Date: May 26, 2020

From: Nikki Dobay, Valerie Sasaki, and Catherine Yao

To: Oregon Department of Revenue

RE: Comments re Notice of Proposed Rulemaking, OAR 150-317-1200 (April 26, 2020)

Context for Comments:

We are concerned, experienced Oregon tax practitioners. We represent clients that are Oregon taxpayers in a variety of different industries and across the state. Many of our clients have an economic footprint that that includes Oregon and other state jurisdictions. We serve on professional and industry committees in Oregon and elsewhere.

Thank you for the opportunity to provide the following comments regarding Oregon Administrative Rule ("OAR") 150-317-1200, which is the Department's guidance regarding the cost input or labor cost subtraction pursuant to ORS § 317A.119. Based on our discussions with the Department, it is our understanding that the Department proposed this rule to address a perceived matching problem regarding inclusion of costs excluded from commercial activity from the cost inputs and labor costs subtraction. Thus, the Department's rule attempts to remove these costs by employing the "commercial activity ratio" in OAR 150-317-1200.

Our impression of the rule is that the intent of the proposed rule is unclear upon a plain reading and that the proposed rule fails to comply with the statutory language found in ORS § 317A.119.

Summary of Law:

ORS § 317A.119 provides:

> (1) A taxpayer shall subtract from commercial activity sourced to this state 35 percent of the greater of the following amounts paid or incurred by the taxpayer in the tax year:
> (a) The amount of cost inputs; or
> (b) The taxpayer's labor costs.
> (2) The amounts in subsection (1)(a) or (b) of this section shall be apportioned to this state in the manner required for apportionment of income under ORS §§ 314.605 to 314.675.
> (3) A subtraction under this section is not allowed for any amount of:
> (a) Expenses from transactions among members of a group, as excluded under ORS 317A.106; or
> (b) Cost inputs or labor costs that are attributable to a person's receipts from an item that is not commercial activity.
> (4) Notwithstanding subsection (1) of this section, the subtraction under this section may not exceed 95 percent of the taxpayer's commercial activity in this state.

Based on a plain reading of the statutory language, we believe the Corporate Activity Tax ("CAT") subtraction is calculated as follows:

1. Determine what, if any, expenses from transactions among members or costs that are attributable to items excluded from commercial activity are included in cost inputs or labor costs (*see,* ORS § 317A.119(3)) and reduce the Oregon CAT filing group's aggregate cost inputs or labor costs by that amount.
2. After any such required reductions, take 35% of the greater of the taxpayer's aggregate cost inputs or labor costs (*see,* ORS § 317A.119(1)).
3. Apply to that net amount the taxpayer's Uniform Division of Income for Tax Purposes Act ("UDITPA") apportionment factor based on the CAT filing group (*see,* ORS § 317A.119(2)).
4. The taxpayer's overall subtraction amount may not exceed 95% of the taxpayer's Oregon sourced commercial activity (*see,* ORS § 317A.119(4)).

(*See* Exhibit A for specific examples.)

The Proposed Administrative Rule:

Based on this understanding of the statute, we consider sections (2), (3) and (5) of OAR § 150-317-1200 flawed because they fail to comply with the statutory requirements set forth in ORS § 317A.119. Further, these flaws are also likely to lead to compliance and administrative burdens for taxpayers and the Department.

The General Rule

The general rule provided in subsection (2) requires the use a commercial activity ratio. That mandate fails to comply with ORS § 317A.119(3), which requires taxpayers to subtract certain expenses related to receipts specifically excluded from commercial activity. Although it is our understanding the Department sees the commercial activity ratio as an alternative method for excluding expenses related to excludable receipts, this is not directly apparent from the text or context of rule as drafted. Rather, many practitioners and taxpayers have interpreted this section of the rule to mean that the commercial activity ratio is to be used in place of a taxpayer's UDITPA apportionment factor; however, most still believe the taxpayer's expenses related to excluded commercial activity are nonetheless required to be subtracted from the taxpayer's cost inputs or labor costs prior to the commercial activity ratio being applied.

Even if section (2) were clarified to deal with the subtraction requirement in ORS §317A.119(3), requiring the commercial activity ratio be used appears to go beyond the Department's rulemaking authority. Because ORS § 317A.119(2) specifically references Oregon's UDITPA provisions for purposes of determining the apportionment factor, the Department's mandating the commercial activity ratio be used seems in conflict with the statute. Although the Department could provide by rule that the commercial activity ratio be used as a safe harbor, it lacks the authority to mandate something through rule that is completely contrary to statute.

Finally, section (2) seems to require wholly in-state taxpayers to apportion their income, which is also contrary to Oregon's UDITPA provisions referenced in ORS §317A.119(2). Specifically, ORS § 314.615 provides that a taxpayer is only required to apportion its income where it has

business activity both within and without the state. Because a wholly in-state taxpayers are not be required to apportion their income under the UDITPA provisions, which are specifically referenced in the subtraction statute, the Department's rule appears to exceed the scope of its rulemaking authority by draft a rule contrary to statute.

The Special Rule

The special rule provided in section (3) is narrowly drafted and fails to comply with the intent of the statute. Section (2) of ORS § 317A.119 requires a taxpayer to apportion its subtraction "in a manner required to apportionment of income under ORS 314.605 to 314.675," again Oregon's UDITPA provisions. Those provisions specifically provide for the manner in which taxpayers are required to apportion their income; thus, it is unclear why the Department has determined a taxpayer may only use its corporate income tax apportionment formula where the taxpayer's corporate income/excise tax filing group mirror the taxpayer's CAT filing group exactly. While it is understandable a taxpayer would only be able to use the exact apportionment factor (*i.e.*, the taxpayer's factor as it appears on its Form OR-20) in that situation, the statute does not seem to preclude a taxpayer from re-computing its apportionment factor using the entities included in its CAT filing group and its general UDITPA apportionment requirements.

For most taxpayers, the special rule in section (3) would never be applicable. Because the Oregon corporate income/excise tax and the Oregon CAT have different definitions of a unitary group (*i.e.*, the CAT definition includes a 50% ownership threshold whereas the Corporate income/excise tax definition includes a 80% ownership threshold) and the Oregon CAT applies more broadly (*i.e.,* it is applied on a worldwide basis and includes pass-through entities), most businesses will be precluded from using the Department's special rule. All multinationals and any business with a partnership in its structure will automatically be precluded from using the Department's special rule because such entities will always have different filing groups, assuming all entities are unitary.

Finally, the special rule in section (3) also fails to address the issue of whether a taxpayer is required to further deduct the taxpayer's expenses related to excluded commercial activity. Again, because this additional deduction is required by statute, most practitioners and taxpayers have assumed that must be done prior to applying the special rule.

The Alternative Method

The alternative method described in subsection (5) of the draft rule also seems out of step with the statutory provision in ORS § 317A.119. This provision appears to be describing when a taxpayer is required to subtract from cost inputs or labor costs certain expenses related to intercompany transactions or other excludable commercial activity, pursuant to ORS § 317A.119(3). As noted above, our reading of the statute is that such a subtraction is required by all taxpayers that have such receipts; therefore, it should not be considered an alternative method.

In addition, the Department's rule requires the use of separate accounting for purposes of this subtraction and only seems to allow the use of this alternative method where a taxpayer maintains separate accounting records in the normal course of its business. Therefore, even if

subsection (5) were not an alternative rule, the Department's significant limitation of the subtraction of these expenses seems contrary to the statutory language and it is unclear why such a narrow interpretation is useful. As with the special rule, as currently draft subsection (5) would be able to be used by very few taxpayers even if it were not in conflict with the statutory language.

Compliance and Administration Burdens

As can be seen from the above comments, the proposed rule will create compliance administration issues for taxpayers, tax practitioners and the Department. Those trying to apply the general, special or alternative rules will have to create information that is not kept in the taxpayer's ordinary accounting practices. This is unlike the UDIPTA provisions which are part of taxpayer's normal recordkeeping and have been used by taxpayers for a long period of time. The Department will also then have to attempt to audit and understand how taxpayers are applying this rule. This will delay audits, increase costs for the Department and potentially lead to unnecessary and unwanted litigation.