OREGON STATE BAR

Taxation Section

VOLUME 15, NUMBER 1 Spring 2012

In This Issue:

Hot Spots in US-Canada Tax Planning

By David C. Streicher
Black Helterline, LLC
and
Carol-Ann Simon, CPA
Perkins & Co.

Just as the economies of the US and Canada are inextricably tied together, so are their people. Countless US citizens reside in Canada, and vice versa. A thorough overview of the related tax issues might require a multi-volume treatise. The purpose of this article is to alert practitioners to tax issues that commonly surface for these types of clients. In the interest of brevity, references to "US persons" mean individuals who are either US citizens or permanent residents. "CAD" is used to refer to Canadian dollars.

The Canadian Tax System

Like the US, Canadian laws provide for federal and provincial income taxes. The federal taxing agency is known as the Canadian Revenue Agency, or "CRA." For 2011, the break points in the federal brackets are 15% (first $41,544 CAD), 22% ($83,088 CAD), 26% ($128,800 CAD), and 29% (over $128,800 CAD). Provincial taxes are lower. For example, Alberta's tax rate is a flat 10%, while Quebec's rate starts at 16% and tops out at 24%. Thus, the highest combined federal and provincial rate ranges from roughly 39% to 50%. Deductions or credits allowed in computing federal tax include retirement plan contributions, Canadian Pension Plan ("CPP") contributions, medical expenses, investment management fees, investment interest, employment insurance, and charitable contributions. No deduction is allowed for mortgage interest, property taxes or provincial income taxes. Only one-half of capital gains are subject to Canadian income tax.

Jurisdiction to impose Canadian taxes is based on residency, rather than citizenship. Thus, a Canadian citizen working overseas is subject to Canadian income taxes only on income or gains derived from Canadian sources.

A Canadian person's assets are deemed sold for fair market value if the person dies, permanently leaves Canada or gives the items away. There is also a deemed disposition every 21 years for assets held in trust. Fortunately, there are several valuable exceptions, including RRSP, RRIF and TFSA accounts; Canadian real estate; revocable trusts for grantors over 65; and interests in life insurance policies. Lifetime or death transfers to spouses are also exempt. For both Canadian and US tax purposes, assets subject to a deemed disposition take on a stepped-up basis. Persons entering Canada start with a stepped-up basis because there is a deemed disposition immediately prior to establishing residency in Canada.

Canada has no estate tax, per se, although most provinces (Alberta and Quebec excluded) levy "probate taxes." For example, the British Columbia probate tax is roughly 1.4% of probate assets.

Since US tax rates are usually lower than Canada's, the US foreign tax credit softens or eliminates US taxes for US persons living in Canada. In general, the US

foreign tax credit will fully eliminate US taxes if the taxpayer's income is almost all Canadian sourced. On the other hand, if there are US sources of income (such as pensions or investments), or if some income is taxed more onerously by the US than Canada (such as stock options or Canadian capital gain dividends), US taxes are likely to be owed. Canada allows a foreign tax credit against Canadian taxes for any US taxes paid on US source income.

RRSPs, RRIFs and TFSAs

The closest Canadian equivalent to an IRA or 401(k) is the Registered Retirement Savings Plan, which is commonly known as the "RRSP." Contributions are tax deductible, and tax is payable as distributions are taken, which may occur at any time. The maximum annual RRSP contribution is roughly 18% of earned income, up to a maximum of $22,000 CAD. At age 71, a RRSP must either be distributed or converted into a Registered Retirement Income Fund (or "RRIF"), which has characteristics similar to an RRSP except that no contributions may be made and there are mandatory annual withdrawals. The Canadian equivalent to a Roth IRA is the Tax-Free Savings Account (or "TFSA"). Contributions are not deductible, but distributions (which may be taken at any time) are not taxable.

In general, US tax laws treat RRSP or RRIF funds like any other investment not sheltered by a qualified plan: dividends, interest and capital gains are taxed as earned, whether withdrawn or not. If a Canadian moves to the US, future income earned by the RRSP or RRIF can be deferred (until distributions are made) if the taxpayer files IRS Form 8891. The cost basis of an RRSP, RRIF or TFSA (generally comprised of contributions and earnings prior to moving to the US) can be withdrawn free of US tax. The taxable-nontaxable computations are based on IRC §72.

In general, if a US person employed in Canada makes contributions (attributable to Canadian services) to an RRSP, a deduction is allowed for both Canadian and US tax purposes. A reciprocal rule applies to Canadian employees living in the US.[1]

IRA Planning When Moving from the US to Canada

A common problem for US persons moving to Canada is what to do with an IRA account. For Canadian tax purposes, the employee's contributions to an IRA or 401(k) may be rolled over tax free to a RRSP or RRIF. But a tax free rollover is not allowed for US tax purposes, meaning that the owner must pay US income taxes (usually a 15% withholding tax) and the IRC §72(t) 10% penalty (if the owner is under 59 ½) on the distribution. The Canadian foreign tax credit may or may not make the taxpayer "whole," since no Canadian credit is allowed against the US tax on the "rollover." Nor is a Canadian credit allowed for the IRC §72(t) penalty. In other words, a full offset depends on whether there are sufficient Canadian taxes eligible for the credit on other sources of income. A common strategy is to leave the IRA dormant until the owner is ready to take distributions. However, a number of US brokerage houses are unwilling to hold IRA accounts for citizens or permanent residents of Canada, which may require transferring the IRA to a more user-friendly broker. Even "friendly" US brokers limit transactions and trades by such Canadian persons.

US Canada Treaty

The US-Canada Treaty is an overlay that often softens the result otherwise mandated by the Internal Revenue Code or Canadian tax laws. The treaty was originally signed in 1980 and has been amended by protocols in 1983, 1984, 1995, 1997 and 2007. It reads like a will with five codicils. A consolidated version of the treaty can be found through unofficial sources. [2] The treaty should always be reviewed prior to giving advice. For example, the withholding rate on Canadian citizens receiving US dividends is only 15% under the treaty, rather than the normal rate of 30%.[3] And the treaty withholding rate on US interest is now zero.[4]

Foreign Bank Account Reporting

A US person with Canadian accounts must check the appropriate box on Schedule B of Form 1040, which mentions that Treasury Form 90-22.1 must be filed. Form 90-22.1 requires taxpayers to make detailed disclosure of offshore accounts (including those in Canada, such as RRSPs and RRIFs). These foreign bank account reporting (FBAR) rules have severely impacted US citizens residing in Canada who have not filed US tax returns. (Failure to file US returns is common because of the extra tax preparation fees and the likelihood that US tax is fully offset by the foreign tax credit). The taxpayer may be exposed to FBAR penalties of up to $10,000 per unreported account per year, or more if the failure to file is willful.[5] Even under the offshore voluntary disclosure initiative, taxpayers in the most favorable circumstances were subject to a penalty

1 Article XXXIXB of US-Canada Tax Treaty or paragraphs 13 and 10 of Article 13 of the July 29, 1997 Protocol

2 See, e.g., http://www.garygauvin.com/WebDocs/Canada-US%20Consolidated%20Tax%20Treaty.pdf

3 Article X

4 Article XI

5 31 USC §5321(a)(5)(B)(i) and (C)(i)

equal to 5% of the highest aggregate balance of offshore accounts at any time during the 2003 - 2010 period.[6]

It is possible to avoid penalties for late FBAR filings by demonstrating reasonable cause. In December, 2011 the IRS issued FS-2011-13 to provide guidance on reasonable case. In Example 4, no FBAR penalty is imposed for a taxpayer who filed both Form 90-22.1 and Form 1040 late. A key fact in Example 4 is that no tax is due. FS-2011-13 goes on to say that the absence of a tax deficiency or only a "de minimis" tax deficiency is a factor weighing in favor of reasonable cause. Query: does a taxpayer who owes a total of $1,000 for his eight years of delinquent returns have a "de minimis" tax deficiency? The other factors weighing in favor of reasonable cause are reliance upon a professional tax advisor, absence of intentional concealment of assets or income, and a legitimate purpose for establishing the account. Factors weighing against reasonable cause include background and education suggesting the taxpayer should have known about FBAR requirements, failure to disclose the account to the tax return preparer, and a tax deficiency related to the omitted foreign account. As a knee-jerk response, there is frequent discussion about renouncing US citizenship or permanent residency, which is described below.

FATCA is Coming

Offshore reporting obligations have been expanded by the Foreign Account Tax Compliance Act ("FATCA"), which is codified at IRC §§ 1471-1474 and 6038D. IRC §§ 1471-1474 apply to "foreign financial institutions," and IRC §6038D applies to US persons having offshore accounts.

While the provisions of IRC §§ 1471-1474 are dense, the intent is relatively simple -- to compel disclosure of tax information from offshore entities that are not subject to Form 1099 reporting. Otherwise, the IRS has no record of income earned by US persons on these offshore investments. Foreign financial institutions are required to liberally share information about accounts held by US persons and, in some cases, withhold a 30% tax on payments made to US persons who do not cooperate with the IRS. If the foreign financial institution does not comply, there is a 30% withholding tax on payments of certain US source income to the foreign financial institution. In Notice 2011-53, the IRS provided timelines for the implementation of IRC §§ 1471-1474. In general, withholding obligations have been delayed to 2014 and 2015, depending on the type of payments involved.

6 OVDI FAQ 52

Effective for tax years beginning after March 18, 2010 (i.e., 2011, for most of us), US citizens, green card holders and tax residents must report offshore assets directly to the IRS by filing Form 8938, Statement of Specified Foreign Financial Assets. Items reported on Forms 3520 (foreign trusts and gifts) or 5471 (foreign corporations) need not be reported a second time on Form 8938 (although the taxpayer must note on Form 8938 that Forms 3520 or 5471 have been filed to report these items). But taxpayers must include on Form 8938 all items already reported on Treasury Form 90-22.1. Single taxpayers living in the US must file Form 8938 if foreign financial assets exceed $50,000 at year end or $100,000 at any time during the year. These threshold amounts are doubled for married taxpayers living in the US and filing a joint return. If living abroad, the threshold for single taxpayers is $200,000 / $400,000, and the threshold for married taxpayers filing a joint return is $400,000 / $600,000. In general, Form 8938 requires disclosure of "foreign financial assets," which generally means accounts holding cash or securities maintained by a foreign bank or brokerage house. However, the instructions indicate that interests in foreign mutual funds, foreign hedge funds, foreign private equity funds, foreign corporations, foreign partnerships and foreign trusts/estates are also included. Foreign real estate is not. The penalty for failure to file Form 8938 is $10,000 per year.

Foreign Trusts and Form 3520

US persons creating or receiving funds from a Canadian "foreign trust" must also check a box on Schedule B and file Form 3520 or Form 3520-A or both. (Under IRC §7701(a)(30), a trust is a "foreign trust" if either (i) no US court is able to exercise primary supervision over the administration of the trust, or (ii) no US person(s) have authority to control all substantial decisions of the trust.) The penalties for failure to file Form 3520 are similar to those for failure to file Treasury 90-22.1. In general, Form 3520 is intended to force US persons to disclose their relationships with foreign trusts and the assets held by such trusts. The rules governing US taxation of foreign trusts are dense. For example, a Canadian citizen or resident who creates and controls a trust for the benefit of a US person is usually not considered the grantor of the trust. Instead, albeit with a few exceptions, the trust is treated as a non-grantor trust, which has the effect of treating as a distribution carrying out DNI what would have otherwise been an after-tax gift from the Canadian to the US persons.[7]

7 IRC §672(f)(1) and (2)

Renouncing US Citizenship or Residency

A discussion about the procedure for renouncing US citizenship can be found in the Foreign Affairs Manual of the US Department of State.[8] Mechanically, the individual must make an appointment with the US consulate, complete and sign Forms DS 4079, 4080, 4081 and 4082 and relinquish the individual's passport. The individual will then be furnished Form DS 4083, Certificate of Loss of Nationality of the United States. To relinquish permanent residency (i.e., a green card), the individual must meet with the US consulate and provide a signed Form I-407. Finally, if the Department of Homeland Security determines that renunciation is motivated by tax avoidance, the individual will be ineligible to receive visas and ineligible to be admitted to the US.[9]

US "Exit Tax"

A collateral consequence of renunciation of citizenship or residency is potential liability under IRC §877A, which works in a manner similar to the Canadian deemed disposition rules. In general, IRC §877A applies only if the former US person (i) has a net worth over $2 million, (ii) paid US income taxes averaging over $147,000 for the prior five years, or (iii) does not certify on Form 8854 that the person complied with all US tax obligations for the five prior years. The tax is imposed on net unrealized appreciation in excess of $636,000. Mechanically, a US person leaving the US must file IRS Form 8854 along with the individual's final income tax return. Until Form 8854 is filed, the taxpayer must continue filing US tax returns on worldwide income -- even if citizenship or residency has been renounced for immigration purposes. It warrants noting that Form 8854 cannot be filed until the taxpayer is in full compliance on prior years. (On the Form 8854, the taxpayer must certify under penalties of perjury that all returns have been filed and all taxes have been paid for the prior five years.)

US Estate and Gift Taxes

In general, a Canadian citizen whose worldwide estate is less than $5 million is not subject to US estate tax, no matter how much property has a US situs.[10] And if US situs property is less than $60,000, there is no US estate tax even if worldwide wealth exceeds $5 million.[11] Finally, the treaty allows a marital credit for transfers to a surviving spouse equal to the lesser of (i) the utilized unified credit, or (ii) the estate tax otherwise payable on the property transferred to the spouse.[12] This effectively doubles the unified credit for married Canadians. With the enactment of "portability" at IRC §2010(c), US persons can shelter $10 million from US estate tax with only minimal planning. Absent a treaty, portability does not apply to deceased nonresident aliens. It is an open question whether any of the US exemption under Article XXIXB2 is portable if a Canadian decedent does not utilize all of the exemption on account of the marital deduction or the marital credit. An enlightening discussion of this issue can be found on pages 17 - 21 of the letter of October 28, 2011 from the American College of Trust and Estate Counsel to the IRS (concerning IRS Notice 2011-82).[13]

8 7 FAM 1260-1268, which is posted at http://www.state.gov/documents/organization/115645.pdf

9 7 FAM 1266 and 8 USC §1182(a)(10)(E)

10 Article XXIXB2 of US-Canada Treaty

11 IRC §2102(b) ($13,000 credit is commensurate with $60,000 of value)

12 Article XXIXB3 of US-Canada Treaty

13 See http://www.actec.org/Documents/misc/Radford_Comments_Notice_2011-82.pdf

Upcoming Tax Section Events

May 7, noon—New Tax Lawyer Committee Meeting (open to all section members), Lane Powell, Portland

May 15, noon—Mid-Valley Tax Forum Luncheon Series: Partnership Taxation Issues presented by Neil Kimmelfield, Salem

May 17, noon—Portland Lunch Series: Hot Tax Topics presented by Carrie Sowders and Mark Birge, Red Star Tavern, Portland

June 4, noon—New Tax Lawyer Committee Meeting (open to all section members), Moss Adams, Portland

June 7-8—Oregon Tax Institute (see information on page ___)

July 17, noon—Mid-Valley Tax Forum Luncheon Series: Business Valuations presented by Dean Allen, Salem

July 19, noon—Portland Luncheon Series: Using IRA and 401(k) Plan Rollovers to Start Businesses presented by David Roth, Red Star Tavern, Portland

For more information about these and other Taxation Section events, visit our website at www.osbartax.com/Events

Fiduciary and Transferee Liability for a Decedent's Taxes

by Tricia M. Olson

Heltzel, Williams, Yandell, Roth, Smith, Petersen, & Lush, P.C.

A person serving as a fiduciary of a decedent's estate (either as a personal representative or trustee) may accrue personal liability for the decedent's tax debts. Federal law, for example, provides that a fiduciary who distributes estate funds or pays estate creditors before paying a federal tax debt of the estate may become personally liable to the extent of the distribution or payment.[1] Similarly, fiduciaries may incur personal liability for an estate's Oregon tax debts by failing to file a required tax return or failing to exercise due diligence in determining or satisfying a tax obligation.[2] Thus, a fiduciary who is dealing with potential tax liabilities of the decedent or limited funds to pay taxes must proceed carefully.

The first step for a fiduciary to take is filing Form 56 (Notice Concerning Fiduciary Relationship) with the Internal Revenue Service ("IRS"). This notifies the IRS that it should send any notices regarding taxes owed by the decedent to the fiduciary rather than the decedent's last address. When the estate or trust terminates, the fiduciary should file a follow-up Form 56 to notify the IRS of termination of the fiduciary relationship. In some instances, a fiduciary may also consider filing a Form 4506 or 4506-T to request copies or transcripts of tax returns filed by the decedent.[3]

This article summarizes some of the steps that a fiduciary can take to minimize his or her personal liability exposure for specific federal and Oregon taxes. It is important to note, however, that if a fiduciary is also a recipient of some of the decedent's assets, the discharge from personal liability as a fiduciary does not also discharge the fiduciary from transferee liability. Accordingly, this article also briefly discusses transferee liability.

A. Decedent's Income and Gift Taxes

1. Federal Income and Gift Taxes

A personal representative may apply for discharge from personal liability for a decedent's income and gift tax obligations as well as federal fiduciary income taxes attributable to the period after the decedent's death.[4] The application is made by filing Form 5495 (Request for Discharge From Personal Liability Under Internal Revenue Code Section 2204 or 6905) with the IRS after filing the applicable tax return. The application must be filed with the Internal Revenue center where the estate tax return is filed. If no estate tax return is required to be filed, the personal representative should file the application with the center where the decedent's final income tax return is filed.[5] If the personal representative is notified within nine months of an amount owed, the personal representative will be discharged from personal liability upon payment of that amount. If there is no notification, the personal representative will be discharged from personal liability at the end of the nine-month period.[6]

A trustee (or personal representative who does not file Form 5495) would retain potential personal liability until expiration of the time limitation for assessment of taxes by the IRS. Generally, that limitation period is three years from the date a return was filed.7 To shorten the limitation period to 18 months, fiduciaries (both personal representatives and trustees) can file Form 4810 (Request for Prompt Assessment Under Internal Revenue Code Section 6501(d)) with the IRS. This form is applicable to personal income, gift, and fiduciary income tax returns and must be filed at the IRS center where the return was filed.[8]

2. Oregon Income Taxes

The steps a fiduciary can take to minimize personal liability for Oregon income taxes are similar to the federal procedures. A fiduciary (personal representative or trustee) may file Form 150-101-151 (Election for Final Tax Determination for Income Taxes and Application for Discharge from Personal Liability for Tax of a Decedent's Estate) with the Oregon Department of Revenue ("ODR") to seek both a final determination of income taxes and discharge from personal liability. The election for final determination applies only to personal or fiduciary income tax returns filed during the fiduciary's period of administration and it generally shortens the limitation period for ODR's assessment

1 31 USC §3713(b).

2 *See, e.g.,* OAR 150-316.382.

3 There is a fee for requesting return copies. Transcripts are often free of charge and may also be ordered online at www.IRS.gov or by calling 1-800-908-9946.

4 IRC §6905(a). This section may not apply to fiduciary income taxes as it refers to liability "of a decedent" for taxes. The author, however, has obtained a certificate of discharge from the IRS for fiduciary income taxes in a probate estate.

5 IRC §6905(a); Treas Reg §301.6905-1(a).

6 IRC §6905(a).

7 IRC §6501(a). There is no time limitation, however, if there was no return filed or the filed return was false or fraudulent. IRC §6501(c).

8 IRC §6501(d); Treas Reg §301.6501(d)-1(b).

to 18 months.[9] If the fiduciary is notified within nine months of an amount owed, the fiduciary will be discharged from personal liability upon payment of that amount. If there is no notification, the fiduciary will be discharged from personal liability at the end of the nine-month period.[10]

B. Decedent's Estate Taxes

1. Federal Estate Taxes

In cases in which federal estate taxes are owed, a personal representative may apply for determination of a decedent's federal estate tax and discharge from personal liability for such taxes.[11] If there is no personal representative appointed, a trustee may apply for the determination.[12] The application is made by written letter or Form 5495 to the IRS center where the estate tax return is filed either before, at the same time, or after filing the return.[13] The IRS will notify the personal representative of the amount of estate tax within nine months after receipt of the application (or within nine months after the estate tax return is filed, if the application was filed before the return). Upon paying the amount noticed, the personal representative is discharged from personal liability for the decedent's federal estate tax.[14] If the personal representative does not receive notification of tax due within that time period, the personal representative is discharged from personal liability.[15]

2. Oregon Estate Tax

A fiduciary (personal representative or trustee) may seek determination of a decedent's Oregon estate tax and discharge from personal liability for such taxes by filing a Form 150-103-005 (Request for Discharge from Personal Liability for Oregon Inheritance Tax) with ODR either before, at the same time, or after filing the decedent's Oregon estate tax return. ODR must notify the fiduciary of any tax due as soon as possible, but no more than 18 months after the application date. If the application was made before the return was filed, ODR must notify the fiduciary of any tax due within 18 months after the return is filed. The fiduciary is discharged from personal liability upon payment of the amount in any notice.[16] ODR has typically been returning the form with their notification of discharge within a few months of filing the estate tax return.

C. Transferee Liability

In some cases, the IRS may seek recovery of a decedent's unpaid taxes from a "transferee" of the decedent's assets. This may occur, for example, if there is no probate estate for the decedent or if the personal representative of a probated estate fails to pay the decedent's tax debts. A "transferee" includes, among others, heirs of an intestate estate, devisees of a decedent's will and distributees of a decedent's trust,[17] as well as transferees of such persons (transferees of the transferees).

1. Transferee Liability for a Decedent's Federal Income Taxes

Transferees may be liable for a decedent's federal income tax deficiency, including penalties and interest, to the extent of the value of assets received from the decedent.[18] The limitation period for the IRS to assess income tax liability against the initial transferee of a decedent's asset is one year after expiration of the decedent's limitation period (generally three years from filing of return).[19] For transferees of a transferee, the limitation period is generally one year after expiration of the limitation period for the preceding transferee.[20]

Internal Revenue Code §6901 describes a collection procedure for the IRS to use against transferees. However, §6901 does not establish a transferee's substantive liability for the decedent's unpaid income taxes. The existence and extent of such liability is determined under state law.[21] Below is a brief summary of how state law may impact liability for a decedent's unpaid income taxes for a transferee of some typical assets of a decedent:

Life Insurance Proceeds

Generally, unless the decedent's estate is the named or default beneficiary, life insurance proceeds are not property owned by the decedent. Accordingly, a lien for a decedent's income taxes typically does not attach to the proceeds. The actual determination of a decedent's right to the proceeds in each case is determined by the terms of the specific insurance policy, as defined by state law.[22] In Oregon, a beneficiary of life insurance (other than the decedent's estate) is entitled to take

9 ORS 316.387(1). There is no time limitation, however, if there was no return filed or the filed return was false or fraudulent. ORS 316.387(3).

10 ORS 316.387(4).

11 IRC §2204(a).

12 *See, e.g.,* IRC §2203 (defining "executor" for purposes of the estate tax).

13 Treas Reg §20.2204-1(a). Form 5495 may be used to request discharge from personal liability for estate tax, but it does not specifically request determination of the estate tax. For this reason, practitioners may wish to supplement the form.

14 IRC §2204(a).

15 Treas Reg §20.2204-1(a).

16 ORS 118.265(1)-(2).

17 IRC §6901(h).

18 *See, e.g., Phillips v. Comr.*, 283 US 589, 603 (1931); *Lowy v. Comr,* 35 TC 393, 397 (1960).

19 IRC §§6901(c)(1), 6501(a).

20 IRC §6901(c)(2).

21 *Comr. v. Stern,* 357 US 39, 45 (1958).

22 *U.S. v. Bess,* 357 US 51, 55 (1958).

the proceeds against claims of the decedent's creditors, unless the decedent paid the insurance premiums in fraud of creditors.[23] If a federal tax lien existed against the policy at the time of the decedent's death, however, the tax lien will extend to the proceeds to the extent of the cash value of the policy.[24]

Property Owned Jointly With Right of Survivorship or as Tenants By The Entirety

Oregon law permits persons to hold both real and personal property jointly with right of survivorship.[25] Oregon law also permits spouses to hold real property as tenants by the entirety whereby the surviving spouse's ownership interest continues free of unsecured creditors of the deceased spouse.[26] A federal tax lien covering taxes owed by one joint tenant (but not the other) may be filed against the joint tenant's proportionate interest in the property during his or her life, and the IRS may foreclose such property.[27] However, if the liable joint tenant dies before a federal tax lien is filed against the property, the surviving non-liable joint tenant takes the property free of the decedent's tax liabilities. This is because the IRS is relegated to collecting from the decedent's probate estate, which no longer owns any interest in the property.[28] This rule is applicable to both real and personal property owned jointly with right of survivorship.[29] However, there are some important exceptions to this rule, including without limitation, instances in which the joint owners are spouses who filed joint income tax returns, [30] or instances in which the joint ownership was created with intent to defraud creditors. [31]

23 ORS 743.046(1), (3)-(4).

24 *Bess,* 357 US at 59; *Kovacs v. US,* 355 F2d 349, 351 (9th Cir), *cert den,* 384 US 941(1966).

25 ORS 93.180; *Halleck v. Halleck,* 216 Or 23, 40, 337 P2d 330 (1959); ORS 105.920.

26 *Brownley v. Lincoln County,* 218 Or 7, 10-11, 343 P2d 529 (1959); Principles of Oregon Real Estate Law §2.13 (Oregon CLE 1995 & Supp. 2003).

27 *See, e.g., U.S. v. Craft,* 535 U.S. 274, 288 (2002) (addressing entireties property).

28 Rev Rul 78-299; Notice 2003-60, 2003-39 I.R.B. 643 (9/23/2003) Q&A 4; PLR 9851036; IRM 5.17.3.8.1.1(8).

29 Note, however, that transfers of personal property into a joint tenancy cannot "derogate from the rights of creditors." ORS 105.920. Further, for bank accounts, there is a "rebuttable presumption" of survivorship that may be overcome by establishing that the decedent intended a different result or lacked capacity when the account was established. ORS 708A.470(1), (6).

30 Spouses are jointly and severally liable for taxes computed from a joint return. IRC §6013(d)(3). Possible innocent spouse relief is beyond the scope of this article.

31 *See, e.g., Alonso v. Comr.*, 78 TC 577, 582-83 (1982).

2. Transferee Liability for a Decedent's Federal Estate Taxes

In the case of a federal estate tax liability, there is a special federal estate tax lien that attaches to all property includable in the decedent's gross estate and lasts for 10 years from the date of death, unless the tax is sooner paid.[32] The IRS does not have to file a notice of such lien.[33] Moreover, the federal estate tax lien is not dependent on state law for determination of property to which it can attach. The IRS can hold spouses, transferees, trustees, surviving joint tenants, and even beneficiaries of life insurance policies personally liable for payment of any unpaid estate tax.[34] A fiduciary may want to consider seeking discharge of the special estate tax lien for certain estate property in some instances such as a sale to a third party.[35] Form 4422 (Application for Certificate Discharging Property Subject to Estate Tax Lien) is used for this purpose.

3. Transferee Liability for a Decedent's State Taxes

Oregon law also provides for transferee liability. Specifically, transferees may be liable for any income tax deficiency of the decedent, including penalties and interest, to the extent of the value of property received by the transferee from the decedent.[36] The exceptions described above for life insurance proceeds and property owned jointly with right of survivorship, however, would apply for state income taxes as well as federal income taxes.[37] The limitation period for ODR to assess an initial transferee's liability is one year after the expiration of the decedent's limitation period[38] (generally three years from filing of return).[39] For a transferee of a transferee, the limitation period is generally one year after the expiration of the limitation period for the preceding transferee.[40] Transferees are also liable for unpaid Oregon estate transfer taxes, with interest, until they are paid.[41]

32 IRC §6324(a)(1).

33 Rev Rul 69-23.

34 IRC §6324(a)(2).

35 The IRS may discharge property subject to the lien if the liability has been fully satisfied or provided for. IRC §6325(c).

36 ORS 314.310(1).

37 "Transferees," for Oregon income tax purposes, include non-bona fide purchasers for value, heirs, legatees, devisees, distributees of an estate, shareholders of a dissolved corporation, assignees or donees of insolvent persons, successors of corporations after reorganization, and fiduciaries acting on behalf of such transferees. ORS 314.310(3).

38 ORS 314.310(4)(a).

39 ORS 314.410(1).

40 ORS 314.310(4)(b).

41 ORS 118.210, 118.230(1). "Transferees" for this purpose include all heirs, legatees, devisees, administrators, executors and trustees, and any grantee or donee of a gift made by the decedent if the gift is subject to tax under ORS 118.010. ORS 118.210.

D. Conclusion

Fiduciaries should conduct a thorough search for potential unpaid tax liabilities of a decedent. If the decedent did not file tax returns, the fiduciary should ascertain whether the decedent had a filing requirement. In cases in which tax liabilities exist, fiduciaries should consider applying to federal and Oregon tax authorities to seek discharge from personal liability and shorten the statute of limitations for assessment of such tax liabilities. The chart below summarizes the tax forms used for such purposes, as discussed in this article.

Have an Article Idea?

If you would like to write an article or suggest a topic for a future article, please contact a member of the newsletter committee. A full listing of committee members can be found on page one. Articles are accepted on a broad range of tax topics on a rolling basis.

Form	Purpose	Who Files	Time Period
FEDERAL:			
56	Notifies IRS of commencement or termination of fiduciary relationship	PR or Trustee	N/A
4506/4506-T	Request copies of returns (Form 4506) or transcripts of returns (Form 4506-T) filed by decedent.	PR or Trustee	N/A
5495	Request discharge from personal liability for income and gift taxes	PR	Discharge in 9 months if no notification of tax owed. If tax owed, discharge after payment of tax.
4810	Request prompt assessment of income, gift and fiduciary income taxes (shortens period of limitation)	PR or Trustee	Shortens limitation period from 3 years to 18 months.
Written Letter/5495	Request prompt assessment and discharge from personal liability for estate tax	PR (or Trustee if no PR)	Discharge in 9 months if no notification of tax owed. If tax owed, discharge after payment of tax.
4422	Request discharge of property from estate tax lien	PR or Trustee	Discharge is matter of IRS discretion
STATE:			
150-101-151	Discharge from personal liability for income taxes owed pursuant to returns filed during fiduciary's administration; shortening of period of limitation for the same taxes	PR or Trustee	Shortens limitation period from 3 years to 18 months. Fiduciary discharged in 9 months if no notification of tax owed. If tax owed, fiduciary discharged after payment of tax.
150-103-005	Discharge from personal liability for Oregon estate tax	PR or Trustee	ODR has 18 months to notify fiduciary of tax owed, but typically notifies much more quickly. Fiduciary is discharged upon payment of amount owed.

The Effects of *AT&T v. Oregon Department of Revenue*

By Brian C. Gates and Gary Holcomb
Ernst & Young LLP

On June 28th 2011, the Oregon Tax Court ruled on a long running case between AT&T and the Oregon Department of Revenue[1] ("the department"). At issue was how AT&T calculated its gross receipts factor in determining its state apportionment for the years 1996 through 1999. The court's decision in favor of the department provides clarification of the statutory language regarding Oregon's gross receipts factor.

AT&T is a public utility company in the telecommunications industry and operates in many different states including Oregon. The governing law relevant to the court's final decision includes Oregon Revised Statutes (ORS) 314.280 and Oregon Administrative Rules (OAR) 150-314.665.[2] ORS 314.280[3] provides the framework for Oregon apportionment calculation. ORS 314.665 defines the sales or gross receipts factor.[4] OAR 150-314.665(4)(1)[5] specifically defines the gross receipts/sales factor that determines the gross receipts in the numerator of the apportionment calculation.

This case involved the department's denial of AT&T's refund claim. AT&T's original return included certain gross receipts in the Oregon numerator; its amended returns did not and instead sourced all receipts to New Jersey. The issue was whether gross receipts from interstate and international (long distance) calls originating from Oregon should be included in the numerator of the Oregon gross receipts factor as governed by ORS 314.280. AT&T did not doubt the validity and application of ORS 314.280 and was not advocating for a different apportionment method. AT&T argued that it was following ORS 314.280, which according to AT&T's interpretation did not require AT&T to include those long distance gross receipts in the numerator of the apportionment calculation.

From AT&T's perspective, there are important differences between a local call and a long distance call. For a local call made by an AT&T customer, the signal travels from the customer's location to a local exchange carrier (LEC) and then to the local destination. For a long distance call, the signal travels from the customer to the LEC, which then transfers the call to an AT&T switching site (Point of Presence, POP) within Oregon. Thereafter, AT&T sends the call from its POP to its Global Network Operations Center in New Jersey and finally to its ultimate destination. These LECs are separate legal entities from AT&T. Further, for both local and long distance calls, AT&T pays the LEC a per call rate established by regulatory rate case proceedings.

As discussed above, the sourcing of receipts from "other than sales of tangible personal property" are based on the location of the greater percentage of the costs of performance. For Oregon apportionment purposes, if the income producing activity is performed both in and outside of Oregon, the sales are apportioned to Oregon if a greater proportion of the income-producing activity is performed in Oregon based on the costs of performance.[6] The main issue in front of the court was whether, based on costs of performance, a greater portion of income producing activity related to long distance calls occurred in Oregon or New Jersey. To determine the location, the court ruled on four separate questions:

- The Cost Object Question
- The Direct Cost Question
- The Access Charge Question
- The Asset/Depreciation Question

Cost Object Question

The first issue was the determination of the activity or "objects" that should be the subject of a cost of performance analysis. The department used individual calls to and from Oregon as the "object" of the transaction.

1 *AT&T Corp, and Includible Subsidiaries v. Department of Revenue*, State of Oregon, TC 4814 amended on January 12th, 2012 to correct typographical errors.

2 Unless otherwise noted, all references to the OAR and ORS are to the 1995 edition which was applied in this case.

3 ORS 314.280 (1) If a taxpayer has income from business activity as a financial institution or as a public utility *** which is taxable both within and without this state *** the determination of net income shall be based upon the business activity within the state, and the Department of Revenue shall have power to permit or require either the segregated method of reporting or the apportionment method of reporting, under rules and regulations adopted by the department, so as fairly and accurately to reflect the net income of the business done within the state.

4 ORS 314.665. Determination of sales factor; exclusions; determination of sales apportionment factor. (1) The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period, and the denominator of which is the total sales of the taxpayer everywhere during the tax period.

5 OAR 150-314.665(4) (1) In General. Subsection (4) of ORS 314.655 provides for the inclusion in the numerator of the sales factor of gross receipts from transactions other than sales of tangible personal property (including transactions with the United States Government); under this section gross receipts are attributed to this state if the income producing activity which gave rise to the receipts is performed wholly within this state. Also, gross receipts are attributed to this state if, with respect to a particular item of income, the income producing activity is performed within and without this state but the greater proportion of the income producing activity is performed in this state, based on costs of performance.

6 Id.

AT&T's position was that the "object" should be the lowest level where costs are differentially incurred. AT&T argued that the "object" would have been its individual products and lines or service areas, but not individual calls. AT&T's contention was that because it used a management tool called the Shared Network Allocation Model (SNAM), which focused on business or product lines, it should be able to use that model as a starting point for the cost of performance analysis. AT&T's support for this position was contained in the language of OAR 150-314.655(4)(4) with emphasis on "accounting principles and conditions or practices utilized in the trade or business[7]. The SNAM model did not contain geographic information and under AT&T's method would have required a further assignment to get Oregon specific costs. AT&T objected to the department's position on the grounds that if you were to start with "calls to and from Oregon", like the department wanted, that would be equivalent to using your question's answer to ask the question. For example, the question might be: "what are the calls to and from Oregon," and the answer would be: "calls to and from Oregon."

The court agreed with the department and defined the cost basis as "individual calls to and from Oregon." The court's reasoning was that the AT&T method was an internal management tool, not an accounting principle. Further, because geography was clearly at issue, a geographically agnostic method like AT&T proposed was incorrect. Finally, the court clarified that the correct question to ask is "which ***transactions*** produced the costs at issue", not what ***calls*** produced the cost at issue, thereby nullifying AT&T's objection over the answer being the actual question.

Direct Cost Question

OAR 150-314.665(4)(1) requires a comparison of direct costs incurred in the state to direct costs incurred outside the state. There was a dispute over what is meant by direct costs. The department interpreted direct costs as those that are only incurred because the revenue producing transaction or activity in question occurred. This is a "but for" approach and only included the small amount of electricity and access charge paid to the LEC as AT&T's only direct costs for a single phone call.

AT&T defined direct costs as all costs that must be incurred to engage in a general business activity in all the product lines of its business. An AT&T witness testified that a direct cost is one that if not incurred "you don't have a company." This method would include virtually all costs incurred by AT&T as a direct cost of the interstate and international call services. AT&T supported this definition by referencing the language at the end of OAR 150-314.665(4)(4), which states, direct costs do not include costs "not part of the income producing activity itself, such as accounting or billing expenses." AT&T interpreted that section as direct costs including all costs with the exception of accounting and billing costs.

Again, the court agreed with the department's interpretation of direct costs, stating that AT&T's method described "activity based costing," an internally focused method for management, not an externally focused accounting process. Additionally AT&T's definition was too broad, including so many costs that the term direct costs would lose all meaning.

Access Charge Question

The third question from the case has the potential for the largest post-decision impact. The issue was whether the access charges AT&T paid to the LECs were includible when calculating direct costs. AT&T agreed that the access charges were direct costs but believed the costs should be excluded from the calculation, in accordance with OAR 150-314.655(4), as the costs were payments to an independent contractor. At the time of the case, OAR 150-314.655(4)(2)[8] excluded costs paid to independent contractors from the definition of direct costs if the independent contractor per-

7 OAR 150-314.665(4)(4) Costs of Performance; Defined. The term "costs of performance" means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer to perform the income producing activity that gives rise to the particular item of income. Included in the taxpayer's cost of performance are taxpayer's payments to an agent or independent contractor for the performance of personal services and utilization of tangible and intangible property which give rise to the particular item of income. For purposes of this rule, direct costs do not include costs that are not part of the income producing activity itself, such as accounting or billing expenses.

8 OAR 150-314.665(4)(2) Income Producing Activity; Defined. The term "income producing activity" applies to each separate item of income and means the transactions and activity directly engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit. Income producing activity includes transactions and activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor. Accordingly, income producing activity includes but is not limited to the following:

(a) The rendering of personal services by employees or by an agent or independent contractor acting on behalf of the taxpayer or the utilization of tangible and intangible property by the taxpayer or by an agent or independent contractor acting on behalf of the taxpayer in performing a service.

(b) The sale, rental, leasing, franchising, licensing or other use of real property.

(c) The rental, leasing, franchising, licensing or other use of tangible personal property.

(d) The sale, franchising, licensing or other use of intangible personal property. The mere holding of intangible personal property is not, of itself, an income producing activity.

formed the services on behalf of a taxpayer.[9] Therefore, the issue was whether AT&T's payments to the LEC were payments to an independent contractor incurred "on behalf of" AT&T.

As mentioned above, AT&T took the position that a LEC met the statutory definition of an independent contractor and payments to the LEC were on AT&T's behalf and were therefore not included in the calculation of direct costs. Conversely, the department believed that the LEC was not an independent contractor so the payments were not on behalf of AT&T and those access charges were included in the calculation of direct costs.

The court analyzed the statute and agreed with the department. The statute excludes "transactions and activities performed on behalf of a taxpayer" as payments to an independent contractor. The court made a distinction between "transactions and activities performed on behalf of a taxpayer" and "providing services or goods to the taxpayer." The court noted that AT&T did not negotiate with the LEC and AT&T was not the party that initiated the transaction that ultimately led to the charge from the LEC to AT&T. The court noted that AT&T does not negotiate with the LEC because the charges are set by tariff and the customer was the party that initiated the call being handled by the LEC. The court, as an example, discussed a hypothetical law firm that incurred hotel costs to lodge their "out of state" attorneys. The court argued that the hotel, in this example, is not a third party contractor who provides benefits on behalf of a taxpayer, but rather the hotel is providing lodging services to the law firm. The court drew a parallel conclusion to the relationship between AT&T and the LEC. One final piece of evidence the court used to support its decision, was the fact that the antitrust decision from the 1980's, which forcefully separated long distance carriers like AT&T from the LECs, showed that the businesses are separate and that LEC's are not performing services ***on behalf of*** long distant carriers, but instead ***for*** long distant carriers. Therefore the court concluded that LECs are not independent contractors of AT&T and that the access charges AT&T paid to the LECs should be included within the direct cost calculation.

Asset/Depreciation Question

The final issue the court examined was whether AT&T appropriately allocated its costs from the SNAM method. As mentioned above, AT&T's use of the SNAM model did not include a geographic component. AT&T used an additional system which incorporated the geographic components necessary to obtain a correct allocation of incurred costs.

AT&T argued that the geographic distribution of networking assets would work as a proxy for the location of costs incurred in providing interstate and international service. Under that system, 1.1% of AT&T's network assets, by value, were in Oregon, with the rest located outside of Oregon. Additionally, AT&T stated that the costs occurring in Oregon included 10% of intrastate costs and 1.1% of interstate costs. The court ruled against AT&T and felt that AT&T's expert's testimony, arguing that intrastate calls consumed resources differently than interstate calls, was conclusory and was not persuasive.

Additionally, the court concluded that AT&T was incorrect when it geographically allocated overall costs according to depreciation ratios of the assets. The court found that this allocation led to inappropriate variations in value and allocation percentages caused by changes in the accounting life of an asset. Further, the court found a lack of relationship between the remaining value of an asset and the cost of an individual phone call.

Conclusion

The court ruled in favor of the department on all issues addressed. The main take away from this case is referenced in the third issue–Access Charge Question, which clarifies how, under prior law, Oregon treated payments to third parties in respect to direct costs for the allocation of gross receipts for state apportionment. For Oregon apportionment purposes, if the income producing activity is performed both in and outside of Oregon, the sales are apportioned to Oregon if a greater proportion of the income-producing activity is performed in Oregon based on the costs of performance. The court in the AT&T case found that certain payments to third parties are included in that definition of direct costs. The inclusion of costs increases the total of direct costs and can change the percentage of direct costs occurring within Oregon. The ultimate result could change the sourcing of gross receipts and the income apportioned to Oregon.[10]

9 Subsequent to this case, OAR 150-314.655(4) was amended in 2009 and removed the independent contractor exception.

10 AT&T has appealed the court's decision in *AT&T Corp, and Includible Subsidiaries v. Department of Revenue*, State of Oregon, TC 4814. If your company or client has taken a tax position in reliance upon the decision in TC 4814, please speak to a tax advisor about the potential effects the appeal may have on your position.

Unrelated Business Income Tax: A Primer

By William Fisher and Bill Manne
Miller Nash LLP

Background

Before 1950, a tax-exempt organization could own and operate a business unrelated to the organization's tax-exempt purpose and avoid paying income tax on the unrelated business income. For example, in 1947 New York University, a tax-exempt educational institution, formed a for-profit subsidiary corporation by the name of C.F. Mueller Company *for the purpose of manufacturing and selling macaroni products*, which it did on a tax-exempt basis.[1] In response to such practices, the unrelated business income tax ("UBIT") was enacted in 1950 to prevent tax-exempt organizations from competing with for-profit businesses on an unfair basis.[2]

Section 513 of the Internal Revenue Code of 1986 ("IRC") subjects any regularly conducted trade or business that is not substantially related to the organization's[3] exempt purpose to UBIT. To determine whether a tax-exempt organization has exposure to UBIT, the principal focus is whether any regularly conducted activity that could be construed as a trade or business is substantially related to the exercise or performance of the organization's exempt purpose. The organization's general need for income or funds, or the use it makes of the profits derived does not factor into the analysis.[4] If the activity is substantially related to the organization's exempt purpose, then it is not subject to UBIT and the organization's exempt status is not threatened. If the activity is not substantially related, is regularly carried on, and is a trade or business, then income derived from the activity is subject to UBIT; if it also constitutes a substantial activity (in light of all the organization's activities), then the organization's exempt status may be jeopardized.

1 *C.F. Mueller Co. v. Commissioner*, 190 F2d 120 (3d Cir 1951).

2 Treas Reg § 1.513-1(b).

3 While this article focuses on UBIT for 501(c)(3) organizations, UBIT also applies to other types of exempt organizations. IRC § 511(a)(2) describes organizations subject to UBIT to include, generally, (1) organizations that are exempt under IRC § 501(a), and (2) state colleges and universities. The UBIT rules applicable to non-501(c)(3) exempt organizations vary slightly from those described here. For example, the U.S. Supreme Court discussed the application of UBIT to 501(c)(7) social clubs in *Portland Golf Club v. Commissioner*, 497 US 154 (1990), observing that the "trade or business" requirement applicable to the UBIT analysis for 501(c)(3) organizations does not apply to organizations exempt under 501(c)(7), (9), (17), or (20) pursuant to IRC § 512(a)(3). Exempt organizations that derive their exemption from a source other than IRC § 501(c)(3) should carefully consider the UBIT rules applicable to their organizations.

4 Treas Reg § 1.513-1.

What Is UBIT?

Let's examine the three requirements: (1) a trade or business; (2) regularly carried on; and (3) not substantially related to the furtherance of the organization's exempt purpose.

1. Trade or Business

Although the IRC and the underlying regulations do not define the term "trade or business," any activity that is "carried on for the production of income from the sale of goods or performance of services" will likely be considered a trade or business for UBIT purposes.[5] One primary consideration in determining whether an activity is a trade or business is the extent to which it competes with for-profit business activities. Income derived in a passive manner (e.g., real property rents, earnings from the sale of real property, interest, dividends, and royalty payments) is not considered to be from a trade or business.

2. Regularly Carried On

Even if the activity is considered a trade or business, it must be regularly carried on to be subject to UBIT. The frequency and continuity with which the activity is conducted determines whether the activity is regularly carried on. Isolated activities (the one-time sale of a product or one-time provision of a service)[6] and activities that are conducted on only an annual basis[7] are generally not considered to be regularly carried on. Additionally, when an income-producing activity that is normally conducted by a for-profit business on a year-round basis is conducted by an exempt organization for only the span of a few weeks, the activity is not regularly carried on.[8]

3. Not Substantially Related to the Furtherance of the Organization's Exempt Purpose

A trade or business that is regularly carried on creates exposure to UBIT only if it is not substantially related to the organization's tax-exempt purpose. Activities that are substantially related generally have a causal relationship with the accomplishment, in whole or in part, of the exempt purpose of the organization.[9] Raising money to fund the entity's operations is not sufficient to pass this test. In other words, the activity contributes importantly to the exempt purpose. As one may suspect, this is a fact-intensive analysis that requires identification of (a) the organization's tax-exempt purpose; and (b) how the activity in question contributes

5 Treas Reg 1.513-1(b).

6 *See* PLR 7905129 (Nov. 7, 1978).

7 Treas Reg § 1.513-1(c)(2)(iii). But see Rev Rul 73-424, 1973-2 CB 190, where the sale of advertising in a book published only annually was considered subject to UBIT because the advertising was sold on a year-round basis.

8 Treas Reg § 1.513-1(c)(2)(i).

9 Treas Reg § 1.513-1(d)(2).

substantially to that purpose. Courts and the IRS have varied from this step of the analysis, however, to apply a commerciality analysis, focusing on whether the activity is unfairly competitive with for-profit enterprises.[10] Therefore, even if an activity is substantially related to the organization's exempt purpose, it may create UBIT exposure if it is operated in the same manner as a commercial operation.[11]

If an activity is a trade or business, is regularly carried on, and is not substantially related to the exempt purpose of the organization, in addition to potential UBIT exposure, the tax-exempt status of the organization is threatened if the activity constitutes a substantial portion of the organization's activities, taking into account all of the organization's activities. No bright-line test is used to determine whether an activity constitutes a substantial portion. In one instance the Internal Revenue Service has defined the term "substantial" in relation to the legislative activities of exempt organizations to be 5% or greater.[12] In another case, the Internal Revenue Service did not revoke an organization's tax exemption even though 75% of its income was derived from unrelated sources.[13] It is reasonably clear, however, that an exempt organization should dedicate well more than half its time, efforts, and activities in furtherance of its tax-exempt purpose; otherwise, it risks loss of its tax-exempt status.

Computation of UBIT

The amount of UBIT payable by an exempt organization is equal to (a) gross income subject to UBIT multiplied by the applicable tax rate; minus (b) allowable deductions that are directly connected with carrying on the trade or business; subject to (c) the modifications set forth in IRC § 512(b). Exempt organizations that derive at least $1,000 of income subject to UBIT must file Form 990-T, "Exempt Organization Business Income Tax Return."

1. Applicable Rates

The first step in calculating the amount of UBIT payable by an exempt organization is to multiply the amount of UBIT taxable income by the applicable tax rate. UBIT tax rates are the corporate tax rates set forth in IRC § 11. If an organization has UBIT taxable income in excess of $100,000 for any taxable year, the amount of the tax determined is increased by the lesser of (a) 5% of the excess or (b) $11,750.

2. Deductions and Credits

In computing the amount of its income subject to UBIT, an exempt organization may subtract allowed deductions that are directly connected with carrying on the unrelated trade or business. To qualify, a deduction must be (a) allowed by Chapter 1 of the IRC (the general income tax provisions applicable to for-profits) and (b) directly associated with the accomplishment of the unrelated trade or business. A deduction meets this second requirement if it has a proximate and primary relationship to the conduct of the business.[14] If these two requirements are met, the expenses are deductible in full in the computation of UBIT payable by the organization. Additionally, any credits for which an organization is eligible may be used to offset UBIT.

Traps and Certain Exceptions

1. Volunteer Activities

Activities that would otherwise be considered "unrelated trades or businesses," but are conducted by volunteers, have been expressly excepted from UBIT.[15] For example, secondhand thrift stores operated by an exempt organization whose purpose is not related to the sale of secondhand goods will not incur UBIT liability for that activity if it is performed by volunteers. Also, if the goods sold by the thrift store are received as contributions, the store may not be subject to UBIT.[16] A 1985 U.S. Tax Court case similarly held that a religious organization's farming activity did not create UBIT liability because the farming activity was performed by volunteer members of the organization.[17]

2. Passive Income

As mentioned above, income derived from certain passive activities is generally not considered to have been received from a "trade or business," and therefore income from such activities is not subject to UBIT.[18] But if passive income is generated through subsidiaries controlled by the exempt organization,[19] or through borrowed money,[20] this exclusion does not apply. IRC § 514 creates UBIT for income derived from certain

10 *See, e.g.*, Tech Adv Mem 200021056 (Feb. 8, 2000). This is also known as the judicial "commerciality doctrine."

11 *Id.* In this case, the organization operated an eating facility in conjunction with its other exempt activities. The IRS ruled that "the operation of an eating facility is presumptively commercial [if it] competes directly with other restaurants, uses profit-making pricing formulas, engages in advertising, has hours of operation competitive with commercial enterprises, and the underlying organization does not have plans to solicit donations." In this case, the operation of the eating facility was held to not be substantially related to the organization's exempt function.

12 Treas Reg § 1.501(c)(3)-1(b)(3)(i).

13 Rev Rul 57-313, 1957-2 CB 316.

14 Treas Reg § 1.512(a)-1(b).

15 *See* IRC § 513(a)(1).

16 Treas Reg § 1.513-1(e).

17 *St. Joseph Farms of Ind. Bros. of Congregation of Holy Cross, Sw. Province, Inc. v. Commissioner*, 85 TC 9 (1985).

18 *See generally* IRC § 512(b).

19 *See* IRC § 512(b)(13).

20 *See* IRC § 514.

"debt-financed property," which is property held to produce income with respect to which there is "acquisition indebtedness" (defined below).[21] While there are certain exceptions to this rule, including property whose use is substantially related to the organization's exempt purpose,[22] a detailed analysis of these rules is beyond the scope of this article.[23]

3. Research

Certain research activities performed by an exempt organization are excluded from UBIT, namely, (a) research performed for any federal or state government; (b) research performed by any college, university, or hospital; and (c) research performed by research institutions that make the results available to the public free of charge.[24]

4. Activities for Convenience of Members, Students, Patients, Officers, or Employees

The IRC excepts from UBIT certain activities, such as restaurants, gift shops, parking lots, and laundries, that are carried on "primarily for the convenience of [the organization's] members, students, patients, officers, or employees,"[25] but only if they contribute importantly to the organization's exempt purpose.[26] Consequently, gift shops,[27] cafeterias,[28] and parking lots[29] owned and operated by museums or hospitals for the use of staff and visitors generally do not create UBIT liability.

5. Bingo; Gambling

Most bingo games and many types of charitable gambling have been excepted from UBIT.[30]

6. Low-Cost Items

An exempt organization may sell "low-cost articles"[31] (e.g., T-shirts, bumper stickers, coffee mugs) without incurring UBIT liability, if the sale of such items is "incidental to the solicitation of charitable contributions."[32] For this exception to apply, however, the exempt organization must allow the recipient to retain the items even if a donation is not made.

7. Membership Lists

The sale or exchange of membership or mailing lists between 501(c)(3) organizations is not subject to UBIT.[33] But the sale of membership lists to other exempt organizations or nonexempt businesses may be subject to UBIT unless the sale is properly structured to result in a "royalty" (described below) to the exempt organization.[34]

8. Royalties

Receipt of royalties does not cause an exempt organization to incur liability.[35] While the term "royalties" is not defined by the IRC or its accompanying regulations, to determine whether any particular item of income falls within this (or any other IRC § 512(b)) exception, one must consider all the facts and circumstances.[36] Additionally, the Internal Revenue Service has stated that "[t]o be a royalty, a payment must relate to the use of a valuable right. Payments for the use of trademarks, trade names, service marks, or copyrights, whether or not payment is based on the use made of such property, are ordinarily classified as royalties for federal tax purposes."[37] Any transaction involving the receipt of royalties by an exempt organization should be carefully structured to avoid creating a joint venture or other structure whereby the exempt organization has too much control over a for-profit entity, thereby potentially resulting in UBIT liability.[38]

Avoiding Loss of Tax Exemption from Unrelated Activities

Organizations that expect to incur UBIT liability can take steps to avoid possible loss of exemption stemming from unrelated activities. One of the most useful tools to avoid loss of exemption is the formation of a for-profit taxable subsidiary to conduct the unrelated activity.

As stated above, there is no bright-line test for determining how much of any unrelated activity is too

21 "Acquisition indebtedness," as defined in IRC § 514(c)(1), is the unpaid amount of "(A) the indebtedness incurred by the organization in acquiring or improving [debt-financed] property; (B) the indebtedness incurred before the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement * * * ; and (C) the indebtedness incurred after the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition or improvement."

22 *See* IRC § 514(b)(1)(A)(i).

23 For an in-depth discussion of this topic, see Bruce R. Hopkins, *The Law of Tax-Exempt Organizations* § 24.12 (9th ed 2007).

24 IRC § 512(b)(7)-(9).

25 IRC § 513(a)(2).

26 Rev Rul 69-267, 1969-1 CB 160.

27 *Id.*

28 Rev Rul 74-399, 1974-2 CB 172.

29 Rev Rul 69-269, 1969-1 CB 160.

30 *See* IRC § 513(f)(2)(A); Treas Reg § 1.513-5.

31 Defined in IRC § 513(h)(2) as items whose cost to the organization that distributes the item is not in excess of $5 each.

32 IRC § 513(h)(1)(A).

33 IRC § 513(h)(1)(B).

34 In one case the IRS ruled that the sale of a membership directory by an exempt 501(c)(6) business league to its members furthered the purposes of the league and was thus deemed a related activity. Rev Rul 75-201, 1975-1 CB 164.

35 IRC § 512(b)(2).

36 Treas Reg § 1.512(b)-1.

37 Rev Rul 81-178, 1981-2 CB 135 (citing *Commissioner v. Affiliated Enter., Inc.*, 123 F2d 665 (10th Cir 1941), *cert denied*, 315 US 812 (1942)).

38 *See, e.g.,* the related discussion in *Sierra Club, Inc.*, TC Memo 1999-86.

much, but in the absence of a definitive threshold level, exempt organizations should consider adopting the following guideline: If an organization's unrelated business taxable income ("UBTI") exceeds 20 percent of its gross income, then the organization's legal risks should be carefully evaluated. Once UBTI exceeds 50 percent of gross income, it may be difficult to continue to maintain the organization's exemption. In either instance, the organization may consider "placing" the unrelated activity in an isolated for-profit subsidiary. By doing so, the organization can avoid the potential loss of its exemption stemming from the activity in question. The subsidiary will pay income tax on income derived from the activity, but any after-tax profits may be remitted to the exempt parent as tax-free dividends.

Maintaining a taxable subsidiary presents the risk that the activities of the subsidiary may be attributed to the tax-exempt parent, which can cause the parent to lose its exemption if the activities are substantial in scope and unrelated to the parent's exempt purpose. This risk is greatest when the tax-exempt parent exercises "operational control" over the for-profit subsidiary.[39] Several factors influence the determination whether operational control exists, including (1) whether the subsidiary has a business purpose separate and distinct from that of the tax-exempt parent; (2) whether the majority of the subsidiary's board of directors are directors of the tax-exempt parent; (3) whether the two entities share officers; (4) whether the two entities share employees; and (5) whether the two entities share facilities and services.[40] If an exempt organization forms a taxable subsidiary to avoid loss of its exemption stemming from unrelated activities, it should take measures to ensure that it does not have operational control over the subsidiary.

UBTI and Oregon Corporate Minimum Tax

Before 2009, Oregon's corporate minimum tax was only $10. If a corporation was subject to income tax in Oregon and had less than that amount of tax due, it was still required to pay $10. This same rule applied for federally tax exempt corporations who had UBTI and were filing an Oregon Form 20.

However, in 2009 Oregon's legislature revised the corporate minimum tax. Corporations with Oregon taxable income, including exempt organizations, are now subject to an increasing scale of minimum tax, dependent upon their "Oregon sales," that ranges from $150 to $100,000.[41] "Oregon sales" for exempt organizations represent that portion of their UBTI that would be properly allocable to Oregon. Consequently, Oregon nonprofits should carefully consider both the federal and state tax implications of their unrelated activities.

Summary

Tax-exempt organizations engaged in the sale of goods or services on a regular basis need to be aware of the UBIT rules and the potential exposure to income tax, penalties, and potential loss of exemption. These organizations should ensure that such transactions are properly structured to avoid creating UBIT exposure where possible.

39 Frances R. Hill & Douglas M. Mancino, *Taxation of Exempt Organizations* § 27.03[2] (2002).

40 *Id.*

41 ORS § 317.090