TAX FOUNDATION Since 1937

1325 G Street N.W., Suite 950
Washington, DC 20005

202.464.6200
www.TaxFoundation.org

Oregon Should Consider Decoupling From the Pass-Through Deduction

Written Testimony for the Oregon Senate Committee on Finance and Revenue

Jared Walczak
Senior Policy Analyst, Tax Foundation

February 6, 2018

Chairman Hass and Members of the Committee:

The enactment of federal tax reform has far-reaching implications for the states. In the longer term, states will find themselves competing for economic activity made possible by changes to the federal tax code, particularly those flowing from the removal of certain disincentives to domestic investment. More urgently, however, states are grappling with the immediate revenue impacts of federal tax reform, and it is here that Oregon finds itself an outlier.

Most states will see a revenue increase under the new law. This is because the base-broadening provisions of the new federal tax law often flow through to states, while the corresponding rate reductions do not. Yet Oregon's Legislative Revenue Office anticipates a $40 million revenue loss in fiscal year 2019, for one simple reason: absent legislative action to the contrary, Oregon will adopt the new pass-through deduction, while most other states will not.

That provision provides a 20 percent deduction against qualified pass-through business income for those with incomes below $315,000 (joint filers). For filers above that threshold, the deduction is limited to the greater of (a) 50 percent of wage income or (b) 25 percent of wage income plus 2.5 percent of the cost of tangible depreciable property, and many service businesses are excluded. (The benefit phases out between $315,000 and $415,000.)

There's no question that the pass-through deduction is significant. The Joint Committee on Taxation estimates that it will cost $414.5 billion over the next ten years. Equally significant, however, is that it is structured as a deduction against federal taxable income, not adjusted gross income.

Since most states begin their individual income tax calculations with adjusted gross income, they need not worry about conforming to this base-narrowing deduction. Oregon, however, is one of six states which begins with federal taxable income, which takes account of the deduction. Decoupling from the pass-through deduction, especially if paired with tax relief, is sound policy.

Whereas greater neutrality was a major goal of tax reformers, the pass-through deduction cuts in the opposite direction. It is a carveout with few benefits. While there are advantages to conforming to the Internal Revenue Code wherever possible, for Oregon and the other states which use federal taxable income as their starting point for conformity, decoupling from the pass-through deduction is an entirely viable option. The case for decoupling is particularly strong in Oregon, where pass-through businesses already receive the advantage of a separate rate schedule.

Oregon's Legislative Revenue Office estimates that the deduction would cost the state $192 million in 2019. With the deduction in place, the Revenue Office projects a net revenue loss of $40 million. Absent the deduction, the state could anticipate a $152 million revenue increase.

The additional revenue that states will receive due to federal tax reform may provide opportunities to cut rates or, better yet, adopt meaningful tax reform. Ideally, states receiving the benefit of base-broadening provisions will not decouple from the handful of provisions which narrow bases to good effect, like full expensing of machinery and equipment purchases or the enhanced Section 179 deduction, both of which eliminate some of the current tax code's disincentives for business investment. The pass-through deduction, however, does not make the tax code more neutral. It is a targeted preference, and there is no reason Oregon or any other state should feel bound to it.

# # #

CONTACT
jmw@taxfoundation.org
(202) 464-5101