OREGON STATE BAR

Taxation Section

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In This Issue:

Application of the "Passive Loss" Restrictions to Members of Limited Liability Companies

*By: Marc K. Sellers**

For purposes of section 469 of the Internal Revenue Code of 1986[1], members of an Oregon member-managed LLC are to be treated as general partners in a partnership. The government doesn't like it, but that is the current state of the law. This article addresses the Oregon Federal District Court's recent decision in *Gregg v. United States*, 186 F. Supp. 2d. 1123 (D. Or. 2000), the first case to address the treatment of LLC members for purposes of the "passive loss" restrictions of section 469.

Federal tax law recognizes that a multi-member LLC may be treated as a partnership for income tax purposes. If so treated, the LLC not only offers limited liability to its members, but also favorable tax results: the flow-through of tax items to its members, and the absence of restrictions on ownership commonly found with respect to S corporations.

However, federal tax law does not address a number of unique aspects of LLCs which may distinguish them from their partnership counterparts. Until recently there was little guidance regarding whether a member of an LLC is to be treated for federal income tax purposes as a general or limited partner in a partnership. In *Gregg*, a case of first impression, the U. S. District Court for the District of Oregon examined the status of a member of an Oregon member-managed LLC in the context of the "material participation" restrictions of section 469. On the facts, the Court determined that the member of the LLC did materially participate in the LLC's business activities for purposes of section 469. More significantly, the Court determined that, in the context of section 469 and its Regulations, members of member-managed LLCs are to be treated as general partners in a partnership.

Section 469: The Passive Activity Rules

Individuals, trusts, estates, and personal service corporations are subject to the passive activity rules of section 469. These loss limitations prohibit taxpayers from utilizing net losses from passive activities to offset other taxable income. In the case of partnerships and LLCs, the passive activity loss rules are applied at the owner (i.e., partner or LLC member) level. The term "passive activity" means any trade or business in which the taxpayer does not "materially participate". §469(c). "Passive activity loss" refers to the amount by which the aggregate losses from all passive activities for the taxable year exceed the aggregate income from all passive activities for such year. §469(d).

Material Participation. Generally speaking, any work done by an individual in connection with an activity in which he or she owns an interest at the time the work was done is "participation in the activity", regardless of the capacity in which he or she does the work.[2] Services performed by a partner for a partnership, whether in his or her capacity as partner or as an independent contractor or employee, are considered participation by the partner. Under section 469, that participation must be "material" in order to treat the income (or loss) from that activity as non-passive. Material partic-

ipation is defined as active involvement in the operations of the business on a "regular, continuous and substantial basis". §469(h). The Treasury Regulations further interpret this standard by providing that a taxpayer materially participates in an activity if, and only if, the taxpayer meets one of seven tests which appear at Temporary Regulations §1.469-5T(a). The first six tests are quantitative; the seventh involves the consideration of relevant facts and circumstances in order to determine whether the taxpayer's involvement is regular, continuous and substantial.

Presumption for Limited Partners. Section 469 provides a general presumption that a limited partner in a limited partnership does not materially participate in the activity of the partnership, except as provided in the Regulations. §469(h)(2). Under the Regulations, an individual's limited partnership interest is treated as an interest in a passive activity without regard to the partner's actual participation, unless the limited partner satisfies at least one of only three of the seven tests. According to the IRS, only general partners may avail themselves of all seven of the tests of material participation. For this reason, the determination of whether a member of an LLC is properly treated for federal income tax purposes as analogous to a limited partner or a general partner is pivotal.

What is a Limited Partner? Federal law does not define the terms "limited partnership" or "limited liability company".[3] The Regulations do provide that a partnership interest will be treated as a limited partnership interest if –

"(A) Such interest is designated a limited partnership interest in the limited partnership agreement or the certificate of limited partnership, without regard to whether the liability of the holder of such interest for obligations of the partnership is limited under the applicable State law; or

"(B) The liability of the holder of such interest for obligations of the partnership is limited, under the law of the State in which the partnership is organized, to a determinable fixed amount (for example, the sum of the holder's capital contributions to the partnership and contractual obligations to make additional capital contributions to the partnership)." Treas. Reg. §1.469-5T(e)(3)(i)(A),(B).

The passive loss regulations refer to state law to determine the legal characteristics of an entity created under that state law.[4] Thus, the legal relations created by Oregon law are critical in determining the status of LLC members.

Limited and General Partners. First, ORS 70.005(15) sets out Oregon's statutory definition of "limited partnership":

"(15) 'Limited partnership' and 'domestic limited partnership' mean a partnership formed by two or more persons under the laws of this state and having one or more general partners and one or more limited partners."

A limited partner is a person who has been admitted to a limited partnership as a limited partner. ORS 70.005(14). A general partner is a person who has been admitted to a limited partnership and named as such in the certificate of limited partnership. ORS 70.005(13). In general, limited partners are not liable for the debts of the LLC. However, a limited partner can become liable if the limited partner participates in the control of the business. ORS 70.135.

Oregon LLCs. With respect to LLCs, under Oregon law there are two categories of LLCs: "manager-managed" and "member-managed" LLCs. ORS 63.001(16), (18).

In an Oregon member-managed LLC, each member has equal rights in the management of the LLC's business and equal capacity to contract for and on behalf of, and bind, the LLC. Each of the members of an Oregon member-managed LLC is an agent of the LLC. The act of a member "for apparently carrying on in the ordinary course the business of the limited liability company or business of the kind carried on by the limited liability company, binds the limited liability company unless the member had no authority to act for the limited liability company in the particular matter and the person with whom the member was dealing knew or had notice that the member lacked authority." ORS 63.140(1)(a).

Members in manager-managed LLCs may not participate in management. In a manager-managed LLC, agency authority is vested solely in the managers; a member is not an agent of the LLC. ORS 63.140(2)(a). Each manager has equal rights in the management of the entity. While members have no rights per se in the management of a manager-managed LLC, certain items are listed in the statute that require the consent of members of the LLC. Subject to certain limitations, members of an LLC (whether member-managed or manager-managed) may agree to regulate the affairs of the company and the conduct of the business, and to govern relations among the members, managers and the company. ORS 63.130(3), (4).

The *Gregg* Case

The taxpayer and other individuals formed Cadaja, LLC in November of 1994. Cadaja was a member-managed LLC organized under Oregon law. The taxpayer contributed substantially all of the capital contributed by the members to the LLC and owned a 49% membership interest in the LLC. From the date of its formation

through the end of 1994 and thereafter, the taxpayer was a managing member of the LLC and worked on its business on a full-time basis.

During its first tax year commencing on November 4, 1994 and ending on December 31, 1994, the LLC realized losses in the ordinary course of its business. As a member of the LLC, the taxpayer claimed a "pass through" of his ratable share of those LLC losses on his 1994 income tax return, pursuant to section 702.

Because the LLC was formed in November, its first tax year was only seven weeks long. The taxpayer did not work on the LLC's business for at least 500 hours during that short tax year, as required by the first test of the Regulations. The IRS took the position that the taxpayer was to be treated as a limited partner for tax purposes and that the taxpayer did not "materially participate" in the business operations of the LLC during the short tax year because he did not satisfy any of the three tests of "material participation" available to limited partners (Treasury Regulations 1.469-5T(a)(1), (5), (6)). Therefore, the IRS determined that the losses were, as to the plaintiff, passive losses not deductible against his non-passive income. The effect of that determination was that the plaintiff was denied the deduction of losses attributable to the LLC for its 1994 tax year.

In making its determination that the taxpayer was to be treated as a limited partner, the IRS focused exclusively upon the "limited liability" attribute of membership in an LLC, citing Treas. Reg. §1.469-5T(e)(3)(i)(B), discussed above. Moreover, the government maintained that, although the LLC was formed under the Oregon Limited Liability Company Act, for federal taxation purposes Oregon law is preempted and does not apply, except as otherwise directed by the provisions of section 469 and its Regulations. Under Temporary Regulation §1.469-5T(e), the government argued that "without a specific designation in the partnership agreement or certificate, the question whether a partnership interest is limited or general turns on the sole criterion, which is, limited liability under state law. If the partnership interest has limited liability under state law, then it is a limited partnership interest. If the partnership interest has general liability under state law, then it is a general partnership interest."

Oregon statutes do limit the liability of a member of an LLC. "A member or manager of the limited liability company is not personally liable for any debt, obligation or liability of the limited liability company merely by reason of being a member or manager or both." ORS 63.165 (1994). Moreover, in *Gregg*, the LLC's Operating Agreement stated that "Members of the Company shall not be liable to the Company or its members for monetary damages for conduct as members except to the extent that the (Oregon Limited Liability Company Act) as it now exists or may hereafter be amended, prohibits elimination or limitation of liability...." Thus, if limited liability were the sole criterion on which the distinction between limited and general partner status turned, the taxpayer in *Gregg* would not have prevailed.

However, the taxpayer argued that the limited partnership test in the Regulations was obsolete and inapplicable to LLCs and their members. The LLC statutes have created a new type of business entity that is distinguishable from limited partnerships. The taxpayer argued that, instead, one must look to the important state law distinctions between general and limited partners and apply these principles to LLC members.

The most significant feature that distinguishes a general partner from a limited partner in a limited partnership is the authority of a partner to conduct business on behalf of the entity and to bind the entity to third parties. Limited partners have no such authority. A limited partner exercising control becomes generally liable within the scope of ORS 70.135.

No such prohibition extends to members of member-managed LLCs. ORS 63.140. Limited liability is conferred upon the member of an LLC by statute and is not conditioned upon a lack of control of the business or operations of the company. ORS 63.165. Accordingly, under Oregon law, limited liability is not the causative or determinative factor in distinguishing between a limited partnership interest and a general partnership interest; it is a consequence of the determination that, because of lack of control and because of qualifying provisions in the partnership agreement, the individual is a limited partner.

In *Gregg*, the taxpayer clearly established a consistent pattern of regular, continuous and substantial business activities on behalf of the LLC. As a member of the LLC, the taxpayer argued that his management authority over the business affairs of the LLC made his role equivalent to that of a general partner in a limited partnership. Were the LLC a "partnership," there is no question that the taxpayer would not enjoy limited liability. He would be a general partner because of his management and control of the business enterprise of that "partnership."

Because the taxpayer had the right to, and did, control the business operations of the LLC, he argued that he should be treated as a general partner, and therefore should have been able to avail himself of all seven tests of the Regulations. Moreover, he contended that he satisfied several of the tests which, according to the Regulations, are only available to general partners.

continued

The District Court's Decision

The District Court agreed with the taxpayer, finding him to be eligible to apply all seven tests of material participation. In so holding, the Court stated:

"Plaintiffs argue that the limited partnership test...is obsolete when applied to LLCs and their members, because the limited liability statutes create a new type of business entity that is materially distinguishable from a limited partnership. I agree.

"A limited partnership must have at least one general partner who is personally liable for the obligation of the limited partnership. If, for federal tax purposes, an LLC is treated as a limited partnership, and all members of the LLC are treated as limited partners because of their limited liability, the consequence of such a treatment does not satisfy the requirement of 'at least one general partner.' In addition, LLC members retain their limited liability regardless of their level of participation in the management of the LLC. But a limited partner in a limited partnership cannot, by definition, participate in the management. (186 F. Supp. 2d 1123, 1128 (2000).)

Citing the legislative history of the Tax Reform Act of 1986 (Senate Finance Committee Report on P.L. 99-514, *supra*), the Court stated:

"The limited partnership test is not applicable to all LLC members, because LLCs are designed to permit active involvement by LLC members in the management of the business. (Citations omitted.) Further, LLC members may materially participate in the LLC without losing their limited liability protection. (Citations omitted.) In the absence of any regulation asserting that an LLC member should be treated as a limited partner of a limited partnership, [the government's] conclusion is inappropriate. Therefore, the higher standard of material participation test for limited partners should not be applied to plaintiff. Plaintiff materially participated in the activity of (the LLC) 'if and only if' he satisfies one of the seven tests set forth in Temporary Treasury Regulation § 1.469-5T(a)(1)-(7)." (186 F. Supp. 2d. 1123, 1128-29 (2000).)

The Court went on to make the factual determination that, under the tests of the Treasury Regulations, the taxpayer had materially participated in the LLC's business activities during the LLC's first (short) tax year.

The government's focus upon limited liability, rather than proper application of state law as mandated by the Regulations, determined the outcome of the issue. The problem for the government in *Gregg* was that it could cite no authority to support its proposition that state law governing distinctions between general partner and limited partner status are "preempted" by the Regulations. The legislative history of section 469 makes it clear that Congress' focus in distinguishing between general partner and limited partner status, like that of state law (including Oregon), hinges upon "control" of partnership operations; not upon "limited liability" as argued by the government. [5]

Conclusion

In many instances a flaw in the government's tax analysis may appear in its failure to consider, or properly interpret, controlling provisions of state law. Practitioners should not overlook opportunities that arise in such situations. The ability to avail oneself of all seven, as opposed to only three, of the Treasury Regulations' seven tests under section 469 can be a material benefit to the taxpayer. While the material participation standards often impose significant barriers to the availability of partnership losses to limited partners, under the Gregg decision this does not have to always be the case for LLC members.

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[1] All Section references, unless otherwise indicated, are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder.

[2] Treas. Reg. §1.469-5T(f)(1).

[3] Treasury Regulations §301.7701-2 sets forth the "four-factor test" to distinguish between partnerships and organizations taxable as corporations for federal income tax purposes. While those tests are useful for those confined purposes, they do not distinguish between limited partnerships and general partnerships.

[4] Treas. Reg. §1.469-5T(e)(3)(i)(B). This is a corollary of the larger principle – found throughout tax law –that state law determines the legal relationships among parties, but federal tax law defines the tax consequences of those relationships.

[5] Senate Finance Committee Report on P.L. 99-514, reprinted in CCH Std. Fed. Tax Rptr. at ¶ 21,960.

Proposed Amendments to Oregon State Bar Tax Section Bylaws By The Executive Committee of the Tax Section.

This publication is intended to satisfy the current bylaws requirement of mailing notice to members of proposed bylaws changes. Members will be sent a mail ballot, at least two weeks after the date of mailing of the newsletter, to vote on the proposed amendments.

Comments:

For some time, the Tax Section has engaged in a process wherein Members-at-Large who are considered to have the skills and interest to become an officer of the section are elected to fill the Secretary's position. From the Treasurer's position, it has been standard procedure for each of the officers to then move through the following positions, in the order presented, serving one year in each officer position: Treasurer, Secretary, Chair-Elect, and then Chair. To accomplish this, each person necessarily serves four years as an officer, and one year following, as Immediate Past Chair. Generally, individuals have not served their first year as an officer until they have been a Member-at-Large for at least a few years. Thus, if a new Member of the Executive Committee serves two full terms as a Member-at-Large (four years, under the current Bylaws), the entire process runs nine years. This exceeds the current limitation contained in Section 1 of Article VI, which is seven years.

More recently, the Tax Section has found it very practical to utilize one year terms for new Members-at-Large. This allows both the incoming Member and the Section to commit only one year, while each gets to know the other. In addition it allows staggering of terms. This is, however, in conflict with Section 6.B of Article VI, which requires Members-at-Large to serve terms of two years. It can also create a conflict with Section 7, which states that a Member-at-Large may serve no more than two successive terms. (Under our current system, while we have adhered to a four year "up or out" policy, serving four years, if any of those years is a one year term, results in service of three successive terms.)

Finally, we propose an amendment which allows the use of "email" to be included within the definition of "mail" where the addressee has an email address on file with the bar or the section.

A marked copy of the proposed changes follows:

1. "Article VI

Terms of Office And Elections

Section 1. No member may serve on the Section Executive Committee for more than ~~seven~~ nine consecutive years."

2. "Article VI

Section 6. At the Section Annual Business Meeting or a mail or email ballot election, the Section membership shall elect:

A. A Chair-Elect, Secretary and Treasurer, each to serve a term of one year; and

B. Members-at-Large to serve terms of two years or less on the Section Executive Committee."

3. "Article VI

Section 7. The Chair-Elect will succeed to the office of Chair on January 1 and serve a term of one year. If theoffice of Chair-Elect is vacant at the Section Annual Business Meeting or a mail or email ballot election, then a Chair shall be elected by the members. No officer shall serve two successive terms in the same office, except the Treasurer. A Member-at-Large may serve no more than ~~two~~ four ~~successive terms~~consecutive years as a Member-at-Large."

4. "Article XIII

Rules Of Order

Section 1. Except as otherwise provided herein, meetings of this Section shall be conducted in accordance with Robert's Rules of Order, Newly Revised (1990 Edition).

Section 2. All references in these Bylaws to "mail" or "mailing" or "mail ballot" shall also include electronic email to a member or addressee who has an email address on file with the Oregon State Bar or the Tax Section of the Oregon State Bar."

Please address questions concerning these amendments to the secretary of the section, Karey A. Schoenfeld.

News from the Oregon Tax Court

I. Court Operations

As many of you are aware, Chief Justice Carson has announced that, in response to the current budget conditions, courts will begin reducing their hours of operation beginning March 1, 2003. Those reductions affect all appellate, tax, and circuit courts statewide.

Effective March 1, 2003, public business hours for the Tax Court will be Monday through Thursday from 8 a.m. to 5 p.m. The court will be closed to the public on Fridays between March 1 to June 30, 2003, due to staff reductions.

It is expected that pursuant to statutory authority the Chief Justice will issue an order extending filing deadlines from Fridays to the following Monday or next public business day. Please contact the court with any questions regarding operations during this time period.

II. Web Resources

Searching for the latest decision from the Oregon Tax Court? Point your web browsers to www.ojd.state.or.us/tax. The court's website provides a wealth of information about practices and procedures of the court as well as the most recent opinions and decisions. Forms for both divisions of the court are available online. Additionally, a new version of the court's informational handbook is available. This handbook includes valuable tips for practitioners as well as pro se litigants. Opinions and orders of the Regular Division and decisions and orders of the Magistrate Division are posted here shortly after being issued by the court.

Caution: Generally, the Oregon Judicial Department's Publications webpage, http://www.publications.ojd.state.or.us/, does not have the most recent decisions or opinions of the Oregon Tax Court. To access the most up-to-date decisions, use the court's webpage at, http://www.ojd.state.or.us/courts/tax/ and select the Decisions, Opinions and Orders link.

In addition to the court's website, opinions and decisions of the both divisions of the court are also available through both Westlaw and Lexis databases. Both Westlaw and Lexis carry decisions of the Regular Division of the Tax Court from January 1962 through the most recently released cases. Westlaw also carries Magistrate Division cases beginning from January 1999 through the most recently released cases.

III. Publication of Magistrate Division Decisions

The court is pleased to announce that the State Court Administrator has decided to publish selected decisions of the Magistrate Division. Volume 16 of the Oregon Tax Reports will include selected decisions of the Magistrate Division from 1997 to 2001; those decisions will not appear in the Oregon Advance Sheets. Future decisions of the Magistrate Division that are selected for publication will appear in both the Oregon Advance Sheets and Oregon Tax Reports.

IV. Rules of the Court

On January 1, 2003, the Oregon Tax Court adopted new rules of court. Many of the changes were technical corrections, however, two changes merit attention by practitioners.

Representation Rule

Each division of the court adopted a new rule on representation. The rules are based on the relevant statutes and arise because of some perceived confusion about the scope of the statutory rules on representation of S corporations in areas other than income tax matters. Court Rule (TCR) 1F and Tax Court Rule-Magistrate Division (TCR-MD) 1E set forth the general rules for representation of parties before the court and then specific representation requirements for entities, such as partnerships and S corporations, distinguishing between cases involving matters on or measured by net income and cases involving property or other tax matters. The summary below includes references to the court rules and relevant statutory authority.

REPRESENTATION IN THE REGULAR DIVISION

General Rule: A party must appear in person or be represented by an Oregon attorney.

- Entities, such as corporations, partnerships, limited liability companies, and unincorporated associations, must appear through an attorney unless a specific exception applies.
- See ORS 9.320; TCR 1F (1).

Special Representative Rules for S Corporations, Partnerships, and Other Entities: For cases that involve taxes on or measured by net income:

• A partnership may be represented by the designated tax matters partner.

• An S corporation may be represented by a shareholder designated as the tax matters shareholder.

• See generally ORS 305.494; ORS 305.230; 305.242; and TCR 1F (2).

• See OAR 150-305.242(2) and 150-305.242(5) for the form of designation.

For property taxes and other cases:

• A licensed attorney must represent an S corporation, partnership, limited liability company, or other entity.

• See TCR 1F (3).

REPRESENTATION IN THE MAGISTRATE DIVISION

Authorized Representatives in Any Case: These people may represent anyone in any case. See ORS 305.230; TCR-MD 1E (1).

• An Oregon attorney;

• An Oregon public accountant (public accountants include CPAs and other licensed accountants); or

• An authorized employee of the taxpayer who is regularly employed by the taxpayer in tax matters.

Appeal from a Notice of Assessment from the Department of Revenue:

• An Oregon licensed tax consultant may act as a representative if the appeal is from a tax administered by the Oregon Department of Revenue.

Property Tax Cases:

• An Oregon licensed real estate broker or state certified, licensed, or registered appraiser may act as a representative.

Special Representative Rules for S Corporations, Partnerships, and Other Entities: For cases that involve taxes on or measured by net income:

• An S Corporation may be represented by a shareholder designated as the tax matters shareholder; and

• A partnership may be represented as the tax matters partner.

• See ORS 305.230(3); ORS 305.245; and TCR-MD 1E (2).

For property taxes and other cases:

• An S corporation, partnership, limited liability company, or trust may be represented by the following:

• An Oregon attorney;

• .An Oregon public accountant;

• An authorized employee of the taxpayer who is regularly assigned by the taxpayer in tax matters; or

• A real estate broker or appraiser (property tax matters only)

• See ORS 305.230(1) and (4); TCR-MD 1E (3).

Magistrate Division Rule 6

As motion practice continues to increase in the Magistrate Division, the court has attempted to make its rules workable and easy to follow for both pro se litigants and experienced practitioners. TCR-MD 6 was amended to clarify the procedures the court and parties should follow when a motion is filed in the Magistrate Division.

Generally, a response to a motion is not due until after the first case management conference. See generally TCR-MD 6B (1). However, in specified situations the court may act on a motion prior to a case management conference; these situations include:

• Motions to dismiss filed by plaintiffs, See TCR-MD 6B (2);

• Pleading-related motions, See TCR-MD 6B(3); and

• Motions for Default, See TCR-MD 6D.

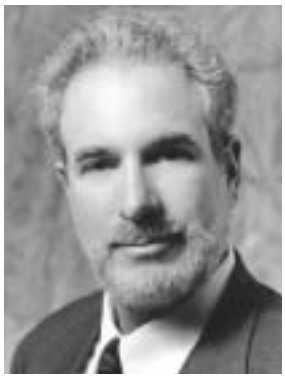
V. Personnel Changes

Paul Pickerell submitted his resignation as Trial Court Administrator for the Oregon Tax Court effective January 31, 2003. Peggy Gottsacker is performing the functions of administrator for the court; she may be reached at 1-800-773-1162 or 1-503-986-5650.

Coming in 2003 ...

... the first Oregon Tax Court Practitioners Roundtable. Sponsored by the Oregon State Bar and Taxation Section, the roundtable will be a half-day CLE in Salem, date to be announced. The CLE will focus on practice issues before both divisions of the Oregon Tax Court. Substantial time will be set aside for comments and suggestions for practitioners who use the court. If you would like further information, please contact the court at 1-800-773-1162 or taxcourt@ojd.or.us.

Message from the President



William S. Manne

For 2003, the Tax Section Executive Committee will continue its successful CLE programs and quarterly newsletter, while expanding its services and outreach into several new areas.

The Portland and Salem lunch forums continue to be well attended and will be sponsoring several new programs and speakers under the respective leadership of Mark Huglin and Barbara Smith. The annual *Tax Institute*, covering advanced topics, is scheduled for September 11th and 12th at the Portland Embassy Suites Hotel. This year's program will be one and one-half days, with a Thursday evening reception at Pittock Mansion. Our *Broad Brush Taxation* program, covering more basic subjects, is slated for the fall (watch these pages for the specific date and place). And, as in the past, the Section will again cosponsor the IRS/ODR Practitioners Forum. As always, we are looking for your suggestions for speakers and topics, so please let us know if you have any ideas or would like to volunteer.

Consistent with the times, the Section will increase the quantity of information transmitted by electronic means. Valerie Sasaki is working on a complete restructuring of the Section's website, and we expect to have the first portions of our totally re-vamped site up and running by this summer. Do check it out and let us know what you like and do not like. The Section is also moving toward distribution of the quarterly newsletter by electronic means, currently targeted for 2004. Please watch these pages for that announcement and for the opportunity to continue to receive a hard copy by mail, if you do not have internet access. We expect electronic distribution of the newsletter will save the Section a substantial amount for duplication and mailing expenses each year.

The Section's Legislative Subcommittee is very busy this year, as sponsor of a bill regarding a change in the definition of independent contractor for Oregon (Senate Bill 40). The Subcommittee also monitors various bills which have been introduced in Salem and in the Portland metropolitan area to raise revenues and address other issues. Again, watch these pages for more on these topics and feel free to suggest legislative issues which you feel the Section should be pursuing.

The IRS/ODR Liaison Committee is under new leadership, with Marc Sellers taking the helm. Marc will be developing an event with IRS and the committee will be exploring news ways to constructively work with ODR. Please let Marc know if you would like to participate.

Finally, as described on page 5, the Section will be voting to amend its bylaws to provide a more flexible and useful schedule for Executive Committee service and updated notice provisions. Should you have any questions or concerns about those changes, please do not hesitate to contact one of our members.

I know everyone on the Executive Committee joins me in saying that it is a true privilege to serve the Section membership, and that we welcome your involvement and input.

William S. Manne

President, OSB Taxation Section

Oregon Pickup Inheritance Tax Based on Federal Tax Credit

*by: Joseph Wetzel**

A. Current Issue

The Oregon Department of Revenue ("Department") has recently decided to attempt to impose an Oregon pickup inheritance tax based on the federal inheritance tax credit that was in effect under the federal Taxpayer Relief Act of 1997. Or, maybe, the Department will use the federal inheritance tax credit in effect before the enactment of the Taxpayer Relief Act of 1997. The Department is still thinking about this. The Department issued its manifesto (called a Policy Statement Regarding Administration of the Oregon Estate Tax) on January 14, 2002 ("Manifesto").

Let us see where this Manifesto comes from and on what authority it is based.

B. Tax Effect of Manifesto

The tax effect on estates that follow the Manifesto will be a substantial increase in the Oregon inheritance tax over what it would have been if current federal law for the state inheritance tax credit had been followed. The newer federal laws continually increase the asset value equivalent that is automatically exempt from the federal estate tax, from $600,000 to $625,000, to $675,000, to $1,000,000 (the $1,000,000 being effective January 1, 2002). If the Department computes the Oregon pickup inheritance tax on the assumption that the federal exempt amount is lower than $1,000,000, then, of course, the state inheritance tax credit grows larger and the Oregon pickup tax grows larger with it. The difference in Oregon inheritance tax could be as much as $33,200.

C. Statutory Texts

Taxes are uniquely a creature of statute. Tax statutes may be interpreted by the courts, but under American law courts are never free to create a tax on their own.

ORS 118.010(1) states that an Oregon inheritance tax is imposed upon the transfer of property and any interest therein.

ORS 118.010(2) states:

> "The tax imposed under this section shall equal the maximum amount of the estate death tax credit allowable against the federal estate tax under section 2011 of the Internal Revenue Code." (emphasis added)

ORS 118.010(5) states:

> "If federal estate tax credits other than the death tax credit result in no federal estate tax, no tax shall be imposed under this section."

ORS 118.160(1) states:

> "Except [for estates in which decedent during his lifetime made transfers within three years of his death or made transfers intended to take effect at his death] . . . , no inheritance tax return shall be required with respect to the estates of decedents dying on or after January 1, 1987, unless a federal estate tax return is required to be filed."

The provisions quoted above are the only provisions that directly relate to the imposition of the Oregon inheritance tax. The only reasonable reading of the statutes is that the federal estate tax death tax credit referred to is the actual death tax credit that applies to the estate at issue. Arguably, there really is no other way to read the Oregon statutes.

Accordingly, the Oregon inheritance tax imposed is simply taken off of line 15 of the federal tax form 706 that applies to the estate in question.

I do not know what the Oregon legislators who voted on the imposition of the Oregon inheritance tax actually intended, if they intended anything. But tax laws are not imposed upon the basis of unstated intentions. Taxes are imposed based on the statutory language enrolled by the presiding officer of each house of the legislature and signed by the governor. We do not enroll unstated intentions and unsigned desires. The Department has no authority under our system to impose or increase a tax that has not been enacted into law.

D. So Where Does This Extra Tax Come From?

The Department claims that the office of legislative counsel and the legislative revenue office came up with the idea (in June, 2001) that ORS 118.010 refers only to the April, 1997 version of federal law (i.e., where the federal exemption amount was $600,000), and does not incorporate the August, 1997 changes (i.e., which increased the federal exemption amount to $625,000 in 1998, $650,000 in 1999, and $675,000 in 2000 and 2001), and certainly does not incorporate the federal changes of 2001 (which increased the federal exemption amount to $1,000,000).

We should be clear about one thing: when the Oregon legislature wants to lock in an Oregon tax law to a federal tax law as of a certain date, it knows how to do it and it knows how to do it explicitly. For example, see ORS 316.012 (i.e., all income tax terms have the same meaning as those terms "in a comparable context in the laws of the United States relating to federal income taxes . . . ."); ORS 316.012(1) (i.e., definition of income incorporates "the laws of the United States relating to income taxes or the Internal Revenue Code as they are in effect and applicable to the tax year of the taxpayer . . . ."); and ORS 316.012(2) (i.e., a reference to any term in the Oregon income tax law other than a measure of income is a reference to federal tax laws "as those laws are amended and in effect on December 31, 2000...."). Accordingly, no argument can be made by the Department, that the Oregon legislature either did not know how to tie the inheritance tax law into a specific federal date, or overlooked doing it.

The Department claims that the Oregon legislature intended to tie the Oregon statute to specific federal dates, but the Department has produced no citations and no evidence that that is so. The Department's position is the purest example ever seen of an ipse dixit (i.e., it is so because I say it is so).

The Department cites only one Oregon Supreme Court case to support its position, namely, *Seal v. McKennon*, 215 Or. 562, 336 P.2d 340 (1959). The *Seal* case was not a tax case. The question presented in that case was whether the Oregon legislature intended a state agency to incorporate by reference the administrative regulations of a federal administrative agency (in this case, regulations dealing with tuberculosis in Oregon livestock). The Oregon Supreme Court held that the legislature intended to adopt as legislation only federal regulations in effect on the date of the state enactment, but that the legislature intended further to allow the state agency to adopt future federal regulations that are consistent with the Oregon legislative guidelines.

The Department cited *Seal* for the proposition that it would be unconstitutional (under the Oregon constitution) for the state legislature to adopt by reference future federal enactments. There are dicta in *Seal* touching that subject, but, as you can see from the above outline of the *Seal* case, the Oregon Supreme Court did not hold that Oregon legislation adopting future federal legislation would be a violation of the Oregon constitution.

Another case (that was not cited by the Department, namely, *Oregon v. Charlesworth*, 151 Or. App. 100, 951 P.2d 153 (1997)) contains dicta to the effect that an Oregon statute adopting by reference future federal laws would be a violation of the Oregon constitution. However, the actual holding of that case was that the Oregon legislature intended to adopt only the then existing federal law dealing with the definition of "racketeering activity" for the Oregon racketeering statute. Once again, the court's statements regarding the unconstitutionality of adoption by reference were dicta.

Apparently, the Department wants to rely on these cases for the proposition that an Oregon statute that adopts by reference future federal statutes is unconstitutional under the Oregon constitution.

But, if the Department is correct, and if the Oregon inheritance tax is read as I think it must be read (i.e., incorporating the current federal tax law that applies to the decedent's estate in question), then the entire inheritance tax law is also unconstitutional: meaning, of course, that there is no Oregon inheritance tax. An unconstitutional law simply does not exist for legal purposes. Finding that a law is unconstitutional does not give the Department, or even the courts, a chance to write their own statute.

Oddly, there is a line of cases in the Oregon Supreme Court that hold that if an Oregon statute is declared unconstitutional, it is not simply wiped off the books, but the Oregon courts, in their wisdom, would simply "construe" the statute to get what the legislature would have intended if the legislature had meant to avoid unconstitutionality. This is a fancy way of the Court's saying that, if a statute is unconstitutional, the court gets to rewrite it. The most recent case in this series is *Newport Church of the Nazarene v. Hensley*, 335 Or. 1, 11, 56 P.3d 386 (2002). If that case were applied to our situation, it would certainly give the Oregon courts an invitation to write their own statute, which might look something like what the Department is claiming the law should be. However, it should be noted that allowing the courts to do such a thing suffers from at least two major defects. First, it runs head-on into the Oregon Supreme Court's uniform practice based on *Portland General Electric v. Bureau of Labor and Industries*, 317 Or. 606, 859 P2d 1143 (1993), which holds that Oregon courts must stick to the literal language of the statute and not look to legislative history, unless the statute is ambiguous. The second problem with "construing" an unconstitutional statute is the supreme irony that the state would be claiming that the Oregon inheritance tax statute is unconstitutional because the changes in federal law were not reviewed and passed by the House of Representatives and the Senate, and signed by the governor: the obvious irony being that when an Oregon court pretends to "construe" a statute and rewrite it, the rewritten language obviously was not considered or passed by the House of Representatives and the Senate, and signed by the governor.

E. House Bill 4077

The 71st Oregon Legislative Assembly, in its fifth special session, passed House Bill 4077 and sent it to former Governor Kitzhaber for his signature. House Bill 4077 would have amended the Oregon inheritance tax law to track the federal law as it changed, but not by adopting the changed federal law, but by simply multiplying the Oregon inheritance tax by a factor that would make up for the decreasing state death tax credit under the federal law. However, former Governor Kitzhaber thought that House Bill 4077 would somehow diminish tax receipts, and so he vetoed it.

F. What to Do?

Tax counsel and other estate advisors would certainly be justified in following the Oregon statutes as they are written. This would mean filing no Oregon inheritance tax return unless the estate was required to file a federal return. It would also mean computing the Oregon inheritance tax strictly based on line 15 of the federal form 706, and contesting any Oregon assertion of additional tax based on its idea that the Department can rewrite the Oregon statutes when it detects a flaw or an unconstitutional defect.

*Wetzel DeFrang & Sandor, Portland, Oregon

From the Editor:

We welcome your contributions to, and suggestions for, the newsletter. To submit an article, please call or email me with your idea rather than sending the article along first. If you have ideas for ongoing columns, let me know.

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Editors note: *Articles included in this newsletter represent the opinions of the authors and not necessarily those of the Taxation Section. They are for information only and should not be construed as providing legal advice. For legal advice please consult the author of the article or your own tax advisor.*

Upcoming Tax Meetings

PORTLAND:

Portland Luncheon Series
Contact: Mark Huglin
mark@draneaslaw.com

March 13, 2003
Understanding the International Tax Issues and Typical Solutions for US Taxpayers with Investments in Foreign Corporations
Speaker: Greg Engrav

April 10, 2003
Portland and Multnomah County Business Tax Update
Speaker: Teresa Williams

May 8, 2003
Topic TBA. *Speaker: TBA*

Portland Tax Forum
Contact: Mark Golding
mgolding@hagendye.com

SALEM:

Mid-Valley Tax Forum
Contact: Barbara Smith
bjsmith@mail.heltzel.com

March 18, 2003
Health Insurance Options and Fringe Benefit Plans to Help Pay for Them
Speaker: Jane Berg and TBA

May 20, 2003
Employer/Employee Relations Issues
Speaker: Mike Petersen and TBA

EUGENE:

Eugene-Springfield Tax Association
Contact: Jeffrey D. Kirtner
jkirtner@hershnerhunter.com

Eugene Estate Planning Council
Contact: Howard Feinman
hfeinman@rio.com

March 4, 2003
Life Insurance Trusts – Legal Issues
Speaker: Kip Steincross, J.D., General Counsel's Office, Wells Fargo Bank

Planning in an Age of Uncertainty
(day long seminar at Valley River) – May 15, 2003
Contact: Marie McMath
MarieMcMath@attbi.com

Taxing Humor...

- For every tax problem there is a solution which is straightforward, uncomplicated and wrong.
- Tax loopholes are like parking meters. As soon as you see one, it's gone.
- Why is simplification such a long word?
- Do your tax return before breakfast and nothing worse will happen to you all day.
- If all tax advisers were laid end to end, they would not reach an opinion.

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