Who Let the CATs Out?

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In this article, the authors discuss Oregon's corporate activity tax, which was signed into law May 2019, and compare it with the Ohio corporate activity tax and other taxes.

In May 2019, Oregon Gov. Kate Brown (D) signed into law H.B. 3427, establishing the Oregon corporate activity tax (CAT) — a gross receipts tax levied in addition to the state's income tax.[1] While the Oregon CAT is similar to the Ohio CAT (in fact, many statutory provisions are identical to those found in the Ohio CAT such that some[2] may call it a copy-CAT), there are several distinctions and ambiguities, some of which may pose either opportunities or risks for taxpayers.

By way of background, the Oregon CAT is a broad-based tax on gross receipts, or commercial activity, computed as seen in Table 1.

Table 1.
Steps for Calculating Oregon CAT

	Step	Description
1	Determine unitary group members	Demonstrated by centralized management, economies of scale, or functional integration.
2	Establish commercial activity	The total amount realized by a person, arising from transactions and activity in the regular course of the trade or business, without deduction for expenses incurred by the trade or business.
3	Determine whether any exclusions apply	47 exclusions apply, including some interest, IRC section 1221 and 1231 assets, repayment of loan principal, dividends received, and receipts from unitary group members.
4	Source Oregon commercial activity	• Sale of tangible personal property: if and to the extent delivered to a purchaser in Oregon. • Service: if and to the extent delivered to a location in Oregon. • Intangible: if and to the extent the property is used in Oregon. • Alternative methods may be permitted.
5	Confirm nexus	Bright-line presence: includes taxpayers that have at least $750,000 of commercial activity or meet other requirements.
6	Apply subtraction	Subtract 35% of the greater of cost inputs (costs of goods sold) or labor costs (capped at $500,000 per employee), apportioned.
7	Calculate CAT liability	0.57% of taxable commercial activity over $1 million, plus $250.

[1] An initial technical corrections bill, H.B. 2164, was enacted in July 2019, and beginning in December 2019 the Department of Revenue has issued a series of temporary regulations.

[2] Namely, the authors of this article.

While the CAT computation as described in Table 1 may seem straightforward, we highlight the following issues to consider in preparing for the Oregon CAT and computing your first estimated payments, which are due April 15.

Unitary Filing

The CAT effectively requires worldwide combined filing — all entities that are unitary with a taxpayer that has nexus with Oregon must file a single combined return on an annual basis.[3] As a benefit, the unitary group may exclude receipts from transactions among its members from its taxable commercial activity.[4] Oregon defines a unitary group as a group of persons with more than 50 percent common ownership, either direct or indirect, that is engaged in a unitary business.[5] A unitary business may be demonstrated by centralized management, economies of scale, *or* functional integration.[6] This test is arguably distinct from the three-factor test laid out by the U.S. Supreme Court in *Mobil*, in which *each* of those three factors must be considered to determine whether a unitary relationship exists,[7] as well as California's three-unities test, which looks to unity of ownership, unity of operation, *and* unity of use.[8] Thus, taxpayers may have an opportunity to take a unitary position in Oregon (to take advantage of the exclusion for intercompany receipts) without necessarily being inconsistent with a non-unitary position in a state with a higher threshold for a unitary relationship.[9]

Agency Exclusion and 'Conduit' Payments

Oregon's agency exclusion is identical to Ohio's, providing an exclusion for "amounts received or acquired by an agent on behalf of another in excess of the agent's commission, fee or other remuneration."[10] The temporary regulations provide several examples of taxpayers that receive funds on behalf of a principal and thus can exclude those amounts.[11] However, some instances of agency relationships are not addressed by the regulation. For example, consider reimbursements received by contractors under a cost-plus contract that does not contain specific language outlining an agency relationship. Ohio has issued guidance stating that those contracts do qualify for the agency exclusion,[12] while Washington, by contrast, has issued regulations stating that reimbursements under cost-plus contracts are included in the business and occupation tax base.[13] Given that Oregon's exclusion is identical to Ohio's and less restrictive than Washington's, taxpayers receiving reimbursements under cost-plus contracts should consider taking the position that reimbursements are excluded from commercial activity.

Additionally, some taxpayers may not technically qualify as an agent but may act as a conduit for funds that are passed between a customer and a third party, such as general contractors like those mentioned above collecting payments for subcontractors, credit card processors collecting fees for merchant banks or issuing banks, or online platforms collecting payments for vendors. Those taxpayers should consider whether those amounts constitute commercial activity, which is defined by reference to "the total amount realized by a person."[14] In this context, taxpayers should also analyze whether the fee collected is an amount realized under IRC section 1001, as many taxpayers have

[3] Or. L. 2019 section 60.

[4] Or. L. 2019 section 58(1)(b)(FF).

[5] Or. L. 2019 section 58(19).

[6] *See id.* at (18). The regulations note that the unitary business principle is applied to the fullest extent allowed by the U.S. Constitution. Or. Temp. Rule No. 150-317-1020(4) (Dec. 9, 2019).

[7] *Mobil Oil v. Commissioner of Taxes*, 445 U.S. 425, 438 (1980). This formulation has been restated by the Supreme Court in *MeadWestvaco Corp. ex rel. Mead Corp. v. Illinois Department of Revenue*, 553 U.S. 16, 30 (2008). *See also Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207, 222 (1980); *ASARCO Inc. v. Idaho State Tax Commission*, 458 U.S. 307, 317 (1982); *F.W. Woolworth Co. v. Taxation & Revenue Department*, 458U.S. 354, 364 (1982); *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 179 (1983); *Allied-Signal Inc. v Director, Division of Taxation*, 504 U.S. 768, 776 (1992).

[8] *Butler Bros. v. McColgan*, 315 U.S. 501, 508-09 (1942).

[9] The Supreme Court has found that a modest volume of intercompany transactions does not necessarily create a unitary relationship. *See ASARCO*, 458 U.S. 307.

[10] Or. L. 2019 section 58(1)(b)(M).

[11] For example, Rule 150-317-1100(5), Example 3, provides that a human resources service providing payroll services to a business may exclude the amounts received from the business that are attributable to the employees' wages and that only the service fee is included in commercial activity.

[12] *See* Ohio Department of Taxation, Opinion of the Tax Commissioner No. 08–0012 (Nov. 21, 2008).

[13] Wash. Admin. Code 458-20-223.

[14] Or. L. 2019 section 58(1)(a)(A).

done for purposes of the Ohio CAT.[15] Notably, commercial activity in Oregon may be a broader term than its Ohio counterpart (gross receipts), in that the latter is limited to amounts "that contribute[] to the production of gross income."

Thus, the IRC section 61 definition of gross income may not be instructive in Oregon as it has been in Ohio.[16] The Washington B&O tax base, by contrast, is even broader, defining "gross proceeds of sales" as the value proceeding or accruing from various sales, without reference to whether the amount is realized by the taxpayer or whether it contributes to gross income.[17] Given the different tests for inclusion in the tax base, taxpayers must evaluate each state independently to determine whether the receipts at issue are includable.

Discounts, Rebates, and Other Reductions to the Purchase Price

The Oregon CAT as enacted by H.B. 3427 excluded "rebates paid to purchasers by retailers or wholesalers." The first technical corrections bill, however, removed this exclusion from commercial activity.[18] Under a newly proposed technical corrections bill,[19] "returns and allowances, as those terms are applicable to section 448 of the Internal Revenue Code, are allowed as an offset against commercial activity in the year that the commercial activity is received."[20] If that provision is enacted, taxpayers that benefit from the exclusion for returns and allowances in Ohio[21] may be eligible for the same exclusion in Oregon.

Also, taxpayers should consider whether amounts that do not explicitly qualify as returns and allowances may still be excluded from commercial activity on the grounds that they are not realized by the taxpayer.[22] For example, a manufacturer that provides discounts to retailers based on prepayment, the volume of goods purchased, or an incentive for sales made should consider whether only the net purchase price is an amount realized. Similarly, pharmaceutical manufacturers that offer price reductions in the form of chargebacks and rebates should consider whether the gross or net price must be used to calculate commercial activity, as should auto manufacturers that offer price incentives to dealers.

Sales of Capital Assets and Depreciable Property

Oregon excludes receipts from the sale, exchange, or disposition of assets described in IRC sections 1221 and 1231 without regard to the length of time the asset is held.[23] Although Oregon has not yet issued guidance defining the scope of this exclusion, Ohio's guidance may prove instructive given that the Ohio CAT has an identical exclusion for section 1221 and 1231 assets.[24] That guidance provides that a broad range of capital assets, including goodwill, qualify for the exclusion. Regarding the sale of a business, stock and assets of the business qualify for the exclusion, while accounts receivable and inventory are subject to the CAT.[25] Additionally, leasing companies should consider whether sales of off-lease property qualify for the exclusion.[26]

[15] Ohio Rev. Code. Ann. section 5751.01(F) defines gross receipts as "the total amount realized by a person, without deduction for the cost of goods sold or other expenses incurred, that contributes to the production of gross income of the person, including the fair market value of any property and any services received, and any debt transferred or forgiven as consideration."

[16] In fact, the temporary regulations provide that commercial activity is not based on or tied to the definition of gross income under the IRC. Or. Temp. Rule No. 150-317-1000(4) (Dec. 27, 2019).

[17] Wash. Rev. Code section 82.04.070.

[18] *See* Or. H.B. 2164 section 58(1)(b).

[19] Or. L.C. 249 (Dec. 20, 2019).

[20] IRC section 448(c)(3)(C) provides that "gross receipts for any taxable year shall be reduced by returns and allowances made during such year." Returns and allowances are recognized accounting terms. Generally, a return is a refund to a customer that returns a product to the seller. An allowance is a partial refund of the purchase price because of a defect in the product.

[21] Ohio Rev. Code. Ann. section 5751.01(F)(2)(cc).

[22] Or. L. 2019 section 58(1)(a)(A). See discussion above in the Agency Exclusion section.

[23] Or. L. 2019 section 58(1)(b)(B).

[24] Ohio Rev. Code. Ann. section 5751.01(F)(2)(c).

[25] Ohio Department of Taxation, "CAT 2005-08 - Commercial Activity Tax: I.R.C. Section 1221 and 1231 Assets Excluded From 'Gross Receipts'" (rev. May 2011).

[26] The Ohio Board of Tax Appeals recently held that sales of off-lease vehicles by an auto finance company qualify for the exclusion. *See Hyundai Motor Finance Co. v. McClain*, BTA Case No. 2015-785 (Feb. 6, 2020).

Interest Exclusion

Interest, except interest on credit sales or interest and service charges received by financial institutions, is excluded from commercial activity.[27] While Oregon does not provide guidance on a credit sale for purposes of the interest exclusion, taxpayers are again encouraged to look to Ohio, which has the same interest exclusion, minus the carveout for financial institutions (which pay the Ohio financial institutions tax).[28] The Ohio Department of Taxation has defined a credit sale as a two-party transaction — specifically, any sale in which the seller agrees to be made whole by the buyer through the receipt of payments over time, whether definite or indefinite, for the transfer of property to a buyer.[29] Under this approach, whether the interest exclusion would apply to a finance company that earned interest from purchased installment contracts depends on the relationship between the finance company and the seller, as seen in Table 2.

Table 2.
Qualifying for the Oregon CAT Interest Exclusion

Seller of Underlying Property	Qualify for Interest Exclusion?
Taxpayer	No. This is a pure two-party transaction that qualifies as a credit sale.
Unrelated retailer	Yes. This is not a credit sale because taxpayer and seller are unrelated.
Non-unitary affiliate	Likely yes. The seller is a separate person for CAT filing purposes.
Unitary affiliate	It is unclear whether affiliate included in taxpayer's unitary filing would be respected as a separate party.

Subtraction for Cost Inputs or Labor Costs

Oregon allows a subtraction from commercial activity that equals 35 percent of the greater of cost inputs (defined as cost of goods sold as calculated in arriving at federal taxable income under the IRC[30]) or labor costs.[31] Under the temporary regulations, that subtraction is then apportioned by 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 exclusion from commercial activity."[32] The requirement to add back exclusions[33] in the denominator of the subtraction, but not the numerator, could potentially be challenged on the grounds that the rule is not found anywhere in the statute, and may also violate fair apportionment requirements under the commerce clause.[34] For example, under an example provided in the temporary regulations, a taxpayer with 20 percent of its activity in Oregon would be limited to an apportioned subtraction of only 14.28 percent after adding back exclusions to the denominator of the fraction.[35]

The apportionment used to calculate the subtraction is computed using Oregon's sourcing rules for corporate income tax,[36] which are based on the Uniform Division of Income for Tax Purposes Act like the CAT, but with the notable distinction that the corporate income tax rules contain a throwback rule for sales of tangible personal property shipped to purchasers in states where the taxpayer is not taxable.[37] This mismatch — using CAT sourcing rules for the base but corporate income tax sourcing rules for the

[27] Or. L. 2019 section 58(1)(b)(A).

[28] Ohio Rev. Code section 5751.01(F)(2)(a).

[29] This definition has been adopted by the Ohio Department of Taxation in previous final determinations.

[30] Or. L. 2019 section 58(2).

[31] Or. L. 2019 section 64(1).

[32] Or. Temp. Rule No. section 150-317-1200(2) (Dec. 27, 2019).

[33] Presumably, the exclusions refer to amounts that are not included in commercial activity under Or. L. 2019 section 58(1)(b).

[34] *Container Corp.*, 463 U.S. 159, 169-170 (An apportionment formula may be struck if "the income attributed to the state is in fact 'out of all appropriate proportions to the business transacted in that state.'").

[35] *See* Or. Temp. Rule No. 150-317- 1200, Example 1. Taxpayer's activity in Oregon = 20 percent ($10 million of Oregon commercial activity/$50 million of total commercial activity). However, the apportioned subtraction = 14.28 percent ($10 million of Oregon commercial activity/$50 million of total commercial activity + $20 million of exclusions).

[36] Or. L. 2019 section 64(2).

[37] Or. Rev. Stat. section 314.665(2)(b).

subtraction — can work to taxpayers' benefit if the throwback rule results in a higher apportionment for the subtraction as compared with the base.[38]

Further, note that while H.B. 3427 (the original CAT bill) defined cost inputs by reference to cost of goods sold under IRC section 471, H.B. 2164 removed the reference to IRC section 471 and replaced it with a general reference to the IRC. This suggests that the legislature may have intended the cost input subtraction to apply to some industries (such as leasing companies) that do not typically have significant costs of goods sold under IRC section 471 but that nonetheless have expenditures (such as interest and depreciation) that are necessary to generate its gross receipts. These taxpayers may consider either taking the position that those expenditures qualify as cost inputs or requesting the use of alternative apportionment to the extent that a more straightforward definition of cost of goods sold does not fairly represent their commercial activity.[39]

Finally, there may be an opportunity to take a broad interpretation of labor costs, which are defined as "total compensation of all employees, not to include compensation paid to any single employee in excess of $500,000."[40] Consider a taxpayer that hires a staffing company to provide help or supply employment services. Even though the individuals providing the services may not be employees of the taxpayer, it may argue that those costs should be included in the subtraction for labor costs on the grounds that excluding those costs from the subtraction does not fairly represent its commercial activity in comparison with a similar taxpayer whose own employees perform the services.[41] The position may be stronger for taxpayers that exercise direct control or supervision over the outsourced employees.

Sourcing of Tangible Personal Property

Sales of tangible personal property are sourced to Oregon to the extent the property is delivered to a purchaser in Oregon.[42] Under the temporary regulations, sales to a warehouse in Oregon that are later shipped by the purchaser to branch stores in other states are nonetheless sourced to Oregon.[43] However, taxpayers may exclude from their commercial activity any receipts from sales to a wholesaler in Oregon, but only if the seller receives certification from the wholesaler at the time of the sale that the wholesaler will sell the property outside Oregon.[44] This rule is distinct from the Ohio CAT, which looks to "the place at which such property is ultimately received after all transportation has been completed."[45]

Although Ohio has a provision for qualified distribution centers,[46] which is comparable to Oregon's wholesaler certification exclusion, ultimate destination sourcing in Ohio is not limited to qualified distribution centers, and all sales are sourced to the ultimate retail location to the extent the taxpayer can substantiate that the location is known at the time of sale (by producing "mark-for" shipping labels, for instance).[47] Wholesalers that ship goods to a retailer's distribution center for ultimate delivery by the retailer to its individual stores should consider whether mark-for data meets the statutory definition of certification for Oregon CAT purposes.

Sourcing of Services

Services are sourced to Oregon to the extent they are delivered in Oregon.[48] The temporary regulations addressing sales other than sales of tangible personal property are analogous to Massachusetts's recent market-sourcing

[38] Under the proposed technical corrections bill, the same CAT apportionment rules would apply to the subtraction apportionment. Or. L.C. 249 section 3(2) (Dec. 20, 2019).

[39] Or. Temp. Rule No. 150-317-1200(5) (Dec. 27, 2019).

[40] Or. L. 2019 section 58(12).

[41] *See* Or. Temp. Rule No. 150-317-1200(5) (Dec. 27, 2019).

[42] Or. L. 2019 section 66(1)(c).

[43] Or. Temp. Rule No. 150-317-1030(4), Example 5.

[44] Or. L. 2019 section 58(1)(b)(DD).

[45] Ohio Rev. Code section 5751.033(E).

[46] Ohio Rev. Code section 5751.01(F)(2)(z).

[47] *See, e.g.*, Ohio Department of Taxation, "CAT 2005-17 Information Release — Commercial Activity Tax — 'Taxable Gross Receipt,' Defined" (rev. Apr. 2006).

[48] Or. L. 2019 section 66(1)(d).

regulations.[49] Particular services covered by the regulation include in-person services, services delivered to the customer or on behalf of the customer, services delivered electronically, and professional services.[50]

Generally, Oregon permits reasonable approximation if the state or states of assignment cannot be determined under the applicable rule for the service type.[51] For professional services (services that require specialized knowledge and may require a professional certification), however, Oregon's default rule is reasonable approximation rather than assignment.[52] Professional services delivered to business customers are sourced as follows:

- first, by assigning the receipts to the state where the contract of sale is principally managed by the customer;
- second, if the place of customer management is not reasonably determinable, to the customer's place of order; and
- third, if the customer's place of order is not reasonably determinable, to the customer's billing address.[53]

Thus, even if a taxpayer provides professional services to business customers in Oregon, those sales should be sourced outside the state to the extent those customers manage the contracts outside Oregon or ordered the services outside Oregon. Because Oregon defines professional services so broadly,[54] many taxpayers may benefit from this sourcing provision.

Finally, unlike the statutes in several other states, Oregon's CAT statute does not provide sourcing rules describing whether distribution and management services provided for regulated investment companies are sourced to the location of the RIC or the location of the ultimate shareholders of the RIC.[55] Thus, asset managers that perform services for RICs located outside Oregon should consider taking the position that those receipts are sourced to the location of the RIC, not the ultimate shareholders.

Summary

As with any new tax, there are uncertainties embedded in the newly enacted Oregon CAT that present both risks and opportunities to CAT filers. Drawing from the established authority in other states, however, may help fill in the gaps. Taxpayers should consider the positions described in this article when computing their annual CAT liability and letting their first CAT return out of the bag. ■

[49] *See* Or. Temp. Rule No. 150-317-1040 and Mass. Regs. Code section 63.38.1.

[50] *See id.*

[51] Or. Temp. Rule No. 150-317-1040.

[52] Or. Temp. Rule No. 150-317-1040(4)(d)(A) and (C).

[53] Or. Temp. Rule No. 150-317-1040(4)(d)(C)(II).

[54] Oregon broadly defines professional services to include management services, bank and financial services, financial custodial services, investment and brokerage services, fiduciary services, tax preparation, payroll and accounting services, lending services, credit card services (including credit card processing services), data processing services, consulting services, video production services, graphic and other design services, engineering services, and architectural services. Or. Temp. Rule No. 150-317-1040(4)(d)(A).

[55] *See, e.g.*, N.Y. Tax Law section 210-A(5)(d)(1) (receipts from a RIC allocated based on number of shares owned by shareholders in the state); Tex. Tax Code Ann. section 171.106(b) (receipts from RICs sitused based on "shareholders who are commercially domiciled in this state or . . . are residents of this state"); Mass. Gen. L. ch. 63, section 38(f) (mutual fund sales sitused to Massachusetts "to the extent that shareholders of the regulated investment company are domiciled in the commonwealth"); Me. Rev. Stat. title 36, section 5212 (receipts from services to a RIC sitused based on "shares owned by the regulated investment company's shareholders domiciled in this State"); Conn. Gen. Stat. section 12-218(e)(3) (receipts from RICs sitused based on "number of shares . . . that are owned by shareholders of such regulated investment company then domiciled in this state"); and R.I. Gen. Laws section 44-11-14.2(a) (receipts from RICs sitused based on the "number of shares owned by the regulated investment company's shareholders domiciled in this state").