

## Oregon Tax Package Contains Corporate Tax Increases, Reduced Tax Rates for Investors in Certain Pass-throughs, and Favorable IC-DISC Provisions

October 17, 2013

### Overview

As part of a “grand bargain” involving reforms to Oregon retirement benefits, education spending, and increased tax revenues, Oregon Governor Kitzhaber recently signed House Bill 3601 (“H.B. 3601”),<sup>1</sup> which includes the following modifications to Oregon law:

- For tax years beginning on or after January 1, 2013, a reduced threshold (from \$10 million to \$1 million taxable income) for imposition of Oregon’s 7.6% corporate income and excise tax rate
- For tax years beginning on or after January 1, 2015, reduced personal income tax rates on nonpassive income earned by partnerships and S corporations (and LLCs taxed as such) for qualifying individual taxpayers
- Favorable tax treatment of “interest charge domestic international sales corporations,” or “IC-DISCs,” formed prior to January 1, 2014

H.B. 3601 is by its terms effective January 1, 2014, with some provisions having retroactive application. However, the bill may be subject to public voter referendum, which could defer its actual enactment or cause the bill to not be enacted. In this Tax Alert we summarize the above-mentioned modifications<sup>2</sup> and we discuss briefly the effective date and referendum issues.

### Reduced Threshold for Top Corporate Excise and Income Tax Rate

Under current law, the top Oregon corporate income and excise tax rate of 7.6% applies to all Oregon taxable income in excess of \$10 million.<sup>3</sup> For tax years beginning on or after January 1, 2013, H.B. 3601 would reduce the threshold for imposition of the 7.6% rate to taxable income in excess of \$1 million.<sup>4</sup>

### Reduced Personal Income Tax Rates for Nonpassive Income Earned by Certain Pass-throughs

Under current law, Oregon personal income taxpayers are subject to a top income bracket of 9.9% that applies to individuals (on income in excess over \$125,000); and to taxpayers filing jointly, head of household, or qualifying widowers with a dependent child (on income in excess of \$250,000). For tax years beginning on or after January 1, 2015, H.B. 3601 would permit personal income taxpayers to elect, irrevocably, to apply reduced tax rates on nonpassive income earned by partnerships, S corporations, and LLCs taxed as either a partnership or S corporation.<sup>5</sup> Depending upon the level of qualified nonpassive taxable income from pass-through entities, the tax rates<sup>6</sup> would be as follows:

<sup>1</sup> Laws 2013, ch 5, Special Session (H.B. 3601), signed by the Governor on Oct. 8, 2013. A copy of the enrolled bill is accessible at: <https://olis.leg.state.or.us/liz/2013S1/Measures/Text/HB3601/Enrolled>.

<sup>2</sup> H.B. 3601 contains certain provisions that are beyond the scope of this Alert, including:

- Starting in 2013, higher-income Oregon personal income taxpayers would not be able to claim the \$183 personal exemption from personal income tax
- Starting in 2013, new income caps would be imposed on the personal income tax deduction for seniors’ medical expenses
- Starting in 2014, increased cigarette taxes
- Changes to funding of the Oregon Rainy Day Fund

<sup>3</sup> Or. Rev. Stat. §§ 317.061(2), 318.020(1). Oregon imposes a corporate excise tax on C corporations that are doing business in the state and imposes a corporate income tax on C corporations that are not doing business in the state but have Oregon source income. Or. Rev. Stat. §§ 317.010(5), 318.020(1).

<sup>4</sup> H.B. 3601, Section 1, amending Or. Rev. Stat. § 317.061.

<sup>5</sup> H.B. 3601, Section 11, amending Or. Rev. Stat. chapter 316. LLCs taxed as partnerships or S corporations are included in this list by operation of Oregon’s conformity to federal classification of entity rules. Or. Rev. Stat. § 63.810. Given that a single-member LLC treated as a disregarded entity is neither a partnership nor an S corporation, an owner of a single-member LLC would not be eligible for the reduced income tax rates for the income generated by the disregarded entity.

<sup>6</sup> H.B. 3601, Section 11, amending Or. Rev. Stat. chapter 316.

<b>Oregon Pass-through Taxable Income</b>	<b>Tax Rate</b>
Up to \$250,000	7%
In excess of \$250,000 up to \$500,000	7.20%
In excess of \$500,000 up to \$1 million	7.60%
In excess of \$1 million up to \$2.5 million	8%
In excess of \$2.5 up to \$5 million	9%
In excess of \$5 million	9.90%

Several requirements must be satisfied in order to qualify for the reduced rates, including but not limited to:

- Income must be “nonpassive,” meaning income other than from a “passive activity” as defined in I.R.C. § 469;
- The electing partner must materially participate in the management of the pass-through entity;
- The pass-through entity must employ at least one non-owner, member, or limited partner; and
- Qualifying employee(s) must perform at least 1,200 aggregate hours of work in Oregon for the pass-through entity by the close of the tax year for which the reduced rate is allowed, and work hours may be considered only for weeks in which a worker works at least 30 hours.<sup>7</sup>

### IC-DISC Provisions

A thorough discussion of the IC-DISC structure is beyond the scope of this Alert. Generally speaking, however, an IC-DISC is a tax-exempt corporate entity that benefits exports. A domestic C corporation requests approval from the IRS to be treated as an IC-DISC for federal tax purposes. As a result of its status as an IC-DISC, the IC-DISC pays no federal income taxes and reduces the exporter’s tax liability by effectively converting a portion of the exporter’s net export income, which is taxable at ordinary income rates as high as 39.6 percent, into qualified dividends generally taxed at 20 percent after 2012. The exporter pays a deductible commission to the IC-DISC, which pays no income tax on that commission. The IC-DISC later distributes its income to its shareholders as qualifying dividends, taxed at the reduced 20% rate for individual shareholders. Various states, including Oregon, have refused to conform to this federal treatment and often require taxpayers to disregard transactions between the taxpayer and its IC-DISC as related-party transactions.

For IC-DISCs formed on or before January 1, 2014,<sup>8</sup> H.B. 3601 would create special provisions, including:

- IC-DISCs would be exempt from Oregon tax except for a 2.5% tax on commissions received;
- Commission payments to the IC-DISC would be deductible; and
- IC-DISC dividends received by Oregon personal income taxpayers would be subtracted from federal taxable income for purposes of calculating personal taxable income.<sup>9</sup>

### Effective Date / Oregon’s Referendum Process / Financial Reporting Effect

Although H.B. 3601 has been passed by the state legislature, signed into law by the governor, and is scheduled to become effective on January 1, 2014, the bill is not considered enacted until: (1) it is affirmatively confirmed by the state’s voter referendum process,<sup>10</sup> or (2) upon expiration of that process without voters having timely filed a qualified referendum petition.<sup>11</sup> Therefore, in Oregon, in addition to being signed into law by the governor (i.e., not vetoed), a law also has to survive the referendum process, or the period for such referendum process must expire, in order for the law to be considered enacted. Accordingly, H.B. 3601 is not presently considered enacted law for financial reporting purposes.

<sup>7</sup> H.B. 3601, Section 11(6), amending Or. Rev. Stat. chapter 316. H.B. 3601 also contains provisions for these rates to be adjusted in later years (2018 and 2022) based on calculations of revenue losses from utilization of the reduced rates. H.B. 3601, Section 13.

<sup>8</sup> H.B. 3601, Sections 6(2).

<sup>9</sup> H.B. 3601, Section 6, amending Or. Rev. Stat. chapter 316.

<sup>10</sup> The Oregon Constitution gives referendum power to Oregon voters to approve or reject certain laws adopted by the Oregon Legislature, provided a qualified petition is timely filed. See, Or. Const., art. IV, § 1(3)(a)-(b).

<sup>11</sup> H.B. 3601, Section 26. The bill will become effective on the 91<sup>st</sup> day after the adjournment of the special legislative session (i.e., January 1, 2014) unless a qualified petition is timely filed under the state’s referendum process (i.e., also within 90 days of the adjournment of the special legislative session). See, Oregon Legislature effective date determination under “Measure History” accessible at:

<https://olis.leg.state.or.us/liz/2013S1/Measures/Overview/HB3601>.

## Considerations

Various provisions of H.B. 3601 may provide potential opportunities for further consideration. For example:

- Can a partnership or S corporation adjust its operations to increase its nonpassive income?
- Are there certain actions that a taxpayer may take prior to January 1, 2014, in order to potentially derive benefit from the IC-DISC provisions?

## Contacts

If you have questions regarding H.B. 3601, please contact either of the following Deloitte Tax professionals.

Doug Andersen  
Partner  
Deloitte Tax LLP, Seattle  
[dougandersen@deloitte.com](mailto:dougandersen@deloitte.com)  
206-716-7430

Scott Schiefelbein  
Senior Manager  
Deloitte Tax LLP, Portland  
[sschiefelbein@deloitte.com](mailto:sschiefelbein@deloitte.com)  
503-727-5382

**This alert contains general information only and Deloitte is not, by means of this alert, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This alert is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Deloitte shall not be responsible for any loss sustained by any person who relies on this alert.**

### About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see [www.deloitte.com/about](http://www.deloitte.com/about) for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms. Please see [www.deloitte.com/us/about](http://www.deloitte.com/us/about) for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.

Copyright © 2013 Deloitte Development LLC. All rights reserved.  
Member of Deloitte Touche Tohmatsu Limited