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February 11, 2020

**VIA EMAIL**

**Re: COST's Letter in Support of -10 and -13 Amendments to H.B. 4009 before the House Committee on Revenue**

Dear Chair Nathanson, Vice-Chairs Marsh and Werner Reschke, and Members of the Committee:

On behalf of the Council On State Taxation (COST), I am writing in support of the -10 and -13 amendments to H.B. 4009. Both amendments make modifications to H.B. 4009, the Oregon Corporate Activity Tax (Oregon CAT) technical corrections bill, that would greatly ease administration for taxpayers subject to this new tax. These amendments are the result of a group effort by COST, the Department of Revenue, Committee staff, and other industry stakeholders -- an effort focused primarily on two specific issues, the Oregon CAT statutory subtraction and the required unitary filing group. COST is appreciative of the efforts of all involved, and the -10 and -13 amendments are a direct result of those efforts. Both amendments will ease the compliance burden of taxpayers subject to the Oregon CAT; thus, COST urges the committee to adopt both.

## About COST

COST is a nonprofit trade association based in Washington, D.C. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce, and today COST has an independent membership of approximately 550 major corporations engaged in interstate and international business representing every industry doing business in every state. COST members conduct substantial business in the state of Oregon, employ a substantial number of Oregon citizens, and own extensive property within the State. COST's objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multijurisdictional business entities—a mission it has steadfastly maintained since its creation.

## The -10 and -13 Amendments Address Much Needed

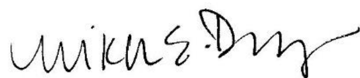
COST has previously pointed out that the Oregon CAT as passed in 2019 requires technical fixes to provide for ease of compliance and administration. Further, I addressed in depth two very specific technical issues in a State Tax Notes Article published on January 13, 2019 (see attached). COST is extremely pleased that both issues are addressed by the -10 and -13 amendments.

The -10 amendment specifically provides technical changes to the statutory subtraction (*i.e.*, 35% of the greater of cost inputs or labor costs) which address ambiguities and procedures that are unduly burdensome. The -13 amendment provides a solution to the provision requiring taxpayers to calculate the Oregon CAT on a worldwide basis, which is a significant burden without any significant benefit to the State. Because each amendment addresses a significant compliance burden for taxpayers, COST is fully supportive of both.

**Conclusion**

Again, COST thanks all stakeholders who were engaged in the process that led to these revisions, and urges the committee to adopt both amendments.

Sincerely,



Nikki Dobay

cc: COST Board of Directors
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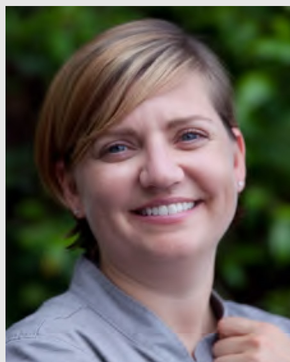
# Oregon CAT Part I: Legislative Fixes Necessary for Administration

by Nikki E. Dobay



Nikki E. Dobay

Nikki E. Dobay is senior tax counsel with the Council On State Taxation. She is a key member of COST's advocacy team covering the 13 most Western states, including Oregon, and regularly provides written comments to and in-person testimony before the legislatures of those states in accordance with COST's policy positions. She can be reached at ndobay@cost.org.

In this article, Dobay cites issues with Oregon's new corporate activity tax, advocating that the legislature enact technical corrections such as a fiscal-year filing option and a water's-edge election to avoid significant compliance and administrative challenges.

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## I. Introduction

In 2019 the Oregon Legislative Assembly enacted a new corporate activity tax (CAT) to tackle education funding. Name notwithstanding, the CAT applies broadly to individuals as well as passthrough entities (and several other entity types). The tax will take effect January 1, 2020, and corporate taxpayers will be required to pay it in addition to the state's corporate excise tax.[1]

The legislature's long and winding road to the CAT is the result of an extraordinary political compromise,[2] which yielded a one-of-a-kind modified gross receipts tax incorporating elements of both the Ohio commercial activity tax and the Texas margins tax. This hybrid approach is sure to create new complexities not seen in either Ohio or Texas.

In conceiving this new and different tax, the legislature provided the Oregon Department of Revenue with less than eight months to implement it. By comparison, Ohio provided a five-year phase-in period, so the DOR has an incredibly heavy lift to meet this aggressive deadline. Nonetheless, the department has diligently worked on several fronts, opening up registration and releasing draft rules prior to January 1, 2020.

Because the legislature is slated to take up a technical corrections bill in 2020 (and likely future years as well), this article analyzes two critical issues that must be addressed during the 2020 session for the tax to be administrable: The state must provide a fiscal year filing option and a water's-edge election. To lay the foundation for the discussion of those issues, the article starts with a detailed overview of the Oregon CAT in its current form. Of course, there are still many other issues that must be addressed by rule or additional legislation. When this article was drafted, however, the DOR was still working on rules that are likely to address many of those

[1] Oregon's general corporate income tax is statutorily referred to as the Oregon corporate excise tax. *See* chapter 317 of the Oregon Revised Statutes.

[2] Although political compromise is not all that unusual and is in many cases desirable, the Oregon CAT is an imperfect hybrid of two competing proposals brought forth during the legislative session. On one side interested parties were advocating for an Ohio-style commercial activity tax, and on the other side were strong advocates for a business activity tax with a value-added tax base. The resulting CAT starts with Oregon-sourced receipts (like the Ohio tax) to which an apportioned subtraction is applied.



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issues. Thus, this article is only one of many expected on the new Oregon CAT.

## II. Overview of the Oregon CAT

### A. Enactment of Legislation

On May 16 Gov. Kate Brown signed into law H.B. 3427, which established the CAT. Again, the term "corporate activity tax" is inaccurate since the tax applies to all entity types, including individual taxpayers.[3] Despite a topsy-turvy legislative session,[4] a technical corrections bill (H.B. 2164) was also approved and signed into law by the governor on July 23.

Although a ballot measure challenging the Oregon CAT was filed in May, its proponents abandoned their efforts following the passage of a trio of bills at the end of the session that would have made a successful challenge difficult.[5] Ultimately, no other challenges were filed and both bills went into effect on September 29, 2019 — 91 days after sine die.

### B. Calculation — Taxable Commercial Activity

Considering H.B. 3427 and H.B. 2164 together (hereinafter referred to as the Oregon CAT legislation), the following is a high-level overview of the Oregon CAT calculation:

- The tax base is equal to a taxpayer's Oregon-sourced commercial activity less the statutory subtraction.[6]
- The statutory subtraction is equal to 35 percent of the greater of a taxpayer's cost inputs or labor costs apportioned to the state using Oregon's Uniform Division of Income for Tax Purposes Act provisions.[7]
  - Cost inputs are generally defined as federal costs of goods sold.[8]
  - Labor costs are capped at $500,000 per employee.[9]
  - The statutory subtraction includes some additional caps/exclusions, which will be discussed in more detail later.
- Tax is imposed at a rate of 0.57 percent on taxable commercial activity above $1 million plus $250.[10]

Each of these components is discussed in more detail later — in addition to nexus and reporting requirements provided by the Oregon CAT legislation.

As noted, the starting point for purposes of determining the CAT is Oregon-sourced commercial activity — much like Ohio's commercial activity tax.[11] This concept involves a two-step analysis. The first question is whether a receipt meets the definition of commercial activity. If the answer is yes, then a taxpayer must next determine whether that commercial activity will be sourced to Oregon.

Starting with the definition of commercial activity, the Oregon CAT legislation broadly defines the term 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."[12] Although commercial activity is broadly defined, the Oregon CAT legislation includes a list of 47

[3]In all likelihood, the name "corporate activity tax" was chosen because it sounded more palatable to voters in a ballot initiative challenge.

[4]During Oregon's 2019 legislative session, Senate Republicans left the state twice to block various bills and proposals.

[5]On May 30, 2018, the Oregon Manufacturers and Commerce (OMC) filed ballot initiative 301, which would have put the Oregon CAT provisions before voters in November 2020. Note that H.B. 3427 also included personal income tax cuts and $1 billion in annual school funding. Those provisions were not included in OMC's ballot initiative. During the last two days of the 2019 session, however, the legislature passed the following bills: S.B. 116 (created a special election in January of 2020 for purposes of any ballot initiative related to the CAT); S.B. 212 (reconnected the personal income tax cuts with the CAT provisions for purposes of any ballot initiative); and S.B. 761 (altered signature requirements by prohibiting electronic signature sheets).

Finally, with the passage of technical corrections bill H.B. 2164, OMC would have likely needed to refer it to the ballot as well. Based on the uphill battle OMC was likely to face, it withdrew initiative number 301 in July of 2019.

[6]*See* definition of taxable commercial activity (H.B. 2164 section 50).

[7]H.B. 2164 section 53. Oregon's corporate excise (income) tax similarly adopts UDITPA. However, the excise tax apportions income, whereas the CAT apportions subtractions from gross receipts.

[8]*See* definition of cost inputs, which "means the cost of goods sold as calculated in arriving at federal taxable income under the Internal Revenue Code." (H.B. 2164 section 50.)

[9]*See* definition of labor costs, which "means total compensation of all employees, not to include compensation paid to any single employee in excess of $500,000." H.B. 2164 section 50.

[10]H.B. 3427 section 65.

[11]In fact, the definition of commercial activity — as well as the applicable exclusions — appear, for the most part, cut and pasted from the Ohio commercial activity tax statutes.

[12]H.B. 3427 section 58; H.B. 2164 section 50.



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specific exclusion provisions. Some of the more noteworthy exclusions include:

- specific interest income;
- IRC 1221 or 1231 income (generally, capital gains);
- specific hedging transactions;
- principal loan repayments;
- trust contributions;
- compensation;
- proceeds from the issuance of the taxpayer's own stock;
- insurance proceeds or litigation damages unless for loss of business receipts;
- gifts or charitable contributions received;
- payments from an agent;
- specific tax refunds or reimbursements;
- contributions to capital;
- receipts from the sale of motor vehicle fuel, cigarettes, alcoholic beverages, etc. (that is, items otherwise subject to Oregon excise taxes);
- specific Medicare or medical assistance payments;
- dividends;
- distributions from passthrough entities;
- receipts to Oregon wholesalers that certify the property will be sold outside the state;
- wholesale or retail sales of groceries;
- specific fees, taxes, or charges being collected and remitted by utilities, telecoms, and other companies; and
- sales by farmers to an agricultural co-op.[13]

The Oregon CAT legislation further provides specific commercial activity definitions for financial institution and insurers.[14]

Assuming a taxpayer's receipts fall within the purview of the general definition of commercial activity and are not specifically excluded, then the taxpayer must determine where the commercial activity will be sourced. The Oregon CAT legislation specifically provides that commercial activity should be sourced as follows:

> "(a) In the case of the sale, rental, lease or license of real property to the extent the property is located in this state.
>
> (b) In the case of the rental, lease or license of tangible personal property to the extent the property is located in this state.
>
> (c) In the case of the sale of tangible personal property to the extent the property is delivered to a purchaser in this state.
>
> (d) In the case of the sale of a service to the extent the service is delivered to a location in this state.
>
> (e) In the case of the sale, rental, lease or license of intangible property, if and to the extent the property is used in this state."[15]

The CAT sourcing provisions generally align with the excise tax sourcing provisions for purposes of sourcing sales. For excise tax purposes, Oregon in 2018 moved to market sourcing for the sales of services and intangibles. Thus, several taxpayers have asked the DOR whether the market-sourcing rules for corporate excise tax purposes can be relied upon regarding the CAT. The department has indicated that it will use the excise tax sourcing rules (including the market-sourcing rules) where applicable. The DOR has not, however, provided guidance as to any specific rules that could be relied upon. Rather, the DOR has indicated that it intends to incorporate any applicable rules into the CAT rules — as opposed to merely incorporating any of those rules by reference. As of this writing, the department's timing regarding this rule was unclear but generally expected in early 2020.

Finally, a taxpayer may petition to use an alternative sourcing method if the general sourcing provisions do not "fairly represent the extent of a person's commercial activity attributable to the state."[16] Similar to the corporate excise tax alternative apportionment rules, an alternative apportionment request may be made by the taxpayer or the DOR. The CAT legislation provides the DOR with rulemaking authority

[13] *Id.*

[14] H.B. 3427 section 58; H.B. 2164 section 50. Specific issues related to financial institutions and insurers will not be covered in this article.

[15] H.B. 3427 section 66; H.B. 2164 section 54. The sourcing rules for financial institutions and insurers are particularly vague, providing that "commercial activity not otherwise described is sourced to Oregon if it is from business conducted in this state." *Id.*

[16] *Id.*



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specifically related to the process by which a taxpayer can request alternative apportionment.[17]

### C. Calculation — The Statutory Subtraction

Next, a taxpayer is required to calculate the statutory subtraction to determine whether there's a CAT liability. Again, the statutory subtraction is equal to 35 percent of the greater of a taxpayer's cost inputs or labor costs apportioned to the state using Oregon's UDITPA provisions.[18] As noted, cost inputs are generally defined as "the cost of goods sold as calculated in arriving at federal taxable income under the Internal Revenue Code."[19]

This definition was amended in the technical corrections bill (H.B. 2164). The specific reference to IRC section 471 was deleted and replaced with the general reference to cost of goods sold (COGS) as determined under the IRC. This change was made based on a recognition that only some taxpayers can claim a COGS deduction under IRC section 471, and that other IRC provisions provide deductions similar to the COGS deduction in IRC section 471. The reference to the federal COGS number does seem to indicate that the legislature intended a taxpayer to pull that number directly from its federal return — at least as a starting point — to ease compliance and administration. This helpful concept, however, quickly becomes ineffective because a large taxpayer's Oregon filing group will typically differ from its federal consolidated return group.

Labor costs are defined as "total compensation of all employees, not to include compensation paid to any single employee in excess of $500,000."[20] The CAT legislation does not provide a definition of who is an employee, and the DOR has not specified whether a deduction may be taken for indirect employee compensation. The department has indicated it will broadly interpret compensation to include fringe benefits and 401(k) expenses.

The cost inputs or labor costs amount is subject to a reduction for exclusions or capped by the taxpayer's Oregon commercial activity. First, the statutory subtraction may not include any expenses related to items excluded from the definition of commercial activity.[21] While understandable in theory, the practical implementation of this exclusion is extremely challenging in many situations and nearly impossible in others. And finally, the CAT legislation provides that a taxpayer's statutory subtraction may not exceed 95 percent of its Oregon commercial activity.[22] Although this last restriction seems unnecessary since the statutory subtraction is capped at 35 percent and is then apportioned, it may be mathematically possible for a significant loss company to potentially hit this 95 percent cap.[23]

Finally, once the taxpayer has determined its cost inputs or labor costs (subject to all exclusions and/or the 95 percent cap), it must then apportion that amount to determine its final statutory subtraction. The CAT legislation references Or. Rev. Stat. sections 314.605 through 314.675, which provide corporate excise tax apportionment rules. Under these provisions, Oregon generally requires a taxpayer to use a single-sales-factor apportionment formula, and as of 2018 has implemented market sourcing for purposes of sourcing services and intangibles. Considering the plain language of the CAT legislation, it appears a taxpayer must use the apportionment factor calculated to determine its corporate excise tax liability.

Interestingly, the DOR recently said publicly that it believes a different apportionment factor should be used: a factor equal to Oregon commercial activity over everywhere commercial activity. That requirement seems beyond the clear statutory language. Further, this particular rule seems designed to ease compliance by using the existing factor where applicable, as opposed to recomputing the factor calculation. Thus, the

[17] *Id*. Also, the DOR is authorized to provide specific alternative sourcing methods that might apply to financial institutions and insurers.

[18] H.B. 2164 section 53.

[19] H.B. 3427 section 58; H.B. 2164 section 50.

[20] *Id*.

[21] The exclusion of cost inputs or labor costs related to non-commercial activity was added with H.B. 2164 section 53.

[22] H.B. 3427 section 64; H.B. 2164 section 53.

[23] For example, a taxpayer with $100,000 in Oregon-sourced commercial activity and a 10 percent Oregon apportionment factor ($1 million in total sales) would hit the 95 percent cap when its cost inputs or labor costs exceed $2.72 million.



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DOR's position seems beyond the scope of its authority.

### D. Calculation — Oregon CAT Liability

To determine its CAT liability, the taxpayer is required to reduce the amount of its Oregon commercial activity by its statutory subtraction. The CAT legislation refers to the resulting amount as "taxable commercial activity."[24] Assuming the taxpayer's taxable commercial activity exceeds $1 million, the CAT is determined by applying a 0.57 percent rate to the amount in excess of $1 million, and then adding $250.[25]

### E. Administration — Who Is Subject to the CAT?

The CAT legislation provides that the CAT "is imposed on each *person* with taxable commercial activity for the privilege of doing business in the state."[26] The term "person" is broadly defined to include all entity types including but not limited to individuals, "combinations of individuals in any form," passthrough entities, limited liability companies, joint ventures, etc.[27] — essentially, everyone!

### F. Administration — Nexus

To determine nexus, the Oregon CAT legislation essentially borrowed the factor presence provisions from Ohio's commercial activity tax laws.[28] Thus, a taxpayer is deemed to have nexus where a person owns or uses capital within the state, has registered with the secretary of state to do business in the state, has "bright-line" factor-presence nexus in the state, or otherwise has nexus to the extent allowed by the U.S. Constitution.[29] Bright-line factor-presence nexus will apply to a person with at least $50,000 of property or payroll within the state, or at least $750,000 of Oregon-sourced commercial activity.[30]

### G. Administration — Who and What Is Required to Be Reported

Note that the Oregon CAT economic nexus provision provides that a taxpayer has nexus for purposes of the CAT with only $750,000 of Oregon-sourced commercial activity, but that a taxpayer does not have a CAT liability until its taxable commercial activity exceeds $1 million. This disparity complicates the CAT reporting requirements, resulting in three potential situations.

First, a taxpayer is required to register with the DOR if it has Oregon commercial activity of at least $750,000.[31] A taxpayer with this level of commercial activity is nonetheless required to register *annually* even if no CAT liability is due, and the failure to register could result in a monthly penalty of $100 per month — capped at $1,000 per year.[32]

Next, a taxpayer with more than $1 million of Oregon commercial activity is, in addition to registering, required to file an annual return by April 15 each year.[33] As with the registration requirement, this return filing requirement is imposed regardless of whether the taxpayer actually has a CAT liability for the year. DOR staff have indicated they intend to provide by rule an extension of at least six months, and that they may be willing to provide a seven-month extension.[34]

Finally, a taxpayer with a CAT liability — meaning its Oregon commercial activity less its statutory subtraction exceeds $1 million (that is, the taxpayer has taxable commercial activity in excess of $1 million) — is required to make quarterly estimated payments of the tax in

[24] H.B. 3427 section 58; H.B. 2164 section 50.

[25] *See* Appendix A for a simple example of the Oregon CAT liability calculation for a multistate taxpayer.

[26] H.B. 2164 section 52.

[27] H.B. 3427 section 58; H.B. 2164 section 50.

[28] Ohio Rev. Code Ann. section 5751.01(H) (2009).

[29] H.B. 2164 section 52.

[30] *Id*. Also, a resident or domiciled corporation as well as a person with at least 25 percent of the person's total property, payroll, or commercial activity within the state will also be deemed to have nexus under the factor presence provision.

[31] H.B. 3427 section 68.

[32] *Id*.

[33] H.B. 3427 section 70; H.B. 2164 section 56.

[34] Although a six-month extension is generally sufficient, with the federal corporate filing extended due date moving to October 15, a seven-month extension would be more appropriate. Specifically, because the Oregon CAT does incorporate federal COGS concepts as well as the requirement that the statutory subtraction be apportioned.



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addition to its other registration and return filing requirements.[35] Those payments are statutorily scheduled for January, April, July, and October.[36]

### H. Administration — Group Filing Requirements

The Oregon CAT must be calculated on a mandatory unitary combined basis for affiliated entities.[37] A unitary group is defined as "a group of persons with more than 50 percent common ownership, either direct or indirect, that is engaged in business activities that constitute a unitary business."[38] The definition of a unitary business appears to be modeled after the Multistate Tax Commission's model definition that specifically references centralized management, centralized administrative functions that result in economies of scale, as well as functional integration.[39] Note that the Oregon CAT legislation includes an "or" — as opposed to an "and" — as the conjunction as it relates to the these concepts, meaning a unitary relationship will be found where only one of the three exists.[40]

Further, the CAT legislation contains no specific provisions that limit the application of the CAT to the water's edge. The DOR has also verbally stated that they interpret the CAT legislation to require mandatory unitary worldwide combined filing. Although requiring the Oregon CAT to be computed on a worldwide basis is a disturbing policy position for the state to take generally, it is difficult to disagree with the DOR's position based on the lack of specific statutory language limiting the CAT's application to the water's edge. Assuming that was the legislature's intent, Oregon would be the only state to require worldwide combined filing without offering a water's-edge election for all types of taxpayers. This position will also create significant technical challenges for taxpayers and the department as they try to comply with and administer the CAT, respectively, which will be discussed in more depth below.

When a group of affiliated entities is determined to be unitary, intercompany transactions or "receipts from transactions among [the group's] members" will be excluded.[41] Also, a unitary group's statutory subtraction cannot include expenses related to receipts from transactions that are otherwise excluded under this intercompany exclusion provision.[42]

### I. Miscellaneous — Use Tax Provision

The CAT legislation also requires a taxpayer to "include as taxable commercial activity the value of property the person transfers into [the] state for the person's own use in the course of a trade or business within one year after the person receives the property outside of the state" — unless the DOR or the taxpayer shows the transfer was not intended to avoid the Oregon CAT.[43] Essentially, this provision acts as somewhat of a "use" tax — an odd concept for an entity-level tax, as opposed to a transaction-based tax. This provision, however, is taken directly from the Ohio commercial activity tax statutes.[44]

As the CAT legislation went through the Oregon legislature, this provision got a lot of attention, including an unsuccessful push to remove it. The issue continues to cause taxpayers significant consternation as they anticipate how the DOR might administer the provision. The DOR has said publicly that it intends to use it as an antiavoidance provision, which is consistent

[35] H.B. 3427 section 70; H.B. 2164 section 56. Note: The Department's draft OAR 150-317-1300 provides that estimated payments will only be required if a taxpayer's estimated CAT liability is $5,000 or more.

[36] H.B. 3427 section 70; H.B. 2164 section 56.

[37] H.B. 3427 section 60.

[38] H.B. 3427 section 58; H.B. 2164 section 50.

[39] H.B. 3427 section 58; H.B. 2164 section 50.

[40] Although this may seem odd and potentially unconstitutional to some, Oregon has previously sidestepped this issue in *Rent-a-Center Inc. v. Department of Revenue*, TC-MD 111031D (May 12, 2014). The court in *Rent-a-Center* provided that "ORS 317.705(3)(a) was amended in 2007 . . . the word 'and' was replaced by 'or' in the list of requirements that explain how the 'sharing or exchange of value' was demonstrated." *Id*. at 11. The court noted that where previously an "and" had been used, all three factors were required to be present; however, with the amendment of "and" to "or," only one factor is required. Because the tax year at issue in the case was 2003, the question whether requiring only one factor is constitutional was not at issue in the *Rent-a-Center* case, and to date that issue has not been the subject of litigation in another Oregon case.

[41] H.B. 3427 section 60.

[42] The exclusion for expenses related to intercompany transactions that are otherwise excluded was added with H.B. 2164 section 53.

[43] H.B. 3427 section 61; H.B. 2164 section 51.

[44] Ohio Rev. Code Ann. section 5751.013 (2009).



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with how Ohio administers its statutory provisions.[45]

### III. Critical Issues Requiring Legislation in 2020

Since the adoption of the Oregon CAT legislation, two technical issues have risen to the top of the Council On State Taxation's priority list of issues that will cause significant compliance and administrative problems. The first relates to the lack of uniform terminology in the CAT legislation regarding the period when the CAT will be calculated, while the second involves lawmakers' failure to include a water's-edge election.

#### A. Fiscal Year Filing Issue

The plain language of the CAT legislation is ambiguous as to whether the tax must be calculated and reported on a calendar-year basis. This issue has two components: first, whether the CAT legislation allows a taxpayer to calculate and report its CAT liability on a fiscal-year basis; and, second, what consequences might taxpayers face if they are required to file on a calendar-year basis.

Turning to the second issue first, taxpayers that file on a fiscal-year basis for federal income tax purposes are concerned they will not be able to use their fiscal-year information to calculate and report their Oregon CAT liability. This is a practical compliance/administration issue as opposed to a policy or legal issue.

Practically, taxpayers that file their federal returns on a fiscal-year basis do not prepare, maintain, or keep tax information on a calendar-year basis. Although there may be some information that can be obtained for different filing periods (that is, monthly, quarterly, or a calendar year), the information required to calculate the CAT — specifically the statutory subtraction information — does not fall within that category.

Because the statutory subtraction is based on federal COGS and requires Oregon apportionment information, taxpayers that calculate their federal and state income taxes on a fiscal-year basis do not have that information until their fiscal year ends — when they have closed their books for financial accounting purposes. Thus, a fiscal-year taxpayer is unable to calculate a calendar-year tax for a return due in April. Even if an extension is provided until October or November for purposes of preparing the return, a fiscal-year taxpayer will still not have the necessary information to prepare an accurate return until the close of its fiscal year, which will likely happen at a later date.

Aside from the practical issue, the Oregon CAT legislation seems sufficiently ambiguous to allow a taxpayer to take a position that it could use its fiscal-year information to calculate and report its CAT liability. Unfortunately, the DOR adamantly disagrees and has consistently hardened its position that the CAT must be calculated and reported on a calendar-year basis.

The DOR's intransigence on this issue is difficult to understand. Again, the CAT legislation is ambiguous at best. First, the bills vacillate between the use of "calendar year" and "tax year." To illustrate, H.B. 3427 section 65 requires the calculation of the CAT on a calendar-year basis, while section 59 requires a "taxpayer's method of accounting for commercial activity, cost inputs and labor costs for a *tax year* shall be the same as the taxpayer's method of accounting for federal income tax purposes for the taxpayer's *federal tax year* that includes the *tax year*" (emphasis added). Also tax year is not defined in the CAT legislation, and H.B. 3427 section 74(2) provides that any term not defined in the CAT legislation shall have the same meaning as provided in Or. Rev. Stat. chapters 305, 314, 316, or 317. Or. Rev. Stat. section 314.085 provides that "the taxable year of a . . . taxpayer shall be the same as its taxable year for federal income tax purposes." Further, Or. Rev. Stat. section 314.011 references the IRC for any term not specifically defined. None of these provisions were amended with H.B. 2164.

The use of both terms muddies the water. And while the DOR's desire to take a conservative position is understandable, it's impractical. As noted, fiscal-year taxpayers simply will not have the information necessary to calculate their Oregon CAT properly even at the time the extended return is due. Thus, those taxpayers will

[45] Note: The Department's draft OAR 150-317-1130 does not explicitly provide that this provision is only to be used on audit. COST has provided comments urging the Department to amend its rule to explicitly provide as such.



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likely be required to file amended returns to calculate the proper amount of CAT due after their books have closed.

Although the state and DOR may not have much sympathy for taxpayers being required to do twice the work, this issue will arguably create twice the administrative work for the department and will raise a host of unintended consequences on audit. Regarding administration, assuming fiscal-year taxpayers will file amended returns annually to ensure the CAT computation is correct, the DOR in turn will be required to process those original and amended returns as well.

What's more, if a calendar-year calculation is required, the DOR will have nothing to cross reference a fiscal-year taxpayer's COGS deduction or apportionment information to. Cross referencing the COGS deduction to the federal return is a key element of this tax. If the department is not able to tie fiscal-year taxpayers' COGS numbers to their federal returns, they will also need additional expertise to audit the federal COGS number. Forcing DOR employees to separately audit a number intended to be derived from the federal COGS number on a calendar-year basis is incongruent and ineffective. This is especially true since there is an easy and effective solution to the issue.

Assuming the DOR believes its hands are tied on this issue, it is incumbent upon the legislature to address this issue in a technical corrections bill. The amount of additional effort required by both taxpayers and DOR employees to properly calculate the CAT on a calendar-year basis for fiscal-year taxpayers is staggering — and for what? Allowing a taxpayer to use prior-year information or aligning the estimated payment and return due dates with the taxpayers' Oregon corporate excise tax due dates should not affect the amount of CAT due. It would simply make the calculation of that tax much simpler and more accurate. Voluntary compliance is the backbone of our U.S. tax system, so why make that more difficult for taxpayers?

And finally, a legislative fix is very simple, and the Texas margins tax provides a model to follow. In Texas, fiscal-year taxpayers are able to use their fiscal-year information for the fiscal year ended during the prior calendar year period to calculate their Texas margins tax liability. To illustrate, an 11/30 fiscal-year filer would use its 11/30/2019 fiscal-year information to file its 2020 Oregon CAT return. Allowing fiscal-year filers to use prior-year information would be a significant improvement to the currently daunting filing requirements these taxpayers face. It would also provide greater efficiencies for the DOR in administration and subsequent audits. Thus, it is imperative for the legislature to make this much-needed change in 2020.

### B. Failure to Provide a Water's-Edge Election

The second issue that must be addressed in 2020 is the apparent requirement to calculate the Oregon CAT on a worldwide basis. As noted, it is difficult to argue with the DOR's position on this issue. Unlike the significant ambiguity of the fiscal-year filing issue, the Oregon CAT legislation's failure to reference the water's edge or provide any type of election makes it difficult to assert that the scope of this tax is limited as such.

However, the failure to include either a water's-edge election or a required limitation would seem to be an oversight — as opposed to a conscious imposition of mandatory unitary worldwide combined filing.[46] Further, the requirement to file on a worldwide combined basis makes considerably less sense as applied to a gross receipts tax.

To illustrate this point, consider a multinational company with several hundred affiliates: If all those entities meet the ownership requirement threshold and are unitary for Oregon purposes, then all those entities will be included in the CAT return if just one has Oregon nexus.[47] From a practical perspective, what if

[46]That position would seem especially egregious as a policy matter when considering Oregon's requirement that only one of the three unities must be met for determining when a unitary relationship exists.

[47]It is important to note that while COST is advocating for a water's-edge election, it does not concede that Oregon's current statutory provisions would pass constitutional muster if challenged. Essentially, the Oregon CAT legislation relies on the unitary concept to create nexus in many situations. Although the unitary concept makes sense conceptually for corporate income tax purposes, it breaks down when applied in the gross receipts tax context. Also, it was never meant to be applied for purposes of determining when affiliated entities would otherwise have nexus with a state. Thus, it is COST's position that the current unitary filing requirements are likely problematic on several levels.



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within this multinational group only a handful of entities filed U.S. federal income tax returns and the majority did not? And what if the non-U.S. entities did not sell into the United States, which would be a typical multinational structure? Assuming these are a taxpayer's facts, it appears that entities that do not file a U.S. federal income tax return would be required to calculate a federal COGS number and Oregon apportionment factor to determine the group's statutory subtraction. This is yet another compliance issue that taxpayers and the DOR (which would be required to audit that number) will face without a legislative fix.

In addition to the added administrative burdens, it is unclear whether worldwide filing will result in any significant additional state tax revenue. Again, considering the multinational company example above, if properly structured it is likely that the non-U.S. entities will have no U.S. sales. If that is the case, then the company's starting point for purposes of determining the Oregon CAT would remain the same (that is, it would include the Oregon-sourced commercial activity of the domestic affiliates only). For purposes of determining the statutory subtraction, the group's cost inputs (that is, federal COGS) or labor costs would increase based on its worldwide information; however, the group's apportionment factor would be diluted based on the inclusion of the non-U.S. affiliate's sales going into the denominator of the group's factor. In most cases this convergence is likely to result in either a minimal increase or decrease in the statutory subtraction.

In other words, although this could benefit the state in some situations (that is, the statutory subtraction would decrease based on the apportionment-factor dilution), it seems equally probable that the statutory subtraction might rise based on the increased inputs or labor costs when calculated on a worldwide basis. Thus, if the inclusion of non-U.S. affiliates is unlikely to increase the starting point for the Oregon CAT, and if it is plausible that the inclusion of the non-U.S. affiliates may increase a taxpayer's statutory subtraction, the increased compliance/ administration costs make little to no sense. Why would the state ask taxpayers or its own DOR to jump through these significant additional compliance hoops for little or no additional revenue?[48]

Further, the inclusion of a water's-edge election would not preclude Oregon from asserting that a non-U.S. entity (either affiliated to a group otherwise subject to the CAT or a non-affiliated entity) that otherwise meets the economic nexus provisions would be separately subject to the tax. Inclusion of a water's-edge election does not prevent the state from otherwise arguing that a foreign or non-U.S. taxpayer that makes sales into Oregon that meet the nexus threshold (above $750,000) is subject to the CAT.[49] Rather, the inclusion of a water's-edge election both aligns Oregon with other states that provide such an election, and eases the administrative burdens taxpayers will experience if required to calculate the statutory subtraction on a worldwide basis.

Even if the practical implications were not so daunting, mandating worldwide combined filing in some situations may violate constitutional requirements. Although mandatory worldwide combined reporting has been upheld as constitutional,[50] that was in a corporate income tax context. And depending on a taxpayer's facts and circumstances, a court could find that a modified gross receipts tax imposed on a worldwide basis distinguishable. This could be exacerbated in Oregon's case, where the state's position is that only one of the three unities is required to create a unitary relationship. Again, considering the aforementioned multinational company example, it seems astonishing that several hundred entities might be required to file a CAT return based on merely one entity within the group meeting the state's nexus threshold. Putting aside the potential tax liability for non-U.S. companies, the potential compliance burden would be significant. While the Oregon CAT legislation is not likely to be found unconstitutional per se, there is a

[48] *See* Appendix B for a detailed calculation and further discussion of this issue.

[49] The state's ability to enforce the collection of the tax may be another matter, but that issue exists for all states attempting to assert nexus over non-U.S. entities for various taxes. While this area has yet to be substantially developed, one might assume that is likely to change as more states adopt economic or factor-presence nexus standards for taxes other than retail sales taxes.

[50] *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983).



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significant risk that, as applied to some taxpayers, the tax is unconstitutional.

Finally, without a water's-edge election, Oregon would be an extreme outlier among states since it would be the only state mandating worldwide unitary combined filing for all taxpayers. And none of the other states that impose a gross receipts or modified gross receipts tax require worldwide combined filing.[51] Moreover, all states that impose a corporate income tax on a worldwide basis (in which combined filing at least makes conceptual sense) provide a water's-edge election for most taxpayers.[52] The states and the water's-edge election have a long history, which ultimately ended with the states conceding on the issue based on pressure from the federal government following proposed retaliation by the some of the United States' closest trading partners.[53]

To avoid potential risks of litigation and backlash from our nation's trading partners and the federal government, as well as to ease the administrative burdens faced by multinational companies and the DOR, Oregon legislators should prioritize amending the CAT in 2020 to provide for a water's-edge election. Considering the legislature's unitary filing mandate appears to be modeled after the MTC's combined filing model, this change could be implemented by adopting the MTC model's water's-edge election.[54] The MTC water's-edge election is binding for seven years and provides the state taxing agency with the general authority to reject a taxpayer's election when it believes the ability to collect the tax would be impeded. Thus, the state would still have significant discretion to preclude the use of such an election when it concludes that a taxpayer attempted to make such an election to avoid tax.

## IV. Conclusion

The new Oregon CAT will likely spark endless discussion in the state and local tax world in 2020 and beyond. For taxpayers trying to comply with this new tax, however, the ability to calculate it in a reasonably efficient manner is particularly important. This is especially true for large multijurisdictional (and multinational) taxpayers. Thus, it is critically important for the legislature to enact technical corrections in 2020 to allow for a fiscal-year filing option and a water's-edge election to avoid significant compliance and administrative challenges for taxpayers and the DOR. While these are by no means the only issues that require legislative fixes and administrative guidance, they should be front and center on the legislature's 2020 priority list.

## Appendix A

Facts: Company selling tangible personal property in Oregon and Washington.

- $100 million (total commercial activity)
  - $75 million in Oregon sales
  - $25 million in Washington sales
- $50 million cost inputs
- $25 million labor costs

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[51] Nevada and Washington require separate filing. Although Ohio allows a taxpayer to make federal consolidated elections, separate filing is the default rule. Texas required combined unitary filing but excludes some foreign entities (80/20 companies).

[52] There are exceptions in states such as Alaska and Montana, where companies in some industries (e.g., oil and gas) are required to file on a worldwide basis.

[53] In the 1980s, worldwide combined reporting became a national issue following the *Container Corp.* case. From foreign nations' perspective, worldwide combination was viewed as states attempting to tax overseas activities, and to place on foreign companies doing business within the United States a burden that was not placed on U.S. companies operating abroad. In 1985 the United Kingdom approved legislation that would have allowed the U.K. Treasury to penalize multinational groups of companies with operations in any U.S. state that employed worldwide unitary combination. Similarly, many Japanese businesses announced that they would not locate or expand operations in any state that applied worldwide combination.

As a result, worldwide combination was thoroughly analyzed (in the 1980s) by the Department of the Treasury's Worldwide Unitary Taxation Working Group, which was commissioned by President Ronald Reagan. The working group included representatives of the federal government, state (both legislative and executive branches), and the business community. In the working group's final report to the president (July 31, 1984), Treasury Secretary Donald Regan noted that the panel agreed on principles that should guide state taxation of the income of multinational corporations, including that states should provide a water's-edge election for both U.S.- and foreign-based companies. Also, Regan recommended that federal legislation be enacted to preclude mandatory worldwide combined reporting should the states fail to resolve the issue on their own.

[54] *See* section 5 of the MTC Proposed Model Statute for Combined Reporting, as approved on August 17, 2006, and amended on July 29, 2011. Note that subsections ii through vii should be analyzed in relationship to the Oregon CAT to ensure they make sense in this context.



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| Oregon-sourced commercial activity | $75,000,000 |
|---|---|
| Statutory subtraction calculation — 35% of COGS | $17,500,000 |
| Statutory subtraction calculation — apportionment factor | 35% |
| Total statutory subtraction | $13,125,000 |
| Taxable commercial activity | $61,875,000 |
| CAT liability — 0.57% x all taxable commercial activity > $1 million | $346,987.50 |
| CAT liability —+ $250 | $250 |
| Total CAT liability | $347,237.50 |

## Appendix B

An example of a calculation of the Oregon CAT liability with and without a water's edge election. Considering our multinational company above, assume the following additional facts:

- The company's sales information:

| Oregon sales | $10 million |
|---|---|
| U.S. sales | $150 million |
| Worldwide sales | $2 billion |

- All of the company's U.S. sales are made through U.S. affiliates.
- The U.S. affiliate's federal COGS is $25 million.
- Assuming the company's federal COGS determined on a worldwide is on par with its U.S. COGS, the total worldwide COGS would be approximately $333 million.[55]
- The Oregon consolidated filing group apportionment factor for corporate excise tax purposes is 7 percent ($10 million (Oregon sales)/$150 million (everywhere U.S. sales)).
- The company's Oregon apportionment factor determined on a worldwide basis would be 0.5 percent ($10 million (Oregon sales)/ $2 billion (everywhere worldwide receipts)).
- The company's statutory subtraction calculation:

| | Water's-Edge | Worldwide |
|---|---|---|
| COGS | $25 million | $333 million |
| 35% cap | $8.75 million | $116.6 million |
| Apportionment factor | 7% | 0.5% |
| Total subtraction | $583,333 | $583,333 |

- The Oregon CAT liability calculation comparison:

| | Water's-Edge | Worldwide |
|---|---|---|
| Oregon source commercial activity | $10 million | $10 million |
| Statutory subtraction | $583,333 | $583,333 |
| Oregon CAT base | $9.4 million | $9.4 million |
| Oregon CAT base less $1 million | $8.4 million | $8.4 million |
| Oregon CAT rate | 0.57% | 0.57% |
| $8.4 million x Oregon CAT rate | $47,975 | $47,975 |
| Additional Oregon CAT | $250 | $250 |
| Total Oregon CAT liability | $48,225 | $48,225 |

In this example, neither the starting point for the CAT nor the statutory subtraction changes. The math to get to the statutory subtraction under the two circumstances did change. For purposes of the water's-edge election calculation, the subtraction was equal to $25 million (federal COGS) x 35 percent x 7 percent (group's Oregon apportionment factor). For purposes of the worldwide calculation, the subtraction was equal to $333 million (federal COGS determined on a worldwide basis) x 35 percent x 0.5 percent (group's Oregon apportionment factor recalculated on a worldwide basis).

For most taxpayers, facts and circumstances would result in either a positive or negative variation to the statutory subtraction. Nevertheless, this example clearly illustrates the flaws in requiring a gross receipts-based tax to be calculated on a worldwide basis. Thus, the increased compliance and administrative issues are simply not worth the state's or taxpayers' time or money. ■

[55] This number was extrapolated by taking the company's federal cost of goods sold number over its total U.S. sales ($25 million/$150 million), which equals 17 percent, and applying that percentage by the company's worldwide sales of $2 billion. This of course is a rough estimation for purposes of this example, and a company's specific information is likely to vary widely.



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