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# Newsletter

# Foreclosures of Reverse Mortgages: Inadvertent Tax Liability To Estate Beneficiaries

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People with debt-free homes will occasionally obtain a reverse mortgage on their homes. The reverse mortgage allows the homeowners to continue living in their own home, while increasing their cash flow due to the payments received from the mortgage company. However, complications arise if the person dies with a reverse mortgage on a home, especially if the balance due on the reverse mortgage is higher than the fair market value of the home at the time of death or, in current slang, underwater.

The general rule is that debt, including tax debt, is the responsibility of the decedent's estate. Children or other heirs of the decedent are not liable for any of the decedent's debt. However, it is possible for estate beneficiaries to inadvertently become liable for additional taxes if a decedent's residence is subject to an underwater reverse mortgage that is then foreclosed and the mortgage company discharges the remaining debt. This is a result of the unique conduit taxation nature of an estate. As a reminder, from a tax perspective, an estate is sometimes referred to as a "pass-through" entity. Each beneficiary, not the decedent's estate, pays income tax on his or her distributed share of income.

If a taxpayer, including an estate, is relieved of a nonrecourse liability in connection with the disposition of encumbered property, the debt relief is included in the taxpayer's amount realized for the purpose of computing gain or loss realized in the property transaction. *See* Treas. Reg. § 1.1001-2. If the taxpayer was instead relieved of a recourse liability, the amount of the forgiven debt is included in the taxpayer's gross income. *See* IRC § 61(a)(12); IRC § 108(a).

Reverse mortgages are generally nonrecourse debt. This is because the Federal Housing Administration (FHA) as part of its Home Equity Conversion Mortgage program insures most reverse mortgages. Therefore, if a reverse mortgage is obtained when the real estate market is high and the market subsequently crashes after most of the equity has been stripped from the home, the borrower (or the borrower's estate) will not be personally liable for the deficiency, if the mortgage was through the FHA program.

Applying this general rule to a reverse mortgage situation might look like this example. Imagine a situation where the decedent's home sells for $200,000 at a foreclosure auction. The outstanding loan balance was $300,000. The amount realized includes the sale proceeds ($200,000) and the amount of the discharge of liability ($100,000). Therefore, the amount realized by the borrower's estate is $300,000.

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The same home was appraised at $200,000 as of the date of the decedent's death. Therefore, the basis of the home is $200,000 because the basis of the home is adjusted to the fair market value of the home at the date of the decedent's death. IRC § 1014(a)(1).

The gain realized is the amount realized ($300,000), less the basis in the home ($200,000). As a result, the gain realized is $100,000. The capital gain is either taxed to the borrower's estate or passed through to the beneficiaries, depending on whether distributions are made to the beneficiaries during the tax year in which the estate realizes the capital gain.

If the estate terminates and is fully distributed to the beneficiaries during the tax year in which the gain was realized, then each beneficiary's share of the capital gain is reported on that beneficiary's personal income tax return without any corresponding distributed assets to pay the resulting increase in personal income taxes.

If the estate does not make any distributions to the beneficiaries during the tax year in which the gain was realized, then the capital gain is taxed directly to the estate. If the estate is unable to pay taxes on the capital gain, then the executor may be able to approach the IRS and ask to settle the outstanding debt. If this approach is contemplated, the beneficiaries should be advised to disclaim their interests in the home to avoid any distribution of the capital gain to the beneficiaries.

In conclusion, any time your client is dealing with an estate that has a reverse mortgage, you should exercise an abundance of caution and make sure you have all of the information prior to advising that client. Be sure you are the first to know whether an estate is insolvent and if a mortgage company will discharge nonrecourse debt as a result of a foreclosure.

# 529 Plans: Beware Transfer Tax Consequences on Change of Beneficiary

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Education savings plans under Section 529 ("529 plans") of the Internal Revenue Code ("IRC") are well-known vehicles for funding qualified higher education expenses. 529 plans offer a unique combination of gift, estate, and income tax benefits to the account owner and beneficiary, which are discussed briefly below. This article addresses the potential unintended transfer tax consequences when an account owner changes the beneficiary of a 529 plan to one in a lower generation.

**A) Transfer Tax and Income Tax Consequences of 529 Plans**

1) Gift Tax: Contributions to 529 plans are considered completed, present interest gifts to the beneficiary.[1] Therefore, contributions are eligible for the annual gift tax exclusion under IRC Section 2503(b) and the generation-skipping transfer tax exclusion under IRC Section 2642(c). Donors may make a lump-sum contribution to a 529 plan in an amount equal to five times the federal annual exclusion ($70,000 single or $140,000 if married) per recipient, provided that the donor files a gift tax return and makes the appropriate election.[2] The contribution is treated as being made ratably over five years, which exhausts the donor's eligibility to make additional annual exclusion gifts to the same beneficiary over that time period. In other words, a donor may contribute $70,000 (or $140,000 if married and electing to gift-split) to a 529 account for a beneficiary, but the donor may not make additional gifts to the same beneficiary over the next five years (whether through additional contributions to the 529 plan or otherwise) without transfer tax consequences. Advisors should caution plan owners that the five-year election is not automatic, and the donor must file a gift tax return. If a married couple elects to gift-split and ratably spread the maximum $140,000 contribution over five years, each spouse must file a separate gift tax return.

2) Estate Tax: Contributions to 529 plans are generally not included in the donor's gross estate for federal estate tax purposes.[3] Since contributions are treated as completed gifts, the plan value is included in the beneficiary's gross estate.[4] An exception occurs where the donor, prior to death, elected to spread a lump-sum contribution over five years pursuant to Prop Treas Reg § 1.529-5(b)(i). In such event, the portion of the contribution allocated to the years after the donor's death is included in his or her gross estate.

3) Income Tax: Investments within 529 plans grow tax-free until distribution.[5] Plan earnings avoid income tax upon distribution provided the funds distributed pay "qualified higher education expenses"[6] to an "eligible

1 IRC § 529(c)(2)(A)(i).
2 Prop Treas Reg § 1.529-5(b)(i).
3 *See* IRC § 529(c)(4)(A); Prop Treas Reg § 1.529-5(d)(1).
4 *See* IRC § 529(c)(4)(A); Prop Treas Reg § 1.529-5(d)(1).
5 *See* IRC § 529(a).
6 "Qualified higher education expenses" include tuition, fees, room and board, books, supplies, computer technology and equipment, education software, and internet access.

educational institution."[7] Nonqualified distributions are (1) subject to a 10% penalty, and (2) taxed at the beneficiary's marginal income tax rate.[8]

**B) Transfer Tax Consequences on Change of Beneficiary**

1) Transfers to Same or Higher Generation: 529 account owners maintain control of the plan by determining when distributions are made and retaining the ability to change the beneficiary or rollover the account balance to a new account. Beneficiary changes can often occur with no adverse transfer tax consequences. Changing to a new beneficiary who: (1) is a member of the same family[9] as the previous beneficiary, and (2) is assigned to the same or higher generation for generation-skipping transfer tax purposes as the old beneficiary is not treated as a new taxable gift.[10]

2) Transfers to a Lower Generation: Plan owners and their advisors must exercise caution in selecting a new beneficiary who is one generation or more below the current beneficiary. If the new beneficiary is in a lower generation (i.e., changing the beneficiary from a child to grandchild), the transfer is treated as a new taxable gift. The IRC does not specify the donor of the new gift. The Service has not issued final Treasury Regulations on point, but Section 1.529-5(b)(3) of the 1998 Treasury Proposed Regulations states that the change in beneficiary is considered a taxable gift from the previous beneficiary to the new beneficiary.[11] If the new beneficiary is more than a generation below the current beneficiary, the transfer will also be subject to generation-skipping transfer tax.

   The five-year election is available to the current beneficiary, and he or she may qualify up to $70,000 (or $140,000 if married) of the deemed gift for annual exclusion treatment. However, if the current plan balance exceeds five times the applicable annual exclusion amount, the excess amount may be subject to gift tax.

The Service's rationale for treating the current beneficiary as the donor of the new gift stems from the fact that 529 plan contributions are considered completed gifts. Therefore, the current beneficiary is deemed to be the owner of the funds in the account, and the current beneficiary is the donor with respect to the transfer to the new beneficiary. This is true notwithstanding the fact that the current beneficiary has no authority to change the beneficiary or distribute funds. The current beneficiary may not even be aware of the existence of the 529 plan.

Commentators have periodically raised concerns about this approach, but the Service has yet to issue final Regulations. In Announcement 2008-17, issued on March 3, 2008, the Service requested public comment on the transfer tax consequences of such a change of beneficiary to a lower generation. As stated in Announcement 2008-17:

> In order to assign the tax liability to the party who has control over the account and is responsible for the change of any beneficiary, the forthcoming notice of proposed rulemaking will provide that a change of [Designated Beneficiary] that results in the imposition of any tax will be treated as a deemed distribution to the [Account Owner] followed by a new gift. Therefore, the [Account Owner] will be liable for any gift or GST tax imposed on the change of the [Designated Beneficiary], and the [Account Owner] must file gift and GST tax returns if required.

Announcement 2008-17 has not resulted in new Proposed Regulations, and the current treatment under Section 1.529-5(b)(3) of the 1998 Treasury Proposed Regulations remains a concern.

**C) Conclusion**

Because the Service has not issued final Treasury Regulations, the transfer tax consequences of a change in beneficiary to a lower generation are not entirely clear. However, the plan owner and his or her advisors must carefully consider the possibility that the Service could assess a gift tax liability against the current beneficiary. For this reason, practitioners should exercise caution and may wish to prospectively file a gift tax return in the year following the transfer to qualify up to $70,000 (or $140,000 if married) of the deemed gift from the current beneficiary to the new beneficiary for annual exclusion treatment.

**Welcome Back**

Michele Wasson of Stoel Rives LLP has returned to serve once again as an editor for the Estate Planning and Administration Section Newsletter. Michele has many volunteer positions and we are honored that she is willing to rejoin us. We look forward to Michele's insight and clarity as an editor.

7 Nearly all colleges, universities, community colleges, and law, medical, or business schools qualify as "eligible educational institutions."

8 *See* Prop Treas Reg § 1.529-2(e).

9 A member of the family of a beneficiary is a defined term under IRC § 529(e)(2) and Prop Treas Reg § 1.529-1(c). IRS Publication 970 lists the following as "members of the family" of the beneficiary: son, daughter, stepchild, foster child, adopted child, or a descendant of any of them; brother, sister, stepbrother, or stepsister; father or mother or ancestor of either; stepfather or stepmother; son or daughter of a brother or sister; brother or sister of father or mother; son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law; the spouse of any individual listed above; or first cousin. Available at http://www.irs.gov/publications/p970/ch08.html#en_US_2014_publink1000178578.

10 *See* Prop Treas Reg § 1.529-5(b)(3)(i).

11 *See* IRC § 529(c)(5)(B); Prop Treas Reg § 1-529-5(b)(3)(ii).

# Federal and Oregon Income Tax Planning for Trusts

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

At 9.9%, Oregon has one of the highest state income tax rates in the country – behind only California, Hawaii, or residents of New York City, which has both a state and city income tax.[4] For long-term capital gains tax rates, this state burden may be over a third of the overall tax and places Oregon residents among the highest payers of capital gains tax on the planet. The savings can be tremendous – nearly $99,000 for every million dollars of capital gains avoided.[5]

First, we'll very briefly summarize how trusts are taxed at the federal level. Then we'll explain Oregon's trust income tax scheme and the importance of being classified as a "resident" or "non-resident" trust. Then, we'll address "source income" and situations involving real estate, income, and businesses with Oregon situs, when Oregon may tax even non-residents and non-resident trusts. More importantly, we'll discuss how this may often be avoided. Next, we'll revisit the two federal tax options available and distinguish between completed gift and incomplete gift trusts. Lastly, we'll explore when these same trusts may actually save federal income tax in many situations as well, despite the common wisdom that trusts pay higher rates of income tax.

1 The author is a member of the Ohio rather than Oregon bar, but is an alumnus of Lewis and Clark Law School.

2 Federal tax rules for trusts are primarily found in Subchapter J of the Internal Revenue Code, IRC §§ 641-692. The top federal income tax bracket of 39.6% (20% for long-term capital gains and qualified dividends) as of 2013 starts at $400,000 taxable income for singles and $450,000 for married filing jointly, which annually adjust upwards for inflation; in 2015 these start at $413,201 and $464,851 respectively. The additional Medicare surtax on net investment income of 3.8%, which acts in many ways like an income tax, starts at $200,000 and $250,000 modified AGI respectively, not adjusted for inflation.

3 Which, to generalize, starts at 10% on taxable estates over the $1 million exemption and increases to 16%, also one of the highest rates in the nation. See Oregon Tax Form OR706 and instructions at http://www.oregon.gov/dor/bus/docs/form-or706_104-001_2013.pdf.

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

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

### Federal Trust Income Tax Scheme

Many trusts, including all revocable trusts and even many irrevocable ones, are "grantor trusts" for income tax purposes, meaning they are not considered separate taxpayers and all gains, income, losses, and deductions of the trust are attributable to the grantor.[6]

This article will assume a familiarity with basic federal fiduciary income tax principles and for the remainder of this article "trusts" will refer to standard non-charitable, irrevocable non-grantor trusts unless specified otherwise – thereby excluding grantor trusts, charitable remainder trusts, and trusteed qualified plans and IRAs.[7]

Trusts and estates have similarities to pass-through entities, but are taxed quite differently from entities taxed as S corporations and partnerships – usually, capital gains are trapped and taxed to the trust and other income is taxed to the beneficiaries to the extent distributed and to the trust to the extent not distributed. That is a highly simplified summing up of a complex subject.[8]

Federal trust income tax rates hit the higher income tax brackets at much lower levels to the extent that income is trapped in trust and not passed out to beneficiaries on a K-1. The top 39.6% federal income tax bracket is reached at only $12,300 for tax year 2015. There is no 35% bracket.[9] The 3.8% net investment income tax is triggered by investment income over this same low threshold.[10]

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

The Oregon fiduciary income tax has the same top tax rate as the individual income tax: 9.9%.[11] Avoiding Oregon

6 See IRC §§ 671-679, especially § 671, for general rules.

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

8 If you want the gory detail, see *A Fiduciary Income Tax Primer* by Philip N. Jones in the Oregon Bar's *Estate Planning Newsletter*, October 2014 special issue report.

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

10 IRC § 1411(a)(2).

11 ORS 316.037; ORS 316.282; OAR 150-316.282(3), (4).

trust income tax is essentially a two-step process: avoid being a resident trust, and avoid source income. Let's take the first step. Oregon tax law differentiates between resident trusts and non-resident trusts.[12] The same tax form is used for both.[13] Oregon's definition of a resident trust is extremely taxpayer-friendly and much narrower than many states':

"[A] 'resident trust' means a trust, other than a qualified funeral trust, of which the fiduciary is a resident of Oregon or the administration of which is carried on in Oregon. In the case of a fiduciary that is a corporate fiduciary engaged in interstate trust administration, the residence and place of administration of a trust both refer to the place where the majority of fiduciary decisions are made in administering the trust."[14]

Thus, unlike many states, the "residency" of an Oregon trust is not triggered by the in-state residency of the settlor and/or beneficiaries, but rather by where it is administered. Oregon has rather liberal (compared with, e.g., California) allowances for corporate trustees who may have offices and administration in several states. Thus, if the primary administration of a trust is done out of state but only incidental functions are performed in Oregon, the trust is still not a resident trust. Permitted functions include "preparing tax returns, executing investment trades as directed by account officers and portfolio managers, preparing and mailing trust accountings, and issuing disbursements from trust accounts as directed by account officers."[15]

Non-resident trusts are simply defined as those that are not resident trusts.[16] Thus, to form a non-resident trust, Oregon residents merely have to find a trustee or trustees out of state that will not administer the trust beyond performing incidental functions in Oregon. This precludes naming an Oregon resident as co-trustee.[17] Trustees with offices in multiple states have an edge because there can still be local contact and incidental functions and meetings in Oregon while the primary administration is done elsewhere. This scheme creates a significant disincentive, to both Oregon residents and non-residents alike, against using Oregon fiduciaries.

Dividing the traditional functions of the trustee, such as naming an out-of-state trustee yet appointing a distribution or investment advisor or committee to direct the trustee to make distributions or investments, is becoming more common, and muddies the waters of this analysis. The administrative code and statute refers only to "trustee," not to the broader term "fiduciary." The Oregon Department of Revenue's examples do not cover such innovative trust designs. Because such advisors may be fiduciaries as well, it is unclear whether Oregon would treat them in the same manner as a co-trustee if any are Oregon residents, or whether their actions would merely factor into the analysis in determining the extent of significant fiduciary decisions in Oregon.[18] Advisors are by default fiduciaries unless the document provides otherwise.[19] Presumably the tax department and court would follow any declaration under the document that an advisor is not a fiduciary even when they outwardly appear to be.

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

The taxable income of an Oregon resident trust is simply its federal taxable income, modified by certain fiduciary adjustments.[20] The federal taxable income for a trust excludes many important deductions that differ from individuals', which will be important in the latter part of this article.

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

This does not mean just any trust company or out-of-state trustee should be used. You don't want to name a California resident as trustee to simply exchange a 9.9% tax for a 13.3% tax. However, many states have no income tax, most notably our neighbor to the north, Washington,

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12 OAR 150-316.282(1).

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

14 ORS 316.282(1)(d) (also mirrored and reinforced in OAR 150-316.282(3)).

15 OAR 150-316.282(5) (including several examples).

16 ORS 316.302.

17 OAR 150-316.282(5), example 3.

18 OAR 150-316.282(5).

19 ORS 130.735(1) ("An adviser shall exercise all authority granted under the trust instrument as a fiduciary unless the trust instrument provides otherwise."). Restatement (Third) of Trusts § 64(2) (2003) also incorporates this presumption: "The terms of a trust may grant a third party a power with respect to termination or modification of the trust; such a third-party power is presumed to be held in a fiduciary capacity." Of course, in many situations, practitioners are going to use Delaware, Ohio, Nevada, or other state DAPT law rather than Oregon law, but these states have similar provisions. *See* Ohio Rev Code §§ 5815.25, 5808.08; Delaware tit 12, § 3313(a).

20 ORS 316.282(2) (also mirrored and reinforced in OAR 150-316.282(6)).

but also Alaska, Texas, Nevada, Florida, and others. Many other trust-friendly states, such as Ohio or Delaware, have an income tax for their own residents, but would not impose a state income tax unless there is a current beneficiary residing in the state.21

**Understanding Oregon Source Income – When It Can and Cannot Be Avoided**

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

"Examples of Oregon source income are: wages or other compensation for services performed in Oregon; income or loss from business activities in Oregon, including rents, S corporations, and partnerships; gain or loss from the sales of real or tangible personal property located in Oregon; income from intangible personal property if the property has acquired Oregon business situs."[22]

Even an out-of-state resident will typically pay Oregon income tax on Oregon source income, not just a non-resident trust. Thus, a non-resident beneficiary of a trust (even a non-resident trust) is taxed by Oregon in the same manner as if the beneficiary had received the income directly if the income resulted from the ownership or disposition of tangible property (real or personal) in Oregon, or from the operation of a trade or business in Oregon.[23]

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

C corporations, for example, are not pass-through entities, so the more complex pass-through entity tax rules do not apply to them. As hinted at by the lack of mention in the Oregon tax return instructions noted above, a Florida or Ohio resident isn't necessarily going to pay Oregon income tax on Precision Castparts stock (a C corporation) when it is sold, or pay Oregon income tax on dividends received, but any C corporation has its own separate taxes to deal with. However, most closely held businesses (even large ones) prefer to avoid the double tax system of C corporations, which can be much more onerous overall, especially upon sale, distribution, or termination.

So, let's assume for the remainder of this section that we are dealing with a pass-through entity: an LLC, a partnership, or an S corporation. The ongoing income of an Oregon pass-through entity with ongoing operations or real estate in Oregon is clearly taxed.[24] However, the sale of the stock (or membership interest) of such entities is not necessarily taxed in Oregon if the owners are out of state. Income from the sale of intangibles is traditionally allocated to the state of the taxpayer's domicile through the doctrine of *mobilia sequuntur personam*.[25] This is generally confirmed through Oregon's adoption of the Uniform Division of Income for Tax Purposes Act ("UDITPA"):[26] "Capital gains and losses from sales of intangible personal property are allocable to this state if the taxpayer's commercial domicile is in this state." More specifically, this is confirmed in Oregon's administrative rules interpreting the statute: "Intangible property. The gain from the sale, exchange, or other disposition of intangible personal property, including stocks, bonds, and other securities is not taxable unless the intangible personal property has acquired a business situs in Oregon."[27]

Thus, the sale of S corporation stock, even if the business has real estate or operations in Oregon, is not Oregon source income, unless the stock itself has acquired a business situs in the state.[28] This might occur if the stock is pledged for indebtedness used in carrying on business in the state, or if the stock itself is not a mere investment but used to further the business of the owner, or if the owner is in the business of buying and selling such stock.[29] There is a history of complex litigation when the stock is a corporate subsidiary, but for most individuals or non-resident trusts

The article **Federal and Oregon Income Tax Planning for Trusts** by Ed Morrow was also published, in nearly identical form, by the Oregon State Bar Taxation Section in their Summer 2015 issue. For those readers who have already enjoyed this article, we apologize for the duplication.

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

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

23 OAR 150-316.282(7); ORS 316.127; OAR 150-316.127-(D)

24 OAR 150-316.127-(D)(1).

25 "movables follow the person"

26 UDITPA § 6(c), http://www.uniformlaws.org/shared/docs/uditpa/uditpa66.pdf. More material on uniformity projects and discussion of state income tax law can be found at the Multistate Tax Commission's website at www.mtc.gov.

27 OAR 150-316.127-(D)(2)(b).

28 OAR 150-316.127-(D)(2)(c).

29 OAR 150-316.127-(D)(1).

the stock is going to be a mere investment, not used to further the business of the owner.[30]

Neither is the sale of an LLC or LP interest going to necessarily be Oregon source income, but the analysis is more complex. For instance, a general partnership interest, whether as part of a limited partnership or not, is Oregon source income,[31] but the limited partnership interest is probably not:

"Limited Partnership Interests. In general, a non-resident's gain or loss from the sale, exchange, or disposition of a limited partnership interest is not attributable to a business carried on in Oregon and is not Oregon source income."[32]

For Oregon source income taxation rules, member-managed LLCs are taxed like partnerships (source), and manager-managed LLCs are taxed like limited partnerships (not source, as cited above).[33] Curiously, limited liability partnerships (LLPs) are taxed for this purpose like general partnerships.[34]

This leaves ample opportunity for proactive pre-sale planning through changing the management structure of an LLC through its Articles of Organization, changing to an S corporation structure (usually not recommended for other reasons), or using tax-free reorganizations from general partnerships or LLPs to manager-managed LLCs to minimize Oregon income tax upon sale. There is no statute, rule, or case law as to how soon before sale that such reorganizations must be done. Ideally this should be done in the tax year before sale, even though there is no good argument against the immediate effectiveness of such changes.

**An Example of Savings**

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

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

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

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

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

**LP (whether or not publicly traded LP)** – no source income; *$990,000 is saved*. Notably, there is no aggregation of limited and general partnership interests where someone may own both.[35] This may lead some to prefer the LP to the LLC model where the owner may want to retain management rights.

**LLP or GP** – all source income to extent apportionable, *up to $990,000 tax*. However, John and his partners may

30 "Nonbusiness capital gains and losses from sales of intangible personal property (i.e., stocks, bonds) are allocable to the taxpayer's state of commercial domicile." Gregory E. Stern, *State Taxation of Mergers and Acquisitions*, 783-4th Tax Mgmt Portfolios (BNA) at A-7 (2010) (citing the UDITPA). This of course, leads to the question of whether the stock is integrally part of the owner's own business or the owner is in the business of buying and selling corporations. "For example, the taxpayer in *W.R. Grace & Co. v. Commr. of Revenue* ('Grace') purchased a majority stock interest in the Miller Brewing Company and later sold its interest at a substantial gain. Grace was a Connecticut corporation doing business in Massachusetts. Massachusetts treated the gain as business income and required its inclusion in Grace's apportionment formula. Grace contended that the gain was nonbusiness income fully allocable to its state of commercial domicile, New York. The state court agreed that Grace was not in the business of buying and selling securities, but found ample evidence that Grace's business included the purchase and sale of operating subsidiaries. The court did not view the fact that Grace was unable to acquire full control of Miller as stripping the holding of its business character. Finding that ownership of Miller was an 'integral component' of Grace's total operations (i.e., unitary), the court concluded that gain from the sale of the interest was apportionable business income." *Id*. at A-30 (footnotes omitted).

31 OAR 150-316.127-(D)(2)(d).

32 OAR 150-316.127-(D)(2)(e).

33 OAR 150-316.127-(D)(2)(f).

34 OAR 150-316.127-(D)(2)(g).

35 OAR 150-316.127-(D)(2)(d), (e).

change the partnership to a manager managed LLC, LP, or S corporation to avoid this outcome.

If the sale is potentially source income, then an enquiry into the nature of the operations may matter – how much of the property/sales/operations are in Oregon?[36] **Structure of the sale – Asset Deal vs. Stock Deal and IRC § 338(h)(10) Elections**

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

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

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

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

**Importance of IRC § 754 to Buyers; Differentiating LP/LLC from S Corporations "Stock Deals"**

As mentioned above, buyers receive a new cost basis for their *outside* basis in the stock or LLC membership interest, but that may not necessarily change the *inside* basis, which is more relevant to ongoing taxation of operations. Inside basis determines the amortization of goodwill or depreciation of a building or equipment. However, an LLC or LP taxed as a partnership under federal tax law may elect to adjust its inside basis upwards to more accurately reflect the sale price.[37] Most estate planning attorneys are familiar with this election in the context of the death of a partner, but it is also applicable to sales and exchanges

**Events Calendar**

**Central Oregon Estate Planning Council Quarterly Meetings**

**When:** September 29, 2015 / November 10, 2015

**Where:** 5:30 – 7:30 pm at Awbrey Glen Golf Course, Bend

**Register:** Contact Cheryl Puddy, Associate Program Officer, The Oregon Community Foundation (541) 382-1170, CPuddy@oregoncf.org

**60th Annual Estate Planning Seminar**

*Sponsored by The Seattle Estate Planning Council and UW School of Law – Graduate School of Taxation*

**When:** November 2-3, 2015

**Where:** Washington State Convention Center, Seattle, WA

**Register:** http://depts.washington.edu/uwconf/wordpress/estateplanning/registration/

**Basic Estate Planning and Administration CLE**

**When:** November 20, 2015

**Where:** Oregon Convention Center, Portland, Oregon

**Register:** https://www.osbar.org/cle

The Editors want to include announcements of upcoming events that may be of interest to our readers. If you know of an event, please send basic information to Sheryl S. McConnell at smcconnellor@aol.com for inclusion in the next issue of the Newsletter.

36 ORS 317.365. [repealed]

37 *See* IRC §§ 743(b), 754.

during lifetime. What this means is that "stock deal" buyers of partnership and membership interests (LLC/LPs taxed as such) can get most of the same benefits as an "asset deal" with a IRC § 754 election, which is not available to corporations or LLCs taxed as S corporations. Thus, buyers of LLC/LPs should be much more amenable to "stock deals" than S corporation buyers, who often insist on asset deals or IRC § 338(h)(10) elections for the aforementioned reasons.

**Special Issues for S Corporations and Non-Grantor Trusts**

In addition to the messy Oregon tax issues for businesses, transferring an S corporation to a non-grantor trust has the added complications of a forcing an Electing Small Business Trust ("ESBT") election, and possibly adding a 3.8% surtax, whereas this tax is more easily avoided in the hands of an "active" investor in the business (or his/her grantor trust or a QSST wherein the beneficiary is active in the business). Whether ESBTs can be "active" business investors and avoid the 3.8% surtax on business income is a complicated issue, even with a high-profile recent taxpayer victory in Tax Court.[38]

**Protecting the Trustee from Having to Diversify While Avoiding Residency Status**

Typically, when corporate trustees take custody of or manage special assets there needs to be special accommodations. This is because the Prudent Investor Act would otherwise require a trustee to diversify assets and neither the settlor nor the trustee may want the trustee to have to actively manage such closely held assets prior to sale. This requirement can be waived in a number of ways. Notably, an investment advisor or committee might be named to direct the trustee to hold or sell the stock, LLC interest, or other asset. Sometimes the settlor or immediate family is the investment advisor, at least for traditional domestic asset protection trusts. However, if the settlor/family were Oregon residents fully managing the investments, this could lead to a finding that fiduciary decisions are made in Oregon or that the advisor is a quasi-trustee and lead to a finding that the trust is an Oregon resident trust.[39] Thus, this design should be avoided. The practitioner should use other methods, such as restricting sale and waiving the duty to diversify and gifting non-voting stock or LLC/LP interests, or should ensure that another out-of-state resident has this role, such as an out-of-state LLC.

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

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

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

Let's tackle the more complicated first: the *incomplete gift*, non-grantor trust. These types of trusts are colloquially known as DING trusts (Delaware Incomplete Gift Non-Grantor Trusts), based on the original private letter rulings that used Delaware trusts, and subsequently written articles.[41] PLRs with such structures have also used Alaska and Nevada law, and there is no reason that laws of other states, such as Ohio or Wyoming, might not also be appropriate, but Delaware's law is still probably the most commonly used.

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

This article will not go through the DING design in depth, but at its basic level, after the dozens of PLRs released in the last two years, it is a trust with several

38 *Frank Aragona Trust v. Commissioner*, 142 TC 9 (2014), http://www.ustaxcourt.gov/InOpHistoric/FrankAragonaTrustDiv.Morrison.TC.WPD.pdf.

39 OAR 150-316.282(5).

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

41 *See, e.g.,* PLRs 200148028 (Aug. 27, 2001), 200247013 (Aug. 14, 2002), 200502014 (Sept. 17, 2004), 200612002 (Nov. 23, 2005), 200637025 (June 5, 2006), 200647001 (Aug. 7, 2006), 200715005 (Jan. 3, 2007), 200729025 (Apr. 10, 2007), 200731019 (May 1, 2007).

unique features to enable the above characteristics.[42] The first three below refer to the how distributions are made.

The settlor retains a lifetime and testamentary limited power of appointment solely exercisable by him-/herself – this may only be permitted in some states, such as Delaware, without compromising asset protection. It is designed to make the gift incomplete yet be curtailed enough so as not to cause the trust to become a grantor trust. Lifetime distributions to appointees are limited to a standard such as health, education, maintenance, and support to prevent grantor trust status, or possibly limited to charitable beneficiaries (this latter idea is not in the PLRs, but could work equally well).

There is a distribution committee composed of adverse parties (beneficiaries) – this is necessary to enable distributions back to the settlor and/or spouse without triggering grantor trust treatment. The committee structure is necessary to prevent adverse estate/gift tax effects to the power holders or grantor trust status as to power holders.

There is a veto/consent power unless the distribution committee unanimously overrules the settlor – this is designed to make the gift incomplete.

The trust is established in a state that permits self-settled trusts (aka domestic asset protection trusts) and would not otherwise tax the trust or beneficiaries. This is designed to prevent grantor trust status and ensure asset protection.[43]

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

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

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

While most trusts permit the trustee to distribute current income and principal in a given year, they do not have to. Many ILITs, for instance, have a clause preventing distributions until the settlor/insured dies, particularly if the goal of the trust is to provide a set amount of liquidity at death for a loan covenant, buy-sell, estate equalization, or estate tax. Does John or his family need the funds this year? Next year? Not for another five years, when John and Jane will be retired and living in Florida? A trust does not need to have any beneficiaries entitled to current distributions of income or principal to be a valid trust; a beneficiary that can be ascertained now or in the future is adequate.[44] Beneficiaries might become current beneficiaries at a later date, sometimes referred to as a "springing executory interest."[45] Trust protectors might be able to add beneficiaries, but practitioners should be careful since this power in itself may cause grantor trust status if not carefully curtailed.[46] Here, the settlor and/or spouse or children would only be entitled to funds during the settlor's lifetime as a result of a committee of adverse parties' lifetime limited power of appointment, rather than via the trustee. This is necessary to prevent grantor trust status.

Oregon income tax thus can be avoided to the extent income is trapped in the trust and is not distributed via a power of appointment from distributable net income to Oregon resident beneficiaries in that tax year. Importantly, Oregon does **not** have throwback rules similar to California and New York that might otherwise try to tax income accumulated and taxed to the trust in prior tax years, nor does it have a specific rule regarding incomplete gift trusts

42 See various presentations by the author on this subject for more detail, such as those available at www.nbi-sems.com or www.mylaw.com. Recent PLRs include: PLRs 201310002 (Nov. 7, 2012) to 201410006 (Oct. 21, 2013), PLRs 201410001 to 201410010 (Oct. 21, 2013), PLR 201426014 (Feb. 24, 2014), PLR 201426014 (Jun. 27, 2014), PLRs 201427010 to 201427015 (Feb. 24, 2014), PLRs 201430003 to 201430007 (Feb. 7, 2014), PLRs 201436008 (Dec. 27, 2013) to 201436032 (Dec. 30, 2013), and PLRs 201440008 to 201440012 (Dec. 31, 2013) PLR 201510001 to 201510008, PLR 201438010-14* (this PLR does not concern an ING trust but has overlapping similar issues and has a similar distribution committee).

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

44 ORS 130.155(2).

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

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

as New York recently passed.[47] Oregon does still have a reference to the old throwback rule on the books, but unlike New York or California, there is no modification to adapt to federal changes made years ago that make the rules primarily apply only to foreign trusts.[48]

To illustrate the tremendous importance of the lack of a throwback rule, let's say John's trust sells the $10 million of assets in 2015. It would incur and pay approximately $2.38 million in federal capital gains tax (23.8%), make no further distributions in 2015, and avoid the $990,000 in Oregon tax assuming it is not otherwise an Oregon resident trust, as discussed above.[49] In 2015, there is a "clean slate" as to 2015 income. If in mid-2016, to take an extreme case, the trust makes $10,000 in dividends and interest before distributing the entire amount of the trust to Oregon beneficiaries, then the only amount on the K-1 for the beneficiaries subject to Oregon tax is the $10,000 of *2015* income.

If distributions were made in 2015, the year of the large capital gains, recall the general rule above for non-grantor trusts: capital gains are generally trapped in trust, unless one of the three exceptions to this general rule applies.[50]

Also, if either John or Jane were to have a "springing executory interest," becoming a traditional current beneficiary later, this would trigger grantor trust status even before that event because income might be accumulated and distributed to them later (and, therefore, trigger Oregon taxation directly).[51] This may also be true if a non-adverse party such as a trustee or trust protector could add them as full beneficiaries later.

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

At first glance, this kind of arrangement reminds one of the oft-cited warnings against large lifetime gifts borne out from Shakespeare's *King Lear*. But King Lear never used a DING trust. Had he done so, he would have avoided a lot of grief. Here, John keeps just enough control via lifetime and testamentary powers of appointment to make the gift incomplete and keep the ultimate beneficiaries in line, but not so much control as to cause grantor trust status. Retaining a veto/consent power and lifetime limited powers of appointment and allowing the children to act without settlor consent only unanimously gives just as much, if not more, access to the trust than if John and Jane were named beneficiaries – as long as at least one of the children is a Cordelia rather than a greedy Goneril or Regan.[52] In most families, John and Jane should not fear the *King Lear* effect. In my experience, most people trust their children far more than their attorney, financial advisor, or bank trust department anyway.

Therefore, with a modicum of creativity, we can use a DING to legitimately avoid Oregon taxation of trust income except to the extent a current year's income is distributed

47 NY Tax Law § 612(b)(41) (new law signed March 31, 2014), http://www.assembly.state.ny.us/leg/?default_fld=&bn=S06359&term=2013&Summary=Y&Actions=Y&Memo=Y&Text=Y.

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

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

50 For an extensive discussion of how the trustee and family can manipulate this, or use beneficiary grantor trust status to alternatively shift, trap, or toggle income, see *The Optimal Basis Increase and Income Tax Efficiency Trust*, a white paper by Edwin P. Morrow III (Dec. 1, 2014), http://ssrn.com/abstract=2436964, that incorporates several published articles therein. A very early version of this paper was presented to the Portland Estate Planning Council on March 13, 2013.

51 IRC § 677(a).

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

via K-1 to an Oregon resident beneficiary. A domestic asset protection trust statute is recommended for such DINGs to avoid grantor trust status, since any potential for creditor access to ordinary self-settled trusts would lead to a finding of grantor trust status. Washington State, though it has no income tax, is not a good candidate for such a trust's situs due to its lack of clear creditor protection through a DAPT statute.[53]

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

**Completed Gift Non-Grantor Trusts**

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

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

Some practitioners would feel more comfortable with completed gift trusts as being less "cutting edge" or susceptible to an adverse ruling. And, they would certainly have additional state and/or federal estate tax benefits in many cases. However, completed gift trusts would potentially be wasteful of exclusion to the extent funds were eventually returned to the settlor/spouse's estate tax base, and it would of course be limited to the amount of exclusion available. There may be ways to leverage such amounts, such as Crummey powers, GRAT pourovers, and the like, but these are beyond the scope of this article. Suffice it to say that both incomplete gift trusts and completed gift trusts may be useful to clients. For those mere single-digit millionaires with estates well under $10.86 million, the completed gift trust option is more viable, and has many other uses.[54]

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

Although trusts reach the highest 39.6% bracket and 3.8% surtax bracket at only $12,300, if settlors are otherwise in that same bracket (or perhaps merely close), there are features that make non-grantor trust taxation more attractive. Despite the Supreme Court's decision in *Knight*, there is still the opportunity for trustees to avail themselves of better above the line deductions than individuals.[55]

For those charitably minded, there is even more benefit. Deductions for gifts to charity from a trust's gross income are not limited to U.S. domestic charities, they are not subject to any AGI limitation, and they are not subject to Pease limitations.[56] Furthermore, they are eligible for a one-year look back. Imagine if we could make a donation in December of 2015 and make it count against our 2014 income! Furthermore, they can be limited to coming from higher income rate categories provided the provision has an economic effect.[57]

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

There are even greater advantages that may be had using a charitable remainder trust as an appointee of trust distributions because it can defer income much more efficiently than individual contributions to charitable trusts.

Non-grantor trusts can also be used to achieve installment sale treatment for a sale of certain assets, provided the non-grantor trust does not in turn sell the same asset for at least two years.[58] However, there are significant traps for

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

54 *E.g., see* Edwin P. Morrow III, *The Upstream Optimal Basis Increase Trust*, CCH Estate Planning Review, May 2014.

55 IRC § 67(e).

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

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

58 IRC §453

the unwary for depreciable or amortizable assets and pass through entities that are beyond the scope of this article.

**Conclusion**

To summarize, establishing a non-grantor, non-resident trust in the manner contemplated in the first part of this article can legitimately avoid 9.9% Oregon income taxes on traditional portfolio income, including capital gains and including sales of closely held C corporations, income from pass-through entities owning out-of-state property or out-of-state businesses, or proceeds of pure ‘stock sales’ of S corporations, LLCs, and LPs, provided they are manager-managed.

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