OREGON STATE BAR

Taxation Section

VOLUME 12, NUMBER 2 Summer 2009

In This Issue:

Previous newsletters are posted on the Taxation Section website.

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

By Alan Pasternack and Neil Kimmelfield[1]

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

Determining Resident Status

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

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

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

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

continued next page

1 Alan Pasternack and Neil Kimmelfield are shareholders at Lane Powell, PC. The authors are indebted to Alan Dale for preparing an early draft of this article.

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

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

Determining the Portion of Income Subject to Oregon Income Tax

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

A. Employment-Related Income

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

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

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

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

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

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

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

2. Deferred Compensation

a. Retirement Benefit Plans.

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

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

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

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

b. Nonqualified Stock Options.

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

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

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

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

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

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

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

B. Income Derived from Real or Tangible Personal Property

1. Income From Ownership or Disposition of Tangible Property

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

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

2. Deferred Recognition Under Code section 1031 or 1033

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

continued next page

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

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

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

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

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

Under ORS 316.124(1) and 316.127(1)(a)(A), Oregon taxes a nonresident partner on his distributive share of partnership income only to the extent it is derived from Oregon sources. If Jack owns an interest in a partnership that operates a business in both Oregon and Washington, Oregon will tax Jack's share of the partnership's income while he is an Oregon resident. Once he has moved to Washington and is no longer an Oregon resident, only the partnership's income from its Oregon business activities will be taxed by Oregon. The result would be the same if the partnership were an S corporation. ORS 316.127(5)(a).

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

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

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

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

3 *See* Code section 704(c).

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

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

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

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

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

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

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

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

Conclusion

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

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

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