Journal of Multistate Taxation and Incentives (Thomson Reuters/Tax & Accounting)
Volume 30, Number 2, May 2020

SHOP TALK

Oregon's New Corporate Activity Tax: Open Questions

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Oregon's new corporate activity tax (the "CAT") went into effect on January 1, 2020, and is codified in Chapter 317A of the Oregon Revised Statutes ("ORS"). The Oregon Department of Revenue (the "Department") started promulgating draft temporary rules on January 2, 2020, many of which have been finalized as temporary rules. To date, the Department has finalized sixteen temporary rules.[1] This includes Or. Admin. R. ("OAR") 150-317-1200, which concerns the subtraction for cost inputs or labor costs. The Department has not issued a rule about ORS 317A.116(4), which concerns car dealers passing on the CAT to purchasers. This article discusses open issues related to OAR 150-317-1200 and ORS 317A.116(4).

CAT: general summary

The CAT is imposed on a person's "taxable commercial activity for the privilege of doing business" in Oregon.[2] Taxable commercial activity generally is defined as a taxpayer's Oregon-source gross receipts from transactions and activity in the regular course of the taxpayer's trade or business (i.e., so-called "transactional test" gross receipts), less a subtraction of 35 percent of the greater of (a) "cost inputs," or (b) "labor costs," apportioned to Oregon.[3] Cost inputs generally are the taxpayer's cost of goods sold ("COGS").[4] "Labor costs" include only compensation paid to employees and are capped at $500,000 per employee.[5]

Although titled a "Corporate Activity Tax," the tax generally applies to "each *person* with taxable commercial activity."[6] Accordingly, pass-through entities (such as partnerships, LLCs, joint ventures, and

S corporations), disregarded entities, and individuals are subject to the CAT.[7] However, certain entities are excluded from the tax (*e.g.*, IRC Section 501(c) entities, health insurance companies subject to certain other Oregon excise taxes, and certain hospitals and care facilities).[8] The tax is $250 plus 0.57 percent of taxable commercial activity in excess of $1 million.[9]

Subtraction for 35 percent of the greater of cost inputs or labor costs

As noted above, taxpayers are allowed a subtraction for 35 percent of the greater of cost inputs or labor costs (the "Subtraction").[10] Taxable commercial activity is limited to Oregon-source commercial activity.[11] Further, the definition of commercial activity excludes over 40 types of gross receipts.[12] Absent an adjustment, the inclusion of cost inputs or labor costs for out-of-state commercial activity or exempt receipts could result in the Subtraction exceeding Oregon-source commercial activity, even with the 35 percent limit. Accordingly, cost inputs and labor costs "shall be apportioned to this state in the manner required for apportionment of income under" the method used by Oregon's version of the Uniform Division of Income for Tax Purposes Act ("UDITPA") for apportioning business income.[13] In addition, the Subtraction does not take into account "[c]ost inputs or labor costs that are attributable to a person's receipts from an item that is not commercial activity."[14]

The Department provided guidance on calculating the Subtraction in OAR 150-317-1200. The Department combined the ORS 317A.119(2) adjustment (out-of-state commercial activity) and the ORS 317A.119(3)(b) adjustment (exempt receipts) into a single step: the commercial activity ratio. "The commercial activity ratio is a fraction, the numerator of which is the taxpayer's commercial activity sourced to Oregon and the denominator of which is the taxpayer's total commercial activity everywhere plus exclusions from commercial activity."[15]

Expressed as a fraction and using "CAR" for commercial activity ratio, "OS" for Oregon-sourced, "CA" for commercial activity, and "EGR" for exempt gross receipt: CAR = OSCA/(CA + EGR).

The commercial activity ratio can be divided into the two adjustments it makes:

1. Remove Out-of-State Commercial Activity: This can be accomplished with the ratio of Oregon-source commercial activity to total commercial activity, or OSCA/CA.

2. Remove Exempt Gross Receipts: The Department accomplishes this with the ratio of commercial activity to the sum of commercial activity and exempt gross receipts, or CA/(CA + EGR). As discussed, below, this ratio contains a key assumption that may not be merited.

Accordingly, the Subtraction involves multiplying cost inputs and labor costs by both the ratio of Oregon-source commercial activity to total commercial activity (OSCA/CA) *and* the ratio of commercial activity to the sum of commercial activity and exempt gross receipts (CA/(CA + EGR)), or OSCA/CA * CA/(CA + EGR). Because CA is in the denominator of the first ratio and the numerator of the second ratio, CA is cancelled out, resulting in OSCA/(CA + EGR): the commercial activity ratio.

Although the Department combining the two adjustments in a single ratio works as a mathematical proposition, it relies on a key assumption: that cost inputs and labor costs are equally spread for all gross receipts. This assumption makes sense in certain contexts (e.g., wages paid to a checker at a store that sells exempt groceries and taxable household goods). However, it does not make sense in other contexts (e.g., costs inputs for exempt groceries and taxable household goods that sell for the same price).

Perhaps in recognition of the potential flaws in its assumption, the Department allows taxpayers to use separate accounting.[16] Unlike the use of separate accounting for Oregon's version of UDITPA, it appears that a taxpayer can use separate accounting without having to demonstrate that the commercial activity ratio results in an unrepresentative Subtraction.[17] The Department giving taxpayers the option to use separate accounting without having to show distortion provides significant relief from formulaic application of the commercial activity ratio. However, key questions remain.

For example, by its terms, OAR 150-317-1200(4) requires use of separate accounting to remove amounts "attributable to a person's receipts from an item that is not *Oregon commercial activity*." (Emphasis added.) It is thus unclear if a taxpayer (1) would have to separately account for both out-of-state commercial activity and exempt gross receipts or (2) could use separate accounting to remove exempt gross receipts but use the ratio of Oregon-source commercial activity to total commercial activity to remove out-of-state commercial activity.

OAR 10-317-1200 also allows the Department or the taxpayer to use "alternative apportionment" if the commercial activity ratio "does not fairly represent the labor cost or cost input subtraction attributable to the taxpayer's commercial activity."[18] The rule does not provide any guidance for the level of distortion necessary to satisfy the "does not fairly represent" requirement. The same language is used in ORS 314.667(1) for when a taxpayer may use, or the Department may require, alternative apportionment rather than Oregon's version of UDITPA. This requires a showing of a significant level of distortion.[19]

Overall, to determine the adjustments to the Subtraction required by ORS 317A.119(2) (out-of-state commercial activity) and ORS 317A.119(3)(b) (exempt gross receipts), OAR 150-317-1200 provides three methods. A taxpayer has a unilateral right to choose between the first two methods (the commercial

activity ratio and separate accounting). The third method requires approval by the Department (alternative apportionment). Despite this flexibility, significant questions remain.

Collection of the CAT on the sale of a vehicle

The Department's CAT guidance includes FAQs on its website.[20] These include the question, "Can I pass the CAT on to my customers?" The Department provides the following response:

> The laws establishing the CAT (Oregon Laws 2019, chapters 122 and 579) do not prohibit any business from recovering a business expense when setting the total price for the sale, lease, or license of an item or the sale of a service. The CAT is imposed on the entity doing business in Oregon and is considered part of the business' expenses. A business may include the CAT with other business expenses when setting the total price charged to customers. However, the total price charged (including any amount estimated to be attributable to the CAT) is included in the business' commercial activity.

Essentially, taxpayers can increase prices to cover an estimate of the CAT liability resulting from the sale,[21] but the increase is additional taxable commercial activity subject to the CAT. The Department's position that amounts collected to cover the taxpayer's CAT liability constitute taxable commercial activity subject to the CAT generally appears to reflect the language of ORS 317A.116(1), that the CAT:

- "is imposed on each person with taxable commercial activity for the privilege of doing business in this state," not on retail sale;
- "is imposed on the person with the commercial activity and is not a tax imposed directly on a purchaser."

Nothing in the Department's FAQ answer quoted above distinguishes vehicle dealers from other taxpayers. It appears, however, that the legislature provided for a different treatment for vehicle dealers. ORS 317A.116(4) provides: "*Notwithstanding subsection (1) of this section,* a vehicle dealer may collect from the purchaser of a motor vehicle the estimated portion of the tax imposed under this section that is attributable to commercial activity from the sale of the vehicle." (Emphasis added.)

As described above, ORS 317A.116(1) provides the basis for treating price increases for the CAT as subject to the CAT. Vehicle dealers, however, can collect an estimate of the CAT "[n]otwithstanding" ORS 317A.161(1). Therefore, it appears that the ORS 317A.161(1) provisions that the CAT is imposed for the privilege of doing business in Oregon and is not imposed on the purchaser do not apply to vehicle dealers. Further, as noted by the Department in its response to the FAQ, nothing in the CAT statute prohibits a taxpayer from recovering the CAT from a price increase.[22] If any business can collect

estimated CAT from a sale, ORS 317A.161(4) generally would be redundant because it merely states that a rule applicable to all businesses applies to vehicle dealers. Such an interpretation of ORS 317A.161(4) generally would violate Oregon's rules of statutory interpretation.[23]

The CAT is a new, comprehensive tax with several different moving parts. Further, many aspects of the CAT are unique, such as the Subtraction. Inevitably, the CAT contains several open issues that will be addressed legislatively, administratively, or judicially over time. These include properly calculating the Subtraction and the CAT impacts on vehicle dealers collecting an estimate of the CAT from the purchaser.

[1] *See* https://www.oregon.gov/DOR/about/Pages/rules.aspx.

[2] ORS 317A.116(1).

[3] ORS 317A.100(16) (defining "taxable commercial activity"); ORS 317A.100(1)(a) (defining "commercial activity").

[4] ORS 317A.100(2).

[5] ORS 317A.100(12).

[6] ORS 317A.116(1) (emphasis added).

[7] *See* ORS 317A.100(14) (defining "person"). At the January 13, 2020, meeting of the House Interim Committee on Revenue, Representative Gordon Smith highlighted the misleading nature of the CAT's full name. *See* http://oregon.granicus.com/MediaPlayer.php?clip_id=27694 at 48:01-48:36 ("I really struggle with the fact that collectively we continue to call it a corporate activity tax when it impacts more than just corporations. I am really hoping that at some point in time we can have a conversation as to what the title of the activity tax should be . . . . Corporate is just a misleading title."). The author supports changing the full name of the CAT to more accurately reflect its scope. Because the tax applies to "commercial activity" (and not solely "corporate activity"), the name "commercial activity tax" is more accurate.

[8] ORS 317A.100(4).

[9] ORS 317A.125(1).

[10] ORS 317A.119(1).

[11] ORS 317A.100(16).

[12] ORS 317A.100(1)(b).

[13] ORS 317A.119(2).

[14] ORS 317A.119(3)(b).

[15] OAR 150-317-1200(2).

[16] *See* OAR 150-317-1200(4) ("a taxpayer may elect the use of separate accounting to remove all cost inputs or labor cost from the subtraction that are attributable to a person's receipts from an item that is not Oregon commercial activity.").

[17] *See* ORS 314.667(1) (requiring showing that application of rules for Oregon UDITPA "do not fairly represent the extent of the taxpayer's business activity in this state.").

[18] OAR 150-317-1200(5).

[19] *See*, *e.g.*, *Stonebridge Life Insurance Co. v. Department of Revenue*, (2006) (taxpayer demonstrated distortion of over 1,800 percent).

[20] Available at https://www.oregon.gov/DOR/programs/businesses/Pages/corporate-activity-tax.aspx.

[21] Because of the Subtraction, the taxpayer's actual CAT rate is not known at the time of the transaction.

[22] The Department's focus on limitations from the CAT statutes is notable. Taxpayers considering price increases to pay for the CAT liability should consider the impact of other laws, such as consumer protection and price labeling laws. The impact of these laws is beyond the scope of this article.

[23] *See Arken v. City of Portland*, 351 Or. 113, 156, 263 P.3d 975 (2011) (noting "the cardinal rule of statutory construction to give significance and effect to every part of a statute" and "the well-established principle to avoid interpretations of statutes that render portions of them redundant.").

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