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2012-2013 Northwest State Tax Summary: Oregon

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There was a great deal of state tax activity in Oregon and Washington in 2012 with the prospect of more developments to report in 2013. The following, Part I of a two-part series, highlights some of the activity in Oregon.

Income Tax Nexus

Economic Presence

In December 2012 a federal bankruptcy court judge held that Washington Mutual Inc., a parent holding company that owned bank subsidiaries conducting business in Oregon, did not have nexus in Oregon for income tax purposes despite its ownership of the banks, the ownership of intangibles used by the banks in Oregon for no fee, and the receipt of dividends from the banks.[1] In reaching its decision, the court rejected Washington Mutual's claim that a physical presence was required under the commerce clause, but it also rejected the state courts' significant economic presence test, instead concluding that the constitutionality of the Oregon tax was subject simply to the substantial nexus test articulated in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). The department did not appeal the decision.

Speaking of an economic presence test, effective in 2008, the Oregon Department of Revenue promulgated a regulation, OAR 150-317.010, adopting that test even after the Legislative Assembly in 2007 failed to adopt a statutory definition of substantial nexus to expressly include an economic presence test. As cases begin to exit the DOR's informal appeals process in 2013, they may begin to appear in the Oregon Tax Court, raising at least two issues besides the economic presence test question: Can the department retroactively apply an economic presence test in accordance with *U.S. Bancorp v. Dep't of Rev.*, 337 Or 625 (2004) (allowing the department to apply its regulation retroactively), and what is the consequence of the legislature having considered and rejected a position later taken by the department administratively? The latter question is also presented in *Comcast v. Oregon Department of Revenue*, pending before the Oregon Supreme Court and discussed below under Property Tax and Centralized Assessment.

P.L. 86-272

At the end of 2011, the Oregon Tax Court ruled in *Ann Sacks Tile and Stone, Inc. v. Oregon Department of Revenue* that Kohler, a parent company, was protected by Public Law 86-272 regarding its own sales force, but was taxable under Oregon law and not protected by P.L. 86-272 by reason of the presence of employees in Oregon providing administrative services to its subsidiaries and a contractual arrangement with distributors and authorized service representatives to provide warranty repair work that it was obligated to provide its customers.[2] The taxpayer sought review by the Oregon Supreme Court, but in 2012 the court dismissed the appeal on procedural grounds without reaching the substantive issue.[3] On the procedural issue, see the discussion below regarding *Ann Sacks Tile and Stone* under Supreme Court Procedure and Jurisdiction.

Income Tax Apportionment (Business Income and Sales Factor)

Oregon is a hotbed currently for business/nonbusiness and sales factor apportionment issues.

[1] *In re Washington Mutual, Inc.*, No. 08-12229 (Bankr. D. Del. Dec. 19, 2012).

[2] *Ann Sacks Tile and Stone, Inc. v. Oregon Department of Revenue*, T.C. No. 4879 (Nov. 29, 2011).

[3] 352 Ore. 380 (2012).

Sales of Operating Assets in Liquidation and the Meaning of 'Business Income'

A decision is expected in 2013 in *Crystal Communications, Inc. v. Oregon Department of Revenue*, SC No. 059271, and *CenturyTel v. Oregon Department of Revenue*, SC No. 059502, both argued to the Oregon Supreme Court in late 2012. In both cases, the court is asked to decide whether the gain from the disposition of operating assets (in the case of *Crystal*, all its operating assets primarily consisting of Federal Communications Commission licenses, and in the case of *CenturyTel*, all its subsidiaries making up its wireless business in an IRC section 338(h)(10) deemed liquidation) was business income under the Uniform Division of Income for Tax Purposes Act's functional test and Oregon's statutory "and disposition" language.

Sales of Investments and the Meaning of 'Business Income'

In *Fisher Broadcasting Company v. Oregon Department of Revenue*,[4] the taxpayer is challenging the department's assertion that the gain on the sale of Safeco company stock in 2007 and 2008 that it acquired as a long-term investment in 1923, and with which it was not unitary, constitutes business income.

Sales of Intangibles and the Sales Factor

In *Tektronix, Inc. v. Oregon Department of Revenue*, a 2012 decision by the Regular Division of the Oregon Tax Court, the court addressed the scope of ORS 314.665 in computing the sales factor for the sale of intangibles.[5] ORS 314.665(a) excludes receipts from the sale of intangible assets unless those receipts are derived from the taxpayer's primary business activity. ORS 314.665(b) includes the net gain from the sale of intangible assets not derived from the primary business activity. The legislature adopted ORS 314.665(a) and (b) to deal with the problem of "treasury function" gross receipts and the decision in *Sherwin-Williams Co. v. Oregon Department of Revenue*.[6] However, the statute refers to "intangible assets." In *Tektronix*, the company had sold assets of two divisions generating a $589 million gain on the sale of goodwill. The taxpayer treated the gain as business income but excluded the proceeds from the sales factor as an occasional sale. The department sought to include the proceeds from the sale of the goodwill in both the numerator and denominator of the sales factor. The court held that ORS 314.665(a) and (b) are applicable only to liquid assets and not the sale of goodwill. Without taking a position on the taxpayer's exclusion on the statutory basis of an occasional sale of a fixed asset, the court left open whether goodwill qualifies as a fixed asset and instead turned to the department's regulation to decide the case. Deciding that the sale of goodwill could not be attributed to any particular income-producing activity of the taxpayer, the court decided that under the department's regulation, OAR 150-314.665(4)(3)(b), the proceeds should not be assigned to either the numerator or the denominator of the sales factor. An appeal has been filed in *Tektronix* to the state supreme court.

Following the *Crystal* and *CenturyTel* decisions by the Regular Division, in a 2012 case Oracle elected, "with respect to gains on the sale of Oracle Japan stock, to no longer litigate in the magistrate division the question of whether the gain was business income."[7] The Magistrate Division decided that regarding the sales factor computation on that type of gain, the department's position that the gain satisfied the functional test of business income, but should be excluded from the sales factor denominator because the proceeds were derived from sales outside the regular course of business, was inconsistent. The court allowed inclusion of the proceeds in the denominator of the sales factor. Interestingly though, that was a conclusion that appeared to have been reached by the Regular Division a few months earlier in *Crystal* and conceded earlier too by the department in *CenturyTel* by stipulation in order to allow it to proceed with direct review by the Oregon Supreme Court. Therefore, it is unclear why the department was litigating the issue in *Oracle*. Also, the Magistrate Division held that Oregon's version of section 18 of UDITPA, providing alternative apportionment, does not grant power to a court to reapportion the income, but only to the department, and that action must be taken before or as part of the assessment process. No appeal was filed in *Oracle*.

Sales Other Than Tangible Personal Property and the Sales Factor

In early 2012 the Regular Division held, in a decision directly contrary to a Massachusetts decision for the same taxpayer, that AT&T's exclusion of its receipts from its sales factor from the sale of interstate and international long-distance calls was in error because the taxpayer's cost of performance analysis did not properly focus on each individual call or transaction, and its

[4]*Fisher Broadcasting Company v. Oregon Department of Revenue*, T.C.-MD 120787D (filed Oct. 26, 2012).

[5]*Tektronix, Inc. v. Oregon Department of Revenue*, T.C. No. 4951 (June 5, 2012).

[6]*Sherwin-Williams Co. v. Oregon Department of Revenue*, 329 Ore. 599 (2000).

[7]*Oracle Corp. v. Oregon Department of Revenue*, No. T.C.-MD No. 070762C (Jan. 19, 2012).

interpretation of direct costs was overbroad.[8] Also, the court distinguished independent contractor services performed "on behalf" of the taxpayer and services provided "to" the taxpayer, finding that access charges paid by AT&T to local exchange carriers were of the latter variety and includable in direct costs. An appeal has been filed in *AT&T*.

In September 2012 the Regular Division also held in *Powerex Corp. v. Oregon Department of Revenue* that the wholesale sale of electricity did not constitute the sale of tangible personal property, and therefore, the sales factor numerator is determined under a cost of performance analysis.[9] *Powerex* has been appealed to the state supreme court.

Ultimate Destination Rule and the Sales Factor

Also in *Powerex*, the parties agreed that the sale of natural gas constituted the sale of tangible personal property, and the court held that the ultimate destination rule, adopted by most states applying UDITPA, and not the contractual delivery point, governed determination of the sales factor numerator.

Multistate Tax Compact Apportionment Elections

In a case similar to *Gillette Co. v. California Franchise Tax Board*, HealthNet has filed an action in the Oregon Tax Court's Magistrate Division asserting that it is entitled to three factor apportionment under the election provided for under Oregon's Multistate Tax Compact.[10] ORS 314.606 provides that in any case in which the apportionment provisions are inconsistent with the compact, the apportionment provisions shall control. Therefore, the question presented, like that in California, is whether the legislature, without following the compact procedures for withdrawal, could simply enact a statute denying the benefit of the election in the compact. On September 24, 2012, the department issued a release observing that this question was pending in the Oregon Tax Court and describing the method for filing protective refund claims. The case has been specially designated to the Regular Division.

Taxation of Insurance Companies

For a number of years, Oregon has struggled with the application of the income tax to affiliated groups that included one or more insurance companies. In *Penn Independent Corp. v. Oregon Department of Revenue*,[11] the statutory scheme provided that insurance companies were subject to a premiums tax. The department successfully argued that because Oregon's scheme required that federal consolidated groups file Oregon consolidated returns starting with the same income, the insurance company that already paid under the premiums tax scheme was not excluded from the Oregon consolidated return because inclusion did not mean that it was taxable.

For later tax years, the premiums tax was repealed in lieu of a corporate net income tax imposed on insurance companies but on a separate return basis. The next question was whether the holding of *Penn Independent* would hold up to again allow the department to include the insurance company affiliates in the Oregon consolidated return of the non-insurance companies. That was the basis for the department's assessment in *PacifiCare Health Systems, Inc. v. Oregon Department of Revenue*.[12] Before that case was heard by the Oregon Tax Court, the department agreed in an informal conference decision that when the insurance company is subject to tax in the state, inclusion of it also in the consolidated return of the non-insurance companies would violate the internal consistency test of the commerce clause. Therefore, in *PacifiCare*, the department did not assert that the insurance company should have been included in the consolidated return of the non-insurance companies even though it could have attained exactly the same result it achieved by denying the intercompany royalty deductions.

Penn Independent had the same internal consistency problem as in *PacifiCare*, but that argument was not presented by the taxpayer and not picked up by the court. To this day, the tax court still cites *Penn Independent* as correctly decided.[13] In *Costco Wholesale Corp. v. Oregon Department of Revenue*, the court adopted a second ground for why *PacifiCare* would not include the insurance companies in the consolidated return of the non-insurance companies — under the statute, if the insurance company is subject to tax in Oregon, it must file its own separate return, and it is expressly excluded from the Oregon consolidated return. In *Costco*, the insurance company was not subject to Oregon tax, and therefore, it was not excluded. Under those facts too, it appears that the internal consistency test is not violated. The appeal period in *Costco* has not yet begun to run.

One month after the *Costco* decision, the Oregon Tax Court Regular Division decided *StanCorp*

[8] *AT&T Corp. v. Oregon Department of Revenue*, T.C. No. 4814 (Jan. 12, 2012).

[9] *Powerex Corp. v. Oregon Department of Revenue*, T.C. No. 4800 (Sept. 17, 2012).

[10] *HealthNet, Inc. v. Oregon Department of Revenue*, T.C.-MD No. 120649D (filed July 2, 2012).

[11] *Penn Independent Corp. v. Oregon Department of Revenue*, 15 OTR 68 (1999).

[12] *PacifiCare Health Systems, Inc. v. Oregon Department of Revenue*, T.C. No. 4762 (July 1, 2008).

[13] *See Costco Wholesale Corp. v. Oregon Department of Revenue*, T.C. No. 4956 (July 16, 2012).

Financial Group v. Oregon Department of Revenue, in which the insurance company was taxable in Oregon, and therefore, was not included in the non-insurance group's Oregon consolidated return.[14] The issue there was the effect of dividends paid by the insurance company to a non-insurance company included in the Oregon consolidated return. Again, the starting point for the Oregon consolidated return is federal consolidated income, and in those cases, there is no dividend income from affiliates. Still, the department argued that if the dividend payer is filing separately, the dividend income should be recognized. The court rejected the department's argument, finding no such provision in the statutes. The court made note that if that was not the intent of the legislature, it was up to the legislature, and not the court, to correct it. The department is still considering whether to appeal *StanCorp Financial*.

Taxation of Real Estate Investment Trusts

With the parent company's (Washington Mutual) nexus issue apparently resolved, some of its former subsidiaries have pending before the Magistrate Division the question whether, before a statutory amendment in Oregon, there was an addback of the dividend received deduction from real estate investment trusts. In 2012 the department settled that issue with another taxpayer while it had an action pending in the Magistrate Division.

Property Tax and Centralized Assessment

In 2012 the parties and friends of the court submitted briefs in *Comcast v. Oregon Department of Revenue*, and in January 2013 the parties argued before the Oregon Supreme Court whether the Regular Division's decision was in error in finding that Comcast was not a communications business and therefore was not subject to central assessment.[15] As a practical matter, at stake under Oregon's property tax system is whether the intangible assets such as goodwill of a number of cable companies and Internet service providers will be subject to property tax in addition to any hard assets they own or use in the provision of their services in Oregon.

Court Procedure

State Supreme Court Procedure and Jurisdiction

The Oregon Tax Court has original jurisdiction for income tax matters, and a losing party has a right of direct appeal to the Oregon Supreme Court. In *Ann Sacks*, discussed above, the tax court entered a general judgment against the taxpayers on December 19, 2011. The taxpayers filed a notice of appeal to the Oregon Supreme Court on January 13, 2012. "Regarding service, the notice of appeal stated that taxpayers had served the notice of appeal on the attorneys for the department by using the Oregon appellate court electronic filing system (eFiling system)." However, as the Oregon Supreme Court noted when the department responded to the notice of appeal with a motion to determine jurisdiction, "parties are not permitted to use eService to serve 'initiating documents,' which are defined to include notices of appeal. ORAP 16.45(3)."[16] As a consequence, despite actual notice having been received by the department's attorneys, the court concluded that the manner of service is a component of appellate jurisdiction and that the taxpayers failed to satisfy the requirement. Consequently, the taxpayers' appeal in *Ann Sacks* was dismissed without reaching the substantive, taxability issue. As will be discussed in Part II of this update regarding Washington developments, procedural mistakes can be fatal to a tax challenge.

Tax Court Procedure and Jurisdiction

In *PacifiCorp v. Oregon Department of Energy*, the Regular Division held that it lacked jurisdiction to hear a declaratory judgment action asserting that a fee imposed under ORS 469.421(8) (a fee on energy resource suppliers to fund the activities of the Energy Facility Siting Council) is a tax and that the tax violated certain provisions of the Oregon Constitution.[17]

Statute of Limitations for Assessments

In an action before the Regular Division, *Oregon Department of Revenue v. Washington Federal*, the issue was whether the department's notices of deficiency were timely issued. ORS 314.410(3)(b)(A) provides that if the IRS or a state makes a correction of tax, and "as a result of the change" the IRS or other state is permitted to assess tax, then "notice of a deficiency under any Oregon law" may be mailed within two years of the department being notified. At issue was the scope of the kind of changes by another state that would cause the Oregon statute to be extended. The department argued that the statute pertains to any case in which another state proposes a change that, if made by Oregon, would change the Oregon tax liability. The taxpayer argued that the other state's changes must be "those that, unless altered by the department, result in a change in Oregon tax liability

[14]*StanCorp Financial Group v. Oregon Department of Revenue*, T.C. No. 5039 (Aug. 2, 2012).

[15]*Comcast v. Oregon Department of Revenue*, SC No. 059764.

[16]352 Ore. 380, 382 (2012).

[17]*PacifiCorp v. Oregon Department of Energy*, T.C. No. 5106 (Jan. 7, 2013).

because of a connecting linkage between Oregon substantive law and the substantive law of a sister state." The best example is how Oregon law links to federal law, and therefore, a federal change directly results in an Oregon change. That result would be much less common for changes in other states' laws. The court analyzed a number of amendments of the statute, described each consequence, and found that a causation effect is required and that aside from the linkage with the federal system, the only sister state proposed changes "resulting" in a change in Oregon tax that appears to satisfy the necessary predicate acts involves the allowance of credits to individuals for taxes paid to other states.[18] ☆

[18]*Oregon Department of Revenue v. Washington Federal*, T.C. No. 5010 (June 29, 2012).