

## **Unweirding Portland, Part 2: Uniformity as a Remedy for Complexity**

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In this installment of SALT Policy Pickles, Dobay and Newgard examine the challenges taxpayers and practitioners face navigating the Portland, Oregon, area's local income taxes and a proposal in the state legislature to provide uniformity with the state income tax.

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In a September 2020 article, we discussed a real SALT policy pickle: Portland's eccentric and off-kilter local tax system — including the significant challenges it poses to administration and taxpayer compliance, as well as the broader economic and business climate.<sup>1</sup> Here, we return

<sup>1</sup> See Nikki E. Dobay and Jeff Newgard, "Unweirding Portland's Targeted Tax Regime," *Tax Notes State*, Sept. 28, 2020, p. 1359.

to Portlandia for two reasons. First, things in Portland continue to be challenging for taxpayers. Second, the Oregon legislature is considering a bill that would allow it to play air traffic controller in pursuing a more uniform state and local tax system in the state.

### Overview of the Portland-Area Taxes

In just a few years, a sea change in the Portland area's tax structure made it one of the highest-taxed regions in the country. To be fair, Portland and Oregon have never had a reputation as low-tax or tax-friendly jurisdictions; the state imposes various income, payroll, and gross receipts taxes. It is worth noting that the state's personal income tax is the most aggressive in the country, levying its second-highest rate of 8.75 percent on incomes above a mere \$9,450. In comparison, California imposes its comparable rate at \$66,295 and New York at \$1,077,550. Oregon also does not index all of its individual income tax rates to inflation.

In addition to Oregon's taxes, three local jurisdictions in the Portland area require individuals and businesses to pay additional income taxes. Since 1981, Portland and Multnomah County — which spans the city's limits and eastern suburbs — have imposed income taxes on business entities. While burdensome, most taxpayers saw these taxes as an immaterial quirk of the local revenue system and complied without much complaint. Then in 2020, there was a significant shift in the region's landscape, with voters approving several new income taxes to support popular social programs.<sup>2</sup>

<sup>2</sup> In May 2020, Oregon Metro referred and voters passed an initiative imposing a personal income and business income tax to finance investments in homeless services. Then, in November 2020, Multnomah County referred and voters passed a measure imposing a personal income tax on "high earners" to increase access to preschool.

All of a sudden, these immaterial, weird Portland taxes became material.<sup>3</sup>

A small business owner operating as a passthrough entity in Portland must navigate up to seven income taxes between city, county, regional, state, and federal governments — each defining income differently. The business is also often subject to state and local taxes on gross receipts, payroll, and property, adding further compliance and payment hurdles.<sup>4</sup> Bearing in mind just those taxes on net income, the following table lists these taxes. Compounding all of them results in a rate of 56.6 percent. Although mechanisms are built into local tax codes to ensure that income is not double taxed at the entity and personal level, the mere sight of all of these rates piled up is staggering.

Tax	Rate
Portland Business License Income Tax	2.6 percent
Multnomah County Business Income Tax	2.0 percent
Multnomah County Preschool for All Income Tax	3.0 percent
Metro Personal Income Tax	1.0 percent
Metro Business Income Tax	1.0 percent
Oregon Personal Income Tax	9.9 percent
Federal Individual Income Tax	37.0 percent

These newly implemented taxes have driven the Portland region to one of the country's highest combined top marginal tax rates. According to a 2021 Tax Foundation report analyzing the taxes paid by Oregon small business owners, the all-in, top marginal income tax rate — including state and local gross receipts and payroll taxes — is 26.19 percent, which is far and away the highest in the country.<sup>5</sup> Likewise, a recent EY report

(conducted for Oregon Business & Industry, the state's largest chamber of commerce) analyzing the tax burden on individuals found that Portland has the second highest combined state and local top marginal personal income tax rate at 14.7 percent, only a sliver behind New York City.<sup>6</sup> Considering that New York City's highest rates do not set in until a taxpayer reaches over \$1 million of income, Oregon's tax incidence stings quite a bit more. And when the top marginal federal tax rate is added to rates provided in these studies, the combined rates are above 60 percent and 50 percent, respectively.

While the rates provide political fodder, tax administration is a growing concern for Portland businesses and residents. Taxpayers subject to myriad Portland taxes — both individual and business — must adhere to different rules for calculating income for each tax. There are circumstances in which the variation in the rules favors taxpayers. However, the costs of computing each tax too often outweigh the value of any tax benefits.

Taxpayers' overall compliance burden must also be considered when discussing voluntary compliance and the localities' ability to collect these taxes. Here, the Portland region is experiencing the worst of both worlds. For the 2021 tax year, nearly a quarter of taxpayers did not file or pay their taxes because of a lack of understanding regarding the multitude of local tax requirements.<sup>7</sup> Some might call it ironic, but there has apparently been a significant disconnect between the voters who passed these taxes and the taxpayers required to comply with and pay them. Reasonable people can debate the merits of high taxes — that is our lot in life, after all — but it is impermissible for a tax system to be so complicated that citizens cannot reasonably comprehend its requirements.

<sup>3</sup>Note that these taxes were in addition to Portland's imposition of the CEO-to-average-wage ratio surtax, which was effective January 1, 2017, and the Portland clean energy surcharge, which is a 1 percent gross receipts tax imposed on retail sales of "large retailers." The clean energy surcharge was approved by voters in November 2018 and became effective January 1, 2019.

<sup>4</sup>These include Oregon's corporate activity tax, Portland's clean energy surcharge, the TriMet transit payroll tax, and many other tax levies aimed at businesses.

<sup>5</sup>Jared Walczak, "Portland Small Business Owners Facing Weirdly High New Taxes — And It Could Get Worse," Tax Foundation (Apr. 8, 2021).

<sup>6</sup>EY, "Oregon State and Local Tax Burdens," prepared for Oregon Business & Industry (October 2022).

<sup>7</sup>Shane Kavanaugh, "Thousands of High-Income Households Failed to Pay Portland Area Taxes to Fund Homeless Services, Preschool," *The Oregonian*, Feb. 7, 2023.

## Complex Tax Rules Plague Portland's Regional Tax Structure

Although each Portland-area tax follows a similar regional structure, taxpayers must understand and comply with a unique set of rules for each tax. For the sake of simplicity (an oxymoron in the context of these taxes), we will look at the local taxes as if they were a single set of requirements relative to Oregon as we consider a few examples of the complexities for taxpayers required to comply with them.

### Taxing Business Entities Presents Unique Challenges

Unlike federal and state income taxes, Portland-area governments levy business income taxes on all entities, including passthrough entities, forgoing the traditional route of taxing passthroughs under the personal income tax. Although this at one time likely created simplicity, the layering of personal income taxes onto the local tax system has eliminated any benefit once envisioned. Rather, this approach presents unique challenges for owners of passthrough businesses and increases the propensity for double taxation.

Portland's jurisdictions do offer an adjustment or deduction for passthrough income against the personal income tax to avoid double taxation between the entity and individual income taxes.<sup>8</sup> Unfortunately, this mechanism falls short of separating personal and business income in all circumstances. While necessary for these business entity taxes, the passthrough adjustment results in a substantial compliance burden for passthrough businesses and their owners, increasing the risk of errors and costly audits.

### Some Businesses Are Subject to Throwback While Others Are Not

One of the bright spots in the Portland-area tax regime (and Portlanders are not used to anything bright — like the sun) is the absence of throwback sales from the apportionment requirements for corporate taxpayers. Oregon is among the 21 states with a throwback policy,

requiring taxpayers to source out-of-state sales to Oregon if they are not taxable in the purchaser's state. Taxpayers, however, are not required to assign these sales to the local jurisdiction for Portland's local business income tax purposes.<sup>9</sup> While Portland clearly intends to avoid throwback in its tax system, local tax statutes result in a "pickley" situation requiring *some* business owners to include throwback sales in apportionment calculations.

Oregon Metro's business income tax applies to taxpayers with global gross receipts exceeding \$5 million; however, the threshold is only an illusion for smaller passthrough business entities, in which the owners or shareholders pay tax on their business income through the personal income tax. Metro's business income tax code explicitly says taxpayers must not assign throwback sales to the jurisdiction. Its personal income tax code, however, simply points to the state's apportionment provisions. Specifically, Metro's code references Oregon's Uniform Division of Income for Tax Purposes Act statutes in ORS 314.605 to OS 314.695, which include the state's throwback requirement. To say this another way, the local jurisdiction(s) impose vastly different throwback requirements depending on a company's total receipts.

Let's explore this further with an example. Jeff (a resident) and Nikki (a nonresident) are the owners of HatCo, an S corporation that manufactures fedoras at facilities in Portland and Vancouver. HatCo has sales of \$4.5 million, which is below the \$5 million gross receipts threshold to pay the business tax. Approximately 50 percent of HatCo's fedoras are sold to customers in Idaho, Montana, and Utah, where its sales are protected by P.L. 86-272. Although HatCo is below the Metro business income tax threshold, Jeff and Nikki must pay tax to Metro on their distributive share of income from HatCo under the Metro personal income tax. To determine her distributive income, Nikki must throw back the sales from the other jurisdictions for fedoras manufactured in Portland to Metro as if they were local. If HatCo sold an additional \$500,000, it would meet the threshold to pay the business

<sup>8</sup> See Metro Code Chapter (MCC) section 7.06.090 and Metro Administrative Rule (AR) 7.06-1135.

<sup>9</sup> See MCC section 7.07.081(d) ("Apportionment of Income").



income tax, under which throwback is not required.<sup>10</sup>

It is odd and impracticable — not to mention constitutionally suspect — to apply a throwback requirement arbitrarily based on a taxpayer's size. To be fair, the Portland-area tax code presumably does not intend for this anomalous tax treatment. Nevertheless, it illustrates the complexities and considerations taxpayers and their accountants and tax preparers deal with in complying with local tax requirements.

### Other Deviations From Oregon Income Tax Law

Portland's local income tax code contains hundreds of pages of ordinances and administrative rules spanning the three jurisdictions. And while the five local taxes reference Oregon taxable income as the starting point in some way, when the local ordinances and administrative rules are considered, these taxes bear little similarity or uniformity to the state's income tax provisions. To keep this article to a reasonable length, we will focus on three that seem to come up regularly.

First, Portland-area income taxes rely on a different presumption of doing business standard than provided by state law and regulation. Generally, Oregon's definition requires a taxpayer to have a stock of goods, office or place of business, or employees or other representatives in the state.<sup>11</sup> The local income tax ordinances and rules provide their own standard for doing business that does not comport with Oregon law.<sup>12</sup> In particular, these taxes declare "advertising or otherwise professing to do business within the District" is sufficient to trigger tax obligations. Considering the Portland media market extends outside these jurisdictions, an out-of-area business with advertising that targets customers

outside the jurisdiction could trigger the presumption under the local guidance. Thus, a business otherwise not taxed under state law could be subject to local tax.<sup>13</sup>

Second, taxpayers must navigate different rules and requirements governing net operating losses. Oregon conforms to the federal regulations and limitations on losses for individuals but provides its own deduction for corporations, allowing a full credit with a 15-year carryforward. For local purposes, however, businesses must navigate different rules. In particular, the local business taxes impose a loss limitation of 75 percent and provide only a five-year carryforward.<sup>14</sup> These differences not only require taxpayers to maintain separate records for tracking their losses at the state and local level, but are also likely to result in a taxpayer owing tax to a local jurisdiction despite having losses at the state level.

And third, Oregon allows expense deductions for taxes and fees businesses incur when operating their trade or business. For state tax purposes, a business can deduct its costs for the state's corporate activity, property, and utility taxes and fees. The Portland-area taxes arbitrarily prohibit taxpayers from deducting some taxes, such as Portland's clean energy surcharge, a gross receipts tax on certain businesses.<sup>15</sup> Denying these deductions makes no sense in determining net income, especially since the state considers them deductible.<sup>16</sup>

### Portland's Tax Structure Could Create Legal Exposure

For all of the issues discussed above, one overarching theme is that the Portland area's local tax regime is complicated. This is evident in the

<sup>10</sup> In practice, this situation is most likely to apply to nonresidents. Generally, resident owners and shareholders of a passthrough business pay personal income tax on the entirety of their distributive share of business income.

<sup>11</sup> See Oregon Administrative Rules 150-317-0030. It is worth noting that Oregon's administrative guidance, not statutory law, asserts an economic presence standard. The absence of a statutory economic nexus standard has sparked debate over the years. Although not entirely germane to this discussion on local income taxes, we want to acknowledge that the statutory silence is perhaps something worth exploring in a future article.

<sup>12</sup> See MCC section 7.07.081.

<sup>13</sup> The lack of a clear nexus standard and standards that potentially exceed the state's nexus rules also raises constitutional concerns.

<sup>14</sup> See MCC section 7.07.071(g) ("Net Operating Loss").

<sup>15</sup> See MCC section 7.07.071(e) ("Certain Deductions Not Allowed").

<sup>16</sup> Also note that the local tax ordinances use the terms "business" and "non-business" income as opposed to "apportionable" and "non-apportionable" income, which the state moved to in 2018. The local codes do provide that business income means the same thing as apportionable income, and that nonbusiness income means the same things as non-apportionable income; however, the failure to simply update the terminology is a head scratcher. As taxpayers attempt to navigate compliance, aligning the local and state terminology would go a long way in easing the compliance burden for taxpayers.

sheer number of taxes, the variations between state and local taxes, and the variations between the local taxes themselves. All this complexity also burdens the taxpayers required to comply with these state and local taxes, and when those burdens become too great — those taxes run afoul of the U.S. Constitution.

States and their political subdivisions are constrained by the due process and commerce clauses.<sup>17</sup> And while there are few limits on how a state can distribute taxing authority to its localities, the impact of that power may have implications for the state.<sup>18</sup> Put another way, a potential challenge regarding the constitutionality of the Portland-area tax system would not just be an issue of local concern. Rather, the state's overall system, including its local taxes, would be subject to a challenge — since the Portland-area regime would be viewed through the lens of the overall state tax system. Practically, this means that attorneys for the state of Oregon may be required to defend against a constitutional challenge in which a taxpayer asserts that the burdens imposed by the Portland-area tax system — which would be considered in the context of Oregon's state and local tax system — are unconstitutional.

So the question then becomes: Are the burdens imposed by the Portland-area tax regime too great? This question would be considered in light of *Pike v. Bruce Church Inc.*,<sup>19</sup> which requires an analysis known as the *Pike* balancing test. Under *Pike*, a law will be upheld “unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits.”<sup>20</sup> While the *Pike* balancing test has long been a constitutional requirement, it has reemerged since the *Wayfair*<sup>21</sup> ruling in 2018, and it is now the standard to which the Portland-area tax regime — as viewed through the lens of Oregon's overall tax system — would be analyzed. The burdens of local taxes and their administration have only begun to be challenged

legally since *Wayfair*.<sup>22</sup> And while the bounds of what burdens will ultimately offend the U.S. Constitution remain unknown,<sup>23</sup> Portland's local regime stands out as one of the more difficult ones — making it ripe for a constitutional challenge.

### Opportunity for Lawmakers to Pursue Uniformity

Oregon provides broad home rule and taxing authority to its chartered localities.<sup>24</sup> Generally, local jurisdictions are restricted only by the state and federal constitutional limits, their charters, or state law if the legislature expressly seeks to preempt a local power.<sup>25</sup> As noted, Portland's local income taxes were once largely immaterial for most taxpayers — and thus not of concern to state legislators. With the proliferation of local taxes in the Portland area, however, state lawmakers have been faced with myriad national and regional studies identifying the Portland metro region as one of the highest-taxing jurisdictions in the country. As a result, state lawmakers are now required to at least consider these taxes and their potential impact on Oregon's overall tax structure and business climate.

To our knowledge, the legislature has avoided exploring whether it should impose limits on the state's local income tax system. In lawmakers' defense, there was little need to until recently, considering that the only such taxes were the low-rate business taxes in the Portland area. But with the growing number of taxes and increasing rates,

<sup>22</sup> Constitutional legal challenges have been filed in Louisiana and Colorado to these states' overall state and local tax systems. See *Halstead Beads v. Richard*, No. 2:21-CV-2106 (2022) (case dismissed by the U.S. District Court for the Eastern District of Louisiana under the Tax Injunction Act, appeal pending in the Fifth Circuit); *Wayfair LLC v. City of Lakewood, Colorado and Mark Ferrandino in his capacity as Executive Director of the Colorado Department of Revenue*, Case No. 2022CV30710 (2022).

<sup>23</sup> According to a study by the State Tax Research Institute, an affiliate of the Counsel On State Taxation, locally administered taxes create significant burdens. See Harley T. Duncan and Sarah L. McGahan, “Locally Administered Sales and Accommodations Taxes: Do They Comport With *Wayfair*?” KPMG LLP, with a foreword by Dobay and Jeffrey A. Friedman (July 2022).

<sup>24</sup> The Oregon Constitution provides various levels of home rule authority to different types of local jurisdictions — including cities, counties, and the Metropolitan Service District. In *Metro v. Portland Business Alliance*, Case No. 20CV46617, the Multnomah County Circuit Court determined that Metro had significant home rule authority under its charter. An appeal of that decision was dismissed. Considering the plain language in the Oregon Constitution, however, Metro's home rule authority appears to be different from that of other types of Oregon localities.

<sup>25</sup> See Or. Const. Art. VI, section 10. For Oregon Metro's constitutional home rule authority, see Or. Const. Art. XI, section 14.

<sup>17</sup> Walter Hellerstein, “Are State and Local Taxes Constitutionally Distinguishable? (Revised),” *Tax Notes State*, Feb. 14, 2022, p. 743.

<sup>18</sup> *Id.*

<sup>19</sup> *Pike v. Bruce Church Inc.*, 397 U.S. 137 (1970).

<sup>20</sup> *Id.* at 142.

<sup>21</sup> *South Dakota v. Wayfair Inc.*, 138 S. Ct. 2080, 2088 (2018).

the legislature is finally placing this Wild West of taxation under the microscope. While not solely to blame, Portland's local tax structure bears some responsibility for the state's declining population growth.<sup>26</sup> Since Oregon relies on personal income taxation more than any other state, the migration trends are a matter of statewide concern rightfully deserving the legislature's attention.

The Oregon House Revenue Committee is spending considerable time this session — including four hearings thus far — exploring legislation to require local tax uniformity.<sup>27</sup> H.B. 2548 would require a local jurisdiction imposing an income tax to consistently follow the state's income tax policies for determining income. If a jurisdiction piggybacked on state laws, the complicated nature of calculating and complying with these taxes would ease significantly. Notably, the legislation would not affect a locality's authority to impose or collect its taxes; rather, it would mandate uniformity and more consistent rules across all jurisdictions.

However, trade-offs come with uniformity. In Portland's case, some local provisions are more favorable than state law, such as not requiring throwback sales for apportionment purposes, but each deviation from state law adds headaches and increases compliance costs for taxpayers.<sup>28</sup> Yet these trade-offs are wholly worthwhile in pursuit of uniformity that simplifies tax compliance, and the benefits of uniformity are not exclusive to taxpayers. If local jurisdictions can administer their taxes with the certainty provided by the state's experience and case law, local revenues will arrive quicker, allowing local officials to distribute them to essential programs and services and local tax administrators to focus on true noncompliance and nonfiling issues.

## Conclusion

Local taxes are often viewed as a necessary evil to fund essential services. And while we argued in our first article that this would all be so much simpler if Oregon had a sales tax upon which Portland could piggyback, we understand that that is one SALT pickle likely never to get sliced. So we understand that the Portland area's local tax choices are limited.

Those taxes, however, have become a significant source of complexity and confusion for taxpayers and undermine the very programs they intend to support. This does not need to be the case for Portland's local income taxes. Local income tax rules that align with state rules would be simple and straightforward, help promote compliance, and improve the perception of these jurisdictions as places worth doing business in. When a business can easily understand and comply with its tax obligations, it will likely remain and expand in the jurisdiction.

As such, Oregon lawmakers and local elected officials should strive to create a uniform tax ecosystem that eases the compliance burden and, ultimately, streamlines the locals' ability to collect taxes required to support crucial public programs. ■

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<sup>26</sup> Allison Frost, "Oregon Population Decline Is Cause for Concern, Say Economists," Oregon Public Broadcasting (Jan. 5, 2023). Also see Anthony Effinger, "They Left: Portland Is Losing Some of Its Biggest Fans," *Willamette Week* (Feb. 1, 2023).

<sup>27</sup> Paul Jones, "Oregon Bill Would Require Local Income Tax Conformity With State," *Tax Notes State Today*, Mar. 23, 2023.

<sup>28</sup> Oregon lawmakers are considering legislation (H.B. 2546) to repeal the state's throwback policy to make the state more attractive to businesses selling tangible personal property. The bill would render this discrepancy between state and local income tax requirements moot.