2013 Special Session Summary
Tax Policy Changes

RESEARCH REPORT # 4-13
November 2013

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Introduction

Governor Kitzhaber called the Legislature into special session on September 30. The purpose of the session was to approve five legislative concepts which grew out of negotiations between the Governor and legislative leadership. The five bills introduced and approved by the Legislature in the Special Session were:

- SB 861—modifies cost-of-living adjustment under the Public Employees Retirement System (PERS) beginning July 1, 2014.
- SB 862—excludes salary increases to pay for insurance coverage in calculation of final salary for members of Oregon Public Service Retirement Plan, subjects PERS payment to collection process associated with criminal action and modifies retirement options available to members of the Legislative Assembly.
- SB 863—Makes legislative finding and declaration that regulation of agricultural seeds and products of agricultural seed is reserved for the state.
- HB 5101—appropriates General Fund and provides additional Other Fund expenditure limitation for revenue increases in the 2013-15 biennium provided for in HB 3601. Allocates funds in the following manner:
    - Education
        - $100 million to State School Fund for distribution to individual districts.
        - $25 million to the Oregon University System.
        - $15 million to the Community College Support Fund.
    - Human Services
        - $10 million to the Department of Human Services for Project Independence.
        - $10 million to the Oregon Health Authority (dedicated cigarette tax revenue) for mental health services.
    - Transportation
        - $5 million to the Elderly and People with Disabilities Transportation Program.
    - Emergency Board
        - $26 million as a special purpose appropriation to be allocated to state agencies for senior services.
- HB 3601—contains seven significant tax policy changes affecting the personal income tax, the corporate income tax and the cigarette tax.

The remainder of this report will focus on HB 3601 and its implications for Oregon tax policy. The next section provides an overview of the bill including its overall revenue impact and the estimated impact of the individual components. This is followed by a detailed analysis for each of the major components of the bill.

Overview of HB 3601

HB 3601 consists of a complex set of tax policy changes designed to accomplish multiple objectives. Overall the bill is designed to raise revenue for education and other services, especially in the 2013-15 biennium. Because it appears to meet the constitutional definition of a bill for raising revenue, its passage required a 3/5 majority vote in each chamber. The major policy objectives of HB 3601 can be identified as:

- Raise additional revenue for education in the current biennium.
- Raise additional revenue for senior services in the current biennium.
- Establish a dedicated revenue source to fund mental health services.
- Restrain the growth of the senior medical deduction and re-allocate its benefits toward lower income households.
- Provide a more favorable tax rate schedule for pass through income of taxpayers who actively manage their businesses.
- Provide additional tax relief for low income working families.
- Expand incentives for Oregon businesses to export their products.

Table 1 contains revenue impact estimates for each of the major components of HB 3601 through the next five biennia. Table 2 breaks down the revenue impact by fund type.

Table 1. Projected Revenue Impact of HB 3601 Components, $M					
Component	**2013-15**	**2015-17**	**2017-19**	**2019-21**	**2021-23**
Apply 7.6% corporate tax rate to income above $1 million; raise rate trigger for allocation to Rainy Day Fund to 7.5%	$74	$74	$34	$36	$39
Disallow personal exemption credit for taxpayers with income above $200,000(J) and $100,000(S)	61	64	76	93	107
Reform and limit senior medical deduction	82	117	158	205	244
Recognize IC-DISC, allow subtraction for dividend payments	-5	-7	-8	-8	-9
Increase earned income tax credit from 6% to 8% of federal	-12	-25	-25	-13	0
Establish election for separate tax rate on eligible active schedule E income	-38	-205	-239	-277	-332
Increase cigarette tax by 13 cents (1-1-14), 14 cents (1-1-16), 15 cents (1-1-18)	27	32	31	29	28
Net Impact	189	50	28	65	77

Table 2. Projected Impact by Fund Type, $M					
Fund Type	**2013-15**	**2015-17**	**2017-19**	**2019-21**	**2021-23**
General Fund	+$168	+$20	-$4	+$36	+$49
Oregon Health Authority Fund (Other Fund)	+21	+30	+31	+29	+28
Rainy Day Fund	-33	-32	+11	+11	+12

Table 3 shows the combined distributional impact on the four primary personal income tax policy areas that were changed: the personal exemption credit, the earned income tax credit, the medical deduction, and the tax rates for non-passive income.[1] In general, these policies have an impact on different groups of taxpayers across the income distribution. For example, taxpayers with income of less than $40,000 will, in aggregate, experience a reduction in taxes. The policy drivers here are the expansion of the earned income tax credit and the change in the medical deduction to a subtraction. Because the deduction is limited to taxpayers who itemize their deductions while a subtraction may be claimed by all taxpayers, many low-income filers will now have the opportunity to offset some of their income with their medical expenses. Taxpayers at the high end of the distribution will also see a

[1] The effective dates for the various policy changes are staggered over time. Because 2015 is the first year in which they are all in effect, tax year impacts described in this report are based on tax year 2015.

reduction in their taxes, driven by the lower rate for certain business income of taxpayers who actively manage their own businesses. Taxpayers between these two groups – those with income between roughly $40,000 to $200,000 – will experience an increase in their taxes. The policies driving this change are the elimination of the personal exemption credit and the reductions in the amount of medical deductions.

Table 3. Personal Income Tax Changes*

Full-Year Filers, Tax Year 2015, $M

		Oregon Tax					Federal Tax ($M)	
		Prior	Current	Change				
Income Class	Returns	Law ($M)	Law ($M)	$M	Percent	Mean ($)	Base	Change
All Returns								
LESS THAN 10,000	230,088	$14	$11	-$2.3	-16.9%	-$10	-$72	$0.0
10,000 TO 20,000	244,812	$92	$85	-$6.9	-7.6%	-$28	-$137	$0.0
20,000 TO 30,000	208,885	$183	$179	-$4.7	-2.5%	-$22	$118	$0.3
30,000 TO 40,000	157,977	$229	$227	-$1.9	-0.8%	-$12	$346	$0.5
40,000 TO 50,000	133,796	$269	$272	$3.2	1.2%	$24	$471	-$0.7
50,000 TO 70,000	219,050	$619	$627	$7.8	1.3%	$36	$1,211	-$1.9
70,000 TO 100,000	241,481	$1,053	$1,062	$9.0	0.9%	$37	$2,125	-$1.8
100,000 TO 200,000	212,207	$1,721	$1,726	$5.1	0.3%	$24	$4,027	-$1.5
200,000 TO 500,000	46,667	$984	$985	$0.6	0.1%	$12	$2,941	-$2.3
500,000 AND OVER	9,173	$956	$920	-$36.0	-3.8%	-$3,928	$3,672	$2.3
TOTAL	1,704,136	$6,120	$6,094	-$26.2	-0.4%	-$15	$14,702	-$5.1
Single Returns								
LESS THAN 10,000	187,777	$14	$13	-$0.7	-5.1%	-$4	-$16	$0.0
10,000 TO 20,000	159,929	$86	$85	-$0.6	-0.8%	-$4	$77	$0.0
20,000 TO 30,000	115,278	$139	$139	-$0.4	-0.3%	-$4	$220	$0.0
30,000 TO 40,000	82,348	$149	$149	-$0.4	-0.3%	-$5	$273	$0.1
40,000 TO 50,000	67,340	$159	$160	$1.6	1.0%	$24	$311	-$0.3
50,000 TO 70,000	93,095	$294	$297	$3.4	1.1%	$36	$662	-$0.6
70,000 TO 100,000	57,392	$276	$278	$2.2	0.8%	$39	$724	-$0.3
100,000 TO 200,000	29,542	$250	$256	$6.5	2.6%	$220	$746	-$1.1
200,000 TO 500,000	4,821	$106	$105	-$1.5	-1.4%	-$314	$357	$0.1
500,000 AND OVER	1,097	$112	$108	-$4.3	-3.8%	-$3,883	$505	$0.1
TOTAL	798,619	$1,585	$1,591	$5.7	0.4%	$7	$3,859	-$2.0
Joint Returns								
LESS THAN 10,000	42,311	$0	-$2	-$1.6	801.8%	-$38	-$56	$0.0
10,000 TO 20,000	84,883	$6	$0	-$6.3	-105.4%	-$74	-$214	$0.0
20,000 TO 30,000	93,607	$44	$40	-$4.2	-9.6%	-$45	-$102	$0.3
30,000 TO 40,000	75,629	$79	$78	-$1.5	-1.9%	-$20	$73	$0.4
40,000 TO 50,000	66,456	$110	$112	$1.6	1.5%	$24	$160	-$0.5
50,000 TO 70,000	125,955	$325	$329	$4.4	1.4%	$35	$549	-$1.3
70,000 TO 100,000	184,089	$778	$784	$6.8	0.9%	$37	$1,402	-$1.5
100,000 TO 200,000	182,665	$1,472	$1,470	-$1.4	-0.1%	-$8	$3,281	-$0.3
200,000 TO 500,000	41,846	$878	$880	$2.1	0.2%	$50	$2,584	-$2.4
500,000 AND OVER	8,076	$844	$812	-$31.8	-3.8%	-$3,934	$3,167	$2.1
TOTAL	905,517	$4,535	$4,503	-$31.9	-0.7%	-$35	$10,843	-$3.1

* Includes the changes made to the tax rates on Schedule E non-passive income, the medical deduction, the personal exemption credit, and the earned income credit.

Schedule E Non-Passive Income

This provision of HB 3601 gives taxpayers the option of having certain income from partnerships, S-corporations, and LLCs (that file as either type of entity) taxed at lower marginal rates. The policy objective is to provide a more favorable rate structure for business income earned by taxpayers who actively manage their own businesses. To that end, the primary requirement is that the taxpayer must "materially participate" in the business so that the income is considered "non-passive" income. As per IRS regulations, "material participation" means that a taxpayer must meet at least one of the following seven criteria:

1. The taxpayer works at least 500 hours during the year in the activity.
2. The taxpayer does substantially all the work in the activity.
3. The taxpayer works more than 100 hours in the activity during the year and no one else works more than the taxpayer.
4. The activity is a Significant Participation Activity (SPA), and the sum of SPAs in which the taxpayer works 100-1,500 hours exceeds 500 hours for the year.
5. The taxpayer materially participated in the activity in any five of the prior ten years.
6. The activity is a personal service activity and the taxpayer materially participated in that activity in any three prior years.
7. Based on all of the facts and circumstances, the taxpayer participates in the activity on a regular, continuous, and substantial basis during such year. However, this test only applies if the taxpayer works at least 100 hours in the activity, no one else works more hours than the taxpayer in the activity, and no one else receives compensation for managing the activity.

Two additional requirements are that the business has at least one full-time, non-investor employee and at least 1,200 aggregate hours of work in Oregon are performed annually by qualifying employees. To meet this requirement, only hours worked in a week in which an employee worked at least 30 hours count toward the requirement.

Table 4. Non-Passive Income Tax Rates

Net Income ($)	Tax Rate
< $250,000	7.0%
$250,000 to $500,000	7.2%
$500,000 to $1 Million	7.6%
$1 Million to $2.5 Million	8.0%
$2.5 Million to $5 Million	9.0%
$5 Million or more	9.9%

The preferential rate structure is shown in Table 4. To take advantage of these rates, the taxpayer's total income is separated into two pots: net non-passive income from qualifying businesses and all other income. These tax rates apply to the net, non-passive income for the taxpayer. Personal deductions (i.e. Schedule A deductions) are not allowed against this income, but will continue to offset other income. The reason for this approach is that business deductions are taken against business income in arriving at the net business income. In a similar fashion, personal deductions are limited to other sources of income. Depending on the amount of other income and personal deductions, some taxpayers with eligible non-passive income may choose not to participate.

Due to the uncertainly of the estimates and the potential impact on the General Fund, the Legislature established a corrective mechanism in the law that could result in tax rate adjustments in 2019 and 2023. In brief, if the revenue loss exceeds a certain threshold, the tax rates would be adjusted upwards effective tax year 2019. A second adjustment, up or down, is possible effective tax year 2023. But in no case will the tax rates exceed 9.9 percent or fall below the rates shown in Table 4.

The exact calculations for this provision will be developed as we approach implementation, but Table 5 shows conceptually how the calculations will likely be made. One important aspect is that taxpayers will have the option each year of whether or not to participate. Because the program is optional, the first step is to calculate taxes without this provision. This is the “opt-out” approach in Table 5 in which the non-passive income rates are ignored and results in Gross Tax A. The second step is the “opt-in” calculation. The lower tax rates are applied to net, non-passive income to determine the gross tax on non-passive income (Gross Tax I). All other income is reduced by personal deductions and subject to the regular tax rates to determine the gross tax on all other income (Gross Tax II). These two gross tax amounts are added together to arrive at combined gross tax amount (Gross Tax B). If Gross Tax B is less than Gross Tax A, the taxpayer will participate in the program.

Table 5. Gross Tax Calculation
Opt-out approach -- Gross Tax A is calculated under traditional method: *(All Income - Deductions) x (Regular Rates) = Gross Tax A*
Opt-in approach -- Gross Tax B is calculated under the new law: *(Non-passive Income) x (New Rates) = Gross Tax I* *(All Other Income - Deductions) x (Regular Rates) = Gross Tax II* *(Gross Tax I) + (Gross Tax II) = Gross Tax B*
The taxpayer will choose the lesser of the two gross tax amounts: *Gross Tax = Lesser of "Gross Tax A" or "Gross Tax B"*

Table 6 shows the distributional impact for tax year 2015. Roughly 93 percent of the tax reduction is attributable to taxpayers with at least $100,000 of income. In percentage terms, taxpayers with an income of $500,000 or more are expected to have a tax reduction of 4.2 percent, in aggregate. The table also shows the interaction with federal taxes, which are increased by $7 million dollars, or 7.7 percent as a result of a lower state income tax deduction. Also, the majority of the impact is expected to occur for joint filers. Roughly 85 percent of the tax reduction, $78 million of the $91 million, is attributable to these taxpayers.

Table 6. Non-passive Income Full-Year Filers, Tax Year 2015, $M									
		Oregon Tax							
		Prior	Current	Change			Federal Tax ($M)	
Income Class	Returns	Law ($M)	Law ($M)	$M	Percent	Mean ($)	Base	Change
All Returns								
LESS THAN 10,000	230,088	$14	$14	$0.0	0.0%	$0	-$72	$0.0
10,000 TO 20,000	244,812	$92	$91	$0.0	0.0%	$0	-$137	$0.0
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40,000 TO 50,000	133,796	$269	$268	-$0.4	-0.2%	-$3	$471	$0.0
50,000 TO 70,000	219,050	$619	$617	-$1.4	-0.2%	-$7	$1,211	$0.1
70,000 TO 100,000	241,481	$1,053	$1,049	-$4.0	-0.4%	-$17	$2,125	$0.3
100,000 TO 200,000	212,207	$1,721	$1,706	-$15.9	-0.9%	-$75	$4,027	$1.5
200,000 TO 500,000	46,667	$984	$955	-$28.9	-2.9%	-$619	$2,941	$2.4
500,000 AND OVER	9,173	$956	$916	-$40.1	-4.2%	-$4,374	$3,672	$2.7
TOTAL	1,704,136	$6,120	$6,029	-$91.1	-1.5%	-$53	$14,702	$7.0
Single Returns								
LESS THAN 10,000	187,777	$14	$14	$0.0	0.0%	$0	-$16	$0.0
10,000 TO 20,000	159,929	$86	$86	$0.0	0.0%	$0	$77	$0.0
20,000 TO 30,000	115,278	$139	$139	-$0.1	-0.1%	-$1	$220	$0.0
30,000 TO 40,000	82,348	$149	$149	-$0.1	-0.1%	-$2	$273	$0.0
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200,000 TO 500,000	4,821	$106	$103	-$3.4	-3.2%	-$710	$357	$0.2
500,000 AND OVER	1,097	$112	$107	-$4.9	-4.3%	-$4,427	$505	$0.2
TOTAL	798,619	$1,585	$1,572	-$13.5	-0.8%	-$17	$3,859	$0.7
Joint Returns								
LESS THAN 10,000	42,311	$0	$0	$0.0	0.0%	$0	-$56	$0.0
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20,000 TO 30,000	93,607	$44	$44	$0.0	-0.1%	$0	-$102	$0.0
30,000 TO 40,000	75,629	$79	$79	-$0.1	-0.1%	-$1	$73	$0.0
40,000 TO 50,000	66,456	$110	$110	-$0.2	-0.2%	-$3	$160	$0.0
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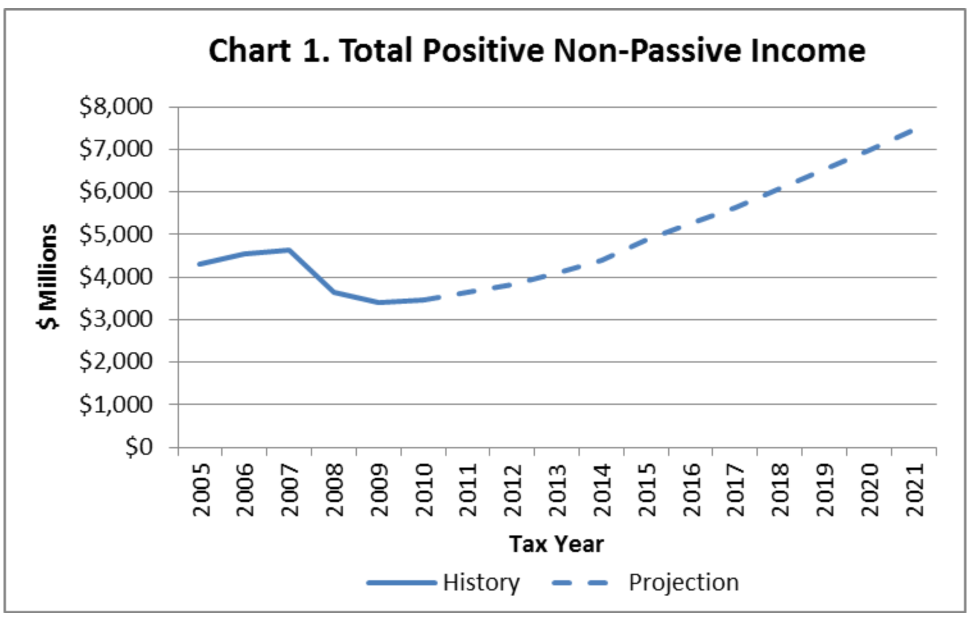
100,000 TO 200,000	182,665	$1,472	$1,458	-$13.1	-0.9%	-$72	$3,281	$1.3
200,000 TO 500,000	41,846	$878	$852	-$25.5	-2.9%	-$608	$2,584	$2.2
500,000 AND OVER	8,076	$844	$809	-$35.3	-4.2%	-$4,367	$3,167	$2.5
TOTAL	905,517	$4,535	$4,457	-$77.7	-1.7%	-$86	$10,843	$6.3

Table 7 shows the distributional impact across the amount of eligible income, as opposed to total taxpayer income. The current projection for 2015 includes 148,144 filers with net, non-passive income or loss; 101,191 of these filers (68 percent) have net positive income and could participate in the program. However, only 77,811 are projected to do so. The other 23,380 are expected to opt-out because participating would actually increase their taxes. For example, assume a taxpayer has net, non-passive income of $60,000, no other income, and $20,000 of itemized deductions. Under the opt-out approach their gross tax would be $3,152. Participation in the program results in gross tax of $4,200 ($60,000 x 7%). Because tax credits are applied equally, this taxpayer would presumably opt-out of the program for that year.

Table 7. Revenue Impact of Non-passive Income Tax Rates
Full-Year Filers, 2015, $M

Income Category	Business Income/Loss Returns	Business Income/Loss Amount	Participants Returns	Share	Income	Share	Tax Impact	Share	Average ($)
Loss	46,953	-$1,462.9							
$0 - $25k	61,402	$461.6	43,932	56.5%	$398.4	8.7%	-$6.1	7%	-$139
$25k-$50k	15,619	$558.6	12,747	16.4%	$502.3	10.9%	-$7.9	9%	-$620
$50k-$75k	7,934	$489.1	6,570	8.4%	$441.0	9.6%	-$7.2	8%	-$1,094
$75k-$100k	4,375	$377.9	3,709	4.8%	$345.1	7.5%	-$5.9	6%	-$1,589
$100k-$150k	4,898	$594.7	4,328	5.6%	$559.9	12.2%	-$10.7	12%	-$2,476
$150k-$200k	2,515	$434.4	2,286	2.9%	$415.9	9.0%	-$8.7	10%	-$3,815
$200k-$250k	1,460	$325.4	1,361	1.7%	$316.1	6.9%	-$7.2	8%	-$5,324
$250k-$500k	2,296	$771.8	2,203	2.8%	$763.6	16.6%	-$19.3	21%	-$8,751
$500k-$1M	435	$295.8	422	0.5%	$293.5	6.4%	-$7.5	8%	-$17,726
> $1M	257	$567.7	254	0.3%	$565.5	12.3%	-$10.6	12%	-$41,636
Subtotal	148,144	$3,414.1	77,811	100%	$4,601.4	100%	-$91.1	100%	-$1,171
Other Filers	1,555,992								
Total	1,704,136								

Chart 1 shows the recent history of non-passive income reported on Schedule E for Oregon full-year filers (2005 to 2010), and current projections through tax year 2021. One notable item from this chart is the impact the Great Recession had on this kind of income. It fell by nearly 22 percent in 2008 (from $4.6 billion to $3.6 billion) and another six percent in 2009 (down to $3.4 billion). Between 2011 and 2014, this income is projected to grow at an average rate of 6.1 percent. In 2015, it is projected to grow 11.1 percent and then average 7.4 percent from 2016 through 2021.

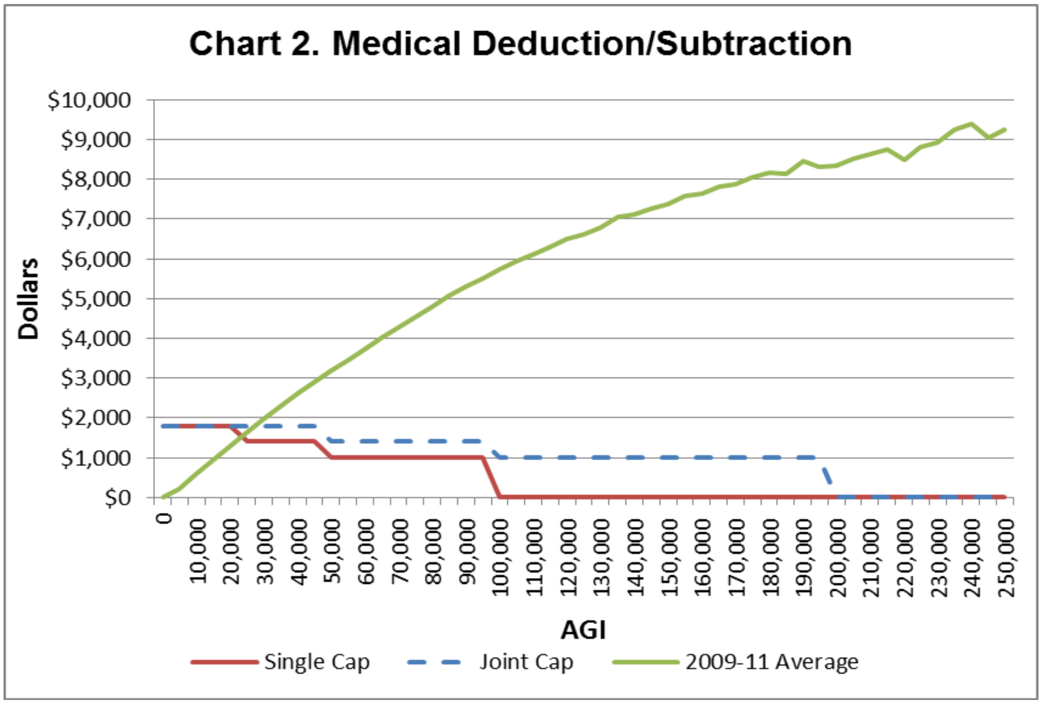


Additional Medical Deduction

The additional medical deduction was created in 1991 and allows taxpayers who are at least age 62 to deduct medical expenses in an amount up to 7.5 percent of their income. In combination with the medical expense deduction allowed in federal law, eligible taxpayers who itemize their deductions have been allowed to deduct all of their medical expenses.[2] Under the new law, the itemized deduction has been converted to a subtraction so that it will be available to all eligible taxpayers, whether they use the standard deduction or itemize their deductions. The policy objective of this change is to contain the growth of a tax expenditure that had been growing faster than the General Fund since the 2001-03 biennium. This trend was expected to continue through at least the 2019-21 biennium.

By itself, expanding its availability would increase the cost of the incentive. However, there are two other changes that reduce costs. First, the eligibility age is increased in one year increments from 62 to 66 by tax year 2020. Second, a three-tiered cap has been created. For joint filers, the subtraction is capped at $1,800 for filers with annual income less than $50,000; $1,400 for filers with income between $50,000 and $100,000; and $1,000 for filers with income between $100,000 and $200,000. No subtraction is allowed for joint filers with income exceeding $200,000. The same caps apply to single filers but the income thresholds are half the amount as those for the joint filers. Chart 2 provides a graphical view of how the phase-out works. For comparison purposes, the average deduction taken in tax years 2009 through 2011 is also provided. During that time period, the average deduction increased with income and reached just over $9,000 for filers with income greater than roughly $235,000.

[2] With the implementation of the Affordable Care Act, the federal threshold for deducting medical expenses was increased from 7.5 percent of AGI to 10 percent of AGI beginning with tax year 2013. If either the taxpayer or spouse is age 65 or older, the 10% threshold is not effective until tax year 2017.



Three examples of how this provision works are included in Table 8. In the first example, taxpayer Single A has $24,000 of income and medical expenses of $2,000. This person is not eligible to itemize their federal or state deductions. Consequently, they are unable to claim any deduction for medical expenses. Under the new law, however, the medical deduction has been changed to a subtraction, so they no longer have to itemize their deductions to claim it. Due to the cap, they cannot claim the full $2,000, but they can reduce their taxable income by $1,800. This subtraction leads to a tax reduction of $162. The second taxpayer, Joint B, who has experienced significant medical expenses, is unaffected by the law. Existing federal deductions – to which the state remains tied – eliminate all taxable income. The third taxpayer, Joint C, loses their deduction and is unable to claim a subtraction because their income of $500,000 is greater than the $200,000 eligibility threshold.

Table 8. Medical Deduction/Subtraction Examples

	Single A		Joint B		Joint C	
	Pre-HB 3601	Current Law	Pre-HB 3601	Current Law	Pre-HB 3601	Current Law
AGI	$24,000	$24,000	$60,000	$60,000	$500,000	$500,000
Medical expenses	$2,000	$2,000	$100,000	$100,000	$15,000	$15,000
Federal Taxes						
Non-medical deductions	$6,300	$6,300	$18,737	$18,737	$78,683	$78,683
Medical deduction	$0	$0	$94,000	$94,000	$0	$0
Taxable income	$13,700	$13,700	$0	$0	$421,317	$421,317
Oregon Taxes						
Itm/Std Deduction	$2,145	$2,145	$112,737	$112,737	$78,683	$78,683
OR medical deduction	$0	$1,800	$4,500	$1,400	$15,000	$0
Taxable income	$20,485	$18,685	$0	$0	$435,787	$450,787
Tax	$1,415	$1,253	$0	$0	$40,423	$41,908
Tax difference		-$162		$0		$1,485

Chart 3 shows the historical cost of the deduction (the solid line) and the projected cost of the subtraction (the dashed line). Under prior law, the program costs were projected to increase over the next ten years due to increases in the number of eligible taxpayers, health care costs, and inflation. The new program is expected to largely stabilize the costs of the program, mainly due to the subtraction limits. Growth during this time period is further limited by the increases in the eligibility age.

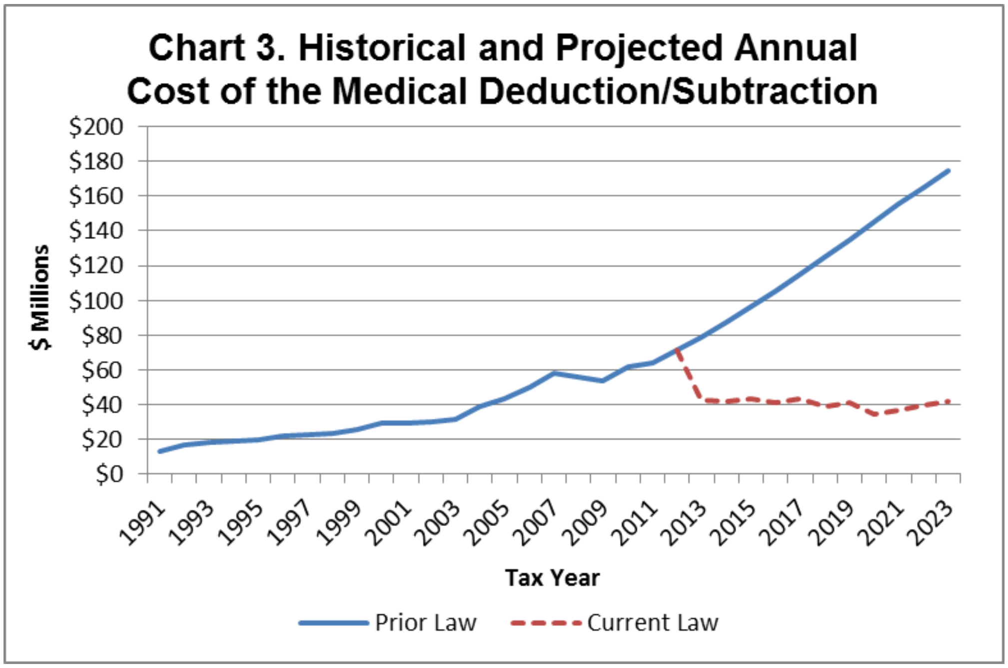


Table 9 shows the distributional impact of the changes to the additional medical deduction/subtraction for tax year 2015. The lower income groups experience a reduction in tax liability. Few filers in these income groups itemize their deductions so the net impact is dominated by the new subtraction, which is a revenue loss. The maximum tax reduction is $162 ($1,800 x 9%). For all income groups above roughly $40,000, the net impact to the General Fund is a revenue gain because the aggregate revenue loss from the subtraction is less than the aggregate revenue gain from the elimination of the deduction.

Table 9. Medical Deduction/Subtraction
Full-Year Filers, Tax Year 2015, $M

		Oregon Tax					Federal Tax ($M)	
		Prior	Current	Change				
Income Class	Returns	Law ($M)	Law ($M)	$M	Percent	Mean ($)	Base	Change
All Returns								
LESS THAN 10,000	230,088	$14	$14	$0.0	-0.1%	$0	-$72	$0.0
10,000 TO 20,000	244,812	$92	$91	-$0.4	-0.4%	-$2	-$137	$0.0
20,000 TO 30,000	208,885	$183	$183	-$0.8	-0.4%	-$4	$118	$0.3
30,000 TO 40,000	157,977	$229	$228	-$1.1	-0.5%	-$7	$346	$0.4
40,000 TO 50,000	133,796	$269	$272	$3.7	1.4%	$27	$471	-$0.7
50,000 TO 70,000	219,050	$619	$628	$9.2	1.5%	$42	$1,211	-$2.0
70,000 TO 100,000	241,481	$1,053	$1,066	$13.0	1.2%	$54	$2,125	-$2.1
100,000 TO 200,000	212,207	$1,721	$1,737	$15.3	0.9%	$72	$4,027	-$1.9
200,000 TO 500,000	46,667	$984	$994	$9.3	0.9%	$200	$2,941	-$0.7
500,000 AND OVER	9,173	$956	$958	$2.4	0.3%	$262	$3,672	-$0.2
TOTAL	1,704,136	$6,120	$6,170	$50.6	0.8%	$30	$14,702	-$6.8
Single Returns								
LESS THAN 10,000	187,777	$14	$14	$0.0	-0.1%	$0	-$16	$0.0
10,000 TO 20,000	159,929	$86	$85	-$0.2	-0.2%	-$1	$77	$0.0
20,000 TO 30,000	115,278	$139	$139	-$0.2	-0.2%	-$2	$220	$0.0
30,000 TO 40,000	82,348	$149	$149	-$0.3	-0.2%	-$3	$273	$0.1
40,000 TO 50,000	67,340	$159	$161	$1.8	1.2%	$27	$311	-$0.3
50,000 TO 70,000	93,095	$294	$298	$4.0	1.4%	$43	$662	-$0.6
70,000 TO 100,000	57,392	$276	$279	$3.4	1.2%	$60	$724	-$0.4
100,000 TO 200,000	29,542	$250	$254	$3.6	1.5%	$123	$746	-$0.3
200,000 TO 500,000	4,821	$106	$108	$1.3	1.2%	$275	$357	$0.0
500,000 AND OVER	1,097	$112	$112	$0.5	0.5%	$476	$505	-$0.1
TOTAL	798,619	$1,585	$1,599	$14.1	0.9%	$18	$3,859	-$1.6
Joint Returns								
LESS THAN 10,000	42,311	$0	$0	$0.0	4.3%	$0	-$56	$0.0
10,000 TO 20,000	84,883	$6	$6	-$0.2	-3.9%	-$3	-$214	$0.0
20,000 TO 30,000	93,607	$44	$44	-$0.5	-1.2%	-$6	-$102	$0.2
30,000 TO 40,000	75,629	$79	$78	-$0.8	-1.0%	-$11	$73	$0.4
40,000 TO 50,000	66,456	$110	$112	$1.8	1.7%	$28	$160	-$0.5
50,000 TO 70,000	125,955	$325	$330	$5.2	1.6%	$41	$549	-$1.3
70,000 TO 100,000	184,089	$778	$787	$9.6	1.2%	$52	$1,402	-$1.7
100,000 TO 200,000	182,665	$1,472	$1,483	$11.6	0.8%	$64	$3,281	-$1.7
200,000 TO 500,000	41,846	$878	$886	$8.0	0.9%	$191	$2,584	-$0.6
500,000 AND OVER	8,076	$844	$846	$1.9	0.2%	$233	$3,167	-$0.1
TOTAL	905,517	$4,535	$4,571	$36.5	0.8%	$40	$10,843	-$5.3

Personal Exemption Credit

In general, personal income tax filers receive a personal exemption credit for each taxpayer and dependent identified on the tax return. The only individuals excluded from this policy are those who may be claimed as a dependent on another taxpayer’s return. An additional personal exemption credit is allowed for each taxpayer with a severe disability (such as the loss of use of one or both legs, the loss of use of both hands, or permanent blindness) and each dependent with a handicap (such as autism, visual impairment, or hearing impairment). The exemption credits allowed for a disability account for roughly one percent of the credits claimed. With the passage of HB 3601, personal exemption credits are limited to single filers with income of less than $100,000 and joint filers with income of less than $200,000. The objective of this policy is to raise revenue to meet the spending goals previously described.

The amount of each exemption credit is indexed to inflation and has grown from $139 in 2000 to $188 in 2013; it is currently projected to be $194 in 2015. Since 2007, the amount of the tax credit has been phased-down for higher income filers to 33 percent of the full credit amount. For example, the 2015 full credit amount of $194 would have been phased-down to $64. Chart 4 shows the prior law with the phase-down, and the new law with the threshold, for a single filer exemption credit in 2015.[3] The area between the solid line (prior law) and the dashed line (new law) represents the reduction in tax credits allowed. For example, a taxpayer with income of $150,000 will lose a credit worth $194 while a taxpayer with income of $300,000 will lose a credit worth $64.

Chart 4. Single Filer 2015 Personal Exemption Credit

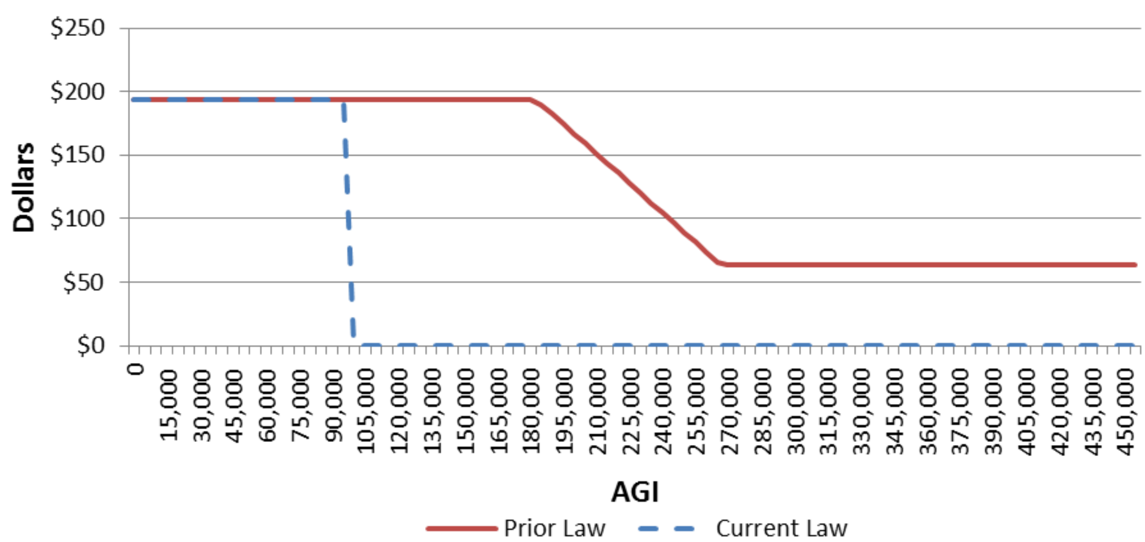


Table 10 shows the distributional impact for tax year 2015. The single filers most affected by the policy are those with incomes between $100,000 and $200,000. Their taxes increase collectively by 2.3 percent or $191 on average. For joint filers, the most affected taxpayers are those with income between $200,000 and $500,000. Their taxes increase by 2.2 percent, or $467 on average. Due to the cross-deductibility of income taxes between the state and federal tax systems, the increase in Oregon taxes is partially offset by reductions in federal taxes. In total, federal income taxes are expected to decline by roughly $5.3 million, which is 19.3 percent of the state increase.

[3] The phase-down for joint filers would have begun at roughly $276,000.

Table 10. Personal Exemption Credit
Full-Year Filers, Tax Year 2015, $M

		Oregon Tax					Federal Tax ($M)	
		Prior	Current	Change				
Income Class	Returns	Law ($M)	Law ($M)	$M	Percent	Mean ($)	Base	Change
All Returns								
LESS THAN 100,000	1,436,089	$2,458	$2,458	$0.0	0.0%	$0	$4,062	$0.0
100,000 TO 200,000	212,207	$1,721	$1,727	$5.7	0.3%	$27	$4,027	-$1.1
200,000 TO 500,000	46,667	$984	$1,004	$20.1	2.0%	$431	$2,941	-$4.0
500,000 AND OVER	9,173	$956	$957	$1.7	0.2%	$184	$3,672	-$0.2
TOTAL	1,704,136	$6,120	$6,147	$27.5	0.4%	$16	$14,702	-$5.3
Single Returns								
LESS THAN 100,000	763,158	$1,117	$1,117	$0.0	0.0%	$0	$2,251	$0.0
100,000 TO 200,000	29,542	$250	$256	$5.7	2.3%	$191	$746	-$1.1
200,000 TO 500,000	4,821	$106	$107	$0.6	0.5%	$121	$357	-$0.1
500,000 AND OVER	1,097	$112	$112	$0.1	0.1%	$68	$505	$0.0
TOTAL	798,619	$1,585	$1,591	$6.3	0.4%	$8	$3,859	-$1.1
Joint Returns								
LESS THAN 100,000	672,931	$1,342	$1,342	$0.0	0.0%	$0	$1,811	$0.0
100,000 TO 200,000	182,665	$1,472	$1,472	$0.0	0.0%	$0	$3,281	$0.0
200,000 TO 500,000	41,846	$878	$897	$19.5	2.2%	$467	$2,584	-$4.0
500,000 AND OVER	8,076	$844	$845	$1.6	0.2%	$200	$3,167	-$0.2
TOTAL	905,517	$4,535	$4,556	$21.2	0.5%	$23	$10,843	-$4.2

Earned Income Tax Credit

The 1997 Legislature created this credit, which at the time was five percent of the federal earned income tax credit and was nonrefundable. The credit became refundable in 2006 and was increased to six percent in 2008. With the enactment of HB 3601, the credit is increased to eight percent of the federal tax credit. The 2013 Legislature attempted to expand this credit with the policy objective of increasing financial assistance to low-income taxpayers, but was unable to do so due to a lack of funding. Table 11 shows the distributional impact for tax year 2015. Because the credit is phased-out as income increases, all of the impact falls on taxpayers with less than $40,000 of income. About half of the tax reduction – $6.5 million – is concentrated on taxpayers with income between $10,000 and $20,000.

Table 11. Earned Income Credit Full-Year Filers, Tax Year 2015, $M									
		Oregon Tax							
		Prior	Current	Change				Federal Tax ($M)	
Income Class	Returns	Law ($M)	Law ($M)	$M	Percent	Mean ($)		Base	Change
All Returns									
LESS THAN 10,000	230,088	$14	$11	-$2.3	-16.7%	-$10		-$72	$0.0
10,000 TO 20,000	244,812	$92	$85	-$6.5	-7.1%	-$27		-$137	$0.0
20,000 TO 30,000	208,885	$183	$180	-$3.7	-2.0%	-$18		$118	$0.0
30,000 TO 40,000	157,977	$229	$228	-$0.6	-0.3%	-$4		$346	$0.0
40,000 AND OVER	862,375	$5,602	$5,602	$0.0	0.0%	$0		$14,448	$0.0
TOTAL	1,704,136	$6,120	$6,107	-$13.1	-0.2%	-$8		$14,702	$0.0
Single Returns									
LESS THAN 10,000	187,777	$14	$13	-$0.7	-5.0%	-$4		-$16	$0.0
10,000 TO 20,000	159,929	$86	$85	-$0.5	-0.5%	-$3		$77	$0.0
20,000 TO 30,000	115,278	$139	$139	-$0.1	-0.1%	-$1		$220	$0.0
30,000 TO 40,000	82,348	$149	$149	$0.0	0.0%	$0		$273	$0.0
40,000 AND OVER	253,288	$1,197	$1,197	$0.0	0.0%	$0		$3,305	$0.0
TOTAL	798,619	$1,585	$1,584	-$1.3	-0.1%	-$2		$3,859	$0.0
Joint Returns									
LESS THAN 10,000	42,311	$0	-$2	-$1.6	797.5%	-$38		-$56	$0.0
10,000 TO 20,000	84,883	$6	$0	-$6.1	-101.5%	-$71		-$214	$0.0
20,000 TO 30,000	93,607	$44	$41	-$3.7	-8.3%	-$39		-$102	$0.0
30,000 TO 40,000	75,629	$79	$79	-$0.6	-0.7%	-$8		$73	$0.0
40,000 AND OVER	609,087	$4,406	$4,406	$0.0	0.0%	$0		$11,143	$0.0
TOTAL	905,517	$4,535	$4,523	-$11.9	-0.3%	-$13		$10,843	$0.0

Corporate Tax Brackets

Oregon currently has two marginal corporate tax rates, 6.6 percent and 7.6 percent. For tax years 2011 and 2012, the 7.6 percent tax rate applied to taxable income above $250,000. Beginning with tax year 2013 that threshold was scheduled to increase to $10 million. With the enactment of this bill, the 7.6 percent bracket now begins at $1 million. The objective of this policy is to raise revenue to meet the spending goals previously described. Table 12 shows the recent history of the corporation tax brackets.

<table>
<tr><th colspan="6">Table 12. Corporation Tax Rates and Brackets</th></tr>
<tr><th rowspan="2">Taxable Income</th><th rowspan="2">Tax Years Prior to 2009</th><th rowspan="2">Tax Years 2009-10</th><th rowspan="2">Tax Years 2011-12</th><th colspan="2">Tax Years 2013+</th></tr>
<tr><th>Pre-HB 3601</th><th>Current Law</th></tr>
<tr><td>< $250,000</td><td rowspan="4">6.6%</td><td>6.6%</td><td>6.6%</td><td rowspan="3">6.6%</td><td rowspan="2">6.6%</td></tr>
<tr><td>$250,000 - $1 million</td><td rowspan="3">7.9%</td><td rowspan="3">7.6%</td></tr>
<tr><td>$1 million - $10 million</td><td rowspan="2">7.6%</td></tr>
<tr><td>> $10 million</td><td>7.6%</td></tr>
</table>

Current law also states that tax collections due to any tax rate exceeding 6.6 percent be directed to the Rainy Day Fund (RDF) beginning with tax year 2013. As per the September 2013 Revenue Forecast, roughly $43 million was to be deposited into the RDF in 2013-15. This bill modified that policy such that, for tax years 2013 through 2016, collections due to tax rates exceeding 7.5 percent would be directed to the RDF. Beginning with tax year 2017, that percentage is reduced to 7.2 percent. The net effect of this policy change is that approximately $10 million will be contributed to the RDF in the 2013-15 and 2015-17 biennia. In the subsequent three biennia (2017-19, 2019-21, and 2021-23), approximately $54, $57, and $61 million will be contributed to the Rainy Day Fund.

Table 13 shows the impact of the change in the 7.6 percent tax rate bracket across industrial sectors. Overall, roughly 2.4 percent of all C-corporations are expected to face higher taxes because of the policy change. The Management of Companies, Manufacturing, and Finance & Insurance sectors are expected to have the largest share of affected companies, with roughly five percent. In terms of total dollar impact, Finance & Insurance, Wholesale Trade, Manufacturing, and Retail Trade account for $13.1 million of the $18.9 million estimated impact for 2015 (roughly 69 percent).

Table 13. Corporate Tax Bracket Impact by Industrial Sector
Tax Year 2015

Industry Sector	Returns				
	Total	Affected	% Affected	Amount ($M)	Average
Agriculture, Forestry, Fishing, and Hunting	1,533	9	0.6%	$0.2	$23,562
Mining	95	2	2.0%	$0.1	$38,384
Utilities	67	3	4.3%	$0.1	$49,190
Construction	2,837	15	0.5%	$0.4	$26,991
Manufacturing	2,308	114	4.9%	$2.6	$22,502
Wholesale Trade	3,557	155	4.4%	$3.9	$24,953
Retail Trade	2,138	76	3.6%	$2.5	$32,183
Transportation and Warehousing	844	22	2.6%	$0.5	$23,783
Information	1,034	25	2.4%	$1.1	$43,788
Finance and Insurance	3,007	148	4.9%	$4.1	$27,297
Real Estate, Rental, and Leasing	1,857	8	0.4%	$0.2	$23,983
Professional, Scientific, and Technical Services	3,747	34	0.9%	$0.4	$13,155
Management of Companies and Enterprises	1,222	63	5.1%	$1.4	$22,903
Administrative, Support, and Waste Management	1,163	13	1.2%	$0.4	$33,284
Education Services	227	7	3.0%	$0.1	$16,014
Health Care and Social Assistance	1,642	9	0.5%	$0.2	$22,726
Arts, Entertainment, and Recreation	387	3	0.7%	$0.0	$7,623
Accommodation and Food Services	833	10	1.2%	$0.2	$21,115
Other Services (except Public Administration)	1,689	17	1.0%	$0.5	$26,381
Total	30,187	733	2.4%	$18.9	$25,796

IC-DISC

Under current federal law, an Interest Charge Domestic International Sales (IC-DISC) corporation benefits from preferential tax treatment. In its simplest form, an export-oriented business (i.e. the taxpayer) creates an IC-DISC. The taxpayer then makes commission payments to the IC-DISC in an amount driven by the amount of their export sales. The income to the IC-DISC is returned to the business owners (i.e. taxpayers) as dividends. The chart below shows this flow of funds. In most cases, the amount of commission payments is exactly equal to the amount of dividend payments. This structure results in a number of tax benefits at the federal level. First, the IC-DISC is not subject to federal corporate income tax. Second, the commission payments are deductible for the taxpayer/owner. Third, the dividends received are subject to the lower capital gains tax rates.

Prior to the enactment of HB 3601, these tax benefits did not flow through to Oregon because IC-DISCs and their associated transactions with the taxpayers/owners were disregarded. Now, with the policies adopted during the 2013 Special Session, Oregon offers preferential tax treatment that mirrors the federal level. First, the deduction for commission payments made to the IC-DISC will be allowed. Second, in lieu of a preferential tax rate on dividend payments made to the owners, the IC-DISCs will be subject to a 2.5 tax rate on their income and the owners will be allowed a subtraction for the dividend payments they receive. The objective of this policy is to encourage exports from Oregon businesses.

Cigarette Tax Rates

The cigarette tax rate is increased by 13 cents beginning on January 1, 2014 from $1.18 to $1.31 per pack. It is then increased to $1.32 on January 1, 2016 and then to $1.33 on January 1, 2018. The goal of this policy change is to provide a continuing source of funding for mental health services. To that end, ten cents of the 13 cent increase beginning in 2014 is dedicated to Mental Health Services; the remaining increase is directed to the General Fund. This dedication occurs for both 2014 and 2015. Beginning with 2016, the total increase is dedicated to Mental Health Services.

Table 14. State Cigarette Tax Rates, Per Pack*

Rank	State	Tax	Rank	State	Tax	Rank	State	Tax
1	New York	$4.35	18	Utah	$1.70	35	Nevada	$0.80
2	Rhode Island	$3.50	19	New Hampshire	$1.68	36	Kansas	$0.79
3	Connecticut	$3.40	20	New Mexico	$1.66	37	Mississippi	$0.68
4	Hawaii	$3.20	21	Delaware	$1.60	38	Nebraska	$0.64
5	Washington	$3.03	22	Pennsylvania	$1.60	39	Tennessee	$0.62
6	New Jersey	$2.70	23	South Dakota	$1.53	40	Kentucky	$0.60
7	Vermont	$2.62	24	Texas	$1.41	41	Wyoming	$0.60
8	Wisconsin	$2.52	25	Iowa	$1.36	42	Idaho	$0.57
9	Massachusetts	$2.51	26	Florida	$1.34	43	South Carolina	$0.57
10	Washington, D.C.	$2.50	**27**	**Oregon**	**$1.33**	44	West Virginia	$0.55
11	Alaska	$2.00	28	Ohio	$1.25	45	North Carolina	$0.45
12	Arizona	$2.00	29	Minnesota	$1.23	46	North Dakota	$0.44
13	Maine	$2.00	30	Arkansas	$1.15	47	Alabama	$0.43
14	Maryland	$2.00	31	Oklahoma	$1.03	48	Georgia	$0.37
15	Michigan	$2.00	32	Indiana	$1.00	49	Louisiana	$0.36
16	Illinois	$1.98	33	California	$0.87	50	Virginia	$0.30
17	Montana	$1.70	34	Colorado	$0.84	51	Missouri	$0.17

* Excludes sales taxes and local taxes.