject to both of the above mentioned US tax withholding requirements, which makes it impractical to carry on business— especially when a number of separate real property interest sales occur throughout the year. In such a situation, a US partnership may need to be created to directly hold the US real estate interest and have the US partnership owned by a foreign partnership. Since there must be two or more partners for each partnership, a general partner corporation which owns a fraction of the partnership interest must be created at each partnership level in order to complete this particular structure.

Reorganization of US real property interest holding structure

We often see transfers of US real property between related foreign parties. Many of these transfers seem to be made based on the incorrect assumption that the property transfers are nonevent for US tax purposes based on the notion that the ultimate owner did not change and that there is no gain according to the fair market value of the property at the time of the original acquisitions and subsequent transfers. The fact that there is no gain to be recognized alone will not relieve the US real property interest transferee from the 10%

withholding required under FIRPTA. Also, when the US real property interest is transferred to an entity which is newly created by the original individual owner of it or vice versa, it is generally an event which requires US tax withholding under FIRPTA. The potential consequences of failing to withhold the required amount include penalty and interest by the IRS on the amount that should have been withheld and remitted to the IRS at the time of the property transfer. This penalty and interest may apply even if there was no gain, as the withholding tax is not based on the gain but on the gross sale price (or fair market value of the property at the time of transfer).

There are quite a few exceptions that can relieve a US real property interest transferee from the FIRPTA withholding but these exceptions generally require proper documents to be filed with the IRS within certain periods of time. The IRS may allow some of such documents to be filed late when the late filing was due to reasonable cause. Otherwise, the IRS could pursue to collect penalties and interest associated with non-withheld amounts until the required amount is remitted to the IRS.

If we see any corporate income tax rate reduction in the near future, we could see a lot of restructuring involving the current US real property interest holding structures by foreign investors. Foreign investors are strongly recommended to consult an experienced cross-border tax advisor before making any restructuring attempts associated with US real property interest holdings.

This bulletin is a summary and is not intended as tax or legal advice. You should consult with your tax advisor to obtain specific advice with respect to your fact pattern. Based on the most recent "best practice" standards for tax advisors issued by the Treasury Department, commonly referred to as Circular 230, we wish to advise you that this bulletin has not been prepared to be used, and cannot be used, to provide assurance that penalties which may be assessed by the IRS or other taxing authority (including specifically section 6662 understatement penalties) will not be upheld.

IRS Considers Guidance and Seeks Comments on Property Simultaneously Held for Sale or Lease ("Dual-Use Property")

By Hertsel Shadian

I. Summary

On February 7, 2013, the IRS issued Notice 2013-13, to provide preliminary guidance and invite comments regarding whether construction and agricultural equipment held simultaneously for sale or lease to customers (so called "dual-use property") by a dealer in such equipment is properly treated as inventoriable property or as depreciable property[1] for purposes of § 167 of the Internal Revenue Code (IRC, or the Code). The notice also invited comments on whether, and under what circumstances, dual-use property may be eligible for like-kind exchange treatment under IRC § 1031.[2]

II. Background

Dealers in construction and agricultural equipment purchase equipment from a manufacturer and generally seek to resell the equipment to customers as soon as possible. However, to accommodate particular needs of its customers, a dealer may lease equipment to a customer prior to selling it. Ordinarily, dealers reacquire their leased equipment upon termination of the lease and thereafter hold the equipment for varying periods before re-leasing or selling it. Alternatively, the lessee may purchase the leased equipment rather than return it to the dealer upon termination of the lease. Dealers ultimately look to dispose of all construction and agricultural equipment by sales, exchanges, or abandonment.

The Internal Revenue Service presumptively has treated such dual-use property held by a dealer as inventoriable property that is not eligible for depreciation deductions.[3] To rebut this presumption, the IRS has required the dealer to show that the property was actually used in the dealer's business and that the dealer

1 Code § 167(a) allows, as a depreciation deduction, a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in a trade or business or held for the production of income; Treas. Reg. §1.167(a)-2 provides that no depreciation deduction may be taken with respect to inventories or stock in trade.

2 Code § 1031(a)(1) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind that is to be held either for productive use in a trade or business or for investment; IRC § 1031(a)(2)(A) provides further that like-kind exchange treatment is not allowed for any exchange of property that is stock in trade or other property held primarily for sale.

3 Rev. Rul. 75-538, 1975-2 C.B. 35.

looks to consumption through use of the property in the ordinary course of business operation to recover the dealer's cost.[4] As a factual matter, it can be difficult to discern whether dual-use property is held primarily for sale to customers in the ordinary course of business or as an asset used in a trade or business.[5]

Construction and agricultural equipment that is treated as inventoriable dual-use property under the presumption is not eligible for § 1031 like-kind exchange treatment because it is property held primarily for sale within the meaning of IRC § 1031(a)(2)(A). Conversely, if the presumption is rebutted and the construction and agricultural equipment is treated as depreciable dual-use property, it may be eligible for § 1031 like-kind exchange treatment if the requirements of IRC § 1031 are satisfied, including the requirement that the property is not held primarily for sale at the time of disposition.

III. New Guidance and IRS Request for Comments

To minimize disputes between the IRS and dealers in construction and agricultural equipment, the Treasury Department and the IRS are considering guidance that clarifies the circumstances under which construction and agricultural equipment that is dual-use property is properly treated either as inventoriable property or as depreciable property. Guidance also is being considered concerning whether exchanges of construction and agricultural equipment that is dual-use property are eligible for § 1031 like-kind exchange treatment or whether these exchanges are ineligible for § 1031 because the equipment is treated as "stock in trade or other property held primarily for sale" within the meaning of IRC § 1031(a)(2)(A).

Accordingly, in Notice 2013-13, the Treasury Department and the IRS requested public comments to assist in developing this guidance. Specifically, comments were requested in regard to the following items:

1. Factors that are relevant in determining whether construction and agricultural dual-use property is inventoriable or depreciable property, or eligible for § 1031 like-kind exchange treatment. For example, the following factors have previously been considered by the Service to be relevant:

(a) The dealer's prior business experience with dual-use property, including the proportion of the dealer's total dual-use property that is leased and the number of times the same property is leased or re-leased by the dealer prior to disposition;

(b) Whether dual-use property may be leased (or held for subsequent lease) for a period exceeding its recovery period for depreciation purposes;

(c) The proportion of annual lease revenue to total revenue, the proportion of annual lease revenue to revenue from sales of leased property, and the proportion of revenue from sales of leased property to annual sales revenue;

(d) Whether lease agreements customarily allow the dealer to terminate the lease and reacquire the property at any time without penalty (and, if so, the frequency with which the dealer exercises this option);

(e) For lease agreements that provide a purchase option, the frequency with which the lessee exercises this option and whether the lessee receives a price reduction;

(f) The manner in which dual-use property is typically disposed of (e.g. sold to lessee, at auction, or through a third-party); and

(g) The dealer's initial classification of dual-use property (as inventoriable or depreciable property) for federal income tax and financial accounting purposes.

Comments are also requested on whether any such factors should be evaluated separately for different classes or product lines of equipment.

2. Whether a safe harbor or bright-line test would be helpful in resolving these issues, and if so what methodology or criteria should be incorporated in such a safe harbor or bright-line test.

3. Whether guidance is needed for dealers of dual-use property, other than dealers in the construction and agriculture industries, regarding whether dual-use property is inventoriable or depreciable property, or eligible for § 1031 like-kind exchange treatment.

4. Whether the Industry Issue Resolution (IIR) process[6] would be a useful approach to resolving these issues.

The IRS and Treasury request that written comments should be submitted by June 16, 2013. Submissions should be sent to CC:PA:LPD:PR (Notice 2013-13), Room 5203, Internal Revenue Service, P. O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (Notice 2013-13), Courier's Desk,

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4 Rev. Rul. 75-538; see also Rev. Rul. 89-25, 1989-1 C.B. 79.

5 Compare *Latimer-Looney Chevrolet, Inc. v. Comm'r*, 19 T.C. 120 (1952), acq. 1953-1 C.B. 5 (new automobiles were "held for use in a trade or business" where automobile dealer provided them to employees for use in the business prior to sale), with *Duval Motor Co. v. Comm'r*, 264 F.2d 548 (5th Cir. 1959), aff'g 28 T.C. 42 (1957), and *Johnson-McReynolds Chevrolet Corporation v. Comm'r*, 27 T.C. 300 (1956) (new automobiles were "property held for sale to customers" where automobile dealer temporarily removed them from inventory for use by employees).

6 See Rev. Proc. 2003-36, 2003-1 C.B. 859

Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC 20224. Alternatively, comments may be submitted electronically to the IRS via the following e-mail address: Notice. Comments@irscounsel.treas.gov. Those commenting are instructed to include "Notice 2013-13" in the subject line of any electronic communication. All comments reportedly will be available for public inspection and copying.

Does the Apportionment Election Under the Multistate Tax Compact Survive State Law to the Contrary?

Harriet A. Strothers, CPA and Daniel S. Lapour, J.D.[1]

The income apportionment provisions of the Multistate Tax Compact ("Compact") have recently become a hot topic in state income tax. Taxpayers doing business in states that have adopted the Compact argue that they are entitled to elect to use the Compact's equally weighted three-factor apportionment formula (sales, property, and payroll) to apportion business income for state income tax purposes instead of using the individual state's formula. Under the Compact, multistate taxpayers have the option to apportion income using either the Compact's formula or in the manner provided by the laws of the state without reference to the Compact.

Recent court decisions and pending litigation have addressed this issue in California, Michigan, Texas and Oregon. While these states all have adopted the Compact, they also all subsequently enacted statutes that created modified apportionment formulas that diverged from the Compact's rules. Generally, these modified formulas add greater weight to the sales factor.

California

The California Court of Appeals recently held that California was bound by the Compact and that a corporate taxpayer, The Gillette Company ("Gillette"), was permitted to elect to use the Compact's equally weighted three-factor formula election.[2] After adopting the Compact, California enacted a statute that assigned double weight to the sales factor for most business activity.[3] For the tax years at issue, Gillette elected to use the Compact's formula instead of California's. The California Franchise Tax Board ("FTB") argued that the apportionment formula in Section 25128 of the Revenue and Taxation Code was mandatory because it required that a double-weighted sales factor be used, notwithstanding California's adoption of the Compact.[4]

Ultimately, the court ruled that the Multistate Tax Compact is a valid, enforceable interstate Compact that California can only nullify by enacting a statute to repeal it. Further, because the Compact is a binding agreement, it "trumped section 25128, such that, contrary to the FTB's assertion, section 25128 could not override the . . . election offered to multistate taxpayers in former section 38006."[5] Lastly, the court held that the FTB's construction of Section 25128 violated both the federal and California constitutional prohibition against the impairment of contracts and the reenactment rule of the California Constitution.[6]

The California Supreme Court has granted the FTB's petition for review of the Gillette decision.[7] In addition, the FTB issued guidance regarding protective refund claims and the risk of incurring the large corporate underpayment penalty, should the Supreme Court overturn the decision.[8]

Michigan

In contrast to the California decision, the Michigan Court of Appeals recently held that a corporate taxpayer, International Business Machines Corp. ("IBM"), was not permitted to elect the Compact's equally weighted three-factor apportionment formula for purposes of the Michigan Business Tax ("MBT").[9] IBM filed its 2008 MBT return, electing to use the Compact's formula rather than Michigan's standard single-sales factor apportionment formula. The court concluded that the Michigan Business Tax Act, which set forth the single-sales factor apportionment method, absolutely precluded the use of any other apportionment method "except as provided ***in this act***."[10] Therefore, the Michigan Business Tax Act "repealed by implication" the Compact's election provision.

Further, the court disagreed with IBM that the Compact is a binding contract. The Michigan Supreme Court "has explained that a statute will not be deemed a contract in the absence of exceedingly clearly-

1 Harriet A. Strothers is a Director in the State and Local Tax department at Moss Adams LLP. Daniel S. Lapour is a State and Local Tax Manager at Moss Adams LLP.

2 *The Gillette Company, et al. v. Franchise Tax Board*, 147 Cal. Rptr. 3d 603 (Oct. 2, 2012).

3 Cal. Rev. & Tax. Code § 25128.

4 *Gillette*, 209 Cal. Rptr. 3d at 610.

5 *Id.* at 616 (emphasis in original removed).

6 *Gillette,* 209 Cal. Rptr. 3d at 618-619.

7 *The Gillette Company, et al. v. Franchise Tax Board*, 291 P.3d 327 (Jan. 16, 2013).

8 FTB Notice 2012-1, *available* at https://www.ftb.ca.gov/law/notices/2012/2012_01.pdf.

9 *International Business Machines Corp. v. Department of Treasury*, 2012 Mich. App. LEXIS 2293 (Mich. App. Nov. 20, 2012) (unpublished).

10 *Id.* at *8 (emphasis in original).

expressed intent by the Legislature."[11] In this case, the court concluded that the legislature did not specify the Compact to be a binding contract.[12] IBM has filed with the Michigan Supreme Court an application for leave to appeal from the Michigan Court of Appeals' decision.[13]

Texas

Several recent decisions by the Texas Office of Administrative Hearings have affirmed the comptroller's long-standing position that the Compact and the three-factor apportionment election do not apply to the Texas Franchise Tax.[14] Texas law provides that a single-sales factor must be used for franchise tax apportionment purposes.[15] In both decisions, the comptroller provided very little analysis and instead relied on prior policy and comptroller decisions. With litigation on this issue still active in Texas,[16] it will be interesting to see whether the recent decisions in California and Michigan have any influence on the outcome.

Oregon

Recent litigation in Oregon involving the issue of whether a taxpayer can elect to use the Compact's three-factor apportionment election has prompted the Oregon Department of Revenue ("DOR") to issue guidance regarding protective claims to secure the right to a refund pending the outcome of the litigation.[17] HealthNet, Inc. filed the action in the Magistrate Division of the Oregon Tax Court, and it was subsequently specially designated to the Regular Division.[18]

Oregon has adopted apportionment provisions separate from the Compact that provide that most taxpayers must apportion business income to Oregon by using a single-sales factor.[19] Further, Oregon enacted a statute that provides that when Oregon's apportionment statutes are inconsistent with the provisions of the Compact adopted by the state, Oregon's apportionment statutes control.[20]

The DOR's guidance provides that "similar to the *Gillette Company v. California Franchise Tax Board* appeal in California, the Compact apportionment election is currently being challenged in Oregon tax court."[21] The DOR's stated position in the notice is that "[p]er Oregon Revised Statute ("ORS") 314.606, the income apportionment election provided in Article III of the Multistate Tax Compact (Compact) is not available on an Oregon tax return."[22]

The release does not address the specific litigation or arguments being furthered by the parties. As with the recent cases in California and Michigan, HealthNet will likely contend that the Compact is a binding agreement that must be withdrawn from in its entirety in order to eliminate the three-factor apportionment election.

To make a protective refund claim, the DOR has provided the following instructions:[23]

- Use the same form (Form 20) as originally filed, check the "Amended" box, and show the computation of refund claim, **or**
- Send a letter with authorized signature that includes:
  - Taxpayer name, FEIN, and BIN as shown on original return,
  - Tax years involved,
  - The amount of the refund claim for each year,
  - The detail of the apportionment formula used, and
  - Name of person to contact, phone number, and fax number.
- Write the words "Protective Claim for Refund—Compact Apportionment Election" at the top in ink. Do not use red ink.
- Mail to: REFUND, PO Box 14777, Salem, Oregon 97309-0960.
- Retain a copy of the protective claim for your files.

When making a claim, pay special attention to the statute of limitations for the filings. The DOR provides that "protective claims for refund generally must be filed with us by the later of three years from the due date of the original return, or the date the original return was filed."[24]

Conclusion

In light of the uncertainty surrounding the Compact election, states are examining whether to repeal the Compact altogether. In California, the legislature repealed the Compact by passing S.B. 1015, which was signed into law by the Governor on June 27, 2012. Further, S.B. 1015 provides that under the doctrine of elections, elections affecting the computation of tax

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11 *Id.* at *8-9.

12 *Id.* at *9.

13 *International Business Machines Corp. v. Department of Treasury*, Michigan Supreme Court Case No. 146440.

14 Tex. Compt. Dec. No. 106,503 (Aug. 10, 2012); Tex. Compt. Dec. No. 106,508 (Jul. 13, 2012).

15 Tex. Tax Code Ann. § 171.106(a).

16 *See Graphic Pkg. Corp v. Combs*, No. D-1-GN-12-003038, Plaintiff's Original Petition (Trav. Cty. Dist. Ct. 2012).

17 *See* http://www.oregon.gov/DOR/bus/Pages/corp-tax_main.aspx.

18 *HealthNet, Inc. v. Oregon Department of Revenue*, T.C. No. 5127 (originally filed July 2, 2012).

19 Or. Rev. Stat. § 314.650.

20 Or. Rev. Stat. § 314.606.

21 *See* http://www.oregon.gov/DOR/bus/Pages/corp-tax_main.aspx.

22 *Id.*

23 *Id.*

24 *Id.*

must be made on an original, timely return. Therefore, California is attempting to prevent taxpayers from filing refund claims via amended returns following the decision in Gillette.

Utah's Governor recently signed into law legislation repealing the Compact, and simultaneously readopting most of the Compact provisions, but not Articles III or IV (dealing with the Compact apportionment election and the uniform allocation and apportionment provisions).[25]

With the potential nationwide ramifications of a taxpayer victory in the Gillette case, it won't be surprising to see other Compact member states seeking to repeal the Compact in the near future.

Save the Date: Oregon Tax Institute

The Tax Section is hosting the 13th Annual Oregon Tax Institute on June 6th and 7th featuring nationally recognized presenters. More information can be found at http://www.osbartax.com/events/view/Oregon-Tax-Institute.

25 S.B. 247, enacted April 1, 2013.