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In This Issue:

Federal and Oregon Income Tax Planning for Trusts

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Most Americans are patriotic and proud to pay taxes as a necessary price of living in such a great country. Oregonians are equally proud of their state. But most would feel just as proud paying half as much. This article will focus on how higher income Oregon residents can legitimately avoid or lower the federal and/or Oregon income tax burden using both incomplete and completed gift trusts.[2] These techniques are most useful to those who anticipate being in the highest income tax brackets, and, due to sharply increased applicable exclusion amounts and dozens of recent private letter rulings from the IRS, are more appealing than ever.[3] Some of these techniques have the side effect of avoiding Oregon estate tax as well, though that is not the focus of this article.[4]

At 9.9%, Oregon has one of the highest state income tax rates in the country – behind only California, Hawaii or residents of New York City, which has both a state and city income tax.[5] For long-term capital gains tax rates, this state burden may be over a third of the overall tax and places Oregon residents among the highest payors of capital gains tax on the planet. The savings can be tremendous – nearly $99,000 for every million dollars of capital gains avoided.[6]

First, we'll very briefly summarize how trusts are taxed at the federal level. Then explain Oregon's trust income tax scheme and the importance of being classified as a "resident" or "non-resident" trust. Then, we will address "source income" and

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2 Prior articles discuss the tax problems and solutions associated with middle class trust beneficiaries having income "trapped" in highest tax brackets of trusts (see *Avoid the 3.8% Medicare Surtax on Trusts*, by Edwin Morrow, December 2012, Trusts and Estates, and Part VII of the more detailed white paper at http://ssrn.com/abstract=2436964). This article will focus on higher bracket taxpayers.

3 Federal tax rules for trusts are primarily found in Subchapter J of the Internal Revenue Code, IRC §§641-692. The top federal income tax bracket of 39.6% (20% for long-term capital gains and qualified dividends) as of 2013 start at $400,000 taxable income for singles, $450,000 married filing jointly, which annually adjust upwards for inflation, in 2015 these start at $413,201 and $464,851 respectively. The additional Medicare surtax on net investment income of 3.8%, which acts in many ways like an income tax, starts at $200,000 and $250,000 modified AGI respectively.

4 Which, to generalize, is 16% on taxable estate over $1,000,000 exemption, also one of the highest rates in the nation. See Oregon Tax Form OR706 and instructions at: http://www.oregon.gov/dor/bus/docs/form-or706_104-001_2013.pdf

5 ORS §316.037, reaching the 9.9% at only $125,000 of income, lower than most state's top brackets – California tops out at 13.3%, Hawaii 11% and New York state and New York City is 8.82% and 3.4% respectively. See state income tax map and charts updated at www.taxfoundation.org

6 Savings may be slightly less due to itemized deductions of tax paid, exemptions, etc.

situations involving Oregon-sitused real estate, income and businesses, when Oregon may tax even non-residents and non-resident trusts. More importantly, we'll discuss how this may often be avoided. Next, we'll revisit the two federal tax options available and distinguish between completed gift and incomplete gift trusts. Lastly, we'll explore when these same trusts may actually save federal income tax in many situations as well, despite the common wisdom that trusts pay higher rates of income tax.

Federal Trust Income Tax Scheme

Many trusts, including all revocable trusts and even many irrevocable ones, are "grantor trusts" for income tax purposes, meaning they are not considered separate taxpayers and all gains, income, losses and deductions in the trust are attributable to the grantor.[7]

This article will assume a familiarity with basic federal fiduciary income tax principles and for the remainder of this article "trusts" will refer to standard non-charitable, irrevocable non-grantor trusts unless specified otherwise – thereby excluding grantor trusts, charitable remainder trusts or trusteed qualified plans or IRAs.[8]

Trusts and estates have similarities to pass-through entities, but are taxed quite differently from entities taxed as S corporations and partnerships – usually, capital gains are trapped and taxed to the trust and other income is taxed to the beneficiaries to the extent distributed and to the trust to the extent not distributed. That is a highly simplified summing up of a complex subject.[9]

Federal trust income tax rates hit the higher income tax brackets at much lower levels to the extent that income is trapped in trust and not passed out to beneficiaries on a K-1. The top 39.6% federal income tax bracket is reached at only $12,300 for tax year 2015. There is no 35% bracket.[10] The 3.8% net investment income tax is triggered by investment income over this same low threshold.[11]

Oregon's Trust Income Tax Scheme - Differentiating Oregon Resident and Non-Resident Trusts

The Oregon fiduciary income tax has the same tax top tax rate as the individual income tax – 9.9%.[12] Avoiding Oregon trust income tax is essentially a two-step process: avoid being a resident trust, and avoid source income.

Let's take the first step. Oregon tax law differentiates between resident trusts and nonresident trusts.[13] The same tax form is used for both.[14] Oregon's definition of a resident trust is extremely taxpayer-friendly and much narrower than many states:

> "[A] "resident trust" means a trust, other than a qualified funeral trust, of which the fiduciary is a resident of Oregon or the administration of which is carried on in Oregon. In the case of a fiduciary that is a corporate fiduciary engaged in interstate trust administration, the residence and place of administration of a trust both refer to the place where the majority of fiduciary decisions are made in administering the trust."[15]

Thus, unlike many states, the "residency" of an Oregon trust is not triggered by the in-state residency of the settlor and/or beneficiaries, but rather by where it is administered. Oregon has rather liberal (compared to e.g., California) allowances for corporate trustees who may have offices and administration in several states. Thus, if the primary administration of a trust is done out of state but only incidental functions are performed in Oregon, the trust is still not a resident trust. Permitted functions include "preparing tax returns, executing investment trades as directed by account officers and portfolio managers, preparing and mailing trust accountings, and issuing disbursements from trust accounts as directed by account officers."[16]

Non-resident trusts are simply defined as those that are not resident trusts.[17] Thus, to form a non-resident trust, Oregon residents merely have to find a trustee or trustees out of state that will not administer the trust beyond performing incidental functions in Oregon. This precludes naming an Oregon resident as co-trustee.[18] Trustees with offices in multiple states, like KeyBank, have an edge because there can still be local contact and incidental functions and meetings in Oregon while the primary administration is done elsewhere. This scheme creates a significant disincentive, to both Oregon residents and non-residents alike, against using Oregon fiduciaries.

Dividing the traditional functions of the trustee, such as naming an out of state trustee yet appointing a distribution or investment advisor or committee to direct the trustee to make distributions or investments, is becoming more common, and muddies the waters of this analysis. The administrative code and statute refers only

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7 See IRC §§671-679, especially §671 for general rules

8 Hence subject to the remainder of Subchapter J, §§641-692, not §§671-679 subpart E grantor trust rules.

9 If you want the gory detail, see the Oregon Bar's Estate Planning Newsletter Volume XXXI, No. 4, October 2014 special issue report *A Fiduciary Income Tax Primer*, by Philip Jones

10 IRC §1; For inflation adjusted brackets see Rev. Proc. 2014-61 at http://www.irs.gov/pub/irs-drop/rp-14-61.pdf

11 IRC §1411(a)(2)

12 ORS §316.037; §316.282; Or. Admin. R. §150-316.282(3), (4)

13 Or. Admin. Code §150-316.282(1)

14 The fiduciary income tax return and instructions are at http://www.oregon.gov/dor/BUS/docs/form-41-fiduciary-income_101-041_2014.pdf

15 ORS §316.282(1)(d), which is also mirrored and reinforced in Or. Admin. Code §150-316.282(3)

16 Or. Admin. Code §150-316.282(5), which includes several examples.

17 ORS §316.302

18 Or. Admin. Code §150-316.282(5), example 3

to "trustee", not to the broader term "fiduciary". Although the Oregon Department of Taxation's examples do not cover such innovative trust designs, because such advisors may be fiduciaries as well, it is unclear whether Oregon would treat them in the same manner as a co-trustee if any are Oregon residents, or whether their actions would merely factor into the analysis in determining the extent of significant fiduciary decisions in Oregon.[19] Advisors are by default fiduciaries unless the document provides otherwise.[20] Presumably the tax department and court would follow any declaration under the document that an advisor is not a fiduciary even when they outwardly appear to be.

Powers of appointment, however, are typically non-fiduciary in nature and such powers should not be considered fiduciary or administrative regardless of the state law presumption, though it may be prudent to reaffirm that such powerholders are not fiduciaries in the trust document. The importance of these distinctions and the pitfalls and opportunities they open up are discussed later herein.

The taxable income of an Oregon resident trust is simply its federal taxable income, modified by certain fiduciary adjustments.[21] The federal taxable income for a trust excludes many important deductions which differ from individuals', which will be important in the latter part of this article.

Although this article primarily discusses inter-vivos planning, the concepts herein also apply to the administration of the trust after the death of the first spouse. This provides a significant tax incentive for Oregonians to name out of state trustees for trusts, including garden-variety "AB" trusts.

This does not mean just any trust company or out of state trustee should be used. You don't want to name a California resident as trustee to simply exchange a 9.9% tax for a 13.3% tax. However, many states have no income tax, most notably our neighbor to the north, Washington, but also Alaska, Texas, Nevada, Florida and others. Many other trust-friendly states, such as Ohio or Delaware, have an income tax for their own residents, but would not impose a state income tax unless there were a current beneficiary residing in the state.[22]

Understanding Oregon Source Income – When It Can and Cannot be Avoided

Once we have successfully created a non-resident trust for Oregon income tax purposes, we next need to resolve when and how even non-residents and non-resident trusts may still be taxed. This brings us to the second part of this article discussing "source" income. Taxpayers selling an asset or block of assets for a large gain are often dealing with depreciated real estate and business entities in state. These present special issues. The best overview defining Oregon source income can be quoted right from the Department of Taxation's own instructions:

> "Examples of Oregon source income are: wages or other compensation for services performed in Oregon; income or loss from business activities in Oregon, including rents, S corporations, and partnerships; gain or loss from the sales of real or tangible personal property located in Oregon; income from intangible personal property if the property has acquired Oregon business situs."[23]

Even an out of state resident will typically pay Oregon income tax on such income, not just a non-resident trust. Thus, a nonresident beneficiary of a trust (even a non-resident trust) is taxed by Oregon in the same manner as if the beneficiary had received the income directly if the income resulted from the ownership or disposition of tangible property (real or personal) in Oregon, or from the operation of a trade or business in Oregon.[24]

This article will ignore wages and compensation and focus on sales of intangible personal property, which is the most likely corpus of a trust, the most likely candidate for large capital gain triggering events and often the most desirable candidate for tax avoidance. It is also the part of the source income concept that is most difficult to understand.

C corporations, for example, are not pass-through entities, so the more complex pass-through entity tax rules do not apply to them. As hinted at by the lack of mention in the Oregon tax return instructions noted above, a Florida or Ohio resident isn't necessarily going to pay Oregon income tax on Precision Castparts stock (a C Corporation) when it is sold, or pay Oregon income tax on dividends received, but any C corporation has its own separate taxes to deal with. However, most closely held businesses

19 Or. Admin. Code §150-316.282(5)

20 ORS §130.735 "An adviser shall exercise all authority granted under the trust instrument as a fiduciary unless the trust instrument provides otherwise." Restatement, 3d, Trusts, §64 also incorporates this presumption "The terms of a trust may grant a third party a power with respect to termination or modification of the trust; such a third-party power is presumed to be held in a fiduciary capacity." Of course, in many situations, practitioners are going to use Delaware, Ohio, Nevada or other state DAPT law rather than Oregon law, but these states have similar provisions. See Ohio R.C. §5815.25, §5808.08, Delaware Title 12, §3313(a).

21 ORS §316.282(2), which is also mirrored and reinforced in Or. Admin. Code §150-316.282(6)

22 For example, see Ohio Department of Taxation Information Release TRUST 2003-02 - Trust Residency — February 2003 http://www.tax.ohio.gov/ohio_individual/individual/information_releases/trust200302.aspx

23 Page 6, Form 41 Oregon Fiduciary Income Tax Return and Instructions at http://www.oregon.gov/dor/BUS/docs/form-41-fiduciary-income_101-041_2014.pdf

24 Or. Admin. R. §150-316.282(7), ORS §316.127; Or. Admin. R. §150-316.127-(D)

(even large ones) prefer to avoid the double tax system of C corps, which can be much more onerous overall, especially upon sale, distribution or termination.

So, let's assume for the remainder of this section that we are dealing with a pass-through entity – an LLC, partnership or S corporation. The ongoing income of Oregon pass-through entity with ongoing operations or real estate in Oregon is clearly taxed.[25] However, the sale of the stock (or membership interest) of such entities is not necessarily taxed in Oregon if the owners are out of state. Income from the sale of intangibles is traditionally allocated to the state of the taxpayer's domicile through the doctrine of *mobilia sequuntur personam.*[26] This is generally confirmed through Oregon's adoption of the Uniform Division of Income for Tax Purposes Act:[27]

> "(c) Capital gains and losses from sales of intangible personal property are allocable to this state if the taxpayer's commercial domicile is in this state." More specifically, this is confirmed in Oregon's administrative rules interpreting the statute: "(b) Intangible property. The gain from the sale, exchange, or other disposition of intangible personal property, including stocks, bonds, and other securities is not taxable unless the intangible personal property has acquired a business situs in Oregon."[28]

Thus, the sale of S corporation stock, even if the business has real estate or operations in Oregon, is not Oregon source income, unless the stock itself has acquired a business situs in the state.[29] This might occur if the stock is pledged for indebtedness used in carrying on business in state, or if the stock itself is not a mere investment, but used to further the business of the owner, or if the owner is in the business of buying and selling such stock.[30] There is a history of complex litigation when the stock is a corporate subsidiary, but for most individuals or non-resident trusts, the stock is going to be a mere investment, not used to further the business of the owner.[31]

Neither is the sale of an LLC or LP interest going to necessarily be Oregon source income, but the analysis is more complex. For instance, a general partnership interest, whether as part of a limited partnership or not, is Oregon source income,[32] but the limited partnership interest is probably not:

> "Limited Partnership Interests. In general, a nonresident's gain or loss from the sale, exchange, or disposition of a limited partnership interest is not attributable to a business carried on in Oregon and is not Oregon source income."[33]

For Oregon source income taxation rules, member managed LLCs are taxed like partnership (source), and manager-managed LLCs taxed like limited partnerships (not source, as cited above).[34] Curiously, limited liability partnerships (LLPs) are taxed for this purpose like general partnerships.[35]

This leaves ample opportunity for proactive pre-sale planning through changing the management structure of an LLC through its Articles of Organization, changing to an S corporation structure (usually not recommended for other reasons), or using tax-free reorganizations from general partnerships or LLPs to manager-managed LLCs to minimize Oregon income tax upon sale. There is no statute, rule or case law as to how soon before sale that such reorganizations must be done. The best we can say is that, for planning purposes, the sooner the better, ideally in the tax

25 Or. Admin. R. §150-316.127-(D)(1)

26 "movables follow the person"

27 Uniform Division of Income Tax Purposes Act ("UDITPA") can be found at http://www.uniformlaws.org/shared/docs/uditpa/uditpa66.pdf. More material on uniformity projects and discussion of state income tax law can be found at the Multistate Tax Commission's website at www.mtc.gov.

28 Or. Admin. R. §150-316.127-(D)(2)(b)

29 Or. Admin. R. §150-316.127-(D)(2)(c)

30 Or. Admin. R. §150-316.127-(D)(1)

31 "Nonbusiness capital gains and losses from sales of intangible personal property (i.e., stocks, bonds) are allocable to the taxpayer's state of commercial domicile" BNA Tax Portfolio 783-4th, citing the UDITPA. This of course, leads to the question of whether the stock is integrally part of the owner's own business or the owner is in the business of buying and selling corporations. "For example, the taxpayer in *W.R. Grace & Co. v. Commr. of Revenue* ("Grace") purchased a majority stock interest in the Miller Brewing Company and later sold its interest at a substantial gain. Grace was a Connecticut corporation doing business in Massachusetts. Massachusetts treated the gain as business income and required its inclusion in Grace's apportionment formula. Grace contended that the gain was nonbusiness income fully allocable to its state of commercial domicile, New York. The state court agreed that Grace was not in the business of buying and selling securities, but found ample evidence that Grace's business included the purchase and sale of operating subsidiaries. The court did not view the fact that Grace was unable to acquire full control of Miller as stripping the holding of its business character. Finding that ownership of Miller was an "integral component" of Grace's total operations (i.e., unitary), the court concluded that gain from the sale of the interest was apportionable business income." *Id*. at IV.B.2.b.

32 Or. Admin. R. §150-316.127-(D)(2)(d)

33 Or. Admin. R. §150-316.127-(D)(2)(e)

34 Or. Admin. R. §150-316.127-(D)(2)(f)

35 Or. Admin. R. §150-316.127-(D)(2)(g)

year before sale, even though there is no good argument against the immediate effectiveness of such changes.

An Example of Savings

Let's start with a basic example that we will go back to throughout this article: John Doe makes over $500,000 annual taxable income (39.6% bracket, plus 3.8% or 0.9% Medicare surtax, thus 23.8% federal capital gains rate, 9.9% Oregon marginal tax rate). John is married and both are Oregon residents. He has $11 million in assets he anticipates selling soon for a capital gain of $10,000,000 – this might be a sale of depreciated real estate, a sale of closely held or publicly traded stock or limited partnership, or perhaps even a forced recognition of gain, like one of the recent corporate inversions such as Burger King or Medtronic, or Kinder Morgan's reorganization of its publicly traded limited partnerships. John would like to explore options that might avoid roughly $990,000 of Oregon income tax. Let's assume that John is not in the business of buying and selling such assets – it is held for investment. Is he out of luck getting around Oregon income tax if the asset is a business? Not necessarily. It depends on the type of business, the structure of the deal, and whether a §338(h)(10) election is made.

Let's examine the Oregon tax savings opportunities based on whether John's assets are C corp stock, LLC (member managed), LLC (manager managed), LP, LLP or general partnership. The design of the irrevocable trust will be discussed in the next section.

C corporation, publicly traded stocks/bonds – John conveys these to a non-resident trust. The trust sells the asset. No Oregon income tax.

LLC (member managed) – John conveys these to a non-resident trust. The trust sells the asset. Oregon income tax apportioned accordingly, up to $990,000. However, John and his partners may change the management structure of the LLC to a manager-managed LLC to avoid this fate.

LLC (manager-managed, by someone other than John) – otherwise same as above, except that *$990,000 is saved*.

LP (whether publicly traded MLP or not) – no source income, *$990,000 saved*. Notably, there is no aggregation of limited and general partnership interests where someone may own both.[36] This may lead some to prefer the LP to the LLC model where the owner may want to retain management rights.

LLP or GP – all source income to extent apportionable, *up to $990,000 tax*. However, John and his partners may change the partnership to a manager-managed LLC, LP or S corporation to avoid this fate.

If the sale is potentially source income, then an enquiry into the nature of the operations may matter – how much of the property/sales/operations are in Oregon?[37]

Structure of the sale – Asset Deal v. Stock Deal and IRC §338(h)(10) elections

Finally, the structure of the deal matters – is John selling stock or LLC interests in a "stock deal", or is the firm selling in an "asset deal", whereby the buyers are purchasing all the assets of the company? Most buyers prefer to buy the assets of a company rather than stock, so they can depreciate assets with a new FMV basis, and avoid latent liabilities of the selling entity. However, certain contractual obligations and benefits may require a stock deal to properly transfer. All the reasons pro and con vary depending on the nature of the business, contracts, depreciable assets and whether it's an S or C corp, etc – many issues beyond the scope of this article. Some buyers may be amenable to structuring a buyout as a stock deal and some may not even consider it, but soemtimes it is simply a matter of negotiation.

Let's bypass that debate and summarize the "asset deal" for Oregon income tax purposes – if all gains pass through to the owner of an LLC/LP/S corp in an asset deal, then we are left with the conclusions noted above. It is harder to avoid Oregon source income and any Oregon income apportioned to the business will pass through and be taxed to a non-resident or a non-resident trust. For a small to mid-size business with operations and employees only in Oregon, that's probably 100%. There would typically be no Oregon income tax avoided by transferring such assets to a non-resident trust prior to an "asset sale", unless a significant percentage could be apportioned elsewhere, as with a truly interstate business.

If it is a "stock deal", the analysis is quite different and as noted above, the gain can be avoided. Here we refer to "stock deal" broadly to include sale of membership or partnership interests.

There is a hybrid of the two types of deals, however, where the parties elect to treat a stock deal, which might be preferred for state law/contractual reasons, as an asset deal for tax purposes, pursuant to §338(h)(10) of the Internal Revenue Code. Like an asset deal, this would likely lead to Oregon source income. Thus, when we speak of stock deals that can effectively avoid Oregon source income categorization, we are speaking more specifically of stock deals wherein the §338(h)(10) election is not made.

Importance of IRC § 754 to buyers, differentiating LP/LLC from S corps "stock deals"

As mentioned above, buyers receive a new cost basis for their *outside* basis in the stock or LLC membership interest, but that may not necessarily change the *inside*

36 Or. Admin. R. §150-316.127-(D)(2)(d) and (e)

37 ORS §317.365

basis, which is more relevant to ongoing taxation of operations. Inside basis determines the amortization of goodwill or depreciation of a building or equipment. However, an LLC or LP taxed as a partnership under federal tax law may elect to adjust its inside basis upwards to more accurately reflect the sale price.[38] Most estate planning attorneys are familiar with this election in the context of the death of a partner, but it is also applicable to sales and exchanges during lifetime. What this means is that "stock deal" buyers of partnership and membership interests (LLC/LPs taxed as such) can get most of the same benefits as an "asset deal" with a IRC §754 election, which is not available to corporations or LLCs taxed as S corporations. Thus, buyers of LLC/LPs should be much more amenable to "stock deals" than S corp buyers, who often insist on asset deals or §338(h)(10) elections for the aforementioned reasons.

Special Issues for S Corporations and Non-Grantor Trusts

In addition to the messy Oregon tax issues for businesses, transferring an S corporation to a non-grantor trust has the added complications of a forcing an Electing Small Business Trust (ESBT) election, and possibly adding a 3.8% surtax, whereas this tax is more easily avoided in the hands of an "active" investor in the business (or his/her grantor trust or a QSST wherein the beneficiary is active in the business). Whether ESBTs can be "active" business investors and avoid the 3.8% surtax on business income is a complicated issue, even with a high profile recent taxpayer victory in Tax Court.[39]

Protecting the Trustee from Having to Diversify While Avoiding Residency Status

Typically when corporate trustees custody or manage special assets, there needs to be special accommodations. This is because the Prudent Investor Act would otherwise require a trustee to diversify assets and neither the settlor nor the trustee may want the trustee to have to actively manage such closely-held assets prior to sale. This requirement can be waived in a number of ways. Notably, an investment advisor or committee might be named to direct the trustee to hold or sell the stock, LLC interest or other asset. Sometimes the settlor or immediate family is the investment advisor, at least for traditional domestic asset protection trusts. However, if the settlor/family were Oregon residents, fully managing the investments, this could lead to a finding that fiduciary decisions are made in Oregon or that the advisor is a quasi-trustee and lead to a finding that the trust is an Oregon resident trust.[40] Thus, this design should be avoided. The practitioner should use other methods, such as restricting sale and waiving the duty to diversify and gifting non-voting stock or LLC/LP interests, or ensure that another out of state resident has this role, such as an out of state LLC.

Structuring the Trust as an Incomplete or Completed Gift Non Grantor Trust

So, in our example, let's say John has assets that would otherwise be able to avoid Oregon source income upon sale if he were to change residency or if assets were in a non-resident trust. The next step, of course, is creating a trust that meets his estate planning and non-tax goals, with one that is a non-grantor trust for income tax purposes and non-resident trust for Oregon tax purposes.

There are two basic trust designs that can be used – a trust structured as an incomplete gift, or one structured as a completed gift. The latter would count against the donor's $14,000 annual gift tax exclusion, $5.43 million gift tax exclusion and if beyond that, be subject to a 40% gift tax.[41] The former only causes a taxable gift to the extent that later distributions are made to individuals other than the settlor/spouse.

Let's tackle the more complicated first – the *incomplete gift*, non-grantor trust. These types of trusts are colloquially known as DING trusts (Delaware Incomplete Gift Non-Grantor Trusts), based on the original private letter rulings, which used Delaware trusts, and subsequently written articles.[42] PLRs with such structures have also used Alaska and Nevada law, and there is no reason that other state's laws, such as Ohio or Wyoming, might not also be appropriate, but Delaware is still probably the most commonly used.

The design of these trusts are slightly more complicated than most due to the conflicting goals of 1) making the gift incomplete; 2) making the trust a non-grantor trust and 3) enabling the settlor to have access to the trust as a potential appointee or beneficiary. Either goal by itself is rather easy for any experienced practitioner to accomplish – all three at once requires some agility.

This article will not go through the DING design in depth, but at its basic level, after the dozens of PLRs released in the last two years, it is a trust with several unique features to enable the above characteristics. [43] The first three below refer to the how distributions are made.

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38 See IRC §743(b) and IRC §754

39 *Frank Aragona Trust v. Comm.*, 142 T.C. 9 at http://www.ustaxcourt.gov/InOpHistoric/FrankAragonaTrustDiv.Morrison.TC.WPD.pdf

40 Or. Admin. Code §150-316.282(5)

41 The available exclusion amount accounts for prior taxable gifts, adjusts annually for inflation and could be up to double with the Deceased Spousal Unused Exclusion (DSUE), gifts split with a spouse, or a jointly settled trust with a spouse.

42 E.g., early PLRs 2001-48028, 2002-47013, 2005-02014, 2006-12002,2006-37025, 2006-47001, 2007-15005, 2007-29025, 2007-31019

43 See various presentations by author on this subject for more detail, such as those available at www.nbi-sems.com. Recent PLRs include: PLRs 201310002 to 201410006,PLRs 201410001 to 201410010, PLRs 201426014,PLR 201427008; PLRs 201427010 to 201427015, PLRs 201430003 to 201430007; PLRs 201436008 to 201436032, PLRs 201440008 to 201440012

1. The settlor retains a lifetime and testamentary limited power of appointment solely exercisable by him/herself – this may only be permitted in some states, such as Delaware, without compromising asset protection. It is designed to make the gift incomplete yet be curtailed enough so as not to cause the trust to become a grantor trust. Lifetime distributions to appointees are limited to a standard such as health education, maintenance and support to prevent grantor trust status, or possibly limited to charitable beneficiaries (this latter idea is not in the PLRs, but could work equally well).
2. There is a distribution committee comprised of adverse parties (beneficiaries) – this is necessary to enable distributions back to the settlor and/or spouse without triggering grantor trust treatment. The committee structure is necessary to prevent adverse estate/gift tax effects to the powerholders or grantor trust status as to powerholders.
3. There is a veto/consent power unless the distribution committee unanimously overrules the settlor – this is designed to make the gift incomplete.
4. The trust is established in a state that permits self-settled trusts (aka domestic asset protection trust) and would not otherwise tax the trust or beneficiaries. This is designed to prevent grantor trust status and ensure asset protection.[44]

Without getting into gritty detail, the dozens of rulings on these types of trusts point to a design whereby, for many taxpayers and situations, we have the perfect tax design, yet the settlor keeps enough control and flexibility not to offend other non-tax estate planning goals.

In many respects, such trusts, because they have very real tax differences, and arguably stronger powers and controls emboldening adverse parties, are much stronger from an asset protection perspective than ordinary self-settled asset protection trusts, which are typically incomplete gift, grantor trusts. Indeed, DINGs are not even "self-settled". The many differences for state, tax and bankruptcy law are beyond this article.

How does this trust function? The management and reporting is like any trust, but the distribution provisions are unique. The distribution committee uses a jointly held limited power of appointment to appoint cash or property during the settlor's lifetime, in lieu of a traditional trustee spray power or direction from the settlor. In addition, the settlor retains a limited power. Together, there is ample flexibility to make distributions – indeed, more flexibility than most trusts that are typically more limited in the trustee's ability to distribute assets.

While most trusts permit the trustee to distribute current income and principal in a given year, they do not ***have to***. Many ILITs, for instance, have a clause preventing distributions until the settlor/insured dies, particularly if the goal of the trust is to provide a set amount of liquidity at death for a loan covenant, buy-sell, estate equalization or estate tax. Does John or his family need the funds this year? Next year? Not for another five years, when John and Jane will be retired and living in Florida? A trust does not need to have any beneficiaries entitled to current distributions of income or principal to be a valid trust, a beneficiary that can be ascertained now or in the future is adequate.[45] Beneficiaries might become current beneficiaries at a later date, sometimes referred to as a "springing executory interest".[46] Trust protectors might be able to add beneficiaries, but practitioners should be careful since this power in itself may cause grantor trust status if not carefully curtailed.[47] Here, the settlor and/or spouse or children would only be entitled to funds during the settlor's lifetime as a result of a committee of adverse parties' lifetime limited power of appointment, rather than via the trustee. This is necessary to prevent grantor trust status.

Oregon income tax thus can be avoided to the extent income is trapped in trust and is not distributed via power of appointment from distributable net income to Oregon resident beneficiaries in that tax year. Importantly, Oregon does **not** have throwback rules similar to California and New York that might otherwise try to tax income accumulated and taxed to the trust in prior tax years, nor does it have a specific rule regarding incomplete gift trusts as New York recently passed.[48] Oregon does still have a reference to the old throwback rule on the books, but unlike New York or California, there is no modification to adapt to federal changes made years ago that make the rules primarily apply only to foreign trusts.[49]

To illustrate the tremendous importance of the lack of a throwback rule, let's say John's trust sells the $10,000,000 of assets in 2015. It would incur and pay approximately $2.38 million in federal capital gains tax (23.8%), make no further distributions in 2015 and avoid the $990,000 in Oregon tax assuming it is not otherwise an Oregon

44 Treas. Reg. §1.677(a)-1(d) – if a settlor's creditors can reach a trust, this triggers grantor trust status

45 O.R.S. §130.155(2)

46 For a discussion on shifting and springing executory interests and how they might be used to ward off IRS tax liens and consideration of trust assets in the event of a divorce even better than wholly discretionary trusts, contact author for separate CLE outline

47 If the trust protector is non-adverse, IRC §677 would probably cause such a power to create a grantor trust if the settlor and/or spouse could be added as beneficiary later. Some attorneys refer to this as a "hybrid-DAPT".

48 N.Y. Tax Law §612(b)(41) new law signed 3/31/14 at: http://www.assembly.state.ny.us/leg/?default_fld=&bn=S06359&term=2013&Summary=Y&Actions=Y&Memo=Y&Text=Y

49 Or. Admin. R. 150-316.737, referencing IRC §665 accumulation distributions, which are now defined to primarily apply to foreign trusts per IRC §665(c)

resident trust, as discussed above.[50] In 2015, there is a "clean slate" as to 2015 income. If in mid-2016, to take an extreme case, the trust makes $10,000 in dividends and interest before distributing the entire amount of the trust to Oregon beneficiaries, the only amount on the K-1 for the beneficiaries subject to Oregon tax is the $10,000 of *2015* income.

If distributions were made in 2015, the year of the large capital gains, recall the general rule above for non-grantor trusts – capital gains are generally trapped in trust, unless one of the three exceptions to this general rule applies.[51]

Also, if either John or Jane were to have a "springing executory interest", becoming a traditional current beneficiary later, this would trigger grantor trust status even before that event because income might be accumulated and distributed to them later (and, therefore, Oregon taxation directly).[52] This may also be true if a non-adverse party such as a trustee or trust protector could add them as full beneficiaries later.

DINGs require distribution committees of adverse parties (typically, children) to permit trustee distributions to the settlor and/or spouse – such adverse party consent negates grantor trust status. Because their children are adverse parties, the existence of this power would not trigger grantor trust status in itself under IRC §677.

At first glance, this kind of arrangement reminds one of the warnings inimical to large lifetime gifts borne out from Shakespeare's *King Lear*. But King Lear never used a DING trust. Had he done so, he would have avoided a lot of grief. Here, John keeps just enough control via lifetime and testamentary powers of appointment to make the gift incomplete and keep the ultimate beneficiaries in line, but not so much as to cause grantor trust status. Retaining a veto/consent power, lifetime limited powers of appointment, and allowing the children to act without settlor consent only unanimously gives just as much if not more access to the trust as if John and Jane were named beneficiaries – as long as at least one of the children is a Cordelia rather than a greedy Goneril or Regan.[53] In most families, John and Jane should not fear the *King Lear* effect. In my experience, most people trust their children far more than their attorney, financial advisor or bank trust department anyway.

Therefore, with a modicum of creativity, we can use a DING to legitimately avoid Oregon taxation of trust income except to the extent a current year's income is distributed via K-1 to an Oregon resident beneficiary. A domestic asset protection trust statute is recommended for such "DINGs" to avoid grantor trust status, since any potential for creditor access to ordinary self-settled trusts would lead to a finding of grantor trust status. Washington state, though it has no income tax, is not a good candidate for such a trust's situs due to its lack of clear creditor protection through a DAPT statute.[54]

However, while there are dozens of DING PLRs on the books now, some practitioners may be nervous about drafting such trusts. After all, if the tax law were obvious, some would argue, there would not be so many people seeking PLRs! While many attorneys are comfortable drafting such trusts based on the reasoning and statutes/regulations cited in the PLRs, some may not be. Are there other options?

Completed Gift, Non-Grantor Trusts

With $5.43 million of exclusion, potentially double for married couples, some clients may not care about using up some of their estate/gift exclusion. Using completed gift trusts may have the double benefit of leveraging the gift and estate tax exclusion, removing growth from the federal estate tax base, and potentially saving a 16% Oregon estate tax as well.

To create a completed gift non-grantor trust, you simply use a DING without the features that make the gift incomplete (or alternatively, remove or add provisions in your standard irrevocable grantor trust that make the trust a grantor trust). This would mean removing settlor limited powers of appointment, veto powers, powers of substitution and the like and keeping the adverse party distribution structure for any distributions to the settlor and/or spouse to avoid grantor trust status.

Some practitioners would feel more comfortable with completed gift trusts as being less "cutting edge" or susceptible to adverse ruling. And, they would certainly have additional state and/or federal estate tax benefit in many cases. However, completed gift trusts would potentially be wasteful of exclusion to the extent funds were eventually returned to the settlor/spouse's estate tax base, and it would of course be limited to the amount of exclusion available. There may be ways to leverage such amounts, such as Crummey powers, GRAT pourovers and the like, but these are beyond the scope of this article. Suffice it to say that the incomplete gift trust is more palatable for wealthier clients, but the completed gift trust may

50 This is assuming there is not an alternative Oregon "source" trigger.

51 For extensive discussion of how the trustee and family can manipulate this, or use beneficiary grantor trust status to alternatively shift, trap or toggle income, see The Optimal Basis Increase and Income Tax Efficiency Trust, a white paper available that incorporates several published articles therein: http://ssrn.com/abstract=2436964. A very early version of this paper was presented to the Portland Estate Planning Council March 13, 2013.

52 IRC § 677(a)

53 To sum up the play, the King gave away the kingdom to two ungrateful daughters rather than the caring one and regretted it.

54 See Ohio R.C. §5805.06(B)(3), discussed in greater detail in 2013 OSBA Annual Conference on Wealth Transfer Planning CLE material, with comparisons between DAPTs and Power Trusts.

also be part of the solution. For those mere single digit millionaires with estates well under $10.86 million, the completed gift trust option is more viable, and has many other uses.[55]

When Non-Grantor Trusts Are More Efficient for Federal Income Tax Regardless of State

Although trusts reach the highest 39.6% bracket and 3.8% surtax bracket at only $12,300, if settlors are otherwise in that same bracket (or perhaps merely close), there are features that make non-grantor trust taxation more attractive. Despite the Supreme Court's decision in *Knight*, there is still the opportunity for trusts to avail themselves of better above the line deductions than individuals.[56]

For those charitably minded, there is even more benefit. Deductions to charity from a trust's gross income are not limited to US domestic charities, they are not subject to any AGI limitation, nor are they subject to Pease limitations.[57] Furthermore, they are eligible for a one-year lookback. Imagine if we could make a donation in December of 2015 and make it count against our 2014 income! Furthermore, they can be limited to coming from higher income rate categories provided the provision has an economic effect.[58]

More importantly, there is a far superior opportunity to shift income to beneficiaries in lower tax brackets. E.g. if a distribution is made carrying out capital gains or qualified dividends to a beneficiary in one of the lower tax brackets, their federal tax rate on this income is 0%. This threshold is higher than many people think – for a married beneficiary filing jointly, this bracket is up to $74,900 taxable income (which is after deductions, so this may be a much higher AGI or gross income). Thus, if the trust makes distributions of $28,000 to three children in such lower brackets, the $84,000 passes gift tax free due to the annual exclusion (assuming the settlor and spouse gift split), and shifts $84,000 to children in a 0% tax bracket. In practical effect, getting a tax deduction for annual exclusion gifts to the kids.

There are even greater advantages that may be had using a charitable remainder trust as an appointee of trust distributions. This will be the subject of a future article to be published in fall of 2015.

Conclusion

To summarize, establishing a non-grantor, non-resident trust in the manner contemplated in the first part of this article can legitimately avoid 9.9% Oregon income taxes

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55 E.g., see *The Upstream Optimal Basis Increase Trust*, CCH Estate Planning Review, May 2014, Morrow

56 IRC §67(e)

57 Pease limitations do not apply to non-grantor trusts and estates. IRC §68(e)

58 For a more extensive discussion, see other DING/OBIT CLE materials from author cited herein

Portland Luncheon Series

The Section holds a monthly lunch and CLE in Portland at the Red Star Tavern, 503 SW Alder Street, Portland. The cost to attend the luncheon is $32, and reservations or cancellations should be made at least 7 days before the luncheon. This information, and other Section information, is available on the Taxation Section's website at: *http://www.osbartax.com/Events/view/Portland-Luncheon-Series*.

September 17, 2015
Oregon Legislative Update
12:00 - 1:30 p.m.
Presenter: Robert Manicke
Stoel Rives

October 15, 2015
Developments in Federal Criminal Tax
12:00 - 1:30 p.m.
Presenter: Bob Weaver
Garvey Schubert Barer

November 19, 2015
Perspectives and Updates from the Bench
12:00 - 1:30 p.m.
Presenter: Judge Henry Breithaupt
Oregon Tax Court

on traditional portfolio income, including capital gains and including sales of closely held C corps, income from pass through entities owning out of state property or out of state businesses, or proceeds of pure stock sales of S Corps, LLCs and LPs, provided they are manager managed.

The use of either completed or incomplete gift non grantor trusts discussed above has significant asset protection, family management and even federal income tax benefits for taxpayers with income above the highest income tax bracket that are beyond the scope of this article. For anyone not in the highest two federal tax brackets, income trapped in trust at the highest income tax bracket starting at only $12,300 of taxable income is too high a price to pay to make any trust strategy avoiding Oregon income tax worthwhile. The clients for whom such a strategy is most useful are those wealthy enough to have significant annual income above the highest federal tax bracket –over half a million dollars, or anticipate future income to be well over that due to anticipated capital gains or other windfall. Oregonians in this category typically have a second residence in Washington, Florida or elsewhere, so perhaps such techniques can entice them from changing their domicile completely.

Income Tax Issues Impacting Oregon's Medical Marijuana Businesses

Bernard Chamberlain[1]

Rumor has it that Oregon produces quality marijuana. The reputation suggests marijuana cultivation is not a new business in Oregon. Certainly, recurrent news stories of drug and property seizures by law enforcement suggest it is an established industry. However, legal developments from 2013 through the present have accelerated the transition many Oregon marijuana businesses are making from underground to above-ground businesses. As they start to exist on paper, many of these businesses have turned their attention to compliance with federal and Oregon income tax law. This article is intended as a brief introduction to these businesses and the tax issues that arise when advising them on tax matters.

Criminal Law and Regulatory Background

Before discussing tax issues impacting Oregon marijuana businesses, a discussion of the non-tax rules which impact business structures in the marijuana industry is important. Common missteps in tax planning can be avoided if a practitioner is familiar with these rules. Federal enforcement priorities, Oregon criminal law, and Oregon Ballot Measure 91 ("Measure 91") all impact the structure of Oregon marijuana businesses.

The Cole Memo

The decision by the federal government not to enforce federal prohibitions against certain marijuana activities has created a zone within which above-ground marijuana activities exist. The federal Controlled Substances Act ("CSA") imposes significant criminal penalties on persons and organizations involved in the production and sale of marijuana. However, a business that does not interfere with federal enforcement priorities can be reasonably assured that it will not be prosecuted under the CSA.

Federal enforcement priorities were outlined in bulleted form in a Department of Justice memorandum dated August 29, 2013 (the "Cole Memo").[2] Federal attorneys were instructed to focus resources and efforts, including prosecution, on persons or organizations whose conduct interferes with the federal enforcement priorities. In addition, the Cole Memo provides that the federal government may challenge state regulatory structures that do not sufficiently protect the enforcement priorities.

The enforcement priorities listed in the Cole Memo are relatively straightforward. They include preventing the "diversion" of marijuana from states where it is legal to other states, preventing the use of state-authorized marijuana activity as a pretext for other illegal activity, and preventing the distribution of marijuana to minors.

Despite the comfort found by marijuana business persons in the Cole Memo, it is important to recognize that Federal investigation and prosecution of Oregon marijuana businesses continued after the release of the memo and continues at this time. The Cole Memo provides that it does not operate as a legal defense to the enforcement of federal law. A marijuana business that engages in activities that interfere with federal enforcement priorities does so at the very real risk of federal prosecution.

Oregon Medical Marijuana Act

Oregon criminal statutes impact the structure of Oregon marijuana business currently in operation. Specifically, an Oregon marijuana business must comply with the Oregon Medical Marijuana Act ("OMMA") to operate legally under state law.[3] This will presumably continue until the first licenses are issued under Measure 91.

OMMA operates as an affirmative defense to criminal prosecution for patients, growers, caregivers, and individuals operating dispensaries.[4] An Oregon marijuana business that does not operate as described in OMMA exposes its owners, employees, and others to potential criminal prosecution under state and federal law.

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1 Bernard Chamberlain is a shareholder with Emerge Law Group, where he practices in the areas of tax, business and estate planning.

2 http://www.justice.gov/iso/opa/resources/3052013829132756857467.pdf

3 ORS 475.300 et seq.

4 ORS 475.319.

Until recently, OMMA encouraged the use of business entities to arguably create permitted reimbursable expenses under the law. Until the passage of HB 3400 in the 2015 legislative session, and its signing by the governor, OMMA contained reimbursement provisions that limited the amount a grower or dispensary could receive for the sale of marijuana to the amount of the reimbursable expenses of the business.[5] [6]

Under OMMA's reimbursement provisions, many growers formed business entities so that they could cause themselves to be paid for services, rather than operating as sole proprietors and limiting their reimbursable expenses to payments to third parties. From July 1, 2015, the reimbursement provisions have been eliminated.

OMMA also provided, and seemingly continues to provide, that marijuana produced by a grower must be treated as the property of a patient. Before July 1, 2015, this requirement was contained in the reimbursement provisions and apparent from the Medical Marijuana Transfer Authorization Form required by the Oregon Health Authority ("OHA") for each transfer to a dispensary.[7] From July 1, 2015, the property requirement remains a slightly altered form.[8]

Dispensaries need not contend with questions about the ownership of their inventory, but they must register with the OHA and the rules for obtaining and maintaining a registration are unwieldy. Thus far, OHA inspectors have tended to be pragmatic. Dispensaries are required to organize as business entities to be registered with the OHA. They are permitted to own the marijuana they sell.[9]

HB 3400 recently added a two-year residency requirement for medical marijuana businesses that may by applied to owners of the business. The statutory language was vague, however, and OLCC is expected to issue regulations clarifying the new requirement.[10] The effective date of the new residency requirement is March 1, 2016.

Measure 91

Measure 91 was passed by the voters on November 4, 2014. Measure 91 permits adults over the age of 21 to possess limited amounts of marijuana for personal use and directs the Oregon Liquor Control Commission ("OLCC") to put in place a system for licensing and regulating marijuana businesses. Personal use became legal of July 1, 2015. The OLCC will start accepting license applications January 4, 2016.

Measure 91 businesses are not expected to be allowed to operated until well into 2016. The OLCC will issue licenses for Measure 91 businesses including producers, processors, wholesalers, retailers, and, it is expected, labs.[11] The first licensed retail outlets are expected to to open sometime in the second half of 2016.[12]

Measure 91 contained tax provisions. It initially imposed a tax on growers of $35 per ounce. For a variety of reasons, that tax has been replaced by a 17 to 20 percent sales tax.[13] Measure 91 also added an IRC § 280E subtraction to the personal and corporate income tax statutes. These subtractions are intended to eliminate the effect of IRC § 280E on the calculation of Oregon individual and corporate income tax. Measure 91 does not incorporate a reimbursement model or patient ownership of marijuana.

Tax Background

Section 280E

Marijuana businesses face a significant challenge to profitability in IRC § 280E. The provision reads, in its entirety, as follows:

> No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.

IRC § 280E.

The elements of IRC § 280E are generally met by Oregon marijuana businesses engaged in a trade or business where its activities include the transfer of possession

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5 See ORS 475.304(7), 475.314(9). The reimbursement and property provisions of OMMA only make sense if one recognizes the law was intended to allow a patient to establish a relationship with a grower without running afoul of criminal prohibitions. It was assumed that growers would be willing to gift much of the resources and effort required to produce the patient's marijuana.

6 Under the reimbursement provisions, the patients were permitted to reimburse a grower for the cost of supplies and utilities, but not other costs. If a patient authorized the transfer of marijuana to a dispensary, OMMA provided that the dispensary was permitted reimburse the grower for the grower's "normal and customary costs of doing business." When the dispensary sold the marijuana to a patient, the patient was permitted to reimburse the dispensary for its normal and customary costs of doing business.

7 http://www.oregon.gov/oha/mmj/Documents/MM%20Transfer%20Authorization%20Form.pdf

8 See HB 3400, Section 83.

9 Despite the name, dispensaries essentially operate as retail stores with limited production activities.

10 See Oregon Marijuana Laws: The Status of Residency Requirements After HB 3400, Parts 1 and 2, at www.emergelawgroup.com/blog.

11 http://www.oregon.gov/olcc/marijuana/Pages/Frequently-Asked-Questions.aspx

12 Id.

13 HB 2041, signed by Governor Kate Brown on July 20, 2015.

of marijuana. Marijuana and its derivatives are listed as a Schedule I controlled substance under the CSA.[14] The federal prohibition trafficking activities includes a transfer of possession of marijuana in exchange for payment.[15] However, criminal distribution of marijuana does not necessarily involve payment.[16]

When advising a marijuana business that does not directly deal in marijuana, it is important to consider that (1) the criminal law concept of prohibited trafficking activities may include activities that do not, at first blush, appear to be trafficking activities, (2) concepts like beneficial ownership or legal title, while relevant for tax purposes, may not be relevant under the CSA. Thus, a person that directs the operation of a trafficking business through a consulting or management services arrangement is likely subject to IRC § 280E. Similarly, a trade or business that includes the processing of marijuana that is the property of another is likely to be subject to IRC § 280E. Although it seems intuitive that the criminal law concept of accessory liability would not implicate IRC § 280E, it is surprisingly difficult to articulate why.[17]

CHAMP and Olive

There are two cases applying IRC § 280E to marijuana businesses that were legal under state law. Both involved dispensaries located in California.

The first case is *Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner (CHAMP)*.[18] That case involved a California nonprofit public benefit corporation. It did not have a federal tax-exempt status. It operated at approximately break-even. Its customers had AIDS, cancer, multiple sclerosis, and other serious diseases. They paid membership fees in exchange for benefits. Management allocated the fees between marijuana and caregiving services. The caregiving services provided were extensive. Its director had 13 years of experience in healthcare services coordinating a state-wide program training outreach workers in AIDS prevention. It was closing its doors and the IRS audited its final return.

There were three key issues in *CHAMP*. The first issue was whether supplying marijuana in compliance with state law is trafficking for purposes of IRC § 280E. Interpreting the text of the statute, the court held that the sale of marijuana in violation of federal law is trafficking for purposes of IRC § 280E, regardless of state law implications. The second issue was whether IRC § 280E applies to a non-trafficking trade or business engaged in by a taxpayer who also traffics in marijuana. The court held that IRC § 280E does not apply to a second, non-trafficking trade or business. The third issue was whether IRC § disallows the adjustment to gross receipts for the cost of goods sold. The court held the adjustment for the cost of goods sold, apparently including indirect costs, was an adjustment to gross income permitted IRC § 280E.

The second medical marijuana case is *Olive v. Commissioner*.[19] The taxpayer in *Olive* operated a business selling marijuana for medical purposes. The business also provided massages, snacks, and movies and educated patrons as to the benefits of medical marijuana, but apparently did not charge for such services. The taxpayer failed to maintain books and records sufficient to allow the Commissioner to verify the taxpayer's income and expenditures.

The issues presented to the Tax Court in *Olive* were essentially the same as those presented in *CHAMP*. On the first issue, apparently in response to an argument that the disallowance of IRC § 280E applies only to expenditures attributable to the sales transaction, the court held that IRC § 280E applies to deductible expenditures of the trade or business as a whole. On the second issue, the court determined that the limited provision of massages, snacks, and movies did not amount to a separate non-trafficking trade or business. On the third issue, after applying the *Cohan* rule to find the taxpayer's cost of good sold (COGS) was approximately 75% of its gross receipts, the court applied the adjustment to gross receipts for the cost of goods sold. As in *CHAMP*, COGS included indirect costs. The Tax Court decision in *Olive* was upheld by the Ninth Circuit on July 9, 2015.

Inventory Accounting

In both *CHAMP* and *Olive*, the taxpayer was permitted to allocate indirect costs to inventory, thereby increasing its COGS. However, the ability of a taxpayer engaged in production or resale activities to use inventories should not be a foregone conclusion. Authority for the allocation of indirect costs to inventory exists under IRC § 471.[20]

Care must be taken to confirm a taxpayer may use inventories. A taxpayer that does not hold title to the property being produced is not entitled to include that property in inventory.[21] There are three scenarios where this issue is likely to arise. Those scenarios are discussed in turn. An additional obstacle to the use of inventories is a failure of a marijuana business with established accounting methods to obtain consent of the IRS Commissioner

14 http://www.deadiversion.usdoj.gov/21cfr/cfr/1308/1308_11.htm

15 *Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner*, 128 T.C. No. 173 (5/15/2007).

16 See 21 USC § 802(11), providing a definition for criminal distribution.

17 When the author suggested to an IRS attorney that IRC § 280E may not incorporate the criminal law concept of accessory liability, the IRS attorney responded that IRS attorneys "took the bar exam."

18 128 T.C. No. 173 (5/15/2007).

19 139 T.C. No. 2 (8/2/2012), aff'd 9th Cir. (7/9/2015).

20 Note that authority for inventory allocations likely does not exist under IRC § 263A because the flush language in IRC § 263A(a) appears to prevent the allocation of otherwise non-deductible expenditures to inventory. CCA 201504011 (December 10, 2014).

21 Treas. Reg. § 1.471-1.

to a change of to a more favorable, inventory-oriented method.

The most common scenario involves the typical Oregon grow. A grower operating in compliance with OMMA may not have sufficient ownership of the plants being grown to treat those plants as inventory. Recall that OMMA provides that the plants must be the "property" of the patient.[22] This language is echoed in the transfer authorization forms required by the OHA for each transfer of marijuana to a dispensary.

The solution to this problem appears to be to determine whether the grow has sufficient benefits and burdens of ownership to treat itself as the owner of the marijuana for income tax purposes.[23] However, such an approach has the potential to raise OMMA compliance issues and therefore concerns about criminal liability.

A second common scenario involves an Oregon marijuana processor. Many processors operate as a service providers. Their customers are frequently the growers and dispensaries that wish to convert marijuana into an extract or edible product. While this arrangement structure may exist in compliance with OMMA, the processor still engages in federally prohibited trafficking activities when it transfers processed marijuana. Accordingly, it finds itself engaged in production of another taxpayer's inventory. Under IRC § 280E, the processor's business will give rise to income tax on its gross receipts.

As with the OMMA compliant grower, the solution to this problem appears to be careful structuring of the processors commercial relationships. Note also that for various factual reasons, the processor is less likely to be able to argue ownership under income tax principles than a grower. The importance of carefully drafted commercial contracts may therefore be more significant.

A third scenario involves an Oregon dispensary accepting marijuana from a grower as a consignee. The arrangement, if clearly consignment, eliminates any argument the dispensary may have for using inventories, at least as to the marijuana held on consignment. In addition, the grower selling marijuana on consignment is prevented from deducting the commission paid to the dispensary because it is a selling expense not allocable to inventory. The solution in this case is simply advising dispensary clients to avoid consignment and to purchase marijuana on standard terms.

In the preceding scenarios, an inability to use inventories would create significant challenges. As a service business, the grower would be unable to deduct any expenditures relating to his or her business. Assuming a gross margin of 50%, the grower's taxable income could be twice that of a grower able to use inventories. However, at least for 2014 and the first half of 2015, the increase in income would likely be more dramatic, as both growers and dispensaries are required to operate at break-even to comply with OMMA.

Finally, the aggressive and routine allocation of indirect costs to inventory or non-trafficking costs to a non-trafficking trade or business raises difficult questions from the risk management perspective. The issue is that the IRS generally has broad authority to adjust a taxpayer's accounting where it believes the adjustments will result in a clearer reflection of income.[24] Clients should be advised of this potential for significant increases to the tax liability attributable to the business where it exists.

Tax Factors Impacting Choice of Entity

The remainder of this article focuses on the factors that are most relevant to choice of business entity decisions for Oregon marijuana businesses. These factors are: entity-level taxation, separation of trafficking activities from other activities, and the interplay between IRC § 280E and pass-through entity structures.

Entity-Level Taxation

The factor of entity-level taxation (the "keep it off my return" factor) raises by implication the issue of owner liability for taxes attributable to the activities of the marijuana business. A C corporation is generally liable for incomes taxes attributable to its business activities. Contrast that with pass-through entities, such as partnerships and S corporations, which are generally not subject to income tax,[25] but whose owners must include the income attributable to the activities of such entities in calculating their individual taxes.[26]

The principals of a marijuana business, especially outside investors, should be aware of this difference and risks posed by IRC § 280E and the risks associated with the IRS challenging aggressive inventory accounting techniques. Under IRC § 280E, a business does not need to make money to generate a significant tax liability.

Non-Trafficking Activities

Formation of a second business entity may support a finding of a second trade or business. The determination is based on the facts and circumstances. Due to a general lack of sophistication in formal business processes, many marijuana businesses are unlikely to be able to take advantage of the second-trade or business model suggested by the *CHAMP* case. This also results from the practical difficulty of starting two businesses simultaneously.

However, in some cases, a client may have conceived of multiple bona fide businesses and have the capability to operate those businesses concurrently. In such cases, at a minimum, attention should be paid to separation of ownership, management, books of account, economic inter-

22 See ORS 475.304(5) (2013); see HB 3400, Section 83.

23 See Paccar, Inc. v. Commissioner, 85 TC 754 (1985).

24 See IRC § 446.

25 IRC §§ 701, 1363.

26 IRC §§ 702, 1366.

relationship between the businesses, and other factors.[27] In addition, the Tax Court in *CHAMP* and *Olive* and the Ninth Circuit in *Olive* have placed particular emphasis on the ability of the non-trafficking business to generate revenue.

Interplay Between IRC § 280E and Pass-Through Structures

The interplay between IRC § 280E and pass-through entity taxation can cause a single dollar of income to be included in income by multiple taxpayers or multiple times by a single taxpayer. This is a common issue in the structuring of marijuana businesses. For example, a dispensary may be operated by an S corporation that leases real property from a sister entity that is a disregarded entity for tax purposes. For one hundred dollars of rent, a deduction of fifty dollars may be disallowed. The same fifty dollars would be included in the income of the owner as rent and as an increase to the owner's pro-rata share of income attributable to the dispensary.[28]

To avoid the common problem of income duplication, related party payments by a trafficking entity should be analyzed for potential inclusion in inventory. Common related party payments include wages, rent, and interest. Owner employee wages will typically be only partly allocable to inventory because of time spend on non-inventory related activities. Rent of a dispensary typically will be only partly allocable to inventory, but timing differences may allow an owner to defer income taxes.[29] Interest is not allocable to inventory.[30] Marketing, advertising, selling, and distribution expenses are not allocable to inventory.[31]

Wages paid to owner-employees may be an example of unavoidable income duplication. Reasonable compensation requirements applicable to entities classified as corporations for tax purposes require that wages be paid, even if a portion of the wage deduction is disallowed under IRC § 280E. The alternative is to use a partnership taxed entity and to compensate partners for their services with allocations of profit (rather than guaranteed payments).[32] However, many business owners will forego the potential tax savings of a partnership-taxed entity to achieve the entity-level taxation of a C corporation.

27 See e.g., Trupp v. Commissioner, TCM 2012-108 (2012) determining whether a taxpayer's undertaking constituted a single or multiple undertaking for purposes of the hobby-loss rules under IRC § 183.

28 See IRC §§ 702 and 1366.

29 Allocation of depreciation to inventory is limited to depreciation reported by the taxpayer in its financial reports. Treas. Reg. § 1.471-11(c)(2)(iii).

30 Treas. Reg. § 1.471-11(c)(2)(ii).

31 Treas. Reg. § 1.471-11(c)(2)(ii).

32 A payment to partner other than in his or her capacity as a partner, a guaranteed payment, is treated as a deduction to the partnership and would therefore presumably be disallowed under IRC § 280E. IRC § 707(c).

Conclusion

The rapidly changing landscape for Oregon marijuana businesses presents ongoing challenges for marijuana business and the professionals advising them. In the area of tax advising and planning, conventional wisdom may not be a reliable guide because of unfamiliar business practices and the effects of IRC § 280E. Accordingly, tax practitioners that re-evaluate common planning techniques in light of the unusual characteristics of Oregon marijuana businesses are in a position to provide beneficial structuring advice to these businesses.

Taxation in Popular Culture: The Blues Brothers[1]

By Dan Eller[2]

The day Jake Blues is released from jail, his brother Elwood takes Jake to see the "Penguin," a nun at the St. Helen of the Blessed Shroud Orphanage (the "Orphanage"). Jake had promised to see the Penguin the day he was released, and Elwood is driven to ensure Jake honors that promise. The Penguin informs the Blues Brothers that the county assessor had taken a property tax assessment in the last month, and had assessed $5,000 against the Orphanage.

Shortly after meeting with the Penguin, the Blues Brothers learn from Curtis, a long-time Orphanage employee and uncle figure, that the Orphanage has eleven days in which to pay the tax assessment. Curtis also tells Jake to get wise and get to church. Showing some latent wisdom (or at least respect), Jake and Elwood go to the Triple Rock Church. While there, Jake literally sees The Light, sending the Blues Brothers on a "Mission from God" that (Spoiler Alert!)[3] leads to them paying the $5,000 assessment at the expiration of the eleven-day deadline.

In order to evaluate the tax aspects of this movie, I need to take an important liberty with the plot: I will assume this story happened in Oregon, not Illinois. If the Orphanage was located in Oregon, we start to see at least two important potential tax-related plot problems.

First, we learn the Orphanage appears to be affiliated with a church. The Penguin tells the Blues Brothers that

1 *The Blues Brothers* (Universal Pictures 1980).

2 Dan Eller is a shareholder in the Portland, OR office of Schwabe, Williamson & Wyatt, who focuses his practice in the areas of tax and business law, advising clients with both transactional and controversy matters. Dan is currently Chair of the Oregon State Bar Taxation Section.

3 In fact, no "spoiler alert" is required because (1) if you have not seen *The Blues Brothers* by now, well, you know you really do not care; and (2) come on, they were on a Mission from God – how could they fail?

the Arch Bishop wants to sell the Orphanage to the Board of Education. If the Orphanage is part of a church, its property should be exempt under ORS 307.140 which, in general, exempts from property taxation property of religious organizations. If the Orphanage is not part of a church or other religious entity, it would probably be a charitable organization qualifying under ORS 307.130. With that in mind, it is difficult to see why the Orphanage would be subject to any amount of property tax. Then again, it is also difficult to see how a used cop car can jump an open bridge span or how John Belushi could do back flips through the Church. In the case of the Orphanage, it is possible it was engaged in some unrelated activity or had some noncompliant parking that caused the assessment. Unfortunately, we cannot tell from the facts of the movie why an assessment might have been appropriate.

Second, the Penguin tells the Blues Brothers that the assessor was just out there within the last month or so, and Curtis informed them that an assessment was due in eleven days. Moreover, we are led to believe that failure to pay the assessment could lead to the property being sold. Given the statements of the Penguin and Curtis, the assessment appears to have been due no more than 60 days after the assessment. One could question the veracity of the taxpayer's statement regarding the date of the assessor's initial visit. Taxpayers facing assessments often get to that point by ignoring deadlines and correspondence from the Department of Revenue (thus, understating the relevant time periods). Here, however, the information regarding the assessor's visit comes from the Penguin, who seems pretty credible. After all, she is a nun. Plus, she wields a pretty mean ruler I would not care to meet for saying otherwise.

Sixty days is simply not enough time for the assessor to foreclose on the property. If the assessment was in the normal course, the Orphanage should have had many months to pay the assessment before the assessor could begin enforced collection activities. If the assessment was due to an omitted property tax assessment or the revocation in whole or part of the Orphanage's tax exemption, the Orphanage should have been provided at least 90 days to appeal such a determination.

It is possible, however, that the deadline has nothing to do with tax procedure. The Penguin tells the Blues Brothers that the Arch Bishop wants to sell the Orphanage to the Board of Education. Given the Blues Brothers are required to meet a deadline at the county, however, the deadline at issue appears to be driven by the assessor, not the Arch Bishop. With that in mind, it remains hard to understand how the assessor could have acted so quickly and why the Orphanage would not have had time remaining -- beyond the eleven days -- in which to either pay the assessment or appeal the act of the assessor.

In the end, this is one of those movies that gets all of the breaks. The overall quality of the underlying story, acting, and musical performances outweighs most, if not all, of the tax problems with the movie. For this reason, I rate this movie the Beer Excise Tax. Most beer drinkers would agree that an excise tax on beer is just a bad idea -- but those folks like beer so much they just look the other way when it comes to the excise tax. That is my assessment of *The Blues Brothers* -- whatever its tax missteps might be, it is still a classic.

Larry J. Brant Wins Award of Merit

By Caitlin M. Wong[1]

To Larry Brant professionalism requires a commitment to continuously develop substantive knowledge of tax law, giving back to the profession on a regular and sustained basis, and treating others the way you want to be treated. Larry's relentless pursuit of professionalism is one of the many reasons the OSB Taxation Section chose Larry as the 2015 Award of Merit recipient. The award recognizes and honors tax attorneys who exemplify professionalism in the practice of tax law and serve as a role model for other attorneys, particularly younger attorneys. Key considerations include reputation, conduct, leadership activities and service to the bar or community in general, and pro bono service.

Born in the Pacific Northwest, Larry began his intellectual development at Portland State University where he majored in Business Administration and graduated with honors in 1981. He continued his academic pursuits at the Willamette College of Law and graduated with honors in 1984. A litigator for his first two years of practice, Larry became attracted to tax law by the intellectual challenge and the respect and support shown among members of the tax community (even when working through tax controversies). He met with Gersham Goldstein who advised him to get an LL.M. in Taxation. The next year, Larry began the LL.M. program at the University of Florida Levin College of Law. He graduated in 1987 and returned to Portland. Today a shareholder at Garvey Schubert Barer, Larry satisfies his thirst for knowledge by spending an hour or two each day reading and writing tax articles and publications. He encourages young tax attorneys to follow in his footsteps and develop themselves by focusing significant energy on building their knowledge of substantive tax law.

Mentoring new practitioners is only one of the many ways Larry gives back to the tax community. Larry's prolific writing career (he has authored over 27 tax-related articles to date) and frequent speaking engagements are inspired by his desire to share his knowledge with other tax practitioners in Oregon and across the nation.

1 Caitlin Wong is an attorney at Black Helterline LLP whose practice focuses on taxation, business, and estate planning. She is also the current chair of the New Tax Lawyers Committee.

For the last few years, Larry has presented at NYU's Institute on Federal Taxation. He has additionally served the OSB Taxation Section through his involvement with the Oregon Tax Institute (he helped organize the committee and served as its chair or co-chair for four of the last six years), the Portland Luncheon Series, and as an officer and member of the Taxation Section's Executive Committee. He is on the Board of Directors for the Portland Tax Forum and teaches Corporate Taxation as an adjunct professor at Lewis & Clark Law School. He is an editor for Thomson Reuters Checkpoint Catalyst and maintains a blog, Larry's Tax Law.[2]

Larry pursues everything he does with enthusiasm and energy. He is constantly in motion. Yet, in addition to fitting in an occasional game of golf, Larry prioritizes taking the time to adhere to the golden rule of treating others the way he wants to be treated. He timely returns telephone calls and emails. He discusses new developments and questions on tax law with colleagues. He has contributed tremendously to the OSB Taxation Section and Oregon's community of tax practitioners through his volunteerism, publications, and speaking. He is a mentor and role model for young tax attorneys.

The OSB Taxation Section presented Larry with the award on June 4 at the Oregon Tax Institute. Larry expressed gratitude to the Section: "I am truly honored and humbled by this recognition from the Oregon State Bar. The OSB Tax Section is comprised of a wonderful group of talented tax practitioners, making receiving this award very meaningful."

Prior recipients of the Award of Merit include Mark Golding (2014), the Honorable Henry C. Breithaupt (2013), John Draneas (2012), Robert Manicke (2010), and David Culpepper (2009). Nominations are now being accepted for the 2016 Award of Merit. Nominations must be submitted by April 15, 2016. Any current or former member of the OSB is eligible to receive the OSB Taxation Section Award of Merit as described in the award standards and guidelines. The Award is granted to the candidate whom the Executive Committee believes to best personify the Oregon State Bar's Statement of Professionalism, and best serves as a role model for other lawyers. Factors considered include reputation, conduct, leadership activities and service within the bar or the community in general, and pro bono service. The candidate's accomplishments must fall within the tax field. Additional information and the nomination form are available on the Taxation Section's website at http://osbartax.com/Award-of-Merit.

2 Larry's Tax Law is available at www.larrystaxlaw.com.

Seeking Nominations for the New Tax Lawyer Committee

The Tax Section's New Tax Lawyer Committee (NTLC) is seeking nominees to serve as 2016 officers and work group leaders. NTLC officers and work group leaders serve one-year terms beginning each January 1st. A description of each officer's duties can be found at http://tinyurl.com/p2djww6, and each work group is described at http://tinyurl.com/p328she.

Nominees must be members of the Oregon State Bar Tax Section and NTLC eligible, meaning attorneys in their first 10 years of practice or who have been members of the Tax Section for less than five years. Participating in the NTLC can be a great opportunity to network with other practitioners, develop leadership skills, and gain exposure to substantive tax issues.

Please email nominations to NTLC.slating@gmail.com by Friday, September 25th. Elections will be held at the NTLC's monthly meeting on Monday, October 5, 2015.

Visit the website (www.osbartax.com/New-Tax-Lawyer-Committee) or contact NTLC Chair Caitlin Wong at cmw@bhlaw.com with questions.

Call for Nominations OSB Taxation Section Executive Committee

The Taxation Section is soliciting nominations for the 2016 Executive Committee of the Oregon State Bar Taxation Section.

The Executive Committee supervises the Taxation Section's activities, including integration of new tax lawyers; law student sponsorships; legislation and rule-making; CLEs such as the Oregon Tax Institute, monthly luncheon series in Portland and Salem, and Broadbrush Taxation; the Section's newsletter and the Section's website.

Members of the Executive Committee must be members in good standing of the Taxation Section. The Bar's bylaws charge the Nominating Committee with using reasonable efforts to ensure that the members nominated reflect the diversity of the Section, the Bar and the community at large, including factors such as practice area, office location, age, gender, race, ethnicity, disability and sexual orientation.

To receive full consideration by the Nominating Committee, nominations must be submitted no later than **Monday, August 31, 2015** via email to this year's Nominating Committee chair at jtarr@sussmanshank.com. Self-nominations are acceptable. Along with a professional bio or resume, we request a statement explaining (i)

in what ways the nominee would contribute to the work of the Executive Committee, (ii) relevant experience, and (iii) application of any of the diversity factors listed above.

The Nominating Committee will develop a slate of one candidate per open position by September 22, 2015. The election will be held at the Taxation Section's annual meeting on October 24, 2015. Nominations from the floor will be accepted at that meeting.

Future Events

Sep 14, 2015
New Tax Lawyer Committee: NTLC Monthly Meeting
Portland
Host: Matt Erdman
Noon-1:00 p.m., Legal Aid Services of Oregon

Sep 16, 2015
New Tax Lawyer Committee: Pub Talk: Intake and Management of Clients with Tax Issues
Portland
Presenter: Dan Eller, *Schwabe, Williamson & Wyatt*
5:30-7:00 p.m., *The Original*

Sep 16, 2015
Portland Luncheon Series: Oregon Legislative Update
Portland
12:00 - 1:30 p.m.
Presenter: Robert Manicke, *Stoel Rives LLP*

Oct 05, 2015
New Tax Lawyer Committee: NTLC Monthly Meeting
Portland
Host: Sarah Adams
Noon-1:00 p.m., Catholic Charities (2470 SE Powell Blvd., Rm. 400)

Oct 15, 2015
Portland Luncheon Series: Developments in Federal Criminal Tax
Portland
12:00 - 1:30 p.m.
Presenter: Bob Weaver, *Garvey Schubert Barer*

Oct 20, 2015
Mid-Valley Tax Forum Luncheon Series: Oregon Tax Law Update and Introduction to New Department of Revenue Software System
Salem
12:00 - 1:30 p.m.
Presenter: Oregon Department of Revenue

Nov 02, 2015
New Tax Lawyer Committee: NTLC Monthly Meeting
Portland
Host: Jeremy Babener
Noon-1:00 p.m., *Lane Powell PC* (601 SW 2nd Ave., Ste. 2100)

Nov 17, 2015
Mid-Valley Tax Forum Luncheon Series: What Are All of These Partnership Agreement Provisions Anyway, and Can I Get Rid of Any of Them?
Salem
12:00 - 1:30 p.m.
Presenter: Dan Eller, *Schwabe, Williamson & Wyatt.*

Nov 18, 2015
New Tax Lawyer Committee: New Tax Lawyer Social
Portland
5:30-7:00 p.m., *The Original*

Nov 19, 2015
Portland Luncheon Series: Perspectives and Updates from the Bench
Portland
12:00 - 1:30 p.m.
Presenter: Judge Henry Breithaupt, Oregon Tax Court

Dec 07, 2015
New Tax Lawyer Committee: NTLC Monthly Meeting
Portland
Host: Dustin Swanson
Noon-1:00 p.m., *Stoel Rives LLP* (900 SW 5th Ave., Ste. 2600)