

Larry's Tax Law

A Pleasant Distraction Courtesy of the Oregon Department of Revenue – Two More CAT Rules Go From Draft to Temporary Status

By Larry Brant and Peter Evalds on 3.18.20 | Posted in Legislation, State and Local Tax, Tax Laws

I hope our readers, their families and co-workers are safe and remain healthy during these trying times. As a distraction for tax geeks like us from the news about the Coronavirus that is permeating our lives these days, Peter and I decided to present more coverage on the Oregon Corporate Activity Tax (“CAT”).

On March 6, 2020, the Oregon Department of Revenue (the “Department”) published two new temporary rules that it had previously presented in draft form. While the rules are substantively the same as they were in draft form, there are several nuances worthy of discussion.

As we previously reported, at a Town Hall Meeting on September 19, 2019, in Beaverton, Oregon, the Department announced that it planned to issue temporary rules in the first quarter of 2020, with the first set of rules to be issued on January 1, the second set on February 1, and the last set on March 1. Within a few minor deviations, the Department kept to its timeline.

At this same Town Hall Meeting, the Department announced its intent to convert the temporary rules to permanent rules during the second quarter of this year. Given that the Department kept to its timeline for issuing the temporary rules, we suspect it will meet the timeline for converting the rules to permanent status. Keep an eye out for notices from the Department, making the rules permanent.

PRACTICE ALERT: If you have any comments or feedback on the rules, please provide the Department with that input as soon as possible or forever hold your peace. Once the rules become permanent, your comments are likely too late. Send any requests for additional guidance on the CAT statute to: Catrules.dor@oregon.gov. Likewise, send any comments about the temporary rules to: rulescoordinator.dor@oregon.gov.

Codification of the CAT

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Before we dive into the last installment of the Department’s temporary rules on the CAT, please note that the CAT law has been codified in new Chapter 317A of the Oregon Revised Statutes. Practitioners and taxpayers no longer need to peruse multiple legislative bills to find answers to their CAT-related questions! The law is now located in one place.

Employee Compensation for Labor Cost Subtraction – OAR 150-317-1220 (Temporary)

The first new temporary rule addresses what constitutes employee compensation for purposes of the Labor Cost Subtraction (defined below).

Background

In determining a taxpayer’s taxable commercial activity (“TCA”), the CAT statute provides that the taxpayer may subtract from commercial activity sourced to Oregon an amount equal to 35 percent of the greater of the following items that the taxpayer pays or incurs in the tax year:

- Cost inputs (defined as the cost of goods sold calculated to arrive at federal taxable income under the Internal Revenue Code (“Code”)); or
- Labor costs (defined as total compensation with respect to all employees, not including compensation paid to any individual employee that exceeds \$500,000 (the “Labor Cost Subtraction”).

In the temporary rule, the Department attempts to define “employee” and “compensation” for purposes of the Labor Cost Subtraction.

Definition of “Employee”

The temporary rule defines “employee” as having the meaning given to it in OAR 150-316-0255 (5), except that the following are expressly excluded from the definition of “employee” for CAT purposes:

- Partners that receive guaranteed payments or distributive income from a partnership;
- Members that receive guaranteed payments or distributive income from an LLC;
- Statutory employees described in Code Section 3121(d)(3); and
- Independent contractors, as defined in ORS 670.600.

OAR 150-316-0255(5) defines employee as “any individual who performs services for another individual or organization having the right to control the employee as to the services to be performed and as to the manner of performance.” Absent extraordinary circumstances, an

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individual is treated as an employee for such purposes if the individual is designated as an employee for purposes of workers compensation, unemployment compensation, social security, or federal withholding.

Statutory Employees

Code Section 3121(d)(3) expressly provides that the following individuals who perform services for remuneration are “statutory employees:”

- Agent-drivers or commission-drivers engaged in the distribution of meat, vegetable, fruit, and bakery products; beverages (other than milk); or laundry or dry-cleaning services, for a principal;
- Full-time life insurance salespeople;
- Home workers performing work, according to specifications furnished by the person for whom the services are performed, on materials or goods furnished by such person which are required to be returned to such person or a person designated by such person; and
- Traveling or city salespeople engaged on a full-time basis in the solicitation on behalf of, and the transmission to a principal of orders from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments for merchandise for resale or supplies for use in their business operations.

PRACTICE ALERT: As stated above, statutory employees are expressly excluded from the definition of “employee” for CAT purposes. Thus, compensation paid to statutory employees may not be included in the Labor Cost Subtraction.

Independent Contractors

The term “independent contractor” is defined in ORS 670.600. As discussed in previous blog posts, the determination of whether a person is an independent contractor or an employee in Oregon is complex and is an area where vast debate may occur between government agencies and the taxpayer. For further discussion, refer to [prior blog posts](#).

PRACTICE ALERT: As stated above, if a person is properly classified as an independent contractor, the compensation paid to that person may not be included in the Labor Cost Subtraction.

Definition of “Compensation”

“Compensation,” for CAT purposes has the meaning in ORS 317A.100(1)(b)(H). It provides:

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“Compensation, whether current or deferred, and whether in cash or in kind, received or to be received by an employee, a former employee or the employee’s legal successor for services rendered to or for an employer, including reimbursements received by or for an individual for medical or education expenses, health insurance premiums or employee expenses or on account of a dependent care spending account, legal services plan, any cafeteria plan described in section 125 of the Internal Revenue Code or any similar employee reimbursement.”

The temporary rule excludes from the Labor Cost Subtraction the following items:

- Compensation in excess of \$500,000 paid to a single employee; and
- Payroll taxes, including but not limited to, Social Security, Medicare, and Federal unemployment.

Example

The temporary rule contains the following example:

Example 1: A2zk Tech Inc. (“A2zk”) employs 50 workers who meet the requirements to be considered employees. Each employee receives a base annual salary of \$375,000. In addition, A2zk pays a total of \$15,000, which includes health insurance and other fringe benefits such as employer-provided retirement contributions, for each of its employees. A2zk also pays \$25,000 in payroll taxes for each employee. Ten of those employees also earned \$150,000 each in commission and bonuses. Although A2zk pays taxes for each employee, any tax amount paid for its employees is not used to calculate the total compensation. Because the total compensation of each of 10 employees exceeds \$500,000 ($\$375,000 + \$15,000 + \$150,000 = \$540,000$), A2zk calculates the total labor cost as $[(40 * \$390,000) \text{ (base salary plus benefits)} + (10 * \$500,000)] = \$20,600,000$.

PRACTICE ALERTS:

- Guaranteed payments made to partners and LLC members are excluded from the Labor Cost Subtraction, whereas S corporation shareholder wages should be includible up to \$500,000 per shareholder/employee. This creates a system whereby owners of otherwise similarly situated pass-through entities are treated differently for CAT purposes based solely on the form of entity chosen.
- Taxpayers will need to review staffing arrangements to determine whether the people who perform services on their behalf are considered employees for purposes of the Labor Cost Subtraction. If such persons fall into one of the categories discussed above

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(e.g., statutory employees or independent contractors), the taxpayer cannot include such compensation in the Labor Cost Subtraction.

- While classifying a worker as an independent contractor may benefit the taxpayer engaging the contractor (e.g., avoidance of the employer portion of payroll taxes), it clearly creates a disadvantage for the taxpayer for CAT purposes (i.e., the remuneration paid to the contractor may not be included in the Labor Costs Subtraction). Be aware, a worker classification decision made for CAT purposes may be looked at by the Department in an income tax audit. Likewise, a worker classification decision made for income tax purposes may be looked at by the Department in a CAT audit. **Consistency is warranted.**

Definition of “Single-family Residential Construction” for Subcontractor Exclusion – OAR 150-317-1120 (Temporary)

The Department issued a temporary rule with respect to the Subcontractor Exclusion (defined below).

Background

House Bill 2164 added an exclusion from TCA for “subcontracting payments for labor costs” that a general contractor makes to a subcontractor pursuant to a residential real estate construction contract (the “Subcontractor Exclusion”).

The Subcontractor Exclusion is subject to the following qualifications:

- It is permitted only for single-family residential construction that is located in Oregon;
- It is not permitted for payments for materials, land, or permits;
- It is not permitted for payments between subcontractors; and
- It is limited to 15 percent of payments by the general contractor for labor.

PRACTICE ALERT: The Subcontractor Exclusion is only available for tax years beginning before January 1, 2026. In 2026, unless the Oregon legislature acts, the Subcontractor Exclusion will no longer be available.

Definition of “Single-family Residential Construction”

The temporary rule provides a needed definition of “single-family residential construction.”

“Single-family residential construction” is defined as:

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“the construction of new single-family housing such as single-family detached or semidetached houses and townhouses or row houses where each housing unit: (1) Is separated from the adjacent unit by a ground-to-roof wall; (2) Has no housing units constructed above or below; (3) Does not share heating or air-conditioning systems; and (4) Does not share utilities.”

PRACTICE ALERT: The Department has narrowly defined “construction” to include only new construction. Does this create an incentive to demolish existing housing that requires substantial rehabilitation to make way for new construction? It is not clear why the Department found the need to make this distinction.

Conclusion

The CAT landscape has been maturing with the issuance of guidance from the Department. This may be the last set of rules that the Department issues in temporary form on the CAT (at least in the immediate future). Next, we will see the Department finalize the temporary rules over the next three months. If you have comments about the temporary rules or requests for further guidance, please notify the Department. As the old proverb states, there is a time to speak and a time to be silent. Being silent in this case is not a good choice.

Tags: compensation, corporate activity tax, Corporate Tax, cost inputs, employee compensation, independent contractors, Labor Cost Subtraction, Labor Costs, members, Oregon, Oregon businesses, Oregon Department of Revenue, Oregon DOR, Oregon Taxpayers, partners, rulemaking, Single-family Residential Construction, Statutory employees, Subcontractor Exclusion, tax practitioner, taxable commercial activity, temporary rules, worker classification