Federal Tax Reform: Implications for Oregon

Congress is considering fundamental tax reform for both the personal income tax and the corporate income tax. Changes to the federal income tax base would have direct effects on Oregon's tax base through the rolling reconnect provision to changes in the IRS code. Federal tax changes also affect state personal income tax revenue indirectly through changes in the federal tax subtraction. House Republicans have developed a detailed plan for changes to both personal and corporate income taxes but legislative language has yet to be written. The President has also developed proposals generally in-line with the House Republican plan but with some important distinctions. At this point, the details and timing of what will become law is highly uncertain. The information below is taken from a report issued by the Tax Foundation ("Federal Tax Reform: The Impact on the States").

The table below summarizes the House Republican including implications for Oregon's revenue.

Component	House Republican Proposal	Impact on Oregon Revenue
	Personal Income Tax	
Rates	Consolidates current 7 rates into 3 with a 33% max rate	Indirect-positive
Standard Deduction	Increases from $12,000 for joint filers to $24,000	Indirect-positive
Personal Exemption	Replace current exemption amount with a $500 credit per dependent	Indirect-uncertain
Alternative Minimum	Eliminates	Minimal
Investment Income	Applies regular tax rates but allows a 50% deduction for capital gains, interest and dividend income.	Direct--negative
Itemized Deductions	Eliminates deductions for state and local taxes, medical expenses and miscellaneous items such as theft losses and job expenses. Retains deductions for mortgage interest and charitable contributions.	Direct-positive
	Business Taxes	
Corporate Tax Base	Converts net income base into "destination- based cash -flow tax". This translates into a destination based tax based on product markets. Such a change would allow for full expensing of capital purchases, elimination of net interest expense and no residual tax on worldwide income.	Direct-uncertain
Rates	Lowers current 35% rate on net income to 20% based on cash flow	Indirect-uncertain
Pass-Through Entities	Places 25% rate cap on pass-through income.	Minimal
Estate Tax	Eliminates	No direct effect. Could complicate admin.

The proposal would directly affect Oregon revenue through the state's rolling reconnect to changes in the federal tax base. The proposed changes to itemized deductions would have a substantial positive revenue impact for the state. Eliminating the deduction for property taxes would increase revenue by $470 million if in effect for a full biennium. Elimination of the itemized deduction for medical and dental expenses above 10% of adjusted gross income would increase Oregon income tax revenue by $240 million for a full biennium. However, the 50% deduction allowed for investment income would have a significant negative effect on Oregon income tax collections. If this provision is worded as a deduction it will cut revenue from these sources, which comprise roughly 8% of the tax base, by roughly half. If these tax base related provisions became federal law, they would also change Oregon law unless the Legislature disconnected from them.

The other major direct effect of the proposal would be changes to the business tax base through adoption of the destination-based cash-flow approach. The expensing provision would move forward the impact of depreciation on tax liability. This would trigger reductions in both corporate and personal income tax collections that would be made up in later years. This short-term revenue loss would be partially made up for by the disallowance of business interest deductions. The net effect of these fundamental changes to the business tax base ultimately depends on the flow of imports and exports across state lines. Since there is no accurate data available for these flows at the state level the impact on Oregon's revenue is uncertain.

Oregon's revenue will also be indirectly affected through the federal tax subtraction allowed on Oregon returns. This means that reductions in federal taxes will indirectly increase state revenue because Oregon taxpayers will have less federal taxes to subtract from their Oregon taxable income. This impact will be muted for higher income taxpayers because the federal tax subtraction is capped at $6,500 and is phased out for taxpayers with adjusted gross income above $125,000 ($250,000 joint). This means that reductions in tax rates and an increase in the standard deduction will indirectly increase Oregon revenue through the federal tax subtraction. However, reductions in the effective tax rate for investment income and elimination of itemized deductions will have a smaller proportional effect because many of these taxpayers are at the cap. Overall the Tax Foundation estimates that the House Republican Plan will reduce federal tax revenue by about 6% over a ten-year period.

In their report, the Tax Foundation also analyzes the implications of tax reform proposals from the administration made during the presidential campaign. Both plans reduce income tax rates and broaden the federal tax base though the specifics are different. The biggest difference in the proposals in terms of its impact on Oregon revenue is treatment of itemized deductions. Instead of disallowing certain deductions, the President's proposal caps overall deductions at $100,000 ($200,000 joint). This would mean a considerably smaller direct impact on Oregon revenue. The President's proposal does not include a deduction for investment income but adds a full deduction for child care expenses subject to an income limit. The indirect effect of the President's proposal is likely to be greater because the overall net impact on Federal revenue is expected to be roughly double the House Republican Plan per Tax Foundation estimates.

The last time the Federal government made significant changes to the tax structure occurred in 1986 when the tax base was expanded through a series of deduction eliminations and rates were reduced. Oregon connected to these base broadening changes and consolidated tax brackets while reducing rates to 5,7 and 9%. The Legislature also expanded the standard deduction at the time. The base broadening and rate reduction occurred during a time of economic expansion so revenue was already growing. However, connecting to the federal changes appears to have accelerated revenue growth as personal income tax collections increased 20.1% between FY 1986-87 and FY1988-89.

While the ultimate form of federal tax reform is highly uncertain, Oregon is uniquely positioned to experience significant revenue effects both positive and negative. The state's automatic conformity to federal tax base changes, heavy reliance on the personal income tax, and its one-of-a-kind revenue limit known as the kicker mean that the timing and specifics of federal tax policy will have important consequences for state revenue.

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