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OREGON STATE BAR

Taxation Section

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NEW RULES GOVERNING OREGON TAXATION OF NONRESIDENT INCOME

By Karey A. Schoenfeld and C. Jeffrey Abbott

The Oregon Department of Revenue implemented new rules in December 2005. Members of the Tax Section submitted comments to the Oregon Department of Revenue, which accepted many of our suggestions for changes. Two of the primary rule changes are reviewed below, including the taxation of stock options, fringe benefits and severance payments of a nonresident, and the taxation of income from the sale of a limited partnership or LLC interest by a nonresident.

Income Earned By a Nonresident

OAR 150-316.127-(A) governs the income of nonresidents for personal services. The Department of Revenue modified the rule to add a method of allocating payments received in forms other than money such as nonstatutory stock options and taxable fringe benefits, when a taxpayer has performed services both inside and outside Oregon.[1]

Nonstatutory Stock Options. There are different rules for allocating income from a nonstatutory stock option, based on whether the option has a readily ascertainable fair market value.

Income from a nonstatutory stock option with a readily ascertainable fair market value will be allocated to Oregon in the year the option must be reported for federal income tax purposes, if a nonresident taxpayer performed services in connection with the grant of such option in Oregon during the year in which the option was granted and either:

1) The taxpayer is required to report the income under IRC Section 83(a) as compensation income, or

2) The taxpayer elects under IRC Section 83(b) to report the value of the option as of the date the option was granted.

If a nonresident taxpayer performs personal services partly within and partly without Oregon in the year in which the option was granted, the taxpayer must use the same allocation formula applied to other personal services for the tax year in which the option was granted, and apply that ratio to the compensation income required to be reported on the federal return. For example, if the taxpayer worked 25 percent of his time in Oregon during the year the option was granted, he must include in Oregon income 25 percent of the compensation income related to the option included in federal taxable income. Generally, Oregon will not tax the

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subsequent gain or loss on the sale of the stock unless the stock has acquired a business situs in Oregon.

If a nonresident taxpayer holds a nonstatutory stock option granted in connection with the performance of services, which does not have a readily ascertainable fair market value that is taxable at exercise, or in a pre-exercise disposition, the taxpayer will also be taxed in the year the option is taxable for federal purposes. If the taxpayer worked in Oregon during the year the option was granted, the income that is recognized for federal purposes must be allocated to Oregon based on the following formula:

$$\frac{\text{Total Days worked in Oregon from date of grant to date of federal recognition}}{\text{Total Days worked everywhere from date of grant to federal recognition}} \times \text{Compensation Related to Option Exercise} = \text{Amount taxable by Oregon}$$

Any further appreciation or depreciation in the value of the stock after the date of exercise represents investment income or loss and is not includable in the Oregon source income of a nonresident unless the stock has acquired a business situs in Oregon.

Taxable Fringe Benefits. New provisions were also added for the taxation of fringe benefits and severance pay. In general, if fringe benefits must be recognized for federal purposes, a portion of the income is allocated to Oregon if the nonresident worked in Oregon during the tax year in which the benefit was received. The nonresident must use the same general allocation rules applicable to other compensation. For example, if the taxpayer worked 55 percent of his time in Oregon, and 45 percent outside of Oregon, 55 percent of the amount of the taxable fringe benefit that is included in federal taxable income is included in Oregon taxable income. OAR 150-316.127-(A)(3)(d)(C).

Severance Pay. In addition, if a taxpayer receives severance pay and the individual worked in Oregon during the term of employment with the company, a portion of the income will be subject to Oregon tax "using any method that reasonably reflects the services performed in Oregon." Severance pay is defined as compensation payable on voluntary or involuntary termination of employment based on length of service, a percentage of final salary, a contract between the employer and the employee, or some other method but does not include "retirement income." Severance pay is taxable to Oregon even if received in a tax year when the taxpayer did not work in Oregon, if the severance pay is based on Oregon employment.

The OAR provides the following examples:

Example 6: JT, a nonresident, worked for Plumbing Inc. for twenty years: eight years in Idaho and twelve years in Oregon. At the end of his 20th year, Plumbing Inc. reorganized and eliminated JTs position. Because of JTs loyalty to the company for his twenty years of service, the company gave JT a lump-sum payment of $36,000. This lump-sum was based on 3% of his final annual salary ($60,000 x 3% = $1,800) multiplied by his number of years of service (20). The lump-sum payment was made because of prior services, thus it is allocable to Oregon to the extent the services were performed in Oregon. JT will include $36,000 in federal taxable income and $21,600 in the Oregon taxable income, computed as follows:

$$\frac{\text{12 (Years worked in Oregon for company)}}{\text{20 (Total years worked for company)}} \times \$36{,}000 = \$21{,}600$$

Example 7: Shawn, a nonresident, worked for Lincoln Foods, Inc. for six years before resigning from the company. Lincoln Foods, Inc. and Shawn entered into a termination agreement that provided $25,000 for Shawn to release a specific claim he may have against the company for wrongful termination or other potential claims. The termination agreement also provided $10,000 to require that Shawn not work for any other food chain within a 100 mile radius of Lincoln Foods, Inc. for a period of 36 months. No employment agreement, benefit plan, or any facts or circumstances indicate that Shawn is entitled to a payment for services he rendered prior to resigning from the company. The payment that Shawn receives pursuant to the termination agreement is in exchange for the release of the wrongful termination claim and the covenant not to compete and is not allocable to Oregon because it is not based on services performed in Oregon.[2]

Example 8: Assume the same facts in Example 7 except that the termination agreement also provided for a lump-sum payment of one month's salary per year worked ($42,000) in addition to a $25,000 payment for release of a wrongful termination claim and $10,000 payment for the covenant not to compete. No employment agreement, benefit plan, or other agreement indicates that Shawn is entitled to a payment for services he rendered prior to resigning from the company. The $25,000 payment for the release of the wrongful termination claim and the $10,000 payment for the covenant

not to compete are not allocable to Oregon because neither is based on services performed in Oregon. The $42,000 lump-sum cash payment based on Shawn's salary and years of service associates the payment with the employer-employee relationship. It is allocable to Oregon because the facts and circumstances indicate that it is paid because of prior performance of services and no other reason. 150-316.127-(A)(f).

As shown in the examples, care should be exercised in drafting separation agreements. The method of allocating payments can have a significant impact on Oregon taxable income.

Income of a Nonresident – Limited Partnerships and LLCs

Changes were also made to OAR 150-316.127-(D). In 2003, the Department deleted the provision regarding the inclusion of income from the sale of a limited partnership interest by a nonresident. The deletion effectively caused income from the sale of any interest in an Oregon Partnership to be taxed in Oregon.

The Department eventually realized that the old rule was valid, and should be reinstated. However,the Department proposed to reinstate it with different language and impact. After comments were submitted, the Department restored the old rule as originally written, which provides that income from the sale of a limited partnership interest by a partner who is not a resident of Oregon will not be subject to Oregon tax unless the partnership interest has otherwise acquired a business situs in Oregon.

The Department also added rules concerning the taxability of income from the sale of an Oregon LLC by a nonresident member or manager. In general, gain from the sale of an LLC interest by a member in a member-managed LLC will be taxed in the same manner as a general partner. Therefore, the gain will be subject to Oregon tax. Similarly, if a nonresident member-manager sells an interest in an LLC, the sale will be subject to Oregon tax. However, if the LLC is manager-managed, and a nonresident member who is not a manager sells an interest in the LLC, the gain will not be subject to Oregon tax unless the LLC interest has otherwise acquired an Oregon business situs.

In order to determine whether an LLC is member-managed or manager-managed, the articles of organization will generally control. For an LLC that is designated as a member-managed LLC in its articles of organization, all members of the LLC will be member-managers. For an LLC that is designated as a manager-managed LLC in its articles of organization, only those persons who are both members of the LLC and are designated as a manager in the LLC's operating agreement (or elected as managers by the LLC members pursuant to the operating agreement) will be member-managers. If for any reason no designation is made, an individual will be considered a member-manager of an LLC if that member has the right to participate in the management and conduct of the LLC's business.[3]

Although the rule changes appear to address the simple cases adequately, a number of fact patterns can result in uncertainty in interpretation. What happens when a member's status changes during the year from a member to a manager who is a member and vice-versa? Is the manager status determined on the day of sale or date of significant events leading up to the sale? Is it possible to remove the nonresident as a manager prior to engaging in sale negotiations to avoid tax or will the Oregon Department of Revenue require an allocation based on the number of days the member was a manager? In addition, care should be taken if any management powers are given to members, as it may cause taxation on the sale of a nonresident member's interest.

The text of these Administrative Rules, and all other Administrative Rules adopted in December can be found at ***http://www.oregon.gov/DOR/adminrules.shtml***.

Footnotes:

1. Payment in forms other than money. Total compensation for personal services includes amounts paid in a form other than money. To the extent the payments are recognized as compensation income for federal income tax purposes, the payments will be recognized as compensation income for Oregon tax purposes and must be apportioned as provided in section (3) of this rule. Examples include but are not limited to, nonstatutory stock options, taxable fringe benefits such as personal use of a business asset, and employer-paid membership fees. 150-316.127-(A)(3)(d).
2. The final version reads "(e) Limited Partnership Interests. In general, a nonresident's gain or loss from the sale, exchange, or disposition of a limited partnership interest is not attributable to a business carried on in Oregon and is not Oregon source income. The gain or loss from the sale of the interest will not be used in the determination of Oregon taxable income unless the limited partnership interest has acquired a business situs in this state (see section (1) of this rule.)" OAR 150-316.127-(D)(2)(e).

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UNRELATED BUSINESS TAXABLE INCOME

By Penny H. Serrurier, Stoel Rives LLP

Nearly every tax-exempt organization is subject to federal income tax on income derived from a business activity that is regularly carried on and is unrelated to the organization's exempt purpose. This income is known as "unrelated business taxable income" and is commonly referred to as "UBTI." The tax on UBTI is computed at regular corporate tax rates if the organization is a corporation and at trust tax rates if the organization is a trust. UBTI is reported to the IRS on Form 990-T. The primary purpose of the tax on UBTI is to reduce the competitive advantage that tax-exempt organizations would otherwise have when they engage in the kinds of income-producing business activities that taxable organizations engage in.

Practitioners who advise tax-exempt organizations need to be aware of UBTI and its exceptions. As tax-exempt organizations are under increasing pressure to find new revenue sources, income from business activity is often seen as a way to diversify an organization's sources of support. Every time an organization considers taking on an activity that will generate revenue, it should consider whether that revenue will be taxed as UBTI.

A. Definition of UBTI

Under IRC §§ 512 and 513, income is taxable as UBTI if it meets three criteria: (1) the income is derived from a trade or business;[1] (2) the trade or business is regularly carried on;[2] and (3) the trade or business is not substantially related to the organization's performance of its exempt functions.[3]

1. Derived from Trade or Business

The Treasury Regulations provide that the term "trade or business", as used in IRC § 513, has the same meaning as in IRC § 162 and "generally includes any activity carried on for the production of income from the sale of goods or performance of services."[4] The Code specifically provides that UBTI cannot be avoided by "bundling" an unrelated business activity with a business activity related to the organization's exempt purpose. IRC § 513(c) provides: "[A]n activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization."). For example, advertising revenue from a trade association periodical (the production of which is an otherwise exempt activity) is considered a business activity separate from the production and sale of the periodical itself.[5]

2. Regularly Carried On

To determine whether an activity is regularly carried on, the Treasury Regulations require that the frequency and continuity of the activity be compared with activities conducted by taxable organizations. If the activity is pursued in a manner similar to comparable commercial activities of taxable organizations, then the activity is deemed to be regularly carried on.[6]

An intermittent activity is considered to be regularly carried on if it is carried on in the same competitive and promotional manner as activities conducted by taxable organizations. However, an intermittent activity that occurs "occasionally or sporadically" (such as an annual dance or festival) is not considered to be regularly carried on.[7]

3. Not Substantially Related

In determining whether a business activity is substantially related to an organization's exempt purpose, the use of funds generated by the activity is irrelevant—it is the activity itself that is subject to the test. A business activity is considered substantially related to an organization's exempt purpose only if the activity itself has "a causal relationship to the achievement of exempt purposes" and the causal relationship is substantial.[8] The activity itself must contribute importantly to the organization's exempt purpose.[9] Whether a business activity contributes importantly to the accomplishment of an organization's exempt purpose depends on the facts and circumstances of each case. The IRS has issued many rulings over the years applying this test to various fact patterns.

The size and extent of an activity are taken into account in determining whether the activity contributes importantly to an exempt purpose. Where an organization carries on an activity related to its exempt purpose but conducts the activity on a scale larger than necessary for performance of its exempt function, the gross income attributable to the "excess" portion of the activity will be taxable.[10]

In addition, the Treasury Regulations provide that, where an organization sells products that result from a business activity that is related to the organization's exempt purpose, revenue from the activity will avoid treatment as UBTI only if the product is sold in the

"same state" as the state in which it was created in that activity.[11] For example, if a dairy herd that is maintained for scientific purposes generates milk, the sale of milk or cream is related to the scientific organization's exempt purpose and is not taxable. However, if the organization then makes and sells ice cream, the milk is no longer in the "same state" and income from the sale of ice cream is UBTI.

The Treasury Regulations also provide that, even if the use of a facility for an exempt function (e.g., a college theatre) does not create UBTI, use of the same facility for an unrelated function (e.g., movies for the general public) will generate UBTI.[12]

B. Exceptions

The exceptions from UBTI fall into two general categories: the exclusion of specified types of passive income described in IRC § 512(b), and the exceptions for activities described in IRC § 513.

1. Exclusion of Passive Income

IRC § 512(b) provides that dividends, interest, annuities, royalties, real estate rental income, and capital gains generally are excluded from UBTI, even if they relate to an unrelated trade or business. However, under IRC § 512(b)(4) and IRC § 514, the general exclusion of these types of passive income from UBTI may not apply if the income if is debt-financed. The debt-financed income rules generally require that a percentage of an organization's income from debt-financed property (property that is held to provide income and with respect to which there is "acquisition indebtedness") and gain from the sale or exchange of such property generally is subject to UBTI unless the use of the property is substantially related to the organization's exempt purpose. Detailed rules relating to income from debt-financed property are contained in IRC § 514.

It is important to note that an exempt organization's share of income from a partnership, limited liability company, or S corporation is not necessarily treated as passive income. Under IRC § 512(c), if a tax exempt organization is a partner in a partnership (or a member in an LLC that is taxed as a partnership), and the partnership engages in a trade or business that is not substantially related to the organization's exempt purpose, the income that flows through to the organization from the partnership will be treated as UBTI, subject to the exclusions described above. Moreover, although certain tax exempt organizations are now eligible to be shareholders of S corporations, IRC § 512(e) provides that an interest in an S corporation is treated as an interest in an unrelated trade or business, and all income or loss from the S corporation (including passive income that would be excluded from UBTI if earned directly by the organization), as well as gain or loss from the sale of S corporation stock, is taken into account in computing the organization's UBTI.

2. Statutory Exceptions

IRC § 513(a) expressly provides that three types of activities are not treated as "unrelated trades or businesses" even though they otherwise fit the definition of that term.

a. Volunteer Activity

Under IRC § 513(a)(1), if substantially all of the work involved in carrying on a trade or business is performed without compensation, the activity is not treated as an unrelated trade or business. An example is the sale of a cookbook created, marketed, and sold by volunteers.

b. Convenience Doctrine

Under IRC § 513(a)(2), a business activity carried on primarily for the convenience of the organization's members, students, patients, officers, or employees is is not treated as an unrelated trade or business. Examples of this exception include on-campus college laundry facilities, college bookstores, and hospital pharmacies.

c. Sale of Donated Items

Under IRC § 513(a)(3), if an activity involves the sale of merchandise, substantially all of which has been donated, the activity is is not treated as an unrelated trade or business. For example, the IRS has ruled privately that the "substantially all" requirement is satisfied by a thrift shop in which 95 percent of all the items sold were donated to the organization.[13] This doctrine also covers the sale of other donated items, such as cars, boats, and used office equipment.

d. Other Exceptions

There are several other exceptions, including certain entertainment conducted at fairs and expositions,[14] certain convention and trade show activities,[15] certain hospital services,[16] and the solicitation of qualified corporate sponsorships.

C. Conclusion

Tax exempt organizations and the practitioners who advise them should take the UBTI rules into account before deciding whether to engage in any income-producing activity that is not closely related to an organization's exempt purpose.

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Unrelated Business Taxable Income

Footnotes:

1. Treas. Reg. § 1.513-1(b).
2. Treas. Reg. § 1.513-1(c).
3. Treas. Reg. § 1.513-1(a), (d).
4. Treas. Reg. § 1.513-1(b).
5. Treas. Reg. § 1.513-1(b).
6. Treas. Reg. § 1.513-1(c)(1).
7. Treas. Reg. § 1.513-1(c)(2)(iii).
8. Treas. Reg. § 1.513-1(d)(2).
9. Id.
10. Treas. Reg. § 1.513-1(d)(3). For example, in Rev. Rul. 73-386, 1973-2 C.B. 191, a trade association supplied companies (members and nonmembers) with job-injury histories of prospective employees. The IRS ruled that the revenue generated from this activity went "well beyond" the exempt purpose of the organization (the promotion of efficient business practices) and concluded that all of the income from the activity was taxable.
11. Treas. Reg. § 1.513-1(d)(4)(ii).
12. Treas. Reg. § 1.513-1(d)(4)(iii).
13. PLR 8122007.
14. See IRC § 513(d)(2).
15. See IRC § 513(d)(3).
16. See IRC § 513(e).
17. See IRC § 513(i).

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New Rules Governing Oregon Taxation ...

3. "(f) Limited Liability Company Interests. The taxation of a nonresident's gain or loss from the sale, exchange, or disposition of an interest in a limited liability company (LLC) operating in Oregon is Oregon source income and is taxed in the same manner as:

   (A) The sale of a general partnership interest under subsection (2)(d) of this rule if the selling member is a member-manager of the LLC; or

   (B) The sale of a limited partnership interest under subsection (2)(e) of this rule if the selling member is not a member-manager of the LLC.

   For purposes of this rule, a person is a "member-manager" of an LLC if that member has the right to participate in the management and conduct of the LLCs business. For an LLC that is designated as a member-managed LLC in its articles of organization, all members of the LLC will be member-managers. For an LLC that is designated as a manager-managed LLC in its articles of organization, only those persons who are both members of the LLC and are designated as a manager in the LLC's operating agreement (or elected as managers by the LLC members pursuant to the operating agreement) will be member-managers." OAR 150-316.127-(D)(2)(f).

WASHINGTON'S NEW APPORTIONMENT FOR SERVICE BASED BUSINESSES

By Reid Okimoto and Valerie Sasaki[1]

Effective January 1, 2006, the Washington Department of Revenue ("Department") adopted a new rule that clarifies the methodology that should be used to apportion service-based revenues to Washington. The revised rule, Washington Administrative Code ("WAC") 458-20-194, modifies the old cost-to-cost ratio by applying a market-based approach to assign costs related to service-based revenue.

The revised rule changes the way Washington Business and Occupation ("B&O") tax is apportioned. Prior to the adoption of the new rule, the Department employed a sourcing methodology to assign costs related to service-based revenue that evolved over time. At one point in time, the methodology assigned all direct costs to the place where the cost was incurred or where the service was performed. Indirect costs were initially sourced to where the cost was incurred. Treatment of indirect costs evolved over time. Eventually, indirect costs were often sourced to the location of the customer for whose benefit the service was performed.

In 2001, in accordance with Washington Determination No. 01-006, the Department took the position that all costs must be assigned to the location where the benefit of the service was received. For taxpayers with centralized administrative and support offices, this required that such taxpayers divide the executive and support costs associated with their centralized management office in accordance with where the benefit was received. This later methodology

proved to be unwieldy. Practitioners and the Department's field auditors found it difficult to apply this rule in practice. This prompted the Department to issue a rule to help clarify and administer sourcing of service revenues for B&O tax purposes.

Revised Rule 458-20-194 attempts to strike a compromise between the prior two methodologies. While the apportionment of revenues to Washington still centers on a cost ratio (i.e., ratio of Washington cost to world-wide costs), the costs are divided into separate classifications and sourced in accordance with the method proscribed by the Rule. Property-related costs such as rent, depreciation, insurance, are included in the numerator as Washington costs if the situs of the property is in Washington. Employee-related costs are included in the numerator if the employees are reported for unemployment compensation purposes as Washington employees. Cost associated with the employment of third-party representatives are assigned to Washington if the place of performance for such services is in Washington. All other costs of doing business are generally assigned to Washington by using a ratio of gross Washington sales over gross world wide sales. At its simplest, the rule attempts to assign direct costs based on location, and indirect costs by relative sales to the state of Washington. It is important to note that while the B&O apportionment factors carry names that are similar to those used in income tax apportionment, the similarities between the two apportionment regimes end there.

The new rule may have the effect of increasing or decreasing a taxpayer's service B&O tax liability, depending on their facts. Under the revised rule an Oregon company with a single employee and no property in the state of Washington could see an increase in service B&O tax due to the assignment of indirect costs to Washington based on relative sales into the State. To illustrate, assume PDX Co. has a single employee that works from his home office in Vancouver, Washington. PDX Co. generates $1 million in worldwide sales of which $100,000 is attributed to Washington because the customer receives the benefit of the service in Washington. Under the new rule, while PDX Co. would continue to have fairly insignificant Washington property and employee costs, it would have 10 percent ($100,000/$1 million) of its indirect cost included in the numerator of its Washington apportionment ratio. This would directly affect the amount of service revenue apportioned to Washington and increase PDX Co.'s service B&O tax. Therefore, for out-of-state businesses, the inclusion of indirect costs as Washington costs will generally result in an increase in the amount of B&O tax due to the state of Washington, notwithstanding a lack of change in business activity or nexus to the State.

For further information regarding this rule change contact Reid Okimoto at (206) 913-4682 or Valerie Sasaki at (503) 820-6857.

Footnotes:

1. Reid S. Okimoto and Valerie Sasaki are with the State and Local Tax practice of KPMG LLP and are based in the firm's Seattle and Portland offices, respectively. The views and opinions are those of the authors and do not necessarily represent the views of KPMG LLP.

COMMUNITY PROPERTY: REPORTING ELECTION AVAILABLE FOR A HUSBAND AND WIFE QUALIFIED BUSINESS ENTITY

By Elizabeth A. Munns, Abbott & Munns LLC

Because Oregon is surrounded by community property states, it is important for Oregon attorneys to recognize the possibilities and implications of community property laws as applied to our clients who are married couples. For example, Revenue Procedure 2002-69 offers us guidance from the IRS on some options available to qualified business entities owned solely by a married couple as community property.

If you have a married couple owning a qualified business entity, the IRS will accept the taxpayers' treatment of the entity as either a disregarded entity or a partnership for federal income tax purposes. A qualified business entity is any business entity wholly owned by a husband and wife as community property under the laws of a state, foreign country or a U.S. possession, where no other person (other than the

spouse) is considered an owner for federal income tax purposes and the business is not treated as a corporation under IRC §301.7701-2. Rev. Proc. 2002-69, 2002-2 CB 831.

How does a married couple owning a qualified business entity make an election to treat the business entity as a disregard entity or a partnership for federal income tax purposes? The couple chooses to either file Schedule C with their Form 1040, with one spouse listed as owner, or file a partnership return (i.e., Form 1065). No other affirmative election or application is needed for the IRS to accept the classification. Be aware, however, that a change in reporting position will be treated for federal income tax purposes as a conversion of the entity. Rev. Proc. 2002-69, 2002-2 CB 831.

So what states have community property laws? Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin are all community property law states. Further, Alaska has a community property election. However, the IRS seems to steer clear of Alaska's election when discussing community property laws and this author makes no specific comment to Alaska's laws.

What else should you be aware of? Spousal agreements. Some states may allow a husband and wife to enter into an agreement affecting the status of property as community or separate property. For treatment as a disregarded entity or partnership to be effective, a husband and wife must own the business as community property under state, foreign county or U.S. possession law. If a married couple living in a community property state has an agreement not to treat property as community property, you need to be aware of this and advise accordingly. You also should be aware of spouses who have moved from community property states owning the business entity to determine if the community property characterization follows and remains with the interest.

Yet again, it is too bad for the non-community property states. The IRS has not extended this option to non-community property states (such as Oregon).

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