

Oregon House Bill 3601

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Looks Like Oregon Tax Laws are Changing Again

House Bill 3601 A ("HB 3601") passed the Oregon House of Representatives and the Oregon Senate on October 2, 2013, during a special session. Governor Kitzhaber signed the bill into law on October 8, 2013. The new law is effective January 1, 2014. This is good news for some Oregon taxpayers and bad news for others.

The most significant impact of HB 3601 is found in six provisions, namely:

I. Corporate Excise Tax Rates. The corporate excise tax rates are increased. Effective for tax years beginning in 2013 or later, a 6.6% tax rate applies to the first \$1,000,000 of taxable income and a tax rate of 7.6% applies to any excess taxable income. Under current law, the 6.6% tax rate applies to the first \$10,000,000 of taxable income and the 7.6% tax rate applies to any excess taxable income. This change in current law represents a substantial increase in tax for many corporate taxpayers.

II. IC-DISCs. Except as expressly provided by Oregon law, DISCs are taxed in Oregon like corporations. ORS 317.635(1). HB 3601 exempts **existing** Interest Charge DISCs (i.e., IC-DISCs formed on or before the effective date of the act) from the Oregon corporate minimum tax under ORS 317.090. HB 3601 also causes any commissions received by DISCs to be taxed at 2.5%, and allows a deduction for commission payments made to **existing** DISCs.

III. Dividends Received from DISCs. HB 3601 allows a personal income taxpayer to subtract from income any dividend received from a DISC formed under IRC § 992.

IV. Personal Exemption Phase-Out. HB 3601 denies personal income taxpayers from claiming the personal exemption credit(s) (current \$90 per exemption) if federal adjusted gross income is \$100,000 or more for a single taxpayer and \$200,000 or more for a married filing joint taxpayer.

V. Senior Health Care Costs. HB 3601 provides a small deduction for "senior" health care expenses not compensated by insurance. The bill, however, adds a phase-out for taxpayers with federal adjusted gross income over certain thresholds. Likewise, the definition of a "senior" starts out at age 62 for the 2013 tax year and increases each year thereafter by one year until tax year 2020.

VI. Reduced Tax Rates for Applicable Non-passive Income. For tax years beginning in 2015 or later, applicable non-passive income attributable to certain partnerships and S corporations will be taxed as follows:

- 7% for taxable income of \$250,000 or less;
- 7.2% for taxable income greater than \$250,000 but less than or equal to \$500,000;
- 7.6% for taxable income greater than \$500,000 but less than or equal to \$1,000,000;
- 8% for taxable income greater than \$1,000,000 but less than or equal to \$2,500,000;
- 9% for taxable income greater than \$2,500,000 but less than or equal to \$5,000,000;
- 9.9% for taxable income greater than \$5,000,000; or
- Upon election of the taxpayer, the rates otherwise prescribed by ORS 316.037 (which provides for a 9.9% rate on taxable income over \$125,000).

To qualify for this reduced rate structure, which is subject to adjustment, taxpayers must make an irrevocable election on their original return (presumably on the 2015 return, but administrative rules yet to be issued by the Department of Revenue should clarify the election process and timing requirements). In addition, the reduced rate structure only applies to "non-passive" income attributable to a partnership or S corporation in which the taxpayer materially participates in day-to-day operations of a trade or business. Last, to qualify the entity must employ at least one non-owner and an aggregate of at least 1200 hours of work must be performed in Oregon during the taxable year by the non-owner employee(s). For the purpose of computing the number of hours worked in Oregon during the taxable year, only hours during weeks in which the non-owner worker(s) performed 30 hours or more of services may be counted.

This last provision of HB 3601 is the most interesting. It appears that disregarded entities (i.e., single-member limited liability companies) are **not** eligible for the reduced tax rates. Why? It is not clear why the legislature omitted these entities.

For many disregarded entities with sufficient Oregon income, it may be worth converting the entities to S corporation status or adding an additional owner in order to qualify for the reduced rate structure. I assume the sole member of many otherwise qualifying limited liability companies may be willing to convert to S corporation status or add an owner with a small ownership interest (e.g., spouse or current employee) in late 2014 to become eligible for the reduced rate structure.

For example, if the pass-through taxable income of a disregarded entity is \$7,000,000, the Oregon tax savings attributable to converting to S corporation status or adding an additional member would be around \$74,000 per year. Is that enough incentive for the sole member of a limited liability company to convert to S corporation status or add another member? Only time will tell.

This last provision of HB 3601 creates a tax inequity among entities operating businesses in Oregon. While many taxpayers believe the Oregon corporate minimum tax contained in ORS 317.090 is unfair as it only adversely impacts C corporations, the reduced rate structure for qualifying S corporations and partnerships is likewise unfair as it ignores another flow-through entity, the single-member limited liability company.

Keep your eye on the ball! The provisions of HB 3601 are effective January 1, 2014.

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