

Larry's Tax Law

## Temporary Rules Keep Pouring in – the DOR Continues Its Efforts to Provide Guidance Relative to the CAT

By Larry Brant and Peter Evalds on 1.21.20 | Posted in Legislation, State and Local Tax, Tax Laws

A dog will immediately respond to you when you call out. On the other hand, when you call out to a cat, the cat will take a message and promise to get back to you later. This is not the case with the Corporate Activity Tax (“CAT”). The Oregon Department of Revenue (“DOR”) is doing everything possible to provide taxpayers and tax practitioners with prompt and helpful guidance and support relative to the CAT, the new state tax regime that became effective on January 1, 2020.

As [previously discussed](#), late last year, the DOR conducted several town hall meetings with taxpayers and tax practitioners across the state to discuss the CAT, answer questions and solicit feedback about administration of the tax regime. In addition, as promised, the DOR started issuing draft temporary rules this past December to provide clarity and address many uncertainties in the new law. It quickly removed the “draft” stamp from the rules. The rules keep rolling in! To date, the DOR has issued a total of 12 temporary rules. We have already [provided a discussion](#) of eight of those temporary rules. In this post, we discuss the remaining four temporary rules.

### 1. Definition of Commercial Activity – OAR 150-317-1000 (Temporary Rule)

The first of the four additional temporary rules addresses the definition of “Commercial Activity.”

“Commercial Activity” is defined in the CAT statute itself as: “[t]he total amount realized by a person, arising from transactions and activity in the regular course of the person’s trade or business, without deduction for expenses incurred by the trade or business.” The statute does not, however, define three important terms: (i) “amount realized,” (ii) “regular course” and (iii) “trade or business.”

The temporary rule expands the definition of “Commercial Activity” by stating that it includes “the fair market value” of amounts realized in the regular course of a taxpayer’s trade or business, provided that the “transactional test” contained in OAR 150-314-0335(5) (which applies to state income taxes and is a model regulation drafted by the Multistate Tax

Commission) is met.

***Transactional Test / Regular Course***

An amount must arise from transactions and activity “in the regular course of the person's trade or business” in order to constitute Commercial Activity.

Unfortunately, the CAT statute does not define “regular course.” However, as noted above, the temporary rule incorporates the “transactional test.” This test defines “regular course.”

Under OAR 150-314-0335(5) (the “transactional test”), transactions occur in the regular course if they “are customary in the kind of trade or business being conducted or are within the scope of what that kind of trade or business does.” This term “regular course” includes “income from sales of inventory, property held for sale to customers, and services which are commonly sold by the trade or business,” as well as “income from the sale of property used in the production of apportionable income of a kind that is sold and replaced with some regularity, even if replaced less frequently than once a year (emphasis added).”

**Practice Alert:** The CAT legislative history confirms that sales of assets that are not in the regular course of the taxpayer’s business would not be subject to the CAT. The legislative history indicates that the term “regular course” was intended to distinguish between a person’s “core function” of its business and “incidental income” that is not derived from the person’s Commercial Activity.

**Practice Alert:** A quick read of the temporary rule could be a bit misleading. **Pause for cause!** The CAT statute itself clearly states that proceeds from the sale or exchange of assets described in Code Section 1221 or Code Section 1231 (without regard to holding period) are excluded from Commercial Activity. The temporary rule seems to be telling us, or at least the DOR believes, that the proceeds from the sale or exchange of an asset that qualifies as either Code Section 1221 or Code Section 1231 property, if it is sold/exchanged and replaced with some regularity, constitutes Commercial Activity. First, “some regularity” is not defined in the rule or the CAT statute. Second, the temporary rule flies in the face of the statute that expressly states that Commercial Activity does **not** include proceeds from the sale or exchange of Code Section 1221 or Code Section 1231 property regardless of whether it is sold or exchanged with any regularity.

**Example:** Oreco, an accounting firm, has taxable Commercial Activity of more than \$1 million in 2020 from the provision of accounting services. It also sells an old copier for \$5,000 in 2020. The copier is not inventory, is not held for sale to customers, and is not commonly sold by the business. The copier might arguably be used in the production of income. However, as Code Section 1231 property, its proceeds should not be subject to the CAT. Additionally, based on the legislative history, the sale of a copier did not occur in the regular course of Oreco’s business (as the sale of copiers is not a component of Oreco’s “core function”). Rather, the sale

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proceeds from the copier is clearly “incidental income” and should not be included in Commercial Activity.

### ***Amount Realized***

The amount realized encompasses both cash consideration as well as non-cash consideration. The temporary rule defines “amounts realized” as “all items of value received in a trade or business,” which includes without limitation “money, property received, debt forgiven and services rendered.”

### ***Trade or Business***

Unfortunately, neither the CAT statute nor the temporary rule define the term “trade or business.” However, the CAT statute itself generally incorporates definitions used “for the purposes of” ORS Chapters 305, 314, 316, and 317. Unfortunately, none of those chapters provide any definitional assistance. However, Oregon law conforms to federal law for the definition of trade or business for purposes of deductions under Code Section 162 to arrive at income under ORS Chapter 316.

Under Code Section 162, merely owning real property that is rented under a triple net lease is not a trade or business because collection of rent alone does not involve sufficient management activity. There is a substantial body of case law under the Code for determining what constitutes a trade or business. The required analysis can be complex. The law turns on the facts and circumstances of each case. In most instances, disputes surrounding this issue end up in the courts.

For illustrative purposes and to put the concept of trade or business in the context of the CAT, consider the following examples:

**Example 1:** Jerry is an accountant who devotes substantially all of his time to an accounting practice. He owns a residential triplex that he rents out. Jerry uses a property management company to take care of tenant matters (including selecting tenants and collecting rent), maintenance and insurance. The single rental of a triplex through a property management company likely does not rise to the level of a trade or business for Jerry. As such, Jerry’s CAT liability should not include the gross rental revenues from the triplex.

**Example 2:** Jerry is a real estate developer who buys land, subdivides it into parcels, builds homes and manages and rents the homes to tenants. The gross revenues from the rental homes likely constitute commercial activity because Jerry is in the trade or business of renting homes.

**Note:** The DOR made it clear in the temporary rule that the method of accounting used by a taxpayer for federal income tax purposes is the method of accounting that the taxpayer must use for purposes of computing its Commercial Activity under the CAT. So, if a taxpayer uses the accrual method of accounting for federal income tax purposes, it will use that method of accounting for CAT purposes. Likewise, if a taxpayer uses the cash method of accounting for federal income tax purposes, it will use that method of accounting for CAT purposes.

## **2. Sourcing of Commercial Activity for Sales of Tangible Personal Property – OAR 150-317-1030 (Temporary Rule)**

This temporary rule relates to the sourcing of receipts from the sale of tangible personal property for CAT purposes. It is nearly identical to OAR 150-314-0429, the sourcing rule with respect to sales of tangible personal property for Oregon income tax purposes.

The main substantive difference between the CAT temporary rule and the income tax rule is that the CAT rules do not contain the throwback rule found in OAR 150-314-0429(7)-(8). The throwback rule provides that sales made out of the state are considered Oregon sales if the state of the purchaser does not tax the seller on such sale.

The lack of a throwback rule for purposes of sourcing Commercial Activity under the CAT makes sense in light of the statutory framework. It is also in line with what the DOR said in the town hall meetings we attended.

ORS 314.665(2)(b) expressly provides that, for Oregon income tax purposes, sales of tangible personal property are sourced to Oregon if property is shipped from an office, store, warehouse, factory or other place of storage in Oregon and “the taxpayer is not taxable in the state of the purchaser.” Similar statutory language is **not** contained in the CAT. So, it seems appropriate that the CAT does not contain a throwback rule.

Other than the absence of a throwback rule, the same rules with respect to sourcing sales of tangible personal property for Oregon income tax purposes apply to the CAT.

## **3. Sourcing Commercial Activity Other Than Sales of Tangible Personal Property – OAR 150-317-1040 (Temporary Rule)**

This temporary rule relates to the sourcing of Commercial Activity other than receipts from the sale of tangible personal property for CAT purposes.

Similar to the rules with respect to sales of tangible personal property, the rules with respect to other activities are nearly identical to the sourcing rules used for Oregon income tax purposes (OAR 150-314-0435).

The few differences between the income tax and CAT rules primarily relate to the difference between the two statutory regimes. For example, references to “shipped or delivered” in the income tax rules were changed to “delivered” in the CAT rules because the CAT refers only to personal property that is “delivered.” Likewise, the exclusions provided by ORS 314.610(7) (receipts from hedging transactions, certain agent transactions and amounts held in trust for others) referenced in the income tax rules were omitted in the CAT rules. (Of course, the CAT has its own agency exclusion and also expressly excludes receipts from certain hedging transactions.)

Otherwise, the income tax rules with respect to sourcing receipts other than from sales of tangible personal property apply to the CAT.

#### **4. Cost Input or Labor Cost Subtraction – OAR 150-317-1200 (Temporary Rule)**

This temporary rule relates to determining the cost input or labor cost subtraction. The temporary rule provides that the subtraction includes all labor cost or cost input expenses regardless of where such expenses are incurred. It also provides that a taxpayer that excludes labor costs paid pursuant to the residential real estate subcontractor exclusion must reduce total cost inputs by such excluded costs.

##### ***Subtraction Computation***

The temporary rule sets forth a methodology to apportion the subtraction as follows:

##### **Step 1: Determine Commercial Activity Ratio.**

**Commercial Activity Ratio** = Commercial Activity Sourced to Oregon / (Total Commercial Activity Everywhere + Exclusions from Commercial Activity)

##### **Step 2: Apportion Costs to Oregon.**

Oregon costs = (Total Labor Costs or Cost Inputs Everywhere) x Commercial Activity Ratio

##### ***Alternative Subtraction Method***

The temporary rule provides an alternative method to the computation set forth above. Under this method, a taxpayer may elect to use separate accounting to remove the cost inputs or labor costs from the subtraction that are attributable to the taxpayer’s receipts from an item that does not constitute Oregon Commercial Activity.

##### ***Subtraction Examples***

The temporary rule sets forth the following examples:

**Example 1:** Grocery & TV Mart (“Mart”) has \$10 million of Commercial Activity attributable to Oregon and a total of \$50 million of Commercial Activity attributable to its U.S.-wide operations. It has exclusions from Commercial Activity of \$20 million. Mart has total labor costs of \$28 million and cost inputs of \$26 million from its U.S.-wide activities.

Mart computes the Oregon subtraction as follows:

**Step 1: Determine the commercial activity ratio.**

Oregon Commercial Activity of \$10 million / everywhere Commercial Activity plus exclusions of \$70 million = 14.2857% Commercial Activity ratio.

**Step 2: Determine the cost subtraction.**

In this example, labor costs are greater than cost inputs. Total labor cost of \$28 million x Commercial Activity ratio of 14.2857% x 35% = \$1,399,999 cost subtraction.

**Example 2:** Construction Company XYZ (“XYZ”) has \$10 million of Oregon Commercial Activity and an aggregate of \$70 million of everywhere commercial activity and exclusions (\$50 million in everywhere Commercial Activity and \$20 million in exclusions from Commercial Activity). XYZ has everywhere labor costs of \$2 million and everywhere cost inputs of \$38 million. A total of \$3 million of XYZ’s cost inputs represent labor costs paid to subcontractors for the construction of single-family residential construction in Oregon and qualifies as an exclusion pursuant to Oregon Laws 2019, chapter 579, section 58.

XYZ computes the Oregon subtraction as follows:

**Step 1: Determine the commercial activity ratio.**

Oregon Commercial Activity of \$10 million / everywhere Commercial Activity plus exclusions of \$70 million = 14.2857% commercial activity ratio.

**Step 2: Determine the cost subtraction.**

Cost inputs are greater than labor costs. If XYZ excludes labor costs paid to subcontractors from Commercial Activity pursuant to Oregon Laws 2019, chapter 579, section 58, the everywhere cost inputs must be reduced by an amount equal to this exclusion. The \$38 million of total cost inputs must be reduced by \$450,000 (15% of the \$3 million of qualifying labor costs paid to subcontractors). Adjusted cost inputs of \$37,550,000 (\$38 million - \$450,000) x Commercial Activity ratio of 14.2857% x 35% = \$1,877,498 cost subtraction.

### ***Alternative Subtraction Apportionment***

In the temporary rule, the DOR provides that a taxpayer may petition it for an alternative apportionment methodology, or the DOR may require that the taxpayer use an alternative apportionment method if the application of the general subtraction computation methodology discussed above does not “fairly represent” the subtraction attributable to the taxpayer’s Commercial Activity.

In order for a taxpayer to obtain an alternative apportionment method, the taxpayer must file a written request with the DOR. The taxpayer or the taxpayer’s authorized representative must sign the request and file it separately from the taxpayer’s return. The request must contain a complete explanation of the proposed method of apportionment and an explanation why the general subtraction computation methodology should not be used.

After receiving the request, the DOR will review it and issue a letter approving or denying the request. If a request is denied, the taxpayer has appeal rights. The DOR may revoke its authorization if, upon audit, it determines that the alternative method does not fairly and accurately measure Commercial Activity. An apportionment method, once approved, must be used until the DOR approves a written request for a change or it revokes the method previously approved.

### **Conclusion**

The CAT landscape is changing almost by the minute with new guidance around every corner. While the CAT may be purring, we still have to keep an eye out for its sharp claws and teeth. We will continue to review and analyze new guidance as it comes out, and analyze issues under the CAT as they come to our attention. Stay tuned!

**Tags:** amounts realized, apportionment, Commercial Activity Ratio, corporate activity tax, Corporate Tax, Oregon, Oregon businesses, Oregon Department of Revenue, Oregon DOR, Oregon Taxpayers, rulemaking, subcontractors, tax practitioner, taxable commercial activity, town hall meeting, transactional test