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OREGON STATE BAR

Taxation Section

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Use of Profits-Only Interests as Compensation Arrangement for LLCs

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Compensating key employees often requires something more than bigger salaries and bigger bonuses. Many employers consider various forms of equity-based compensation to give key producers a "piece of the action" so that the compensation for the employee is tied to the success and growth of the business.

For businesses organized as corporations, such equity-based compensation often takes the form of grants to employees of restricted stock or stock options. Generally such grants result in compensation income to the employee when the stock is granted or becomes vested or when an option is exercised[2]. Such grants are never taxable to the issuing corporation and are matched by a compensation deduction for the corporation.

For a business organized as an LLC,[3] similar techniques can be used, but the treatment of LLC membership interests issued for services is considerably more complicated than the corresponding treatment (already complex) of stock issued by a corporation for services.[4] Furthermore, some commentators argue that, under current law, compensatory grants of LLC membership interests that include an interest in LLC capital and profits can result in taxable gain to the issuing LLC as well as income recognition to the employee receiving the grant.[5]

However, LLCs (and other tax partnerships) have available another equity compensation technique – one that cannot be utilized by corporations – that can provide a valuable equity interest to an employee without either the employee or the LLC being subject to taxation at the time the interest is granted.[6] This technique is the grant to an employee (or other service provider such as a consultant) of a "profits-only" membership interest in the LLC.

Nature of Profits-Only Interest

A profits-only membership interest gives the recipient a specified share in future profits and gains realized by the LLC after the date of the grant without giving the recipient any share in the existing LLC assets (*i.e.*, its capital) as of the date of grant. An employee who receives a profits-only membership interest receives an initial capital account credit of zero even though he or she has a positive percentage or other interest in future income and gain.

Example 1: A and B form a new LLC. A contributes $100 and B agrees to manage the LLC in exchange for a 20% profits-only membership interest. The members agree to share all profits and gains 80% for A and 20% for B. A's initial capital account credit is $100 and B's initial capital account credit is $0. If the LLC were to liquidate before it realized any income or loss, its $100 in assets would be distributed solely to A in accordance with the initial capital accounts.

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If the LLC has $10 in profits in year 1, the profits would be allocated $8 to A and $2 to B. If the profits were not distributed, the members' capital accounts would be adjusted to $108 for A and $2 for B.

At the beginning of Year 2, the LLC sells all its assets for $210, recognizing $100 of gain. The gain would be allocated $80 to A and $20 to B. The final capital account balances would be $188 for A and $22 for B and the $210 in proceeds would be allocated in those amounts.

Note that in the example, although B has a "profits-only" membership interest and has an initial capital account balance of $0, B can subsequently have a positive capital account balance representing B's share of post grant date profits that are not distributed.

A profits-only membership interest is contrasted from a "regular" membership interest that gives the recipient an interest in both LLC capital (as of the date of grant) and LLC profits.

Example 2. Acme LLC grants a fully vested 20% membership interest to Able, a key employee. Just before the grant of the membership interest, the net value of Acme's assets is $1,000 (and the aggregate of the capital accounts of the existing members of Acme is $1,000). As of the date of grant, Able has a capital account of $200 and the capital accounts of existing Acme members is reduced to an aggregate of $800. Future Acme profits are allocated 20% to Able and 80% to the existing Acme members.

The grant of a regular membership interest in both capital and profits is generally taxable to the recipient and may also result in taxable gain to the LLC and its existing members.[7]

Tax Treatment of Profits-Only Interests – Ancient History

The historical treatment by the courts and the IRS of the tax consequences of the receipt of a profits-only interest for services has been somewhat convoluted. In *Sol Diamond*, 56 TC 530 33, *aff'd* 492 F2d 286, the Tax Court and the Seventh Circuit Court of Appeals both held that a profits-only interest was taxable to Mr. Diamond. However, the Tax Court and the Circuit Court had different rationales, and the decision seems to rest on the peculiar facts surrounding Mr. Diamond's receipt and quick sale of his partnership interest.

In a 1977 General Counsel Memorandum[8] the IRS proposed a revenue ruling that would have, if issued in the proposed form, treated the grant of a profits-only interest as non-taxable. However, no revenue ruling on this issue was ever issued.

In the 20 years following *Diamond*, the treatment of profits-only interests remained unclear. Cases such as *St. John,*[9] *Hale,*[10] *National Oil,*[11] *Kenroy*,[12] and *Campbell*[13] held that particular profits-only interests did not result in current taxation for the recipients, but the rationales of the decisions were not consistent. It was not clear from these decisions whether (a) the grant of a profits-only interest was not a taxable event or (b) the grant was taxable but the amount of taxable income was either too speculative to be determined or was considered to be zero based on a liquidation valuation approach. These confusing approaches by the courts are well summarized in a 1991 article by Steve Frost, "Receipt of Capital and Profits Interests Continues to Have Uncertain Tax Consequences," *Journal of Taxation*, July 1991.

Tax Treatment of Profits-Only Interests Nearly Modern History – And Current Law So Far

After the *Campbell* decision cited above, the IRS issued an unprecedented practical solution to the quagmire that had developed around profits-only interests. Revenue Procedure 93-27, 1993-2 C.B. 343, provided a safe harbor under which most profits-only interests would not be taxed. What was unprecedented about the approach was that the revenue procedure did not even attempt to spell out the technical and theoretical underpinnings of this taxpayer-friendly safe harbor. The revenue procedure did not resolve whether the grant of the profits-only interest was an issuance of property for IRC § 83 purposes or whether the transaction avoided tax under IRC § 721 and did not establish rules for the method of valuation of profits-only interests. Rather, the revenue procedure merely provided a results-oriented safe harbor stating that if a profits-only interest met these requirements, the IRS would not assert that the grant of the interest was taxable.

The three exceptions described in Revenue Procedure 93-27 are:

(1) Where the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease;

(2) Where within two years of receipt, the partner disposes of the profits interest; or

(3) Where the profits interest is a limited partnership interest in a "publicly traded partnership" within the meaning of IRC § 7704(b).

It is common when an employer grants any form of equity interest to an employee in exchange for services for the employer to impose vesting or "golden handcuff" restrictions. Thus an LLC might issue a profits-only interest to an employee with a restriction that requires the employee to forfeit the membership interest if he or she terminates employment within a specified vesting period. Under the safe harbor approach of Revenue Procedure 93-27, before the 2001 modification described below, such a restricted profits-only interest created a possible problem under IRC § 83.

Under IRC § 83, membership interests that are subject to a "substantial risk of forfeiture" based on a requirement that the recipient continue to perform services for a vesting period are technically treated as not owned by the recipient until the vesting conditions have been satisfied. A membership interest that qualified as a profits-only interest under Revenue Procedure 93-27 on the date it was granted arguably would not qualify as a profits-only interest on the vesting date if the employee had a positive capital account balance on

the vesting date due to his or her share of profits during the period between the grant date and the vesting date.

> **Example 3**. On March 1, 2007, Acme LLC issues a profits-only membership interest to employee Baker granting her a 5% interest in future profits. The terms of the grant provide that if Baker terminates employment before January 1, 2009, she will forfeit her entire membership interest. On March 1, 2007, Baker has a $0 capital account. During 2007 and 2008, the LLC had $1,000 of profits and $50 was allocated to Baker/ Acme makes no distributions during 2007 and 2008. As of January 1, 2009, Baker's capital account has a positive balance of $50.
>
> For purposes of Revenue Procedure 93-27, Baker arguably is not treated as receiving a membership interest in Acme LLC until January 1, 2009, the date her membership interest becomes vested.[14] However, on the vesting date, Baker's membership interest does not qualify as a profits-only interest because Baker now has a $50 capital account and an immediate liquidation of Acme LLC would entitle her to a $50 distribution.

In 2001 the IRS issued a results-oriented fix for this vesting quandary. Revenue Procedure 2001-43, 2001-2 C.B. 191, provides that where a profits-only interest is issued subject to restrictions, the interest will be tested to determine if it meets the profits-only requirement of Revenue Procedure 93-27 ***as of the date of grant and need not be re-tested as of the date of vesting***. Furthermore, Revenue Procedure 2001-43 provides that no IRC § 83(b) election is required for restricted profits-only interests. In effect, Revenue Procedure 2001-43 adopts a fiction of presuming that an IRC § 83(b) election is always filed for profits-only interests subject to vesting restrictions.

Tax Treatment of Profits-Only Interests – Modern History and Pending Changes

In May, 2005, the IRS issued proposed regulations dealing with the overall tax treatment of compensatory partnership equity interests. REG 105346-03, Fed. Reg. Vol. 70, No. 99, p. 29675 (the "Proposed Regulations"). The Proposed Regulations address both regular partnership and LLC interests (*i.e.*, capital and profits) as well as profits-only interests. In effect, the Proposed Regulations attempt to unify the treatment of both types of interests by treating any partnership or LLC membership interest as "property" for purposes of IRC § 83 and then applying the rules under that section to determine tax consequences.

For these purposes, the Proposed Regulations adopt a general rule that a grant of an LLC membership interest results in taxable income to the recipient as of the grant date or, if later the vesting date, based on the fair market value of the interest on the grant date or the vesting date. Under this general rule, the fair market value of an LLC membership interest must be determined using general valuation techniques and taking into consideration all applicable facts and circumstances, including (1) whether or not the membership interest entitles the recipient to an immediate capital account, (2) where applicable, discounts for lack of control and lack of marketability, and (3) the potential for future earnings in the LLC. Under the general rule of the Proposed Regulations, a profits-only interest is treated as just another LLC membership interest, with its lack of a present interest in existing capital just one of the factors to be used in determining its fair market value. Under this general rule, nearly every grant of a profits-only LLC membership interest would result in some taxable income to the recipient, but it would be less income than would result from a grant of a full interest in capital and profits.

Recognizing the valuation complexities inherent in this general rule, at the same time that it released the Proposed Regulations, the IRS issued Notice 2005-43, 2005-24 IRB 1, which contains a draft revenue procedure (the "Proposed Procedure"). The Proposed Procedure would (when it becomes effective) supersede Revenue Procedures 93-27 and 2001-43 and would provide that an LLC and all of its members may elect (a "Liquidation Value Election") to apply a safe harbor under which the fair market value of a membership interest is treated as being equal to the liquidation value of such interest. As a person receiving a profits-only interest has a $0 initial capital account, the liquidation value of the membership interest would be zero. Thus the Proposed Procedure would allow an approach that maintains the tax-preferred treatment of a profits-only interest, but only if the LLC and all its members make the Liquidation Value Election.

However, under the Proposed Regulations and the Proposed Procedure, a Liquidation Value Election would apply to all compensatory membership interests granted by an LLC, not just to profits-only interests. While application of a Liquidation Value Election to profits-only interests would have a taxpayer-friendly result (a zero taxable amount on grant), such an election could have an adverse effect on capital and profits interests by disregarding otherwise applicable valuation minority interest and lack of marketability discounts. Furthermore, in the proposed form the mechanics for making a Liquidation Value Election would be burdensome, requiring the affirmative unanimous approval of all the members of an LLC and the person to whom a membership interest is issued.

If the Proposed Regulations and the Proposed Procedure become final, one significant change will be the need to make IRC § 83(b) elections in connection with profits-only membership interests issued by an LLC with a Liquidation Value Election in place if the membership interest is subject to forfeiture restrictions. Under Revenue Procedure 2001-43, an interest is tested as of the grant date, rather than the vesting date, to determine if it qualifies as a profits-only interest. Revenue Procedure 2001-43 expressly provides that no IRC § 83(b) election is needed for this purpose. If the Proposed Regulations and the Proposed Procedure become final, a profits-only interest will be valued at zero (under a Liquidation Value Election) only as of the grant date. If the recipient does not make an IRC § 83(b) election, the inter-

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est will be valued as of the vesting date when even using a liquidation value method the interest may not have a zero value. Thus in order to obtain a zero liquidation value for a profits-only interest, the recipient will have to make an IRC § 83(b) election within 30 days after the date of grant.

Planning for Grants of Profits-Only Interests

As described above, a profits-only membership interest should result in a zero initial capital account balance for the recipient. For the grant of a profits-only interest in connection with the start up of an LLC, that is relatively easy to accomplish. Example 1 above illustrates the grant of a profits-only membership interest upon commencement of a new LLC.

Granting a profits-only interest to an employee or other service provider of an existing LLC requires some additional planning. Typically, the assets of the LLC should be valued as of the grant date and the capital accounts of the existing members should be adjusted to reflect the unrealized appreciation (or depreciation) in the LLC's assets.

> **Example 4**. Acme LLC has four members who each contributed $100 to the LLC when it was formed in 2005. Acme LLC has distributed to its members 100% of its net taxable income so that each of the initial members still has a $100 capital account. However, the value of Acme's assets (net of any liabilities) has increased to $1000.
>
> Betty is a key employee of Acme and its members want to give Betty a profits-only interest to provide her additional compensation and further incentive. Acme adjusts the capital accounts of each of the four initial members from $100 to $250. Acme then gives Betty a 10% profits-only interest as of January 1, 2008. (Assume the Proposed Regulations and Proposed Procedure described above have then become effective and that Acme has made a Liquidation Value Election.) Betty's initial capital account is $0 and the liquidation value of her membership interest is $0.
>
> If Acme had not adjusted its capital accounts as of the date of the grant to Betty, the liquidation value of Betty's interest would be $60 rather than $0 because the aggregate capital accounts of the initial members would be only $400 and Betty would have been entitled to a 10% share in the $600 of unrealized appreciation.

If an LLC is likely to grant profits-only interests on a regular basis, it would be most practical to have the grants be done on an annual or semiannual basis on a date as of which it will be easy to determine overall value. Furthermore, the LLC will have to determine what method of appraisal or other valuation will be used to determine the value of all LLC assets for purposes of adjusting capital accounts as of each grant date.

Conclusion

Under existing Revenue Procedures 93-27 and 2001-43, or under the Proposed Procedure if and when it is issued in final form, profits-only membership interest will be a very useful method of providing equity-based compensation to employees and other service providers of LLCs with no up-front tax cost to the recipients. The ability to issue equity in the form of profits-only interests has been and will continue to be a significant advantage for businesses organized as LLCs as opposed to businesses organized as corporations.

Endnotes

1 David Culpepper is a tax partner in the Portland office of Miller Nash LLP. His practice focuses on tax and business planning for LLCs and S-corporations, tax planning for real property exchanges and transactions, business acquisitions, and executive compensation.

2 There is an exception for incentive stock options under IRC § 422 that are not taxable to the employee upon exercise and are not subject to regular tax until the employee sells the stock. However, the exercise of an incentive stock option is subject to alternative minimum tax.

3 This article focuses on LLCs that are treated as partnerships for income tax purposes. Thus the article does not consider single-member LLCs or LLCs that elect to be treated as corporations for income tax purposes.

4 See "ABA Tax Section Comments on Exchanges of Partnership Equity for Services," Tax Analysts Doc 2006-65, 2006 Tax Notes Today 1-34 (December 29, 2005).

5 See, for example, Martin J. McMahon Jr., "Recognition of Gain by a P'Ship Issuing an Equity Interest for Services: the Proposed Regulations Get It Wrong," 109 Tax Notes 1161 (Nov. 28, 2005) ("McMahon").

6 However, the grant of a profits-only LLC membership interest generally will not result in a compensation deduction for the issuing LLC.

7 See McMahon, footnote 5.

8 GCM 36346, July 23, 1977.

9 *St. John v. United States*, 53 AFTR 2d 84-718 (DC, Illinois, 1984).

10 *Hale*, TC Memo 1965-274.

11 *National Oil Co. v. Comm'r*, TC Memo 1986-596.

12 *Kenroy, Inc.*, TC Memo 1984-232.

13 *Campbell*, TC Memo 1990-162 (1990).

14 Baker could have avoided this treatment by making an election under IRC § 83(b) within 30 days after the original grant date. Such an election would have resulted in her being treated as the owner of the membership interest for tax purposes from the original grant date. (See Rev Rul 83-22, 1983 1 C.B. 17.) The example assumes Baker did not make this election.

Global Tax Advisors Need To Understand New Rules Governing U.S. GAAP Accounting for Uncertain Income Tax Positions

By Neil D. Kimmelfield

In July 2006, the Financial Accounting Standards Board ("FASB") issued FIN 48 (Accounting for Uncertainty in Income Taxes), effective for fiscal years beginning after December 15, 2006.[1] Under FIN 48, a company may book an income tax benefit on its financial statements only if it is "more likely than not" that the benefit will be sustained if it is examined by a fully informed taxing authority. FIN 48 must be applied by every company that prepares financial statements in accordance with U.S. generally accepted accounting principles ("GAAP"), including all SEC registrants and many non-U.S. owned subsidiaries providing financial statements to U.S. lenders. Global tax advisors will now be expected to conform their advice to the new standards so that their clients can properly compute their tax reserves.

Summary of the FIN 48 Analytical Process

Under FIN 48, a company preparing financial statements in accordance with U.S. GAAP must apply a multi-step analytical process to its income tax "positions" in all taxing jurisdictions.

Step 1: Identify the company's income tax positions. The term "position" includes not only the claiming of a deduction or credit on a tax return, but all other decisions that affect reported income tax liabilities (*e.g.*, the decision not to file a return with a particular jurisdiction or the decision to apportion income to one jurisdiction rather than another). FIN 48 applies to all income taxes, including federal, foreign, state, and local income taxes.

Step 2: Determine, for each income tax position, whether it is "more likely than not" ("MLTN") that the position will be sustained, based on the "technical merits" of the position, if it is examined by the appropriate taxing authority. *If a company determines that a tax position does not satisfy the MLTN standard, it may not book any benefit from the position*. In making the MLTN determination, companies must assume that the taxing authorities will have all relevant information. Companies may not take into account the possibility that the position will be undetected.

Step 3: Measure the financial statement benefit to be recognized for each income tax position that satisfies the MLTN standard. For each such position, the amount recognized is "the largest amount that is greater than 50 percent likely of being realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information." The measurement process requires companies to predict the taxing authority's risk assessment and willingness to compromise.

Judgments Required by FIN 48

The standards imposed by FIN 48 require companies to make numerous judgments. Since the standards are new and unfamiliar, companies are treading carefully as they put new processes in place.

Judgments Related to MLTN Determinations

Although MLTN determinations must be based on the "technical merits" of tax positions, FIN 48 does not require a company to make a legal determination about whether the courts would sustain each tax position if it were challenged by the taxing authority. Rather, the company must make its judgment based on all available evidence. For example, a company may determine that a tax position satisfies the MLTN standard based on a reasoned judgment that the taxing authority, if fully informed, would not challenge the position. In some cases, of course, such a determination cannot be made without an assessment of how a court would likely rule.

Judgments Related to Measurement

Auditors should require only that companies have a reasoned basis for determining the largest amount of tax benefit from a return position that is MLTN to be realized after audit. There are many ways of making such a determination. Notwithstanding the attention that has been given to an illustrative example in FIN 48,[2] the guidelines do not require companies to generate multiple settlement scenarios in the measurement phase of their analysis, and companies should not get bogged down in such a process.[3]

Judgments Related to Documentation

A company's outside auditor will ask the company for documentation supporting the company's FIN 48 determinations. There are no clear rules as to what constitutes adequate documentation, and companies are understandably concerned that their auditors may require a massive record to support the tax estimate. Hopefully, that concern will turn out to be unfounded — auditors should not require companies to document the FIN 48 process beyond what is necessary to explain the company's decisions.

Highly certain positions. A company should not need written analyses supporting its "highly certain" tax positions. As a practical matter, a company should have a system for inventorying its highly certain positions and identifying, for each position, a resource for supporting the judgment that there is no material uncertainty (*e.g.*, an individual with responsibility for the applicable return), but not much more should be required.

Uncertain positions. More documentation will be needed in connection with positions that are not highly certain. For example, the determination that it is MLTN that a tax

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position would be sustained on audit often will be based on a legal analysis and may require guidance from counsel. However, there is no reason to assume that auditors will require companies to obtain formal "Circular 230" opinions to support most legal conclusions.

SEC Registrants Must Apply FIN 48 in Their Interim Period Financial Statements for the First Quarter of 2007

In the first year that a company adopts FIN 48, the company must (1) apply FIN 48 to all prior-period tax positions taken in years that are not closed by the statute of limitations and (2) report the cumulative effect of applying FIN 48 to those positions as an adjustment to the opening balance of retained earnings. Since FIN 48 is effective for fiscal years beginning after December 15, 2006, a calendar year company will not need to apply FIN 48 on an annual financial statement until early 2008.

However, a company that is an SEC registrant must include disclosures related to FIN 48 in the financial statements filed with the company's Form 10-Q for the first quarter of the year of adoption. According to informal guidance given to the AICPA by the SEC staff, a registrant must include in all of its interim period financial statements a disclosure of the "total amount of unrecognized tax benefits as of [the] date of adoption." In order to determine this amount, the registrant must apply a full-blown FIN 48 analysis to all tax positions taken in all jurisdictions in all open years. Clearly, some companies will not have the resources to satisfy this requirement on a timely basis for the first quarter of 2007.

For many companies, the sheer volume of work required by the transition to FIN 48 is daunting. However, with assistance from counsel, companies generally should not have difficulty interpreting the recognition and measurement standards of FIN 48 and applying them to individual tax positions.

Endnotes

1 The full text of FIN 48 is available on the FASB website **(http://www.fasb.org/pdf/fin%2048.pdf)**. For a general explanation of FIN 48, see Neil D. Kimmelfield, Lewis M. Horowitz, and Paige L. Davis, "Accounting for Uncertainty in Income Taxes – The Effect of FASB Interpretation No. 48," **(http://www.lanepowell.com/pdf/pubs/kimmelfieldn_004.pdf)**, The Tax Executive, July-August 2006, at 292.

2 See FIN 48, paragraphs A21 and following.

3 For a more extended discussion of this issue, see Neil D. Kimmelfield, FIN 48: Measuring Tax Benefits in the Real World, **(http://www.lanepowell.com/pdf/pubs/kimmelfieldn_005.pdf)** Tax Notes, October 31, 2006, at 501.

No De Minimis Limit on Substantiating Charitable Gifts

Starting in 2007 (or more precisely, for gifts made during tax years beginning after August 17, 2006), charitable gift recordkeeping is slightly more onerous. One making donations by cash or check must retain a "written communication" from the charity or a "bank record." See IRC § 170(f)(17), enacted as Section 1217 of the Pension Protection Act of 2006. A "bank record" includes cancelled checks, bank or credit union statements and credit card statements. Bank or credit union statements should show the name of the charity and the date and amount paid. Credit card statements should show the name of the charity and the date of the transaction. IR 2006-1992, December 14, 2006. "Written communication" means a receipt showing the name of the charity, the date of the gift, and the amount of the gift. This overlaps existing law (primarily IRC § 170(f)(8), which requires a contemporaneous written acknowledgement of any gift of $250 or more) and adds a couple of modest changes. First, absent a "bank record," there is no longer a $250 de mimimis threshold for a contemporaneous written acknowledgement. Also, informal gifts of currency in "pass the hat" situations are no longer deductible -- unless the donor manages to get a written receipt.

OSB TAXATION SECTION

Events Calendar

Tax Section CLEs – held at noon at the University Club, Portland

October 16 Tax Shelters / Post UPS *by Gersham Goldstein*

November 8 Oregon State Tax Legislative Update *by Robert Manicke*

December 20 Washington Update *by Mark Prater*

Broadbrush Taxation 2007
Friday, October 19, 8:30 a.m. to 4:30 p.m.
Oregon Convention Center, Portland

OREGON CREDITS – CONTRIBUTIONS TO A TRUST FOR CULTURAL DEVELOPMENT

By C. Jeffrey Abbott, Abbott & Munns LLC & Neil D. Kimmelfield, Lane Powell PC

(This article is the first in a series addressing some of the numerous Oregon tax credits.)

Under ORS 315.675, a taxpayer is allowed a credit against income taxes for amounts contributed to the Trust for Cultural Development Account, established under ORS 359.405 ("Oregon Cultural Trust" or "Trust"). The credit is allowed for a taxable year only to the extent the taxpayer has contributed at least an equal amount to "Oregon cultural organizations" during the year. A "cultural organization" is an entity exempt from tax under section 501(c)(3) of the Internal Revenue Code and "organized primarily for the purpose of producing, promoting or presenting the arts, heritage, programs and humanities to the public" or "organized primarily for identifying, documenting, interpreting and preserving cultural resources." ORS 315.675(1). The statute does not explain how to identify an "Oregon" cultural organization. The Oregon Cultural Trust website, however, identifies over 1,000 qualifying organizations. *See* www.culturaltrust.org. Many taxpayers may make contributions throughout the tax year to qualifying cultural organizations without knowing that it enables them to make qualifying contributions to the Trust with little or no tax cost or even, possibly, a federal income tax saving.

The credit is equal to 100% of the amount contributed to the Trust but, in the case of an individual taxpayer, cannot exceed the lesser of the taxpayer's tax liability or $500. The Oregon Department of Revenue ("ODR") clarifies on page 93 of its Publication 17 1/2 ("Individual Income Tax Guide") that married taxpayers are allowed up to a $1,000 tax credit on a joint return. If the taxpayer is a corporation, the limit is the lesser of the tax for the year or $2,500. The credit cannot be carried over to another year.

ORS 315.675(7) states: "The credit allowed under this section is in addition to any charitable contribution deduction allowable to the taxpayer." A plain reading of this section suggests that a contribution to the Oregon Cultural Trust may generate a charitable contribution deduction as well as a credit. If this is the case, a $500 contribution to the Oregon Cultural Trust may yield a $500 Oregon itemized tax deduction (with a $45 tax benefit at the 9% tax rate) as well as a $500 credit.

Notwithstanding ORS 315.675(7), the ODR takes a different view. The Individual Income Tax Guide states on page 93: "If you claim your donation to the Oregon Cultural Trust as a tax credit on your Oregon return, you cannot claim a charitable contribution on your Oregon return." Similarly, the instructions for line 39 of the Oregon Form 40 state: "Any federal benefit due to a federal deduction must be reported as an Oregon addition." If the donation to the Trust is treated as a payment of Oregon income tax, these statements make sense, since federal itemized deductions for Oregon income tax payments must be added back to Oregon taxable income. On the other hand, if the donation to the Trust is allowable as a charitable contribution deduction, the authority for these statements is unclear.

What, then, is the correct federal income tax treatment of contributions to the Oregon Cultural Trust? A document on the Oregon Cultural Trust website titled "Frequently Asked Questions: Cultural Tax Credit" states:

> Under IRC Section 170(c)(1), contributions to the Oregon Cultural Trust qualify as deductible charitable contributions on the federal tax return.

If that is correct, a contributing taxpayer who is subject to the alternative minimum tax may obtain a federal income tax benefit for making the contribution because each dollar of contribution (up to the maximum amount creditable) will reduce Oregon income tax by one dollar and will increase charitable contributions by one dollar.

The correctness of the Trust's statement is open to question, however. Although a thorough analysis of the deductibility of contributions to the Trust under section 170(c)(1) is beyond the scope of this article, the following passage from the IRS' Chief Counsel Advice 200435001 nicely summarizes the relevant issues, albeit in connection with the similarly-structured Oregon Child Care Tax Credit:

> [A] charitable **contribution** deduction under I.R.C. § 170 may not be allowable for a payment that qualifies for the Oregon Child Care Tax Credit, if the credit is viewed as a quid pro quo benefit that eliminates the necessary charitable intent for federal tax purposes. However, if receipt of the **credit** from the **state** is viewed as a disqualifying benefit, arguably the taxpayer's transfer of the **credit** to the **state** to satisfy the state tax liability should be viewed as a payment of state tax, for purposes of the federal deduction for tax payments in I.R.C. § 164 or § 162.

In other words, it is possible that a contribution to the Trust is deductible as a payment of Oregon income tax, rather than as a charitable contribution. If that is the case, and there is no clear authority on this point, a taxpayer subject to the alternative minimum tax may obtain no federal income tax benefit from contributing to the Trust, because the contribution will merely replace a direct payment of state income tax.

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In essence, a taxpayer who receives a $500 tax credit for a $500 contribution to the Trust has effectively earmarked $500 of state funds for use by the Trust and *may* also obtain a federal tax benefit *if* the contribution is deductible for federal income tax purposes as a charitable contribution *and* the taxpayer would not have obtained a federal benefit for the Oregon income payment avoided by means of the credit. Under ORS 315.675(7), it also appears that the taxpayer is entitled to an Oregon charitable contribution deduction, but the ODR clearly does not agree.

In light of the foregoing, a contributing taxpayer is likely to be interested in how the Trust uses contributed funds. The Trust's use of contributed funds is governed by rules in ORS 359.426-444. Generally, forty-two percent of the trust must be distributed in a fiscal year. Seven and one-half percent are allowed to be used for administrative activities of the Arts Program per ORS 359.426 and the remainder of the forty-two percent must be distributed equally to (a) the preservation of stabilization of an investment in Oregon's cultural resources through the Cultural Development Grant Program as provided for under ORS 359.431; (b) Oregon's counties and to nine federally recognized Indian tribes through the Community Cultural Participation Grant Program as provided for under ORS 359.436; and (c) the Core Partner's Agencies under ORS 359.441. Any further analysis of the Trust's use and accumulation of funds are beyond the scope of this article. Additional information on the Trust's use of funds may be found on the Trust's website. *See* www.culturaltrust.org.

Notification Regarding Updated Web Site:

The Taxation Section has updated its web site, which can be found at **http://osbtaxation.homestead.com/Index.html**. The Web site has the past issues of the Taxation Newsletter along with other helpful resources. Please take a moment to review it. If you would like to see anything added to the site, please contact one of the Executive Committee members.

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