OCPP OREGON CENTER for PUBLIC POLICY

Because facts matter.

Executive Summary

November 15, 2018

** Updated on December 10, 2018*

Oregon Can Raise $376 Million by Clamping Down on Offshore Corporate Tax Avoidance

By Daniel Hauser

Oregon can clamp down on multinational corporations shifting profits overseas, create a more level playing field for Oregon businesses, and raise millions in revenue by enacting “complete reporting” by large corporations. That law would make it difficult for multinational corporations to avoid Oregon corporate income taxes by artificially shifting profits earned in Oregon to subsidiaries located abroad.

- Over the past four decades, the Oregon corporate income tax has declined dramatically. This is due in part to multinational corporations avoiding taxation by shifting profits overseas.

- Oregon only taxes income reported within the nation’s borders. This “water’s edge” designation leaves the door open to shifting profits abroad as a way to avoid taxation.*

- Recent changes at the federal and state level may give multinational corporations even more leeway to shift profits abroad to avoid taxes.

- Complete reporting means that Oregon would require corporations to include in their taxable income the income of all their affiliates, even those outside of the United States. Instituting complete reporting could raise an additional $376 million in each two-year budget period — a conservative estimate.

- Nearly all of the revenue would come from foreign, out-of-state, and rich investors.

- Oregon’s small businesses would be among the largest beneficiaries of a shift to complete reporting.

Complete reporting is a smart, effective way Oregon can make corporations pay their fair share to support schools and essential services.

Report

November 15, 2018

Oregon Can Raise $376 Million by Clamping Down on Offshore Corporate Tax Avoidance

By Daniel Hauser

Oregon can clamp down on multinational corporations shifting profits overseas, create a more level playing field for Oregon businesses, and raise millions in revenue by enacting "complete reporting" by large corporations.[1] That law would make it difficult for multinational corporations to avoid Oregon corporate income taxes by artificially shifting profits earned in Oregon to subsidiaries located abroad. Instituting complete reporting could raise an additional $376 million in each two-year budget period — a conservative estimate. Nearly all of the revenue would come from foreign, out-of-state, and rich investors.

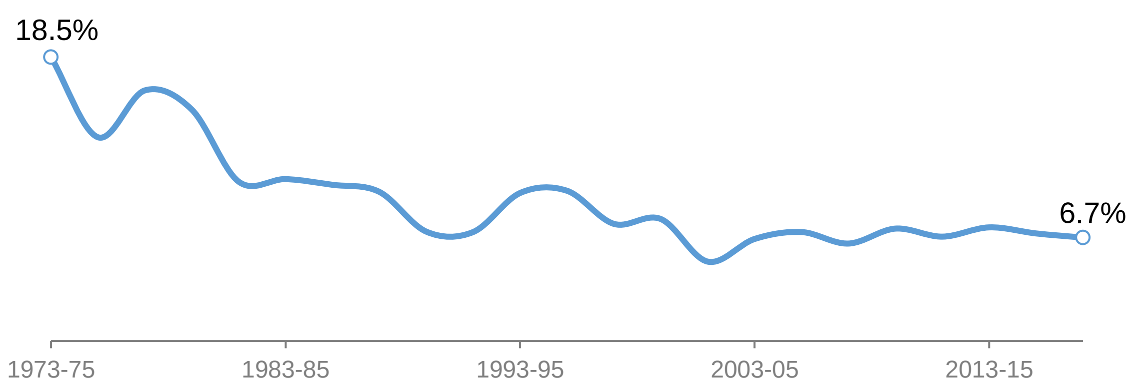
Corporate tax avoidance by large, multinational corporations is part of the reason why Oregon's corporate income tax rate has shrunk over time. Complete reporting is a smart, effective way Oregon can make corporations pay their fair share to support schools and essential services.

Tax avoidance by multinational corporations is costing Oregonians dearly

Over the past four decades, the Oregon corporate income tax has declined dramatically as a source of revenue to fund the public services that support economic opportunity and a decent quality of life for all Oregonians. Nearly all income taxes collected by the state of Oregon go to fund three things: education, public safety, and health and human services.[2] In the mid-1970s, the corporate income tax accounted for 18.5 percent of all income taxes collected in Oregon. That share is projected to drop to 6.7 percent in the current budget period.[3] Looked at from a different perspective, as a share of Oregon's economy the corporate income tax has dropped by more than half since the mid-1970s.[4]

Corporate share of total income taxes far below historic high

Share of Oregon income taxes paid by corporations from the 1973-75 to the 2017-19 biennium



Source: OCPP analysis of Oregon Office of Economic Analysis (2017-19 forecast) and Legislative Revenue Office (1973-75 to 2015-17 actual) data.

OREGON CENTER FOR PUBLIC POLICY | OCPP.ORG

One of the factors driving this decline has been multinational corporations avoiding taxation by shifting profits overseas. The particular mechanisms for avoiding taxes vary, but the basic strategy is the same: shift profits from the place they were earned to a place that levies little or no taxes on corporate income. This strategy requires having subsidiaries in different jurisdictions, which is why tax avoidance is largely the province of large, multinational corporations.

While it is difficult to come up with a precise figure, it is clear that corporate tax avoidance is vast. Annual estimates of how much income corporations shield from taxes by the U.S. government range from $300 billion to $392 billion.[5] The non-partisan Congressional Budget Office (CBO) puts the figure at $300 billion per year over the next decade.[6]

Oregon suffers when corporations hide profits abroad. One study estimated that offshore tax sheltering costs Oregon about $225 million per year.[7] In determining how much a corporation owes in income taxes to the state, Oregon's corporate income tax calculation starts with the federal taxable income of the corporation. Oregon taxes the portion of that federal income based on the share of its total sales the company made to Oregon customers during the tax year. When a company's federal taxable income is shrunk by shifting profits abroad, so too is the amount subject to Oregon's corporate taxes.

"Water's edge" exposes Oregon to offshore corporate tax avoidance

When it comes to taxing corporations that have subsidiaries — a common structure of multinational corporations — states have a choice: tax the parent company and each subsidiary as separate entities or tax them together as one unit. The former approach opens the door for corporations to shift profits to subsidiaries outside the state, and thus avoid taxation. The latter approach, called "combined reporting," adds up the income and expenses of all the related companies and treats them as one. This approach eliminates the tax advantage of shifting profits to related companies.[8] Oregon generally follows the combined reporting approach.

However, the state's combined reporting requirement does not extend to foreign subsidiaries. Instead, Oregon connects to the federal consolidated tax returns, which only includes income reported within the nation's borders. This "water's edge" designation for corporations leaves the door open to shifting profits abroad as a way to avoid taxation.

Water's edge was not always the law in Oregon. Prior to 1984, Oregon required corporations to report all of the income and apportionment factors — the factors used to determine the share of income attributed to Oregon — from subsidiaries located abroad.[9] During that time, Oregon followed the method called "complete reporting." But a coordinated international push by multinational corporations successfully pressured states, Oregon included, to institute "water's edge" by threatening to pull investment unless the complete reporting method was changed.[10]

Recent federal and state actions may exacerbate the problem of tax avoidance

Recent changes at the federal and state level may give multinational corporations even more leeway to shift profits abroad to avoid taxes.

New opportunities for tax avoidance may arise out of the massive 2017 Tax Cuts and Jobs Act, which substantially changed how the U.S. taxes corporations, particularly multinational corporations.[11] While the Act included a handful of provisions intended to rein in tax avoidance by multinational corporations, some experts question whether the new policies will be effective and point out that the law created new incentives to shift profits outside of the U.S.[12] For example, the Foreign Derived Intangible Income (FDII) deduction could end up promoting the offshoring of manufacturing facilities and other real assets.[13]

The Oregon legislature's recent repeal of the state's tax haven law also makes it easier for corporations to engage in tax avoidance. Enacted in 2013, the Oregon tax haven law required multinational corporations to report on their corporate tax returns the income earned in a list of more than 40 countries with a history of serving as tax havens — the British Virgin Islands, the Cayman Islands, and Cyprus, for example. The Oregon Legislative Revenue Office estimated that the law netted at least $20 million in corporate income tax collections in 2014.[14] In 2018, Oregon lawmakers mistakenly repealed the tax haven law under the misimpression that it was unnecessary, given the provisions in the 2017 federal tax act aimed at deterring offshore tax avoidance. However, as noted above, experts are dubious of the effectiveness of those safeguards. Further, corporations have signaled their intent to block states from including the new revenue in their definitions of what is taxable.[15]

In short, at both the federal and state level, recent changes in the law could result in corporations shifting even more profits overseas to escape taxation.

Solution: Reinstate complete reporting

Oregon can address offshore corporate tax avoidance by reinstating complete reporting, the standard that existed prior to 1984. With complete reporting, this analysis estimates Oregon could raise roughly $376 million each budget period to invest in schools, health care, and other essential services.[16]

Complete reporting means that Oregon would require corporations to include in their taxable income the income of all their affiliates, even those outside of the United States.[17] This would remove the incentive for corporations to shift profits overseas, since those profits would have to be included in their corporate tax returns. Oregon would then apply its usual apportionment formula — the method for calculating what portion of a company's profits is taxable by Oregon.

An illustration of how complete reporting works

Assume that Big International Corporation had global sales of $1 billion. Of those sales, $800 million were in the U.S., including $100 million in Oregon. The company reports that its total global profits were $150 million, with $50 million of those profits earned in the U.S.[18]

Under water's edge, the Oregon sales as a share of U.S. sales would be used to determine the apportionment factor (12.5 percent).[19] This factor would then be applied to the U.S. profits ($50 million) to reach the apportioned taxable income to Oregon ($6.3 million).[20] After applying Oregon's corporate income tax rates, Big International would owe $465,000.

Under complete reporting, Oregon's share of the global sales (10 percent) is applied to the global profits ($150 million) to reach the apportioned taxable income to Oregon ($15 million). With the same tax rates applied, Big International would now owe more than $1.1 million in taxes to Oregon.

Oregon could raise significant revenue from complete reporting

Oregon could raise an estimated $376 million in additional revenue per budget period by shifting to complete reporting. These dollars would be coming exclusively from multinational corporations that sell goods or services in Oregon — using Oregon's infrastructure, public safety, and other shared services — but shift some of their profits overseas. This is enough to add more than 2,000 teachers to Oregon schools.

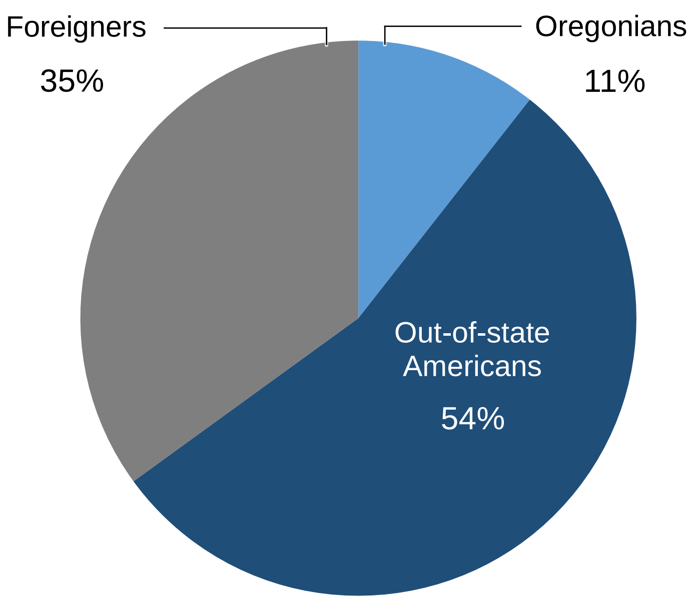
The $376 million figure is rough but conservative. It is derived from information on the amount of corporate taxable income raised at the federal level and an estimate of how that income would be apportioned to Oregon. The appendix explains the methodology for arriving at this revenue estimate.

The tax would be paid by out-of-state, foreign, and rich investors

Enacting complete reporting in Oregon would raise the taxes of investors in the multinational corporations that engage in offshore tax avoidance.[21] Investors in large multinational corporations largely reside outside of Oregon, including outside of the U.S.[22] The Institute on Taxation and Economic Policy (ITEP) estimates 35 percent of the tax would be paid by foreign investors, 54 percent would be paid by American investors who live outside of Oregon, and 11 percent would be paid by Oregonians.[23]

Non-Oregonians pay bulk of tax

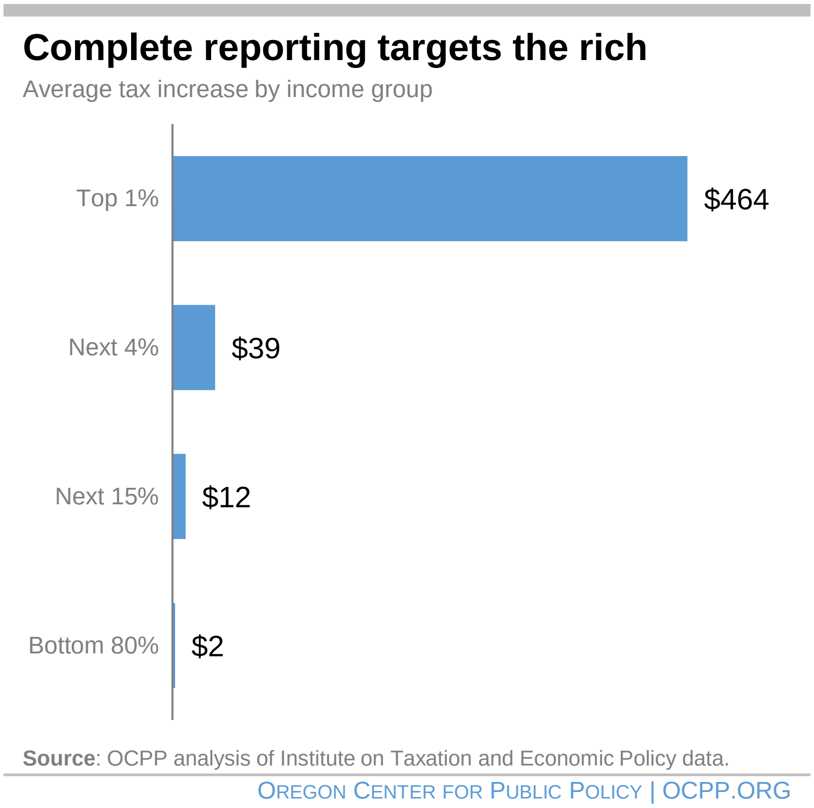
Share of tax increase paid by foreign and U.S. out-of-state investors under complete reporting



Source: OCPP analysis of Institute on Taxation and Economic Policy data.

OREGON CENTER FOR PUBLIC POLICY | OCPP.ORG

Of the 11 percent paid by Oregonians, ITEP estimates it would be predominantly paid by high-income taxpayers.[24] Nearly half (47 percent) would fall on the top 1 percent, who would see an average annual tax increase of about $450. By contrast, the bottom 80 percent of taxpayers would pay close to no additional tax each year.



Complete reporting would help Oregon's small businesses compete

Oregon's small businesses would be among the largest beneficiaries of a shift to complete reporting. Offshore tax avoidance is the province of large corporations, as it requires foreign subsidiaries and a battalion of tax accountants and attorneys to exploit the loopholes. This leaves small corporations – many of them family-owned – at a competitive disadvantage against large, multinational corporations that exploit tax havens. Small corporations are also hurt through having to pay higher taxes to make up for those not being paid by the multinational corporations, or through weaker public services they rely on, such as infrastructure and workforce training. One study estimated each Oregon small business paid nearly $700 more in taxes in 2015 because of corporate tax avoidance.[25]

Objections to complete reporting are outdated and inaccurate

When Oregon abandoned complete reporting in 1984, one of the reasons was a concern that the state's apportionment formula would deter investment in Oregon. The basis of that concern no longer exists. The corporate income tax apportionment formula determines what share of a corporation's income a state gets to tax. In the early 1980s, Oregon employed a formula that equally weighted three factors to determine the share of income taxable in Oregon: property, payroll, and sales. Multinational corporations pushed to eliminate complete reporting, arguing that it encouraged businesses to reduce their property (factories or other facilities), and payroll (employees) in Oregon. Since then, Oregon has dropped the three-factor apportionment formula and shifted to so-called "single sales factor," where only a corporation's sales in Oregon count when it comes to apportioning corporate income.

Multinational corporations would have no incentive to reduce investment or employment in Oregon as a result of complete reporting, now that Oregon has adopted single sales factor apportionment. With complete reporting, a multinational corporation with a large factory and many employees in Oregon would pay the same amount in taxes if they fired half of their employees as they would if they doubled their employees in Oregon. Complete reporting would increase the taxes paid by multinational corporations. Their taxes would not vary based on property investment or employment in Oregon, only their sales. Therefore, multinational corporations have no incentive to cut investment or employment as a result of Oregon shifting back to complete business activity in determining corporate taxes.

Conclusion

Returning to complete reporting is a smart, effective way for Oregon to push back against offshore corporate tax avoidance. The purported justification for eliminating complete reporting more than three decades ago no longer exists today. Meanwhile, multinational corporations have found ways to shrink their Oregon tax obligations by shifting their profits overseas. The ultimate winners in these corporate tax avoidance schemes are mainly out-of-state, foreign, and high-income investors. The losers are Oregon families and small businesses forced to endure underfunded schools and essential services.

Complete reporting could raise roughly $376 million per budget period — funds that would go a long way in improving the quality of life and economic opportunity for all Oregonians.

Appendix: Revenue Estimate

Estimating the revenue raised from the implementation of consolidated complete reporting is difficult because we do not have access to all of the corporate tax information needed. However, a number of academics and government analysts have estimated the amount of taxable income left outside of the federal tax base as a result of tax avoidance by multinational corporations.[26] These estimates range from $300 billion to $392 billion.

Our analysis relies on the Congressional Budget Office's (CBO) estimate of $300 billion per year as the amount of taxable income lost due to offshore corporate tax avoidance.[27] This estimate from a non-partisan entity with long experience calculating economic impacts is below the average of other available estimates. To be as conservative in the estimate as we can, we also assume the controversial conclusion by the CBO that the new federal tax legislation will reduce offshore tax avoidance by $65 billion per year, rather than increase offshore tax avoidance, as a number of experts have warned. Thus, our analysis assumes the total U.S. loss of taxable income due to offshore tax avoidance to be $235 billion per year — a conservative estimate.

The next step in the analysis is figuring out the amount of this $235 billion that is taxable and apportioned to Oregon. There are a number of viable options to proxy for this calculation. Options include relying on Oregon's share of the national population (1.27 percent), national economy (1.23 percent), national personal consumption expenditures (1.27 percent) and all state corporate income tax revenue (1.28 percent).[28] These similar factors provide a credible proxy for Oregon's actual share of apportioned corporate taxable income. These four factors generate a range of estimates from $2.88 billion to $3 billion each year in additional taxable corporate income as a result of Oregon shifting to complete reporting. This analysis used the lowest figure, based on Oregon's share (GSP) of the national economy (GDP).

The last step in the analysis is applying a tax rate to the additional corporate taxable income. One option would be to apply Oregon's top corporate income tax rate of 7.6 percent, since this income is mainly being piled on top income from already profitable corporations. But to be conservative, we apply the effective corporate income tax in Oregon over the last few filing periods: 6.53 percent. By multiplying this rate with the aforementioned estimates of increased Oregon taxable income, we find Oregon could raise between $188 and $196 million in new revenue *each year*. (This analysis is in the same ballpark as the estimate by U.S. PIRG that Oregon loses $225 million each year in revenue from international corporate tax avoidance.[29])

On a two-year basis, which Oregon uses for budgeting purposes, the revenue estimates range from $376 to $392 million.

**This paper was updated to reflect that, contrary to what is often assumed, Oregon tax law does not provide for a water's edge election. Rather, it connects to the federal consolidated tax return which uses the water's edge. In other words, there is no choice on the matter.*

Endnotes

[1] The policy called complete reporting in this paper sometimes goes by the name of "combined worldwide reporting" or "ending the water's edge election." They refer to the same policy.

[2] Legislative Fiscal Office, *2017-19 Budget Highlights Update*, March 2018, available at https://www.oregonlegislature.gov/lfo/Documents/2017-19%20Budget%20Highlights%20Update.pdf.

[3] Legislative Revenue Office, *Basic Facts 2018*, available at https://www.oregonlegislature.gov/lro/Documents/2018%20FINAL%20-1.pdf; Oregon Office of Economic Analysis, *September 2018 Economic Forecast*, available at https://www.oregon.gov/das/OEA/Documents/forecast0918.pdf.

[4] Legislative Revenue Office, *Basic Facts 2018*, available at https://www.oregonlegislature.gov/lro/Documents/2018%20FINAL%20-1.pdf; U.S. Bureau of Economic Analysis, *Gross Domestic Product by State*, May 2018, available at https://www.bea.gov/.

[5] Estimates inflated to 2017 dollars with the CPI-U-RS. Jeff Ferry, *Revenue Gains From Sales Factor Apportionment Corp Income Tax*, Tax Notes, Nov. 27, 2017, p. 1313, available at https://d3n8a8pro7vhmx.cloudfront.net/prosperousamerica/pages/4124/attachments/original/1517324113/171127_article_Ferry_in_Tax_Notes.pdf?1517324113; Kimberly A. Clausing, *Profit Shifting Before and After the Tax Cuts and Jobs Act*, October 2018, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3274827; Congressional Budget Office, *The Budget and Economic Outlook: 2018 to 2028*, April 2018, available at https://www.cbo.gov/system/files?file=115th-congress-2017-2018/reports/53651-outlook.pdf; Fatih Guvenen et al., *Offshore Profit Shifting and Domestic Productivity Measurement,* National Bureau of Economic Research, 2018, available at https://www.nber.org/papers/w23324.pdf. A much lower level of increased taxable income ($142 billion) was estimated as part of a global evaluation of profit-shifting, but since it uses a less robust data source for U.S. multinational corporations this analysis does not include it. The referenced global evaluation is from: Thomas R. Tørsløv, Ludvig S. Wier, and Gabriel Zucman, *The Missing Profits of Nations*, National Bureau of Economic Research, 2018, available at https://www.nber.org/papers/w24701.pdf.

[6] Congressional Budget Office, *The Budget and Economic Outlook: 2018 to 2028*, April 2018, available at https://www.cbo.gov/system/files?file=115th-congress-2017-2018/reports/53651-outlook.pdf.

[7] Phineas Baxandall et al., *Closing the Billion Dollar Loophole: How States Are Reclaiming Revenue Lost to Offshore Tax Havens*, U.S. PIRG, 2014, available at https://uspirg.org/reports/usp/closing-billion-dollar-loophole.

[8] While Oregon is often listed among the states that require combined reporting, that is not fully the case, leaving "Oregon more susceptible to these domestic tax shelters than states that impose . . . combined reporting," according to the Oregon Department of Revenue. Oregon Department of Revenue, *Out-of-State Tax Shelters Report*, January 2014, p. 12, available at https://www.oregon.gov/DOR/about/Documents/bn_tax-shelters_2014.pdf.

[9] Nancy Foran and Dahli Gray, *The Evolution of the Unitary Tax Apportionment Method*, 1988, available at http://www.accountingin.com/accounting-historians-journal/volume-15-number-1/the-evolution-of-the-unitary-tax-apportionment-method/.

[10] Ibid.

[11] House Resolution 1, An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, 115th U.S. Congress, available at https://www.congress.gov/bill/115th-congress/house-bill/1.

[12] Chuck Marr, Brendan Duke, and Chye-Ching Huang, *New Tax Law Is Fundamentally Flawed and Will Require Basic Restructuring*, Center on Budget and Policy Priorities, April 2018, available at https://www.cbpp.org/research/federal-tax/new-tax-law-is-fundamentally-flawed-and-will-require-basic-restructuring; Rebecca Kysar and Kimberly A. Clausing, "Will the Trump tax cuts accelerate offshoring by U.S. multinational corporations?" panel at Economic Policy Institute event, May 2018, available at https://www.youtube.com/watch?v=WeFBXWY2mgU.

[13] Ibid.

[14] Daniel Hauser, *Repealing Oregon's Tax Haven Law Is a $20 Million Gamble*, Oregon Center for Public Policy, February 19, 2018, available at https://www.ocpp.org/2018/02/19/fs20180219-tax-haven-federal-tax-scheme/.

[15] Michael Mazerov, *Oregon Should Reinstate Its Tax Haven Law*, Center on Budget and Policy Priorities, June 5, 2018, available at https://www.cbpp.org/sites/default/files/atoms/files/6-5-18sfp.pdf.

[16] Estimates conducted by the Oregon Center for Public Policy. More information is available in the appendix.

[17] Bill Parks, *Past Time for California to Retire Water's Edge*, State Tax Notes, 2018, available at https://www.taxnotes.com/state-tax-notes/corporate-taxation/past-time-california-retire-waters-edge/2018/04/02/26xzz.

[18] This hypothetical assumes that all the foreign sales were manufactured abroad by a foreign subsidiary, and that all of the U.S. sales were manufactured here by the U.S. parent.

[19] This calculation is $100 million (Oregon sales) divided by $800 million (U.S. sales) to reach the sales factor of 12.5 percent.

[20] Multiplying the sales factor (12.5 percent) by the U.S. profits ($50 million) results in the apportioned taxable income of $6.3 million.

[21] Cronin et al. *Distributing the Corporate Income Tax: Revised U.S. Treasury Methodology*, 2013, National Tax Journal 66 (1): 239-62.

[22] Steven M. Rosenthal, *Slashing Corporate Taxes: Foreign Investors Are Surprise Winners*, Tax Notes, October 2017, available at https://www.taxnotes.com/tax-notes/corporate-taxation/slashing-corporate-taxes-foreign-investors-are-surprise-winners/2017/10/23/1x78l.

[23] Estimates provided in October 2018 by the Institute on Taxation and Economic Policy. The share of taxes paid by Oregonians assumes a significant share of closely-held Oregon C-corporations engage in profit shifting, making this a conservative assumption.

[24] Ibid.

[25] Alexandria Robins and Michelle Surka, *Picking Up the Tab 2016: Small Businesses Bear the Burden for Offshore Tax Havens*, USPIRG, November 2016, available at https://uspirg.org/sites/pirg/files/reports/USP%20PickTab%20Nov16%201.0.pdf.

[26] Op. cit. 4.

[27] Jeff Ferry estimated a loss of national revenue of $116 billion from offshore tax avoidance, which was revised back to taxable income by dividing the sum by the statutory tax rate at that point of 35 percent, and then adjusted for inflation to $332 billion in annual taxable income. Kimberly Clausing used two methods to estimate the lost taxable income and found inflated estimates of $320 billion and $392 billion. The inflated estimate by Guvenen et al. was $300 billion. The Congressional Budget Office's estimate was $300 billion. All figures are inflated to 2017 values using the CPI-R-US, except for the CBO which does not clarify a particular tax year.

[28] Economic data from the U.S. Bureau of Economic Analysis, Gross Domestic Product by State, May 2018, available at https://www.bea.gov/. Population data from the U.S. Census Bureau, American Community Survey 2017 1-year estimates, available at https://factfinder.census.gov/faces/nav/jsf/pages/index.xhtml. Personal consumption data from the U.S. Bureau of Economic Analysis, Personal Consumption Expenditures, available at https://apps.bea.gov/iTable/index_regional.cfm. Corporate income tax receipt data exported from the State & Local Government Finance Data Query System, Urban-Institute-Brookings Institution Tax Policy Center, data from U.S. Census Bureau, Annual Survey of State and Local Government Finances available at https://slfdqs.taxpolicycenter.org/.

[29] Op. cit. Baxandall et al.