

Tax Impacts Bulletin

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Oregon Legislators Reach “Grand Bargain” Democrat and Republican Lawmakers Come Together in a Rare Moment of Bipartisan Cooperation

During the 2013 special session of the Oregon State Legislature, citizen lawmakers from both sides of the aisle came together to pass HB 3601, in an effort to slow the growth of government pensions while funneling more dollars to schools, colleges and mental health programs. The “grand bargain,” as it’s being called by its supporters, achieves this by increasing taxes on some taxpayers, mostly highly profitable corporations and high income individuals, and decreasing taxes on some small businesses owners.

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INCREASE IN C-CORPORATION TAX RATES

C-corporations pay taxes at a graduated rate based on net income apportioned to Oregon; for tax years beginning on or after January 1, 2013, businesses with apportioned taxable income of \$1 million or less will not see an increase in their tax liability and will continue to pay taxes at a rate of 6.6%. However, those corporations with apportioned taxable income greater than \$1 million and less than \$10 million will see the rate at which they pay taxes increase by 1% from 6.6% (previously enacted 2013 rate, note that the 2012 rate was 7.6%) to 7.6%. Taxpayers with apportioned taxable income in excess of \$10 million will continue to pay taxes at a 7.6% rate. The following table illustrates the 2013 corporate tax rates before and after the law change:

Apportioned Taxable Income	Before	After
Up to \$1 million	6.6%	6.6%
\$1 million to \$10 million	6.6%	7.6%
Greater than \$10 million	7.6%	7.6%

Per HB 3601 any penalty or interest, including interest on the underpayment of estimated tax, which is the direct result of the corporation tax rate change, will be waived by the Department of Revenue.

Since 2009, all corporations are subject to a graduated minimum tax based on apportioned sales regardless of whether or not they have taxable income; this minimum tax ranges from \$150 to \$100,000. Corporations will continue to pay the greater of the minimum tax or the income tax based on the new rates discussed above.

It should be noted that in May 2013 the Oregon Supreme

Court issued a taxpayer-favorable ruling in a significant corporate tax case: C corporations are now allowed to offset the minimum tax with certain Oregon business credits. Based on the Department’s own guidance, all corporate tax credits (including R&D and BETC) qualify to offset minimum tax with the exception of the:

- Contribution of computers or scientific equipment credit
- Surplus kicker credit

The following taxpayers could benefit from this ruling and should act quickly in order to receive the full benefit for which they are eligible:

- Filed as a C-Corporation for tax years 2009 through 2012
- Paid Oregon corporate minimum tax due to taxable losses or minimal income (the more the minimum tax paid, the greater the possible benefit)
- Generated qualifying business tax credits in 2009 through 2012, or had credits carrying over into 2009 and later

DECREASE IN POST-2014 TAX RATES ON CERTAIN PASS-THROUGH INCOME

Prior to the enactment of HB 3601, owners of an interest in an S-corporation or Partnership were at a current rate disadvantage compared to their C-corporation counterparts. They paid taxes on pass-through income at the individual rates, which quickly reach 9.0% when Oregon Adjusted Gross Income (AGI) exceeds \$50,000 and tops out at 9.9% when Oregon AGI exceeds \$250,000. Therefore, an entity taxed as a C-corporation could potentially receive a 3.3% benefit on apportioned taxable income.

In order to mitigate this distortion for some pass-through



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owners for tax years beginning in 2015 and beyond the legislature enacted the following tax rates on pass-through income, assuming the income passed through qualifies (see “Who Qualifies,” below):

Pass-Through Income	Tax Rate
Up to \$250,000	7.0%
\$250,001 - \$500,000	7.2%
\$500,001 - \$1,000,000	7.6%
\$1,000,001 - \$2,500,000	8.0%
\$2,500,001 - 5,000,000	9.0%
Over \$5,000,000	9.9%

It should be noted that the new pass-through rates do not apply to single member LLCs, which are treated as disregarded entities for income tax purposes, or sole proprietorships (unincorporated businesses). This gives an advantage to those businesses with one owner that operate as an S-corporation, and may be a reason to change the legal structure of your business to take advantage of the new lower rates.

Who Qualifies, You Ask?

In order to benefit from the new lower rates, the business and its owners must pass two tests. First, the income must be non-passive to the owner under federal law (IRC Sec. 469), which means the owner must “materially participate” in the business. This usually means working for the business at least 500 hours during the year. This also will exclude rental income from the lower rate, unless it’s earned by a materially participating rental real estate professional. Passive investors in partnerships and S corporations will not see any reduction in their Oregon tax rates.

Second, the business must employ (as a W-2 employee) at least one non-owner in Oregon on a substantially full-time basis (at least 30 hours per week) for at least 1,200 hours during the tax year. Weeks in which employees worked less than 30 hours are not counted for this test; to reach the 1,200 hours, the entity must have at least one non-owner employee who logged at least 1,200 hours during weeks in which that employee worked at least 30 hours.

What About Non-Residents?

In order for non-resident shareholders/partners to take advantage of the reduced rates, the taxpayer must file a non-resident individual tax return and may not join the filing of a composite tax return with other non-resident shareholder/partners of the entity.

Should the taxpayer for any reason not wish to be taxed at the reduced rates on qualified pass-through income an irrevocable election may be made on the taxpayer’s original return.

MEDICAL EXPENSE DEDUCTION

For the 2012 tax year and prior, taxpayers who had reached the age of 62 by the end of the tax year were allowed a deduction for medical expenses even if they

had phased out of the federal deduction on Schedule A. The taxpayer merely took a deduction for the lesser of their medical expenses incurred or 7.5% of their federal Adjusted Gross Income (AGI) as an itemized deduction on the Oregon tax return. In addition, the amount was not subject to any phase-out for high income taxpayers. This was a potentially valuable deduction for older high income Oregonians with high out-of-pocket medical expenses.

The legislature chose to significantly scale back this tax benefit. For tax years beginning in 2013, the deduction is now an Oregon subtraction and is capped at \$1,800 per qualifying person and \$3,600 per joint return. The deduction phases out based on income and reaches \$0 at \$200,000 of AGI for joint filers and \$100,000 for separate filers. The phase-out is as follows:

Federal AGI	Deduction
Between \$50k & \$100k for joint filers	\$1,400
Between \$100k & \$200k for joint filers	\$1,000
Over \$200k for joint filers	\$0

The age at which an individual may qualify for the medical expense deduction is gradually raised as follows:

Tax Years	Eligible Age
Beginning in 2013	62
Beginning in 2014 and 2015	63
Beginning in 2016 and 2017	64
Beginning in 2018 and 2019	65
Beginning in 2020 and beyond	66

ADDITIONAL CHANGES

The new law also phases out the personal exemption credit (currently \$183 per person) for joint filers, surviving spouses and head of households with federal AGI in excess of \$200,000 and single filers with federal AGI in excess of \$100,000.

The earned income credit allowed to individuals is now 8% of the allowed federal earned income credit (the previous Oregon credit rate was 6%).

FINAL THOUGHTS

Even though less beneficial than reported in the press, the compromise agreed to by state legislators has the potential to lower the tax burden on some qualified small and medium sized businesses. This could prove to make Oregon a bit more attractive to the community that employs a majority of Oregonians – but only if they operate in the right legal structure.

For any questions or additional clarification, please contact your tax advisor, or a **Perkins tax expert**.



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