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Decoding the Tax Cuts and Jobs Act – Part X: Oregon Disconnects from IRC Section 199A

By Larry Brant and Steven Nofziger on 4.26.18 | Posted in Legislation, Tax Cuts and Jobs Act, Tax Laws, Tax Planning, Tax Procedure, Tax Reform

As we have been discussing these past several weeks, the Tax Cuts and Jobs Act ("TCJA") drastically changed the Federal income tax landscape. The TCJA also triggered a sea of change in the income tax laws of states like Oregon that partially base their own income tax regimes on the Federal tax regime. When the Federal tax laws change, some changes are automatically adopted by the states, while other changes may require local legislative action. In either case, state legislatures must decide which parts of the Federal law to adopt (in whole or part) and which parts to reject, all while keeping an eye on their fiscal purse.

Oregon's legislature faces that same task. Generally, Oregon's income tax laws are a bit of a hybrid. Subject to certain adjustments, Oregon's definition of "taxable income" is continually tied to the Federal definition of taxable income (in a manner called the "rolling reconnect"). Other ties to Federal tax law must be updated, with December 31 being the typical connection date.

Earlier this month, Governor Kate Brown stated that "[t]he passage of federal tax reform in December 2017 created a situation that Oregonians didn't ask for." Oregon lawmakers recently made some headway, responding to one of the biggest impacts of the TCJA—the new 20 percent deduction for "qualified business income" under Internal Revenue Code ("IRC") Section 199A. This blog post will briefly examine Oregon's legislative response to IRC Section 199A under newly enacted SB 1528.

IRC 199A BACKGROUND; SB 1528

As discussed in our January 2018 blog post, IRC Section 199A allows owners of certain pass-through entities a 20 percent deduction on "qualified business income" ("QBI"). SB 1528 is a relatively short proposal coming out of the Oregon Senate. Much of it addresses a new tax credit. The portion of the bill addressing IRC Section 199A is tucked away in Section 10 at the very end of the bill. It simply states: "There shall be added to federal taxable income for Oregon tax purposes the amount allowable as a deduction under Section 199A(a) of the Internal Revenue Code for the tax year." SB 1528 was signed into law on April 13 and is effective June 2. It applies to tax years beginning on or after January 1, 2018.

The effect of this provision is to affirmatively disconnect Oregon's income tax system from the Federal definition of "taxable income" with respect to any deduction allowable under IRC Section 199A. In other words, affected taxpayers must, for Oregon purposes, add back the amount of the QBI deduction, such that 100 percent of QBI is subject to Oregon income tax.

Oregon's Legislative Revenue Office estimates that disconnecting from IRC Section 199A will yield about $250 million in state tax revenue in the 2017-19 biennium and over $1 billion over the next six years.

IMPLICATIONS OF DISCONNECTING FROM IRC SECTION 199A

Oregon's disconnect from IRC Section 199A raises several practical questions. First, how does a taxpayer who has claimed an IRC Section 199A deduction compute his or her Oregon taxable income? Does the taxpayer merely add-back the deduction amount to taxable income or does the taxpayer have to make additional adjustments to arrive at Oregon taxable income? Logically, the prior should be the case. We suspect that the Department of Revenue will soon release guidance on the issue.

Second, there has been lots of shop talk about whether SB 1528 impacts the Accumulated Adjustments Account (AAA) of S corporations. Currently, S Corporations must track AAA in order to compute the amount of undistributed, previously-taxed S corporation income. Will S corporations need to maintain two AAA accounts — one that takes the 20 percent deduction into account, and one for Oregon (and other states that disconnect from IRC Section 199A) that does not? While we have heard some debate over this issue from practitioners, we believe the answer is clearly no. AAA is a corporate-level item and the IRC Section 199A deduction is taken into account at the shareholder level. However, it is possible that there are other tax nuances of S corporations that may be impacted by Oregon's disconnect with IRC Section 199A which we are overlooking. In time, we will likely find these issues if they exist.

What happens for pass-through entities that do business in multiple states and are required to apportion income to some states that conform to IRC Section 199A and some, like Oregon, that do not? For example, assume an S corporation apportions 80 percent of its income to Oregon and 20 percent to State B, which allows pass-through entities to take the IRC Section 199A deduction. Can a shareholder who is a resident of State B take the IRC Section 199A deduction with respect to income apportioned to State B? Most likely yes. Although SB 1528 provides no guidance on this issue, it appears likely that shareholders should be able to claim the deduction with respect to income apportioned to State B under existing apportionment principles. This issue will almost certainly complicate the tax returns of owners of pass-through entities doing business in multiple states.

Meanwhile, state revenue auditors may start scrutinizing taxpayers' apportionment positions more closely. In the forgoing example, the S corporation shareholder would benefit from having more income apportioned to State B, his or her state of residency, to take advantage of that state's conformity to the Federal IRC Section 199A deduction. Given the potential tax benefits, some owners of closely-held pass-through entities may be inclined to take aggressive apportionment positions. Given the potential loss of tax revenue, it is likely that Oregon (and other states that disconnect from IRC Section 199A) will increase audit activity surrounding income apportionment to try to catch taxpayers who, without business justification, apportion an excessive amount of their income to states that permit the deduction. Because of the potential for increased audits, pass-through entities should carefully document and maintain evidence to support their apportionment positions. It will be interesting to see how state revenue agencies approach this issue.

CONCLUSION

There are many provisions of the TCJA that will likely **not** be picked-up by all of the states. IRC Section 199A is likely not an anomaly. We suspect many of the new provisions created by the TCJA, including the provisions dealing with deductibility of alimony, 100 percent expensing of tangible personal property, bonus depreciation, and/or deductibility of interest, may not be incorporated into the tax regimes of all states. This is especially true in states facing the most significant budget constraints. This is not a new phenomenon – some of the provisions of many prior tax acts were not picked up by all of the states. The number of provisions of the TCJA that will likely not be picked up by the states, however, may be greater than we have ever seen. The result is simple. State tax planning will be more complicated than was historically the case. So much for tax simplification!

Stay tuned for additional guidance on this topic and further blog posts on the TCJA!

Tags: Accumulated Adjustments Account (AAA), Decoding the Tax Cuts and Jobs Act, Governor Kate Brown, income tax, Internal Revenue Code, Internal Revenue Service, IRC § 199A, IRS, Oregon, pass-through entity, S Corporations, SB 1528, State and Local Tax, taxable income