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Submit Your Nominations for the Taxation Section Award of Merit

The Executive Committee of the OSB Taxation Section would like to recognize and honor those among us who exemplify professionalism in the practice of tax law in Oregon. The committee is currently accepting nominations for the Taxation Section's third Award of Merit. Nominations must be received by January 1, 2012. The Award will be granted to the candidate whom the 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 competence, ethics, conduct with others and the courts, and pro bono contributions to the Bar and tax system. The candidate's accomplishments must fall within the tax field. If a recipient is selected, the Award will be presented at the 12th Annual Oregon Tax Institute. Previous award recipients include David Culpepper of Thede Culpepper Moore Munro & Sillman and Robert Manicke of Stoel Rives.

More information about the criteria for the award and the nomination form is available online at www.osbartax.com/Award-of-Merit.

Oregon Taxation of the Sale of LLC Interests

By Elisabeth S. Shellan[1]

Imagine the following scenario: Your client owns an interest in a limited liability company ("LLC") that operates a business in Oregon or owns real property located in Oregon. Your client has never set foot in Oregon. But when your client sells his or her LLC interest, can Oregon tax your client? This article will discuss how Oregon taxes the gain from the sale of an LLC interest owned by a nonresident individual or a corporation.[2]

This question is particularly interesting because Oregon, like most states, views the source of the income realized from the sale of an LLC interest as different from the source of the income generated by the LLC's operations.[3] In the case of a nonresident individual owner, for example, with respect to income from operations, Oregon "looks through" the LLC[4] and taxes the owner's distributive share of the LLC's Oregon-source income. In contrast, Oregon taxes the income from the sale of an LLC interest as income from the sale of intangible personal property, which is Oregon-source income only if the LLC interest itself has a "business situs" in Oregon.[5]

Gain from the Sale of an LLC Interest Owned by a Nonresident Individual

Oregon imposes a tax on the income of nonresident individuals derived from or connected with sources in Oregon.[6] Oregon law states that the gain derived from the disposition of intangible personal property constitutes income derived from sources within Oregon only to the extent that

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1 Elisabeth Shellan is an associate at Stoel Rives LLP in Portland, Oregon. The author thanks Robert Manicke and Eric Kodesch for their assistance with this article.

2 Unless otherwise indicated, this article assumes the LLC will be treated as a partnership for tax purposes pursuant to Treas. Reg. § 301.7701-3, Or. Rev. Stat. § 63.810 and Or. Rev. Stat. § 316.277.

3 See Prentiss Willson & Mark Windfeld-Hansen, *State Taxation of Pass-Through Entities: General Principles*, 1500 Tax Mgmt. Multistate Tax Portfolios (BNA) at 1500:0028a (2001 & Supp 2010).

4 Or. Rev. Stat. § 316.127(1)(a). This principle is also followed in the Internal Revenue Code. I.R.C. § 701 ("A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.").

5 Or. Rev. Stat. § 316.127(3).

6 Or. Rev. Stat. § 316.037(3).

such income is from property employed in a business, trade, profession or occupation carried on in Oregon.[7]

In *Bishop v. Department of Revenue*, Gary Bishop, a California resident, was a general partner in an Oregon limited partnership that owned and operated a Christmas tree farm in Oregon.[8] Mr. Bishop wanted to sell half of his interest to Lillian Peste (who was a current limited partner in the partnership), but the other general partner refused to give his consent unless Mr. Bishop first converted his general partnership interest to a limited partnership interest.[9] Accordingly, one-half of Mr. Bishop's general partnership interest was converted to a limited partnership interest, which Ms. Peste then bought.[10] Mr. Bishop excluded this gain from his Oregon tax return.[11] The Oregon Department of Revenue (the "Department") and Mr. Bishop agreed that "a general partnership interest has a situs in Oregon because, by definition, it is intangible personal property used in a trade or business. [And] a limited partnership interest has no situs in Oregon unless it is employed in a business."[12] The parties disagreed, however, as to whether the partnership interest sold was properly characterized as a limited partnership interest. The Department asserted that, based on a step transaction theory, Mr. Bishop had actually sold a general partnership interest with a situs in Oregon.[13] (The Department was apparently concerned that the situs of a partnership interest may be shifted outside the state by agreement.)[14] The Tax Court declined to apply the step transaction doctrine, finding that there was a "significant change in the interests owned by the taxpayers."[15] The court then followed the legal analysis agreed to by the parties and concluded that the gain from the sale of Mr. Bishop's limited partnership interest was not subject to taxation by Oregon.[16]

After the tax year at issue in *Bishop*, the Department promulgated a rule addressing the taxation of a nonresident individual's gain from the sale of an interest in an Oregon LLC.[17] Under the Department's rule, treatment of the gain depends on whether the seller is a member-manager of the LLC.[18]

Seller is a Member-Manager

If the seller is a member-manager of the LLC, then the sale is treated as a sale of a general partnership interest.[19] Essentially, the Oregon Administrative Rule treats the general partner/member-manager as if it were carrying on the business of the LLC in Oregon.[20] This follows the stipulations of the parties in *Bishop*.[21] Therefore, a nonresident member-manager's gain or loss from the sale of an LLC interest in an LLC doing business in Oregon is Oregon-source income.[22]

Once the income is determined to be Oregon-source income, assuming the LLC is taxable in more than one state, the gain or loss is generally allocated as provided in section 314.635 of the Oregon Revised Statutes.[23] Under that statute, gain or loss from the sale of a partnership interest is allocable to Oregon in the ratio that the original cost of partnership tangible property in Oregon bears to the original cost of partnership tangible property everywhere, determined at the time of sale.[24] However, if more than 50 percent of the value of the partnership's assets consists of intangibles, gain or loss from the sale of the partnership interest is allocated to Oregon in accordance with the sales factor for the partnership for its first full tax year immediately preceding its tax year during which the partnership interest was sold.[25]

Seller is Not a Member-Manager

If the seller is not a manager of the LLC, then the sale is treated as a sale of a limited partnership interest.[26] In general, a nonresident's gain or loss from the sale of a limited partnership interest is not Oregon-source income even if the partnership is carrying on Oregon business in Oregon.[27] As the Oregon Tax Court explained in *Bishop*, a limited partnership interest is similar to a bond or a share of stock in that the interest confers no right to control or management of the partnership and no right to specific partnership assets.[28] The gain or loss from the sale of the interest will not be used to determine Oregon taxable income unless the limited partnership interest has acquired a business situs in Oregon.[29]

Intangible personal property of a nonresident has a situs for taxation in Oregon when used in the conduct of the taxpayer's business, trade or profession in Oregon.[30] For example, if a nonresident pledges intangible personal property in Oregon as security for the payment of indebtedness, taxes or the like incurred in connection with a business in Oregon, the property pledged has a business situs in Oregon.[31] If intangible personal

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7 Or. Rev. Stat. § 316.127(3).
8 Bishop v. Dept. of Rev., 13 Or. Tax. 472, 473 (1996).
9 *Id.* at 473-74.
10 *Id.* at 474.
11 *Id.*
12 *Id.* at 475.
13 *Id.* at 476.
14 *Id.* at 476-77.
15 *Id.* at 476.
16 *Id.* at 477.
17 Or. Admin. R. 150-316.127-(D). These rules were substantially revised by the Department effective January 20, 2006, with comment by the Oregon State Bar Tax Section. *See* Or. Rev. Stat. 63.001(20), (22).
18 Or. Admin. R. 150-316.127-(D)(2)(f); cf. *CRIV Investments, Inc. v. Dept. of Rev.*, 14 Or. Tax. 181, 184 (1997) (stating that "[w]hen the income is <u>distributable</u> partnership income, it is immaterial that taxpayer is a limited rather than a general partner" (emphasis added)).
19 Or. Admin. R. 150-316.127-(D)(2)(f)(A).
20 This rule corresponds to the "aggregate theory" of partnership taxation.
21 *Bishop*, 13 Or. Tax. at 475.
22 Or. Admin. R. 150-316.127-(D)(2)(d).
23 *Id.* The rule appears to assume that the gain or loss is nonbusiness income. *See* Or. Rev. Stat. § 314.625.
24 Or. Rev. Stat. § 314.635(4).
25 *Id.*
26 Or. Admin. R. 150-316.127-(D)(2)(f)(B). This rule corresponds to the "entity theory" of partnership taxation. The Oregon Tax Court has stated that "[s]itus, like guilt, should not be attributed by association." *Bishop*, 13 Or. Tax. at 475.
27 Or. Admin. R. 150-316.127-(D)(2)(e).
28 *Bishop*, 13 Or. Tax. at 475.
29 Or. Admin. R. 150-316.127-(D)(2)(e).
30 Or. Admin. R. 150-316.127-(D)(1)(a).
31 Or. Admin. R. 150-316.127-(D)(1)(b); *Bishop*, 13 Or. Tax. at 475.

property of a nonresident has acquired a business situs in Oregon, gain from the sale of the property, regardless of where the sale is consummated, is income from sources within Oregon and is taxable to the nonresident.[32] As a practical matter, it seems doubtful that an LLC member who is not a manager could use his or her interest to conduct business in Oregon without running afoul of the limitations placed on members who are not managers regarding the control they may exercise over the LLC.[33]

Who is a Member-Manager?

The Department's rule describes a "member-manager" as a person who has the right to participate in the management and conduct of the LLC's business.[34] The rule states that if an LLC is designated as a member-managed LLC in its articles of organization, all members of the LLC will be member-managers.[35] The rule goes on to say that if an LLC is designated as a manager-managed LLC in its articles of organization, only those persons who are both members of the LLC and designated as managers in the LLC's operating agreement (or are elected as managers by the LLC members pursuant to the operating agreement) will be member-managers.[36]

Commentators have suggested that in a manager-managed LLC, those members not designated or elected as managers will be treated as limited partners for purposes of the Oregon income tax rules, even if those individuals are actively involved in the business operations of the LLC.[37] However, the Oregon Tax Court suggested that a court might inquire into whether, as a matter of fact, an ostensibly limited partnership interest conferred any right to managerial control.[38] If so, gain from the disposition of such an interest could be subject to tax in Oregon, as would gain from the sale of a general partnership interest, on the theory that any partner exercising managerial control is doing business through the partnership. Overall, this rule has been described as "straightforward and administrable."[39] Yet, although this rule is facially simple, additional questions could arise without ready answers. For example, (1) how should changes in interests during the tax year be treated, and (2) what if a member-manager delegates authority to a nonmember manager?[40]

32 Or. Admin. R. 150-316.127-(D)(1)(b).

33 James S. Fenwick et al., *State Taxation of Pass-Through Entities and Their Owners* ¶ 11.03[3] (2009); Or. Rev. Stat § 63.140(2)(a).

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

35 *Id.*; *see* Or. Rev. Stat. § 63.047(1)(d).

36 Or. Admin. R. 150-316.127-(D)(2)(f)(C).

37 Sheldon Banoff & Richard M. Lipton, *Are LLC Members GPs or LPs for State Tax Purposes? The Question Won't Go Away!* 104 J Tax'n 380, 381 (2006).

38 *See Bishop*, 13 Or. Tax. at 476 (Tax Court rejected the Department's contentions that ownership of a 5 percent general partnership interest would taint a limited partnership interest held by the same individual; the court upheld the character of the limited partnership interest).

39 Banoff & Lipton, *supra* note 37.

40 *Id.*

What if the LLC Interest Is Owned by a Corporation Based Outside Oregon?

Sale of an LLC Interest Owned by a Corporation Doing Business in Oregon

Oregon imposes an excise tax measured by net income on corporations doing business within Oregon.[41] If a corporation is doing business solely in Oregon, then all of its taxable income is taxed by Oregon, including gain from the sale of an LLC interest held by the corporation. On the other hand, if a corporation is doing business in multiple states, then gain must be classified as business or nonbusiness income pursuant to the Uniform Division of Income for Tax Purposes Act ("UDITPA") as adopted by the Oregon Legislature.[42]

Business income is defined as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, the management, use or rental, and the disposition of the property constitute integral parts of the taxpayer's regular trade or business operations."[43] This definition gives rise to two tests for business income: the transactional test ("[i]ncome arising from transactions and activity in the regular course of the taxpayer's trade or business"[44]) and the functional test ("income from tangible and intangible property if the acquisition, the management, use or rental, and the disposition of the property constitute integral parts of the taxpayer's regular trade or business operations"[45]).[46] Capital gains that constitute business income are apportioned.[47] Other gains constitute nonbusiness income and are to be allocated.[48] Under section 314.635(4) of the Oregon Revised Statutes:

> Gain or loss from the sale of a partnership interest is allocable to this state in the ratio of the original cost of partnership tangible property in the state to the original cost of partnership tangible property everywhere, determined at the time of the sale. In the event that more than 50 percent

41 Or. Rev. Stat. ch. 317.

42 Or. Rev. Stat. § 314.615.

43 Or. Rev. Stat. § 314.610(1). Income that does not satisfy this definition constitutes nonbusiness income. Or. Rev. Stat. § 314.610(5).

44 Simpson Timber Co. v. Dept. of Rev., 326 Or. 370, 372, 953 P.2d 366 (1998) (internal quotation marks and citation omitted).

45 *Id*. (internal quotation marks and citation omitted).

46 The Oregon Supreme Court has held that these two tests are separate and that the functional test is not a subset of the transactional test. Pennzoil Co. and Subsidiaries v. Dept. of Rev., 332 Or. 542, 546, 33 P.3d 314 (2001), *cert. denied*, 535 U.S. 927 (2002). The Regular Division of the Oregon Tax Court recently held that the functional test is divisional; gain from the sale of property satisfies the functional test if any of the acquisition, management, use, rental, or disposition of the property constitutes integral parts of the taxpayer's regular trade or business. *See* Order, Crystal Communications, Inc. v. Dept. of Rev., TC 4769 (Or. Tax. Reg. Div. July 19, 2010) (gain from liquidation sale satisfied the functional test).

47 Or. Rev. Stat. § 314.650 ("All business income shall be apportioned to this state by multiplying the income by the sales factor.").

48 Or. Rev. Stat. § 314.625.

of the value of a partnership's assets consists of intangibles, gain or loss from the sale of the partnership interest shall be allocated to this state in accordance with the sales factor of the partnership for its first full tax year immediately preceding its tax year during which the partnership interest was sold.

A corporate partner, the regular course of business of which does not include buying and selling LLC interests, would have a strong argument that the gain from the sale of the LLC interest is not business income under the transactional test.[49] Under the functional test, however, if the acquisition, management, use, rental or disposition of the LLC interest is integral to the business, its sale would likely be treated as generating business income.[50] If gain from the sale of the LLC interest satisfies neither the transactional test nor the functional test, the gain should be nonbusiness income allocable under section 314.635(4) of the Oregon Revised Statutes, even if income from the LLC's operations would be apportionable under either the transactional or the functional test of UDITPA.[51]

Sale of an LLC Interest by a Corporation Not Doing Business in Oregon

Oregon also imposes an income tax on corporations not "doing business in Oregon," but with Oregon-source income.[52] "Income from sources within th[e] state" includes income from intangible property having a situs in Oregon.[53] The corporation income tax law applies relatively infrequently and generally incorporates the operative provisions of the corporation excise tax law, including the allocation and apportionment provisions for gain or loss from the sale of a partnership interest.[54]

Does the Answer Change if the LLC Owns Real Estate?

Practitioners are interested in whether gain from the sale of an interest in an LLC classified as a partnership is deemed to be income from the sale of an intangible asset if the LLC owns real estate (or tangible personal property).[55] Oregon case law contains no authority on point, but section 63.239 of the Oregon Revised Statutes states that "a membership interest is personal property. A member is not a co-owner of and has no interest in specific limited liability company property." This statute is consistent with the limited commentary on the issue, which suggests that a partner would not be expected to look through the partnership and treat the sale as if it had sold its share of the partnership assets directly.[56] Thus, the general rules described above apply and do not appear to be overridden by the fact that the LLC may hold Oregon real property.[57]

What if the LLC Is a Disregarded Entity?

There are no Oregon court cases dealing expressly with the sale of a disregarded single-member LLC, and there is only limited case law from other jurisdictions. Nevertheless, commentators believe that states will not treat the sale of a disregarded entity as the sale of an intangible, but will instead treat the seller as if it held the assets of the disregarded entity directly.[58] Oregon, which ties to federal entity classification law, should treat the sale of a single-member LLC in the same manner as the sale of a corporate division.[59] If the sale is deemed to be a sale of assets, Oregon would, in general, use the transactional and functional tests to determine whether the sale of assets generated business or nonbusiness income.[60]

Conclusion

In conclusion, (1) Oregon taxes a nonresident individual's gain from the sale of an interest in an LLC operating in Oregon only if the selling member is a member-manager of the LLC or the interest has acquired a business situs in Oregon; and (2) Oregon will generally tax a corporation doing business in Oregon on an apportioned amount of the gain from the sale of an interest in an LLC, unless the gain is treated as nonbusiness income, in which case the gain will be allocated pursuant to the special rules in section 314.635 of the Oregon Revised Statutes for allocation of income from the sale of a partnership interest.

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49 Fenwick et al., *supra* note 33, ¶ 11.03[3].

50 *Id.*

51 *See id.* The later use of cash proceeds from the sale of an LLC interest should not determine whether gain from the sale of the property constitutes business income. *See* Terrace Tower USA, Inc., v. Dept. of Rev. 16 Or. Tax. Magis. Div. 131 (1999).

52 Or. Rev. Stat. ch. 318.

53 Or. Rev. Stat. § 318.020(2).

54 Or. Rev. Stat. § 318.031.

55 Jerome R. Hellerstein & Walter Hellerstein, 1 *State Taxation* ¶ 9.12 (3d ed 2010).

56 Fenwick et al., *supra* note 33, ¶ 11.03[3].

57 While not directly on point, note that section 314.258 of the Oregon Revised Statutes requires withholding of Oregon income tax if a nonresident individual or corporation not domiciled or qualified to do business in Oregon conveys "fee title to any real estate located in the State of Oregon," unless an exception applies.

58 Fenwick et al., *supra* note 32, ¶ 11.04; Michael W. McLoughlin & Walter Hellerstein, *State Tax Treatment of Foreign Corporate Partners and LLC Members After Check-the-Box,* 8 St. & Loc. Tax Law. 1, 27 (2003).

59 *See* Or. Rev Stat. §§ 63.810, 316.007, 316.012, 317.013, 317.018.

60 Fenwick et al., *supra* note 33, ¶ 11.03[3].

Facilitating Fraud: The Perils of Cooperating with a Tax Avoidance Scheme

By Karl A. Iverson Kaufman[1]

A recent Tax Court case illustrates the danger of cooperating with another person's tax avoidance scheme.

In *CHC Industries, Inc.*,[2] an independent consultant performed services for a company and earned a $275,800 consulting fee. Rather than submitting an invoice for the services to the company, however, the consultant submitted an invoice to a corporate affiliate of the company. After paying the invoice, the affiliate became insolvent and was unable to pay its $2 million income tax liability. The Tax Court concluded that the affiliate's transfer to the consultant was fraudulent under state law and that, under I.R.C. § 6901(a)(1), the independent consultant was liable as a transferee for $275,800 plus interest.

The Taxi Transaction

Nancy Caldarola worked as an independent consultant to Fortrend International, L.L.C. ("Fortrend"). Under the consulting agreement, Fortrend would pay Caldarola a finder's fee if she introduced a company to Fortrend and the company entered into a transaction with Fortrend or a Fortrend affiliate. The finder's fee would be either 10 percent of Fortrend's gross fee or 25 percent of Fortrend's net fee from the transaction.

In 1999, Caldarola introduced Fortrend to Midcoast Capital Credit Corp. The introduction resulted in the "Taxi Transaction." In the Taxi Transaction, Fortrend acquired the stock of two taxi companies through a series of complicated transactions. In May 2000, before the Taxi Transaction closed, Caldarola incorporated CHC Industries, Inc. ("CHC"), the petitioner. In October 2000, after the Taxi Transaction closed, Fortrend agreed to pay a $275,800 finder's fee to CHC. The Service stipulated that the $275,800 finder's fee was fair consideration for the services Caldarola provided Fortrend.

Rather than submitting an invoice to Fortrend, however, CHC submitted invoices to two Fortrend affiliates, including St. Augustine, Inc. ("St. Augustine"). Although CHC never performed services for St. Augustine, the invoice stated it was for "consulting services rendered for St. Augustine, Inc." After receiving the invoice, a Fortrend employee wired CHC $275,800 from a St. Augustine bank account. CHC did not know, and the transfer did not indicate, which of the two Fortrend affiliates made the wire transfer.

The $275,800 payment was one of a number of payments St. Augustine made with respect to the Taxi Transaction. St. Augustine attempted to deduct those payments on its 2000 federal income tax return. However, no creditor paid by St. Augustine performed services for St. Augustine, and the Service denied the deductions. Because of the Taxi Transaction payments and the disallowed deductions, St. Augustine became insolvent.

The Service assessed a $2,337,499 deficiency in St. Augustine's 2000 federal income tax. At the time of assessment, however, St. Augustine had no assets. The Service therefore asserted that CHC was liable as a transferee under I.R.C. § 6901(a)(1) for receiving St. Augustine's assets in a transfer that was fraudulent under state law.

Transferee Liability

In some circumstances, the Service may collect unpaid taxes from a person to whom the taxpayer transferred assets. I.R.C. § 6901(a) provides the Service with a procedure to assess and collect taxes from a transferee "in the same manner and subject to the same provisions and limitations as in the case of the taxes with respect to which the liabilities were incurred." That section, however, is procedural; it does not create a substantive liability. Instead, state law determines whether a transferee is liable for the transferor's Federal income tax liability.

The Service asserted that I.R.C. § 6901(a)(1) applied because St. Augustine's transfer constituted constructive fraud under the California Civil Code. Specifically, California Civil Code section 3439.04(a)(2) provides that a transfer is fraudulent if the debtor transfers an amount without receiving reasonably equivalent value in exchange and either (1) the debtor was engaged in a transaction for which its remaining assets were unreasonably small in relation to the transaction or (2) the debtor reasonably should have believed that it would incur debts beyond its ability to repay.[3]

The Tax Court explained that St. Augustine's Taxi Transaction payments rendered it insolvent, that it reasonably should have believed that the Service would disallow its deductions, and that it reasonably should have believed that it would be unable to pay its income tax liability. Accordingly, CHC's transferee liability turned on whether it provided services to the transferor that were reasonably equivalent in value to the $275,800 payment.

CHC's Substance over Form Defense

It was uncontested that, despite what was written on the invoice, CHC never provided services directly to St. Augustine. However, CHC argued that the substance over form doctrine applied to treat Fortrend as the transferor. The Service stipulated that the finder's fee was reasonable compensation for CHC's service provided to Fortrend. Thus, according to CHC, it was not liable under California law because the transferor (Fortrend) received reasonably equivalent value in exchange for the payment.

The Tax Court disagreed with CHC and declined to apply the substance over form doctrine. The court reasoned that the following circumstances weighed against applying the doctrine:

- CHC facilitated the Taxi Transaction by introducing Fortrend and Midcoast Capital Credit Corp.
- CHC likely was aware of the type of transaction that Fortrend intended to carry out in the Taxi Transaction.

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1 Karl A. Iverson Kaufman is an associate at Thede Culpepper Moore Munro & Silliman LLP in Portland, Oregon. Karl practices in the areas of tax law, business law, tax-exempt organizations, and estate planning. Karl received his J.D. from the University of Oregon School of Law (Order of the Coif, 2007) and his Master of Laws in Taxation from New York University School of Law (2010), where he was a graduate editor of the Tax Law Review and awarded one of six Wilf Tax Scholarships, the school's top merit scholarship.

2 *CHC Industries, Inc. v. Comm'r*, T.C.M. 2011-33.

3 Cal. Civ. Code § 3429.04(a), a provision in the California Uniform Fraudulent Transfer Act, is substantively identical to Or. Rev. Stat. § 95.230, a provision in Oregon's Uniform Fraudulent Transfer Act.

- St. Augustine claimed a deduction for the payment to CHC.
- Petitioner did not explain why it submitted an invoice to St. Augustine despite not having performed any services for St. Augustine.
- The $275,800 payment was made by St. Augustine for the sole purpose of St. Augustine claiming a federal income tax deduction.

The court therefore determined that St. Augustine was the transferor.

Conclusion

Despite what it claimed on the invoice, CHC never provided services to St. Augustine. Thus, St. Augustine's transfer to CHC was not for reasonably equivalent value and was fraudulent under California law. Accordingly, the court concluded, CHC was liable as a transferee under I.R.C. § 6901(a)(1) for $275,800 plus interest.

The reported decision does not indicate why CHC invoiced St. Augustine rather than Fortrend. However, it seems likely CHC was accommodating a request from Fortrend. CHC now has reason to regret its accommodation.

Oregon Businesses Benefit from Income Tax Reconnect

By Daniel S. Lapour[1]

Oregon, similar to many other states with an income tax, has adopted a policy of general (or "rolling") conformity to the federal Internal Revenue Code ("I.R.C.") relating to the computation of taxable income.[2] This means that federal changes to the I.R.C. which relate to the definition of taxable income are automatically incorporated into Oregon law without requiring action by the legislature. Conformity to the I.R.C. promotes simplicity and uniformity, thereby reducing administrative and compliance burdens. However, conformity can also lead to the loss of legislative control over state revenue since federal deductions will extend to state taxes as well.

Oregon's income tax forms reflect our state's general conformity to the I.R.C.: the state taxable income calculation begins with federal taxable income before adjustments are made to arrive at Oregon taxable income. In 1997, Oregon first adopted "rolling" conformity to the I.R.C. and, as such, automatically connected to changes as they were made to the I.R.C. Rolling conformity was temporarily suspended for tax years 2003 to 2005, and then reestablished in 2006, with exceptions.[3]

Oregon's abandonment of rolling conformity from 2003 to 2005 was triggered by the state's need to closely examine the financial impact of a federal tax package[4] that would automatically be incorporated into Oregon law. A similar event occurred in February 2009 when the Oregon Legislature analyzed whether Oregon's conformity to a new federal stimulus plan[5] moving through Congress would result in a significant loss of tax revenue. The Oregon Legislative Revenue Office estimated that conforming to the stimulus plan would result in a direct cost to Oregon of $135 million during the 2009–2011 biennium.[6] The suspension of rolling conformity and later selective adoption and rejection of certain federal adjustments create unique federal conformity issues for tax years 2009–2011, as discussed below.

Tax Year 2009

On February 14, 2009, Oregon enacted H.B. 2157, which suspended rolling conformity by fixing the I.R.C. connection date to December 31, 2008—before the tax provisions of the stimulus plan became effective.

Subsequently, after state lawmakers had time to sort through the federal stimulus package and its tax effects, H.B. 2078 updated the I.R.C. connection date to May, 1 2009, with exceptions, thereby updating Oregon's tax laws to conform to some—but not all—of the federal stimulus provisions. Specifically, Oregon decoupled from additional federal deductions allowed with regard to bonus depreciation,[7] discharge of indebtedness,[8] and I.R.C. § 179 expenses.

Bonus Depreciation

The American Recovery and Reinvestment Act of 2009 includes a special first-year bonus depreciation deduction at a 50 percent rate for 2009, for certain property acquired on or after January 1, 2009 and before January 1, 2010.[9] Under H.B. 2078, Oregon specifically disconnected from this provision.[10] Therefore, any federal bonus depreciation deduction allowed for qualified property acquired on or after January 1, 2009 and before January 1, 2010 requires an addition on the Oregon return for the first year. A subtraction is allowed on the Oregon return for subsequent years.

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1 Daniel S. Lapour is a Manager in the Portland office of Deloitte Tax LLP. The author would like to thank Scott Schiefelbein for his many helpful comments and suggestions. Scott Schiefelbein is a Senior Manager in the Portland office of Deloitte Tax LLP. The author may be reached at dlapour@deloitte.com. This article does not constitute tax, legal, or other advice from Deloitte Tax LLP, which assumes no responsibility with respect to assessing or advising the reader as to tax, legal, or other consequences arising from the reader's particular situation.

2 Or. Admin. R. 150-317.018(1).

3 Oregon decoupled indefinitely from several federal provisions, including I.R.C. § 199 relating to the domestic production activities deduction and I.R.C. § 139A relating to the exclusion of federal subsidies for prescription drug plans from gross income. Or. Rev. Stat. §§ 316.836 and 316.837.

4 Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27) (enacted May 28, 2003).

5 American Recovery and Reinvestment Act of 2009 (P.L. 111-5) (enacted February 17, 2009).

6 Research Brief, The American Recovery and Reinvestment Act of 2009 (The Impact on Oregon), Oregon Legislative Revenue Office, March 2009, available at http://www.leg.state.or.us/comm/lro/2009_session/american_recovery_act.pdf

7 I.R.C. § 168(k).

8 I.R.C. § 108.

9 I.R.C. § 168(k). The specific requirements for qualifying for the federal bonus depreciation deduction are beyond the scope of this article.

10 Or. Rev. Stat. § 316.739(2).

Discharge of Indebtedness

I.R.C. § 108(i) allows a taxpayer to defer discharge of indebtedness income in connection with the reacquisition of an applicable debt instrument occurring in 2009 and 2010. Because Oregon disconnected from this federal provision, for these tax years Oregon taxpayers must add back this deferred income and recognize the income during the current year.[11]

Expensing Depreciable Assets

The stimulus plan also provides for a temporary increase in limitations on expensing of certain depreciable business assets under I.R.C. § 179. For tax years beginning on or after January 1, 2009, Oregon requires an addback for the additional federal deduction allowed by the temporary increase in limitations. [12]

Tax Year 2010

In early 2011, the Oregon Legislature considered S.B. 301, which would reconnect Oregon to the federal definition of taxable income for tax year 2010, including all of the federal tax changes Congress made in 2010, but with exceptions for bonus depreciation and certain expensing provisions. The bill moved quickly through the Senate and House and was signed into law on March 9, 2011.

While S.B. 301 incorporated the changes Congress made in 2010 into the definition of federal taxable income for Oregon purposes, it continues the disconnect from federal deductions related to bonus depreciation, discharge of indebtedness, and additional expensing allowed under I.R.C. § 179. However, the bill provided that these decoupling provisions only apply to tax years beginning on or after January 1, 2009, and before January 1, 2011.

Decoupling from Federal Provisions Enacted in 2010

The Creating Small Business Jobs Act of 2010[13] and the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010[14] extended the federal bonus depreciation deduction for tax year 2010 and beyond and increased the bonus depreciation deduction from 50 percent to 100 percent for assets acquired and placed in service after September 8, 2010. Oregon taxpayers, however, must add back any first year bonus depreciation deduction reported for federal purposes for property acquired before January 1, 2011.[15] Additionally, for tax year 2010, Oregon remained disconnected from I.R.C. § 108(i) and any temporary increase in limitations on expensing of certain depreciable business assets under I.R.C. § 179.[16]

Conforming to Federal Provisions Enacted in 2010

The passage of S.B. 301 connects Oregon to many changes made by Congress in 2010, including the expansion of the definition of "dependent" to include children up to age 26 for the federal income tax exclusion for group health care coverage pursuant to the Patient Protection and Affordable Care Act.[17] If Oregon had not conformed to the expanded definition of "dependent," Oregon employers would have faced the logistical problem of identifying employees who received expanded health coverage under this new law and imputing Oregon state income to those employees equal to the value of the increased coverage. By conforming to the expanded federal law, Oregon has allowed its employers to avoid that problem (as well as the potential employee morale problem such treatment would have caused).

Tax Year 2011

Oregon S.B. 301 also reestablished rolling conformity with the I.R.C. for tax years beginning on or after January 1, 2011, eliminating any exceptions for bonus depreciation and expensing provisions.[18] When the bill was first moved to the floor of the House after unanimous passage by the Senate, it was discovered that the reconnection was incomplete because the bill failed to reconnect Oregon to the federal bonus depreciation and expensing provisions for tax year 2011. The House amended the bill to reconnect to these federal provisions, and the Senate concurred in the House amendments and re-passed the bill.

As a result, for tax year 2011, taxpayers will not be required to add back federal deductions on their Oregon return related to federal bonus depreciation, discharge of indebtedness, and additional expensing allowed under I.R.C. § 179. Oregon taxpayers, however, are still entitled to the subtractions resulting from previous addbacks of bonus depreciation in prior years. Even for tax years beginning on or after January 1, 2011, Oregon continues to be disconnected from federal subsidies for prescription drug plans under I.R.C. § 139A and domestic production activities deduction under I.R.C. § 199.

Conclusion

With the passage of S.B. 301, the Oregon Legislature extended most federal tax benefits to Oregon taxpayers for tax years beginning on or after January 1, 2011. The Oregon Legislature will presumably continue to review and monitor federal tax changes to determine the impact on state revenue. However, with rolling conformity reestablished, specific legislation will be required to prevent the adoption of any federal changes.

11 Or. Rev. Stat. § 316.739(1).
12 Or. Rev. Stat. § 316.739(3).
13 P.L. 111-240
14 P.L. 111-312
15 Or. Rev. Stat. § 316.739(2).
16 Or. Rev. Stat. § 316.739(1) and (3).
17 Patient Protection and Affordable Care Act (P.L. 111-148) (enacted March 23, 2010).
18 S.B. 301, adopted March 9, 2011, section 31.

(Personal) Goodwill Hunting: Why it Pays to Re-read *Martin Ice Cream Co*.

By Jay Richardson[1]

When *Martin Ice Cream Co*., 110 T.C. 189 (1998) was issued, lawyers rejoiced. While the holding in *Martin* did not specifically address any shareholder-level tax issues, the case allowed tax practioners to argue that an individual can own and therefore sell "personal goodwill."[2] While the facts in *Martin* were unique in the business world (how many clients "revolutionized" an industry the way Arnold Strassberg revolutionized the retail premium ice-cream industry?), was *Martin* limited to such unique circumstances? If the answer to that question is no, then how far away from the facts of *Martin* can a practitioner hunt for saleable personal goodwill? The sale-of-personal-goodwill issue has been litigated several times since *Martin*. These cases show that while a little revolution is not essential, some individuals claimed personal goodwill in transactions that, had they read *Martin*, they may have thought twice before allocating sales proceeds to personal goodwill.

A Goodwill Primer. A brief review of personal goodwill in the context of a business sale is appropriate before we review the recent cases. In a business sale, sellers want to defer gain and pay favorable tax rates. Buyers want to deduct their purchase price. Goodwill (a capital asset) may be sold and can receive an allocation of purchase price. Goodwill is generally favorable to both buyers and sellers. Buyers can amortize goodwill over 15 years. The seller gets a favorable long-term capital gains tax rate.

But whose goodwill are we talking about: the goodwill of a corporation or the goodwill of a key shareholder? Both can, in theory, own goodwill. If a corporation sells its goodwill, the goodwill will be taxable to the corporation. A subsequent distribution of cash to a selling shareholder, whether as compensation or a dividend, will be taxable to the shareholder. If the shareholder owns and sells the shareholder's goodwill, the prospect of double taxation is reduced.

The *Martin* Case. *Martin* is a long case at 78 pages. The key facts of *Martin* are as follows: Martin Ice Cream Co. was a distribution company whose success was based upon the relationships of one its founders, Arnold Strassberg, with customers. Arnold Strassberg introduced premium ice cream into supermarkets, revolutionizing how premium ice cream was sold to consumers. When Martin Ice Cream Co. was being purchased, the parties involved in the transaction, from the beginning, treated Arnold's personal relationships as his own. Arnold individually signed a "bill of sale" that listed "customer lists" and "other business records as requested by Buyer, and the goodwill associated therewith." The buyer also required Arnold to sign a consulting and noncompete agreement; these payments would be ordinary income to Arnold. The Tax Court held that Arnold had "personal goodwill" which was distinct from any goodwill of Martin Ice Cream Co. because:

1. The success of Martin Ice Cream Co. was ultimately dependent upon relationships developed by Arnold in a business dependent on personal relationships rather than capital investment; and

2. Arnold was not bound by a written noncompetition agreement with Martin Ice Cream Co.

These two requirements appear simple enough. What happens when personal goodwill is claimed in their absence? Cases since *Martin* show why *Martin's* simple requirements should be present to prop up the personal goodwill claim.

The *Solomon* Case: Don't Hunt for Personal Goodwill when the Facts are Materially Different from *Martin*. In *Solomon v. Commissioner,* 95 T.C.M. (CCH) 1389 (2008), the taxpayers stretched the limits of *Martin* in every way possible. In *Solomon*, a corporation sold a line of business to a competitor. The shareholders (a father and son and their spouses) entered into covenants not to compete with the buyer. They claimed personal goodwill even though:

1. The company in question was a capital-intensive business (one involving "processing, manufacturing and sale rather than personal services") whose success did not entirely depend on the personal relationships of its owners. It is important to note here that while the *Solomon* court noted a difference between "capital" and "service" businesses, the fact that a business is a service-oriented business does not necessarily mean that a service business's individual owner who attempts to sell personal goodwill is given reduced scrutiny.[3]

2. The buyer in *Solomon* required noncompete agreements from the taxpayers, but not employment or consulting agreements suggesting that the individuals had no personal goodwill to sell.

3. The individual taxpayer's claim to personal goodwill appears to have arisen after the transaction was completed; personal goodwill was not even mentioned in the sale documents. The court even noted that the buyer never required that any of the purchase price be allocated to the customer list and that the customer list was apparently of little, if any, value to it.

The Tax Court held that payments received by the father and son were attributable to the covenants not to compete and not the sale of a customer list.

The *Muskat* Case - Claim Personal Goodwill from the Beginning when the Facts Support It. No one apparently read *Martin* before the transactions in *Muskat v. United States*, 554 F.3d 183 (1st Cir. 2009). Mr. Muskat was the shareholder of a meat-packing company that sold its assets. Like Martin Ice Cream Co., the success of the company was dependent upon personal contacts in the industry.

The asset purchase agreement in *Muskat* allocated nearly $16 million of the purchase price to the company's goodwill. Mr. Muskat signed a noncompete agreement for which he was to be paid almost $4 million. Mr. Muskat reported the $1 million he received in the first installment of the noncompete

1 Jay Richardson is senior counsel at Buckley LeChevallier in Portland, Oregon.

2 Actually, MacDonald v. Comm'r, 3 T.C. 720 (1944) acknowledged personal goodwill long before *Martin Ice Cream Co*.

3 *See, Kennedy v. Comm'r*, T.C.M. 2010-206 (2010).

payments as ordinary income. After the transaction was over, Mr. Muskat had a *Martin* "moment" and amended his personal tax return, reclassifying the noncompete payments as capital gain for the sale of "personal goodwill." Mr. Muskat took the position that, due to his advanced age, the buyer was really not gaining anything of value by virtue of payments under a noncompete agreement and, therefore, the payments under the noncompete agreement were really payments for the sale of his personal goodwill.

By now, it should not be hard to see why the Tax Court held against Mr. Muskat:

1. None of the agreements even mentioned personal goodwill.

2. The concept of personal goodwill was not even discussed during negotiations. In *Martin*, the parties from the outset recognized Arnold's personal goodwill as a saleable asset.

The *Howard* Case: Merely Listing Personal Goodwill as an Asset in a Purchase Agreement Will Not Help if the Facts are Otherwise Against You. In *Howard, v. United States,* 2010 U.S. Dist. LEXIS 77251 (E.D. Wa., 2010), Dr. Howard started his Spokane dental practice in 1972. In 1980, Dr. Howard incorporated his practice. He was the sole shareholder, director and officer. As part of his practice's incorporation, he executed a covenant not to compete that expired 3 years after he ceased to own any corporate stock. In 2002, Dr. Howard and his corporation entered into an asset sale agreement between Dr. Finn and his professional corporation. Most of the purchase price was allocated to the personal goodwill of Dr. Howard.

No surprise, the IRS viewed the goodwill as a corporate asset and treated the payment to Dr. Howard as a dividend from his professional corporation. In his arguments to the court, Dr. Howard relied (amazingly) on *Martin.* Ultimately, the court sided with the IRS and by now it should be easy to see why.

1. Dr. Howard was bound by a covenant not to compete with his company that extended three years after the close of the sale. This should have been an obvious red flag. Lack of a covenant not to compete between Martin and Martin Ice Cream Co. was a critical fact in support of Arnold's personal goodwill in *Martin.*

2. Dr. Howard apparently believed that simply listing personal goodwill on an asset purchase agreement would suffice. The concept of his personal goodwill, however, was never even discussed during negotiations.

3. Arnold Strassberg's contacts presumably would have and could have followed him anywhere because of his exceptional abilities. There was no evidence that Dr. Howard's patients would follow him.

On a side note, *Howard* also stands for one very important concept in the personal goodwill area not mentioned specifically in *Martin*. Although the purchase price allocation in *Martin* was unclear, less than half of the overall purchase price was allocated to Arnold's personal goodwill. The purchase price in *Howard* was allocated almost entirely to personal goodwill. Dr. Howard may have been greedy.

Conclusion

Some commentators look at the cases since *Martin* as signaling an unwillingness by courts to recognize the validity of personal goodwill in any case. I do not. Certainly a business owner who personally revolutionizes an industry like Arnold Strassberg probably has saleable personal goodwill. After all, the court in *Martin* noted that Arnold had "built the wholesale distribution of super-premium ice cream to supermarkets" and "changed the way ice cream was marketed to customers in supermarkets." Why should an Arnold-like international business owner, who has shaped an industry with his revolutionary ideas, be able to pursue the sale of personal goodwill while a local business owner, who may be well known in a regional, rural city, may not? Perhaps the way to approach personal goodwill is simply this circular approach: If an individual owner has developed personal goodwill, then the owner should be able to sell the personal goodwill. Personal goodwill is built on the seller's solid relationship with customers, seller's excellent reputation in the industry, and seller's unique skills that drive business to the seller's business. If that seller has not signed a covenant not to compete, then he or she should consider structuring a transaction as a sale of personal goodwill.

The Tax Lawyer Can Help Ease the Impact of the Estate Tax Burden After the Death of Business Owner

By Katherine VanZanten[1]

When the founder of a business dies and passes a small business to his heirs, the estate tax burden can be daunting and hamper business activities. The personal representative should consider whether the estate is eligible to pay the estate tax over time.

Businesses can survive an estate tax burden by paying the estate tax in installments. An executor should consider making an election under I.R.C. § 6166 if a portion of the estate tax is attributable to the decedent's closely held business. I.R.C. § 6166 was designed to allow the executor to pay the estate tax in installments to avoid jeopardizing a decedent's closely held business. The basic rules for qualifying, making, and maintaining an I.R.C. § 6166 election are set forth below.

Eligibility. An estate is eligible for an I.R.C. § 6166 election if: a) the decedent was either a U.S. citizen or a resident alien and b) the value of the interest held in a closely held business is greater than 35 percent of the decedent's adjusted gross estate. Passive assets of a closely held business are not considered when valuing the business for the I.R.C. § 6166 election. Passive assets are defined in I.R.C. § 6166(b)(9)(B)(i) as any asset other than an asset used in carrying on a trade or a business.

I.R.C. § 6166(b)(1) defines an "interest in a closely held business" as: (a) an interest as a proprietor in a trade or business carried on as a proprietorship, (b) an interest as a partner in a partnership carrying on a trade or business, if (1) 20 percent or more of the total capital interest in such partnership is included in determining the gross estate of the decedent, or (2) such partnership had 45 or fewer partners, and (c) stock in a

1 Katherine VanZanten is a shareholder at Schwabe, Williamson & Wyatt in Portland, Oregon.

corporation carrying on a trade or business, if (1) 20 percent or more in value of the voting stock of such corporation is included in determining the gross estate of the decedent, or (2) such corporation had 45 or fewer shareholders.

The 45 or fewer shareholders or partners element is set to expire on December 31, 2012. For purposes of meeting the requirements of I.R.C. § 6166, husbands and wives are considered to be one shareholder or partner.

Though the requirement is not found in I.R.C. § 6166, the IRS has taken the position (and prevailed) that the business must be an active trade or business. Rev. Rul. 2006-34 sets forth a list of factors to determine which kind of real estate activities constitute active trades or business. Merely holding investment property, whether it be real estate or other assets, is not considered an active trade or business. In Rev. Rul. 2006-34, the IRS evaluated the decedent's business to determine if it was an active trade or business. Some of the factors they considered were: the amount of time the decedent devoted to the trade or business, whether an office was maintained from which the activities of the decedent were connected, whether the decedent maintained regular business hours, the activities the decedent pursued in furtherance of the business, and whether the decedent personally made or arranged for various services to the business properties.

Making the Election. To make an election, the executor must file no later than the time for filing the federal estate tax return or on the last day of extension for filing such a return. The election is made in Part 3 of IRS Form 706. If the election is made at the time the return is filed, it applies to the tax due at that time as well as any deficiencies. If the election is made at a later date, the election would only apply to the deficiencies.[2] For purposes of evaluating whether a I.R.C. § 6166 election can be made, the business must be appraised.

Installment Payment. Installment payments can be made in 2 to 10 annual installments.[3] Tax payments can be deferred for up to 5 years though interest payments must be made during the deferral period. The portion of the estate tax that can be paid over time is the same ratio as the closely held business interest is to the gross estate.

For example, a businessperson dies and his closely held business is worth $900,000. Assume also that his gross estate is $2 million and his estate tax is $101,250. The business interest meets the percentage test. The portion which qualifies for deferral is $45,562.50.

$$\frac{\$900{,}000}{\$2{,}000{,}000} \times \$101{,}250 = \$45{,}562.50$$

Interest accrues on the unpaid portion of the tax. Currently, the interest rate is 2 percent on the deferred tax attributable to the first million dollars of taxable value of the business.[4] The one million dollar base is adjusted for inflation. For estates of decedents dying in calendar year 2011, the inflation adjusted amount is $1,360,000. The remaining amount owing will accrue interest at 45 percent of the underpayment rate (4 percent through September 11, 2011).

Acceleration of Payment. Once an I.R.C. § 6166 election is made, the executor must comply with all the rules and regulations in order to avoid the acceleration of the tax. I.R.C. § 6166(g)(1) provides that certain distributions, sales or exchanges or withdrawals from the closely held business that equal or exceed 50 percent of the value of the closely held business interest can accelerate the amount due under the I.R.C. § 6166 deferral.

Certain transactions do not result in an acceleration of the tax. For example, some redemptions, reorganizations, and transfers to beneficiaries will not accelerate the tax. Generally, acceleration does not occur if a transfer is to the beneficiaries under a will or trust by reason of death of a family member.

I.R.C. § 6166(g)(2) requires the estate or trust to use undistributed net income to pay down unpaid portions of the deferred estate tax. If the estate fails to make a required installment payment on or before its due date of the payment, the balance is required to be paid upon notice and demand by the IRS.

The IRS may require the executor to post a bond to secure payment of the estate tax.[5]

Oregon and Washington. If an executor makes a federal I.R.C. § 6166 election, that election can be used as a basis to make installment payments for the state estate tax in both Oregon and Washington. Oregon law allows for installment payments under section 118.225 of the Oregon Revised Statutes. The maximum time for deferral in Oregon is 14 years. To make installment payments, Oregon law requires the Department of Revenue to obtain a bond or some other type of security for the unpaid balance owing.

In Washington the executor must make the election on the Washington State Estate and Transfer Tax Return (line 12) and on Federal Estate Taxpayer Form 706. Washington allows for the same percentage of deferral as allowed under the I.R.C.. For example, if the I.R.C. § 6166 election results in deferral of 20 percent of the federal estate tax, 20 percent of the Washington estate tax may be deferred.

Conclusion. Estate taxes can severely hamper the cash flow of a closely held business. Making an I.R.C. § 6166 election can allow the business to continue by preserving estate assets needed for business operations.

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2 Treas. Reg. § 20.6166-1(a).

3 I.R.C. §6166(a)(1).

4 I.R.C. § 6601(j).

5 I.R.C. § 6165.