

Larry's Tax Law

Oregon Tax Compliance Alert - Reduced Tax Rates May Be Available to Taxpayers for Non-Passive Income That Flows Through From Certain LLCs or S Corporations

By Larry Brant on 3.8.16 | Posted in Oregon Tax Laws

As reported in my [November 2013 blog post](#), for tax years beginning in 2015 or later, under ORS 316.043, applicable non-passive income attributable to certain partnerships and S corporations may be taxed using reduced tax rates. The reduced tax rates are as follows:

- 7 percent for taxable income of \$250,000 or less;

- 7.2 percent for taxable income greater than \$250,000 but less than or equal to \$500,000;

- 7.6 percent for taxable income greater than \$500,000 but less than or equal to \$1,000,000;

- 8 percent for taxable income greater than \$1,000,000 but less than or equal to \$2,500,000;

- 9 percent for taxable income greater than \$2,500,000 but less than or equal to \$5,000,000; and

- 9.9 percent for taxable income greater than \$5,000,000.

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In accordance with ORS 316.037, the Oregon income tax rates that would otherwise apply to individual taxpayers are 9 percent on taxable income over \$5,000 (up to \$125,000), and 9.9 percent on taxable income over \$125,000. At first blush, the reduced tax rates offered under ORS 316.043 look desirable. An understanding of the statute, however, is needed before jumping in head first.

1. **Election.** To qualify for this reduced rate structure, which is subject to adjustment as provided by ORS 316.044, taxpayers must make an **election** on their **original** return by checking Box 22c and completing and attaching Oregon Department of Revenue Schedule OR-PTE, OR-PTE-PY or OR-PTE-NR. **The election cannot be made on an amended return.** Does the original return have to be timely filed? The statute is silent. **Caution is advised!**
2. **Material Participation.** The reduced rate structure is **only** available to taxpayers who materially participate in day-to-day operations of a partnership or an S corporation that constitutes a trade or business.
3. **Non-Passive Income Only.** The reduced rate structure **only** applies to “**non-passive**” income that flows through to the taxpayer from the partnership or S corporation.
4. **One or More Non-Owner Employees.** The S corporation or partnership **must** employ at least one non-owner and an aggregate of at least 1,200 hours of work must be performed in Oregon during the taxable year by the non-owner employee(s). For the purpose of computing the number of hours worked in Oregon during the taxable year, only hours during weeks in which the non-owner worker(s) performed 30 hours or more of services may be counted.
5. **Irrevocable.** Per the statute, once made, the election is irrevocable—it cannot be amended or revoked. Does this mean that once an election is made, the taxpayer is required to use the reduced rate structure for all future tax years, or does it simply mean that the taxpayer cannot revoke the election for the particular tax year the election is made? Logic dictates that the election is made for each tax year, so the later should be true. **The statute, however, does not provide a clear answer to this question. Caution is advised!** The Oregon Department of Revenue has not yet written administrative rules to accompany ORS 316.043. I suspect, it will address this question in any rules it drafts.
6. **No Disregarded Entities.** The owner of a disregarded entity (e.g., a single-member limited liability company or a sole proprietorship) is **not** eligible for the reduced tax rates.
7. **Limited Deductions.** For purposes of computing the taxpayer’s income, which is subject to the regular income tax rates, the taxpayer is allowed to use all subtractions, deductions or additions otherwise allowable under the Oregon tax laws set forth in ORS Chapter 316. For purposes of computing the non-passive income to which the reduced tax rates apply, however, the taxpayer is only allowed to take into consideration depreciation deductions or adjustments directly related to the partnership or S corporation. **Consequently, before**

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making the election to use the reduced tax rates, an analysis of the impact of the limited use of subtractions, deductions and additions against the non-passive income needs to be undertaken.

8. **Composite Returns.** A taxpayer who uses the reduced income tax rates may **not** join in the filing of a composite return under ORS 314.778.

Until the Oregon Department of Revenue drafts administrative rules to accompany ORS 316.043, the questions discussed above will remain unanswered. Consequently, **caution is advised.** Careful review and consideration is required before tax practitioners jump into an election under this alternative tax rate regime. Unfortunately, traps exist for the unwary.

Tags: income tax, limited liability companies (LLCs), non-passive income, reduced tax rates, S Corporations