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Larry's Tax Law

Oregon's New Corporate Activity Tax

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We are taking a break from our multi-post coverage of Opportunity Zones to address a recent, significant piece of Oregon tax legislation.

On May 16, 2019, Governor Kate Brown signed into law legislation imposing a new "corporate activity tax" ("CAT") on certain Oregon businesses. The new law expressly provides that the tax revenue generated from the legislation will be used to fund public school education.

Although the new tax is called a "corporate" activity tax, it is imposed on individuals, corporations, and numerous other business entities. The CAT applies for tax years beginning on or after January 1, 2020.

To help defray the expected increased costs of goods and services purchased from taxpayers subject to the CAT that will assuredly be passed along to consumers, the Oregon Legislative Assembly modestly reduced personal income tax rates at the lower income brackets.

The Tax

The tax will be $250 plus 0.57 percent of each taxpayer's taxable commercial activity ("TCA") that exceeds $1 million; however, no tax is owed if TCA does not exceed $1 million.

TCA is defined as commercial activity sourced to Oregon less certain subtractions (discussed below). Taxpayers will remit the tax to the Oregon Department of Revenue ("DOR") quarterly. The CAT will be imposed on each person with TCA who has "substantial nexus" with the state (discussed below). The Legislative Assembly has declared that the tax is not subject to Public Law 86-272.

Commercial Activity

"Commercial activity" for taxpayers other than insurers and financial institutions is defined as "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." As such, it is conceptually a gross receipts tax.

Over 40 separate items are expressly excluded from the definition of "commercial activity." Some of the more significant exclusions are:

- most interest income;

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- proceeds from the sale or exchange of capital assets described in Section 1221 of the Internal Revenue Code of 1986, as amended (the "Code") and certain property used in a taxpayer's trade or business described in Code Section 1231;
- receipt of loan principal payments;
- proceeds from stock issuances;
- insurance proceeds;
- gifts or charitable contributions received;
- amounts received by an agent for someone else;
- capital contributions;
- dividends received;
- distributive income received from pass-through entities;
- receipts from sales to a wholesaler in Oregon where the seller receives certification at the time of sale that the buyer will resell the property outside the state;
- receipts from retail or wholesale sales of "groceries" (defined as "food" as defined in 7 U.S.C. § 2012(k));
- receipts from transactions among members of a unitary group; and
- amounts collected to pay various taxes and fees (including franchise fees, privilege taxes, and the new heavy equipment rental tax).

Transfers of Property

A provision in the new law, akin to a "use" tax, requires a person to include as TCA the value of any property the person transfers into the state for such person's own use in a trade or business within a year after the person receives the property outside of Oregon.

For a unitary group, the taxpayer must include as TCA the value of all property that any of the taxpayer's members transferred into the state for use in a trade or business by any of its members within a year after the taxpayer receives the property outside of Oregon.

Property that is brought into the state within a year after the taxpayer receives it outside of Oregon may not be included as TCA if the DOR ascertains that the property's receipt outside the state followed by its transfer into the state within a year was not intended to avoid the CAT.

Persons Subject to the CAT; Excluded Persons

The CAT applies to "persons." "Persons" include individuals, business trusts, estates, partnerships, limited liability partnerships, limited liability companies, associations, joint ventures, clubs, societies, C corporations, S corporations, qualified subchapter S subsidiaries, qualified subchapter S trusts, trusts, disregarded entities, and any other entities.

Several types of entities are excluded from the CAT, including governmental entities, farm cooperatives, most tax-exempt organizations under 501(c), 501(d), 501(e), 501(f), 501(j), or 501(n), unless their exemption

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has been denied under certain circumstances, and any person with commercial activity that does not exceed $1 million for the calendar year unless that person is part of a unitary group with commercial activity of $1 million or more ("excluded persons").

Unitary Groups

Unitary groups must register, file, and pay the CAT as a single taxpayer. A "unitary group" is defined as a group of persons with more than 50 percent common ownership (direct or indirect) that is engaged in business activities constituting a unitary business. A "unitary business" is defined, in turn, as a business enterprise in which the members or parts of the enterprise share or exchange (directly or indirectly) value, demonstrated by the presence of any one of the following:

- centralized management or a common executive force;
- centralized administrative services or functions resulting in economies of scale; or
- flow of goods, capital resources or services demonstrating functional integration.

A unitary business may include a business enterprise in which either horizontal or vertical integration is present. Horizontal integration is one in which each part of the enterprise are in the same general line of business, like manufacturing, wholesaling, or retailing. Vertical integration includes the steps in the production of natural resources, including exploration, mining, refining, and marketing.

Unitary group members will have joint and several liability for the CAT.

Substantial Nexus

As noted above, a person must have "substantial nexus" with Oregon in order to be subject to the CAT. Substantial nexus is present if the person: (a) owns or uses a part or all of its capital in the state; (b) holds a certificate of existence or authorization issued by the Secretary of State authorizing the person to do business in the state; (c) has bright-line presence in the state; or (d) otherwise has nexus with the state to the fullest extent permitted under the U.S. Constitution.

Bright-line presence means that a person:

- owns at any time during the calendar year property in Oregon with an aggregate value of at least $50,000 (owned property is valued at original cost; rented property[1] is valued at eight times the annual rental rate);
- has during the calendar year payroll in Oregon of at least $50,000 (including any amount subject to withholding, any other amount the person pays as compensation to an individual under the supervision or control of the person for work done in the state, and any amount the person pays for services performed

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in the state on the person's behalf by another);
- has during the calendar year commercial activity, sourced to the state, of at least $750,000;
- has at any time during the calendar year within the state at least 25 percent of the person's total property, total payroll or total commercial activity; or
- is a resident of Oregon or is domiciled here for corporate, commercial, or other business purposes.

Sourcing

Commercial activity is sourced to Oregon as follows:

- in the case of the sale, rental, lease or license of real property, if and to the extent the property is located in Oregon;
- in the case of the rental, lease or license of tangible personal property, if and to the extent the property is located in Oregon;
- in the case of the sale of tangible personal property, if and to the extent the property is delivered to a purchaser in Oregon;
- in the case of the sale of a service, if and to the extent the service is delivered to a location in Oregon; and
- in the case of the sale, rental, lease or license of intangible property, if and to the extent the property is used in Oregon. If the receipts are not based on the amount of use of the property, but rather on the right to use the property, and the payor has the right to use the property in Oregon, the receipts must be sourced to Oregon to the extent the receipts are based on the right to use the property in Oregon.

***Note*:** Different sourcing rules (not discussed in this post) apply to insurers and financial institutions.

A person may request, or the DOR may require or permit, an alternative method if these sourcing provisions do not fairly represent the extent of such person's commercial activity attributable to Oregon.

The legislation gives the DOR authority to adopt rules to provide additional guidance with respect to the application of the sourcing rules, and to provide alternative methods of sourcing commercial activity that apply to financial institutions and to insurers, and to any other persons, or a subset of persons, that are engaged in similar business or trade activities. We expect administrative rules will be adopted by the DOR in the near future to further define the scope of these provisions.

Subtraction

In determining a taxpayer's TCA, a taxpayer is directed to subtract from commercial activity sourced to Oregon an amount equal to 35 percent of the greater of the following amounts that the taxpayer pays or incurs in the tax year: (a) the cost of goods sold ("COGS") as determined under Code Section 471; or (b) the taxpayer's labor costs (defined as total compensation with respect to all employees, not including compensation paid to any individual employee that exceeds $500,000). Such amounts must be apportioned to Oregon in the manner required for apportionment of income under ORS Sections 314.605 to 314.675. In no case may the subtraction exceed 95 percent of the taxpayer's commercial activity in the

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state.

Registration

Any person or unitary group with commercial activity that exceeds $750,000 in the state during a tax year is required to register with the DOR. The DOR may impose a penalty for failing to register of up to $100 per month for an unregistered person or unitary group, up to $1,000 in a calendar year. Penalties may be imposed not earlier than 30 days after the date on which the commercial activity of the person or unitary group exceeds $750,000 for the tax year.

Returns and Remittance of Tax

Every person doing business in the state with commercial activity for a tax year that exceeds $1 million must file an annual return no later than April 15 of the following year. The CAT is due and payable to the DOR on or before the last day of January, April, July and October of each year for the previous calendar quarter.

Underpayment or Underreporting

For tax years beginning on or after January 1, 2020, and before January 1, 2021, and to returns filed on or before April 15, 2021, the DOR may not impose interest or penalties that would otherwise apply to the CAT due if such interest or penalty is based on underpayment or underreporting that results solely from the operation of the CAT. A taxpayer must, however, pay at least 80 percent of the balance due for any quarter or the DOR may impose a penalty pursuant to ORS 314.400(3).

Applicability of Other Tax Laws

Provisions under ORS chapters 305 and 314 relating to audit and examination of returns, periods of limitation, determination of and notices of deficiencies, assessments, collections, liens, delinquencies, claims for refund and refunds, conferences, appeals to the Oregon Tax Court, stays of collection pending appeal, confidentiality of returns and the penalties relative thereto, and the procedures relating thereto, apply to the determinations of taxes, penalties and interest under the CAT provisions. Any term not defined in the CAT statutes has the meaning under ORS chapter 305, 314, 316 or 317.

Preemption of Local Taxes

The statute vests the authority to impose a CAT solely in the Legislative Assembly. A city, county, district or other political subdivision or municipal corporation of Oregon may not impose a CAT or a tax on receipts from grocery sales. Such preemption does not apply: (a) to any tax, or to subsequent amendments to any tax, if the law is in effect on April 1, 2019, or is adopted by initiative or referendum petition at an election held prior to March 1, 2019; or (b) to the imposition of franchise fees or franchise taxes.

Opposition to CAT

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The CAT is not entirely out of the woods yet. An industry trade group, Oregon Manufacturers and Commerce, filed a referendum on Thursday, May 30, 2019, seeking repeal of the CAT. In order to be on the ballot next year, proponents of the repeal will need to gather 75,000 signatures within 90 days following the end of the legislative session. While voters rejected a proposed gross receipts tax in 2016 (Measure 97), the CAT appears to have more support from the Oregon business community.

Reduction in Personal Income Tax Rates

For tax years beginning on or after January 1, 2020, personal income tax rates for the lowest three brackets will be reduced, as follows:

- The 5 percent bracket (applicable to income of up to $2,000) is reduced to 4.75 percent,
- The 7 percent bracket (applicable to income of between $2,001 and $5,000) is reduced to 6.75 percent, and
- The 9 percent bracket (applicable to income of between $5,001 and $125,000) is reduced to 8.75 percent.
- The 9.9 percent bracket (applicable to income of over $125,000) remains unchanged.

These income tax brackets reflect single taxpayers. They are effectively doubled for married taxpayers filing jointly, surviving spouses, and heads of household.

The minimum and maximum dollar amounts for each personal income tax bracket (except for the top bracket) will increase by the cost-of-living adjustment for each calendar year.

Conclusion

Assuming the CAT is not repealed next year, business owners with over $1 million of commercial activity will be subject to the tax.

The following are some of our initial thoughts with respect to the CAT.

- The CAT operates in a pyramiding manner, such that the tax is paid each time there is a transaction in the goods cycle. That is, a seller of raw materials will pay the tax on sales to a manufacturer. The manufacturer will pay it when selling to a wholesaler (if the goods will be sold in Oregon). The wholesaler will pay it when selling to a retailer (unless an exception applies, like for groceries). The retailer will pay it when customers buy its goods (other than excepted items like groceries).
- Because the tax applies to each individual person or business entity, related taxpayers that do not comprise a unitary group will pay the tax on sales between themselves.

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- The CAT may be a factor in a company's analysis of whether to do business in Oregon, either for the first time or in a continuing fashion.
- The CAT will likely disproportionately affect businesses with low profit margins but high revenues. Such businesses will likely pass along any added costs to customers. However, if they are unable to do so, the CAT could result in business failures.
- A business that cannot increase the price it charges for sales of goods or services (e.g., it is subject to statutory or contractual restrictions with respect to its prices) will not be able to pass along the tax to its customers.
- A business that sells both exempt and non-exempt goods and/or services (e.g., food and other products) will likely need to keep track of sales separately by each category.
- The COGS and labor deductions will become important deductions, and administrative guidance will be needed on these deductions. Based on the statutory language, the deduction is the greater of either labor costs or COGS, not a combination of both. This deduction will likely require businesses to set up a means to separately track these items.
- Because the sourcing rules look to where goods are shipped, Oregon manufacturers who export most of their products are more likely to feel the effects of the tax via increased COGS, rather than the tax on their own sales (as out-of-state sales are exempt).
- The tax on property transferred into the state is akin to a "use" tax, requiring taxpayers to self-assess the tax on items purchased out of state and brought into the state. This will likely be a large area of taxpayer error and the focus of DOR audits.
- Similarly the "self-certification" of wholesale sales made out of state will likely be an area of DOR audit focus, as it would lend itself to potential abuse.

Oregon businesses need to prepare themselves for CAT compliance. If the referendum is successful, Oregon voters will have a say in whether the CAT goes into effect on January 1, 2020. Stay tuned!

[1] We think the Legislative Assembly intended for this test to apply to property owned or rented, because it illustrated how rental property is to be valued. However, the test by its terms applies only to owned property.

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