

Be Careful What You Wish For - What May Be Good for Federal Income Tax Purposes May Not Be So Good For Purposes of the Oregon CAT

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I apologize in advance for focusing my blog these past several weeks on the new Oregon Corporate Activity Tax ("CAT"), but my mind keeps finding new facets to this tax regime that I suspect most tax practitioners and even the lawmakers who passed the legislation may not have envisioned or anticipated. So, please indulge me as I explore another one of these numerous issues in this installment of the blog.

After the passage of the Tax Reform Act of 1986 and the introduction of Code Section 469, we started seeing tax practitioners focusing attention on trying to figure out how their clients could be characterized as active participants in a trade or business activity. Their goal is simple - they want to avoid the deduction limitations imposed by the passive activity loss rules contained in Code Section 469.

Likewise, after the passage of the Tax Cuts and Jobs Act ("TCJA") in late 2017 and the introduction of Code Section 199A, we started seeing tax practitioners focusing attention on trying to figure out how their clients' pass-through entities could be characterized as "qualified trades or businesses." Their goal is simple - they want their clients to qualify for the 20% deduction available to taxpayers under Code Section 199A.

All this said, with the passage of the CAT, tax practitioners need to consider one more tax regime in their tax planning efforts and its possible impact on their clients with revenues sourced to Oregon. Admittedly, given that the tax itself is only 0.57% of gross revenues sourced to Oregon (after certain subtractions, exclusions and only on such revenues above \$1,000,000), it is arguable that other tax considerations will generally be the driver of any tax planning efforts. Nevertheless, the CAT cannot (and should not) be ignored in the tax planning equation.

For illustrative purposes and to put my concern in context, please ponder the following (likely common) situation:

Client X is a retired surgeon. During her career, client X earned a seven-figure salary from her surgical practice. Over the years, she acquired real estate for investment purposes. In the early years, her real estate acquisitions included single-family homes, duplexes and triplexes. She was actively involved in the acquisition of the properties, management of the properties, securing tenants for the properties, making capital improvements to the properties, and repairing and maintaining the properties. Once Client X built sufficient equity in the properties and they increased in value, she traded up to bigger properties in tax-deferred exchanges under Code Section 1031. Today, she owns an apartment complex with 350 units and a nine-story commercial office building. Client X has hired a property management company that handles all of the work she used to perform. She gets a check each month and monitors the income/expense statements of both properties. Both properties are located in Eugene, Oregon. Client X's annual aggregate gross revenues from the properties are approximately \$4,900,000.

Does this fact pattern sound familiar?

In the early years of Client X's real estate activities, tax practitioners would be eager to characterize her real estate activities as an active trade or business (and her as a material participant) for Code Section 469 purposes with the goal in mind of deducting early start-up losses against her active medical practice income. This characterization (based upon the limited facts provided above) may have been plausible in the years before the property management company was engaged.

Following the enactment of the TCJA, tax practitioners would be desirous to conclude Client X's real estate activities constitute a "qualified trade or business" with the goal of qualifying her for the 20% deduction under Code Section 199A. Again, this characterization may have been plausible in the years before the property management company was engaged.

The CAT should be a consideration in any tax planning effort for Client X. Without getting granular, the potential annual tax liability attributable to the CAT for Client X would be approximately \$22,480 ($\$4,900,000$ less $\$1,000,000 = \$3,900,000 \times 0.57\%$, plus \$250). So, I guess Client X would not want me waking up in the middle of the night over that amount of tax. She certainly would not want me to be spending too many billable hours on this effort. Regardless, it is a tax that may be an unexpected liability and should be discussed with Client

X. Tax surprises (especially those surprises that result in a tax owing) generally make for an unhappy client.

As I have discussed in great detail in prior blog posts, the CAT is imposed on "taxable commercial activity." Taxable commercial activity is defined as a taxpayer's "commercial activity" that is sourced to Oregon, less a specified subtraction. Thus, the starting point under the CAT is determining the "commercial activity" of a taxpayer.

The definition of "commercial activity" under the CAT is: "the 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."

So, at least for the Code Section 199A deduction, and possibly the characterization of income and losses under Code Section 469, taxpayers may want their activities to be classified as active trades or businesses. **Not so fast!** For purposes of the CAT, however, they may not want that characterization. So, some consideration of the CAT is required in any tax review and planning for clients. It is that simple.

The take-aways from my last sleepless night are also quite simple:

- Revenues from real estate rental activity that does not constitute the conduct of an active trade or business are not subject to the CAT. On the other hand, revenues from real estate rental activity that constitutes the conduct of an active trade or business could be subject to the CAT.
- The impact of the characterization of an activity for federal income tax purposes, or for that matter any other state or local income tax purpose, should not be ignored for CAT purposes.
- While the CAT results in a tax on gross revenues at the measly rate of 0.57%, it should not be omitted from any tax planning efforts. Most taxpayers believe no tax is a good tax. More importantly, nobody likes unpleasant surprises such as having to pay a tax that they were not informed in advance about by their tax practitioner.

The CAT is keeping me up nights thinking about all of its implications and some of the many consequences that lawmakers may not have intended when they passed the legislation. I will likely continue to stay up nights pondering more issues. That is just my nature! Consequently, I will continue to share my thoughts about the CAT with you. If you too cannot sleep, feel free to email me your thoughts, concerns and questions about the CAT. We can stay awake figuring out the answers to these puzzling issues.

Stay tuned for more!

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