SB 727: Reject the SALT regime for pass-through taxpayers

Testimony for Senate Committee on Finance and Revenue – Bennett Minton – 3.29.2020

Madam Chair and members of the committee:

I'm Bennett Minton, on behalf of Tax Fairness Oregon, a network of volunteers who advocate for a rational and equitable tax code. Joining me in drafting our testimony was Brenda Gilmer, a tax lawyer and former official in Montana's revenue department. We spent a couple hours discussing the -1 amendment and its implications. We are deeply concerned.

Many of us agree on the narrative behind the 2017 tax act. With respect to this subject, Congress had a political aim: harming taxpayers in predominantly blue states by limiting the SALT deduction. Commentary reported that Republicans wanted to pressure Democratic states to cut taxes and the services that fund them.

As you know, many states tried workarounds, and they didn't fly with the IRS. Now, apparently, the IRS has signed off on a New Jersey regime, which is the basis of this amendment. The IRS also issued an NPRM in December. In a related release, the IRS said:

> "[T]he proposed regulations will clarify that State and local income taxes imposed on and paid by a partnership or S corporation on its income are allowed as a deduction by the partnership or S corporation in computing its non-separately stated taxable income or loss for the taxable year of payment, and therefore are not subject to the State and local tax deduction limitation for partners and shareholders who itemize deductions."

In other words, states may create a workaround that allows certain taxpayers – owners of pass-throughs – to take an unlimited SALT deduction on their pass-through income. You have before you a proposal that purports to do that. We have two sets of issues with it.

One, the Senate and House revenue committees have been devoting attention to the preferential tax treatment Oregon accords pass-throughs. TFO has been researching the effects of the preferential rates. Our analysis of the state's regime for pass-through income finds that it achieves no discernable goal. It saves affected taxpayers amounts too insignificant to influence their behavior, and it costs the state more than a hundred million dollars per year. As we note often, the legislature spends inordinate attention on proposals that would violate Section 316.003 providing for "the same tax burden on all households earning the same income."

And yet, the committee is now considering how to make the federal SALT deduction work for some small group of taxpayers, those with the money and sophistication to weigh an annual election to shift tax liability to the pass-through entity and away from its individual owners.

We read the bills and follow the money

We could argue about the philosophy behind the SALT deduction, whether it encourages states to tax its citizens and how it contributes to unequal tax burdens. But looking just at this proposal, we're having trouble with the inconsistency of your deliberations.

Let's review the 2017 tax act in broad strokes: it favors capital over labor income. The law cut the corporate tax rate, created a roughly equivalent deduction for pass-through income, slashed the application of the estate tax, and offered a pittance of tax relief to some middle- and lower-income wage workers. It shifted income up and the tax burden down. It looks to us like you're participating in that continuing effort, rather than upholding the principle that income is income and should be so taxed.

Our second issue is how this regime works in the real world.

In the committee's March 17 hearing, legislative counsel asserted that this regime would be revenue-neutral, because the tax credit to individuals would be offset by the tax paid at the entity level. That may be so in an academic setting.

Brenda spent many years as a tax regulator. I spent many years involved in federal corporate tax. From our perspectives, a class of taxpayers and their advisors are responsible for a share of GDP in gaming the tax system. My former colleagues maneuver our clients through this cat-and-mouse game with the IRS and the states.

In this case, we are concerned that partnerships may game the regime to lower the aggregate tax in ways that the state lacks the expertise and resources to monitor effectively. This is because S corporations are limited to ascribing pro-rata distributive shares of the entity's items of income, deduction and credit to its shareholders – but partnerships are not so limited. Under the proposed regime, the state potentially would sanction a Pandora's box for shifting counterbalancing income streams to individual partners – be they individuals, S corporations, C corporations, trusts or estates – based on their unique abilities to avoid Oregon tax.

In response to a characterization of my oral testimony, I reiterate our concern with the links in this chain. The IRS of course intends that different types of pass-through entities would be treated the same. But the underlying provisions governing the different entities are not the same. The question is the degree to which partnerships could manipulate income in a way unavailable to S corps, for example. Furthermore, certain taxpayers will have the wherewithal to elect the alternative regime, and others may not even become aware of the opportunity. A similar calculation governs taxpayer behavior in other circumstances we have noted for the committee: Taxpayers have different capacities to use elections the tax code provides them. The result is that similarly situated taxpayers are treated differently, owing to the complexity of the code. The -1 proposal has ramifications that we believe the committee has not fully considered. Therefore the revenue effect may be different than counsel asserts.

The -1 regime would be effective beginning next year, and therefore apply to tax receipts in fiscal 2023 and later. Meanwhile, a new president and Congress are going to deal with the SALT limitation before it expires in 2025. The IRS will have new priorities, perhaps shifting its stance in the rulemaking announced a few days after the 2020 election. It could reverse its interpretation of any ambiguity in the law and decide that no distinction in the SALT limitation applies to pass-through owners. And we understand that you're dealing with the world as it is, not as it may be.

But for all these reasons, we urge you to set this proposal aside.