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The Use of Reduced Income Tax Rates for Non-Passive Income

Oregon law (ORS 316.044) requires that if the use of the reduced income tax rates for certain business income during tax years 2015 and 2016 significantly exceeded their initial estimated use, the tax rates would need to be increased - thereby reducing the tax benefit - beginning with tax year 2019. For tax years 2015/2016 the estimated state revenue loss as a share of state total income was .088%; the actual revenue loss was .070% of total income. Consequently, no tax rate adjustment is currently required. The rest of this report provides background and additional detail on the analysis leading to this conclusion.

In the 2013 Special Session, the Legislative Assembly passed HB 3601, making several changes to Oregon tax law. One of these policies was the creation of a reduced tax rate structure for certain income from pass-through entities. For qualifying business owners who chose to participate in the program, up to $250,000 of their non-passive income could be taxed at 7%. The marginal tax rate then increases as qualified income approaches $5 million. Income above that amount is taxed at the standard 9.9% rate. The table below shows the reduced tax rates, as listed in ORS 316.043(2).

Non-Passive Income Tax Rates	
Net Income ($)	Tax Rate
Up to $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%
Above $5 Million	9.9%

Included in the law is the requirement that the Legislative Revenue Officer report the actual impact of this program compared to the estimates made for the 2013 Special Session. If the actual use of the policy is significantly different from the estimated use, then the statutory tax rates are to be proportionately modified. This report is the first of two required reports. The first report is due by July 1, 2018, based on tax years 2015 and 2016. The second report is due by July 1, 2022, based on tax years 2019 and 2020.

The key metric required to compare the estimated and actual use of the policy is the revenue loss divided by total income (as reported on tax returns) for each two-year period: 2015/2016 and then

2019/2020. For 2015/2016, if the ratio for actual use exceeds the ratio for estimated use by more than 15 percent, the tax rates in 316.043(2) are proportionately increased to achieve a ratio of roughly 105 percent of the estimated ratio, but in no event are they adjusted above 9.9%. Any change would be effective with tax year 2019.

For 2019/2020, the reduced rates may be adjusted upward or downward. If the actual ratio is more than 25 percent greater than the estimated ratio, then the tax rates are proportionately increased such that the ratio is approximately 115 percent of the estimated ratio. If the actual ratio is less than 75 percent of the estimated ratio, then the tax rates are proportionately reduced such that the ratio is approximately 85 percent of the estimated ratio. In no event are the rates adjusted above 9.9% or below the original rates provided in ORS 316.043(2). Any change would be effective with tax year 2023.

The two tables below contain the ratio calculations based on the original estimates and the actual impacts calculated from tax returns, for tax years 2015 and 2016. The table on the left contains the estimates from the 2013 Special Session. The estimated revenue losses for tax years 2015 and 2016 were $95.6 million and $103.3 million; the two-year combined total estimated revenue loss was $198.9 million. The estimated total income for the two years was $225,665 million. The resulting ratio is 0.088%. Statute requires the tax rates to be adjusted if the actual ratio is at least .101% (.088% times 1.15).

Estimated Impact, $M

Tax Year	Revenue Loss	Total Income	Ratio
2015	$95.6	$110,264	
2016	$103.3	$115,401	
Total	$198.9	$225,665	0.088%

Actual Impact, $M

Tax Year	Revenue Loss	Total Income	Ratio
2015	$70.0	$121,134	
2016	$103.3	$127,887	
Total	$173.3	$249,021	0.070%

The table on the right contains the actual impacts from the Department of Revenue using tax returns for tax years 2015 and 2016 (as reported in May 2018). The actual two-year revenue loss was $173.3 million and total income was $249,021 million, resulting in a ratio of 0.070%. Because the actual ratio from tax return data is less than the ratio based on estimated data, statute does not currently require any change in the reduced tax rates identified in ORS 316.043(2).