Comments HB 2456
As Amended and Passed by the Oregon House of Representatives on April 24, 2013

May 2013

To: Members of the Oregon Senate Finance and Revenue Committee

cc: Oregon Legislative Revenue Office
Oregon Department of Revenue

These comments relate to House Bill 2456 which, as passed by the House on April 24, 2013, contains only one operative provision: the addition of income or loss of certain foreign corporations to the Oregon taxable income of a consolidated group.

We are a group of Oregon tax lawyers who try to follow legislative developments affecting Oregon's tax system. Some of us have clients that would be affected by this bill, while others do not. We share a desire that the Legislature make a fully informed choice about this provision, and we recommend that the Legislature undertake further study of the issues we raise below. We are not writing on behalf of the Oregon State Bar or any organization.

1. <u>HB 2456 Uses the Montana Approach Without Taking into Account a Key Difference Between the Montana and Oregon Corporate Tax Systems</u>.

The bill would require corporations filing Oregon consolidated returns to include income and loss attributable to certain affiliated companies incorporated in certain foreign countries in their Oregon tax returns. By including income of non-US entities in Oregon consolidated returns, the bill represents a very substantial shift in the approach that Oregon has taken to corporate taxation for the past 30 years. We respectfully suggest that such a significant change should not be undertaken without a full understanding of this shift.

In testimony before the House Revenue Committee, witnesses stated that this bill follows the provisions adopted by the Montana Legislature regarding entities incorporated in tax-haven jurisdictions. However, the bill fails to take into account a major difference between the Oregon and Montana corporate tax systems: Oregon is a "water's edge" consolidated return filing state, while Montana is a worldwide combined filing state, as pointed out in the July 19, 2012 Montana Department of Revenue memorandum submitted as an exhibit in the House Revenue Committee proceedings.

This is an important distinction. For 30 years, Oregon has included only the income and loss from US-incorporated entities in Oregon consolidated returns. The Legislature made this policy decision to change from worldwide combined reporting to our current system in 1984 and 1985 over many months of careful deliberation and review. The Oregon system is based on the federal consolidated return system, which includes only subsidiaries incorporated in the United States. Generally, Oregon law requires that if affiliated unitary corporations file a federal consolidated return, they must file an Oregon consolidated return.

Under Montana's worldwide combined approach, which the Oregon Legislature expressly rejected in 1984 and 1985, multinational enterprises ***must include*** all foreign affiliates in their Montana returns unless the enterprise makes a "water's edge" election. Only if the enterprise makes a water's-edge election are foreign affiliates excluded from the Montana returns, except that Montana then requires those foreign affiliates formed in certain countries to be re-included in the Montana return.[1]

By contrast, under HB 2456, corporations filing Oregon consolidated returns would still be required to ***exclude*** all foreign affiliates from their returns other than those formed in the countries specified in the bill. Oregon would include some foreign corporations but not others, based on a presumption that any corporation formed under the laws of a listed jurisdiction must be organized for the purpose of sheltering income from tax. Apart from the fact that the bill reaches this presumption without identifying any standards or criteria (a topic discussed in Section 3 below), the bill does not take into account the possibility that the enterprise may operate not only in the United States and in listed jurisdictions, but also in other foreign countries. For example, the bill would prohibit a multinational enterprise that has income in a Luxembourg affiliate from offsetting that income against losses incurred by a Belgian, French, Canadian or Japanese affiliate. We are concerned that, by borrowing Montana's list of jurisdictions without also allowing worldwide combined reporting, Oregon could unintentionally distort the tax base for multinational enterprises, with the possible result that Oregon would seek to tax a greater share of the net income of the enterprise than it is allowed to tax under the Commerce Clause of the US Constitution. Whereas Montana's system (as well as those of the District of Columbia and West Virginia) lets the enterprise address this issue by forgoing a water's-edge election and use worldwide combined reporting instead, Oregon's system does not let the enterprise make this choice.

The July 19, 2012 Montana Department of Revenue letter repeatedly refers to ***worldwide combined*** reporting as a "fair and equitable" method of apportioning income, and the Montana letter correctly states that the US Supreme Court has upheld worldwide combined reporting as satisfying the Commerce Clause of the US Constitution. Oregon's system, which requires exclusion of the income and loss of ***all*** foreign affiliates, builds on the federal system and was enacted to respond to concerns expressed by the Reagan Administration and foreign trading partners. But a hybrid approach that extends the tax

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[1] We are aware of two other jurisdictions that have foreign "tax haven" provisions similar to Montana's list: the District of Columbia and West Virginia. *See* DC Code Ann § 47-1801.04(49), W Va Code § 11-24-3a(38). All three allow worldwide combined reporting as an alternative.

base beyond US corporations, without also allowing the rest of the worldwide tax base to be counted, would be unique among the states and has not been tested in the courts.

We also have not seen such a hybrid approach supported in the historical record. The federal government and state governments have considered approaches in the past that would have defined the tax base for state tax purposes as including domestic unitary affiliates (the water's-edge approach) plus affiliates formed in "tax haven" jurisdictions. We have had limited time to review these efforts, and the efforts of the states do not appear to have developed into specific legislative language until Montana adopted its law.[2] However, the most thoughtfully vetted federal bill proposed at the height of the concern about state taxation of foreign income would not have followed the hybrid approach of HB 2456. Senate Bill 1974, introduced in 1985, would have generally limited states to a water's-edge tax base, plus corporations formed in "tax haven" jurisdictions as defined in the bill and by federal regulations. However, the bill also would have permitted states to allow corporate taxpayers to elect worldwide combined reporting as an alternative. *See* S 1974 (1985) *reprinted at* 131 Cong. Rec. S17970-03, 1985 WL 698961 ("[T]his subsection shall not preclude any State from permitting a taxpayer to be taxed on a worldwide unitary basis pursuant to an unconditional election by such taxpayer.").[3]

While we do not advocate returning to a worldwide combined approach, we do recommend further study to determine whether the Commerce Clause of the US Constitution would require Oregon to follow Montana's approach of providing the option

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[2] In 1984 a working group of states and business representatives agreed on certain general principles, including a modified water's-edge approach that would have included the income of domestic corporations and corporations in tax haven jurisdictions. However, the group failed to agree on a definition of "tax haven" or on the degree of interaction necessary between a corporation formed in a tax haven jurisdiction and the rest of the water's-edge group. *See* Office of the Secretary, Treasury Department, *Final Report of the Worldwide Taxation Working Group* (August 1984) (discussion of "Principle One"), *available at* www.archive.org. A number of states, including Oregon, quickly adopted water's-edge limitations; it appears that none of those state laws adopted a provision targeting foreign tax haven jurisdictions. Hellerstein & Hellerstein, *State Taxation* ¶ 8.17 (3d ed Nov 2012).

[3] Another bill introduced at approximately the same time, Senate Bill 1113, would have tied the states to the federal approach to tax havens, by allowing states to tax income included on the federal return through Subpart F of the Internal Revenue Code; Oregon presently follows a version of this approach. *See* Joint Committee on Taxation, *State Taxation of Multinational Business* at 32 (Sept 29, 1986) (reporting on S 1113 and S 1974, 99th Cong., 1st Sess. (1985). Congress did not pass either bill.

of worldwide combined reporting before Oregon could require inclusion of the income of affiliates formed in selected foreign countries.

2. Listing Particular Jurisdictions Raises Concerns Under the Foreign Commerce Clause and the Foreign Affairs Doctrine.

We also believe it would be beneficial to explore whether any unintended consequences may result from identifying particular foreign jurisdictions for special treatment (described throughout the legislative materials as "tax haven jurisdictions"). From the late 1970s through the mid-1990s companies litigated against California over whether worldwide combined reporting caused such an effect on international commerce that it prevented the United States from "speaking with one voice" in matters of foreign policy. *See* US Const Art I, § 8, cl 3 (sometimes referred to as the "Foreign Commerce Clause," giving Congress power "to regulate Commerce with foreign Nations, and among the several States.")

Ultimately, the US Supreme Court held that, while a state's attempt to tax foreign commerce will be subject to "additional scrutiny," ***worldwide*** combined reporting did not violate the "speak with one voice" doctrine. *See Barclays Bank PLC v. Franchise Tax Board*, 512 US 298, 317-31 (1994). The Court found it significant that Congress had failed to pass any legislation prohibiting the states from using worldwide combined reporting, even though litigation over worldwide combined reporting had first reached the Court some 11 years previously. *Id.* at 324-26. In light of that history, the Court held that the state law was valid because there were no "'specific indications of congressional intent'" to bar worldwide combined reporting. *Id. at 324.*

We are not aware of a specific congressional restriction that would clearly invalidate a state law that may impose varying amounts of tax on income of a foreign corporation based on the particular foreign jurisdiction in which the corporation is incorporated. However, to date the laws in Montana, the District of Columbia and West Virginia have not attracted attention comparable to the repeated United States Supreme Court appeals over worldwide combined reporting. Therefore, it is difficult to assess whether a court would invalidate HB 2456 on Foreign Commerce Clause grounds.

In addition to raising potential Foreign Commerce Clause problems, a state's singling out of specific countries for unfavorable treatment could raise concerns under the "foreign affairs" doctrine. For example, the US Supreme Court struck down an Oregon Cold War-era statute that attempted to prevent personal property of Oregon decedents from passing to heirs in Communist countries. *See Zschernig v. Miller*, 389 US 429 (1968). The Court held that the Oregon law "affects international relations in a persistent and subtle way." 389 US at 440. More recently, the US Court of Appeals for the First Circuit Court invalidated a Massachusetts law that prohibited state agencies from contracting with companies that were "doing business with Burma." *See National Foreign Trade Council v. Natsios*, 181 F3d 38 (1st Cir 1999).

In the short time available, we have been unable to conduct analysis sufficient to reach a conclusion about whether HB 2456 would violate the Foreign Commerce Clause or the foreign affairs doctrine. We have, however, concluded that further study of the issue is warranted, taking into account the following points:

- The 1984 working group of states and business entities noted above sought consensus on a definition of tax haven jurisdictions. While the working group itself could not agree, the group did not recommend that states adopt their own independent definitions or lists.

- Senate Bill 1974, discussed above, would have empowered the US Treasury, not states, to determine which countries are named as tax havens. This would have avoided any issue about whether the US government was speaking with one voice.

- On April 15, 2013, two bills were introduced in Congress, namely, HR 1554 (the "Stop Tax Haven Abuse Act") and HR 1555 (the "International Tax Competitiveness Act of 2013"). One feature of these bills would be to treat certain foreign corporations as US corporations, which would cause their income to be included in the federal consolidated return. We have not had the opportunity to study these bills in depth, but the potential for overlap with the subject matter of the Oregon bill seems apparent.

We recommend further analysis of the above issues so as to determine whether a court would invalidate the bill as tending to (a) prevent the federal government from "speaking with one voice" in matters of foreign commerce or (b) otherwise impermissibly interfere with US conduct of foreign affairs.

3. <u>The Bill Should Give Guidance to the Department of Revenue About Future Additions or Deletions</u>.

Section 3 of the bill requires the Department of Revenue to submit scheduled reports to the Legislature with recommendations for revisions to the list of jurisdictions that would be included in ORS 317.715. In its current form, the bill provides no guidance as to how such a jurisdiction is to be identified, and neither the Legislature nor the Department of Revenue appears to have conducted any independent analysis of the issue. The bill seems to simply incorporate Montana's list.

We found evidence that development of such a list is inherently difficult. The 1984 working group of states and businesses failed to reach agreement on criteria for defining a tax haven jurisdiction. US Senate Bill 1974 would have defined a tax haven corporation as one that "is not subject to substantial foreign tax on its net income," delegating further definition to the Treasury Department, and commentators criticized that bill both for having inadequate standards and for basing the definition on a foreign country's choice to impose an income tax. *See* Joint Committee Report at 315. The Multistate Tax Commission attempted to define criteria for a list but withdrew that effort in 2011. *See* Multistate Tax Commission, Proposed Amendment to MTC Model Statute for Combined Reporting—Inclusion of Companies Doing Business in "Tax Havens" Under Water's Edge Election (May 27, 2011), *available at* http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Committee_and_Subcommittees/June_6,_2011_Executive_Committee_Meeting/taxhavenhearingofficerreportfinal.pdf., Multistate Tax Commission, Resolution Adopting Amendment to Model Combined Reporting Statute; Definition of "Tax Haven" for Water's Edge Election (July 27, 2011), *available at* http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Committees/Executive_Committee/Scheduled_Events/44th_Annual_Meetings/taxhavenfinal1.pdf.

We believe that it will be burdensome for the Department of Revenue comply with the mandate included in Section 3 of the bill. For this reason, we recommend that any bill that authorizes the Department of Revenue to revise the list of jurisdictions included in ORS 317.715 include criteria for inclusion of a jurisdiction on the list. A set of criteria, developed in a transparent manner with the opportunity for public input, would reduce the likelihood of unintended consequences, such as the prospect that a company would form an affiliate in a foreign jurisdiction for legitimate business reasons, then discover that the jurisdiction has been added to the list. Establishing the criteria now would allow companies to evaluate for themselves whether a particular jurisdiction is likely to appear on the list at some point in the future, and it would permit companies to structure their affairs to avoid the root policy problems that the bill seeks to address.

4. The Bill Should Define What Level of Ownership Is Required for Inclusion of the Foreign-Subsidiary Income.

Under current law, Oregon has several requirements that a corporation must meet in order to be included in an Oregon consolidated return. One of those requirements is that the corporation be unitary with the other included corporations, which requires a fact-intensive analysis. However, by adopting the federal consolidated return requirements, Oregon also effectively requires an 80% ownership test for unitary subsidiaries to be included in the Oregon consolidated return. As drafted, HB 2456 includes the unitary concept but does not include any requirements for an ownership percentage. This ambiguity could lead to substantial compliance difficulties. For example, it is unclear whether an Oregon taxpayer with an affiliate incorporated in a jurisdiction on the list must complete the complex unitary business analysis even if the taxpayer owns only a small percentage of the company (e.g., 10% or 20%). We recommend that the Legislature consider amending the bill to employ the same ownership threshold (i.e., 80%) regardless of nation of incorporation.

5. The Bill Imposes New Reporting Requirements That May Present Significant Compliance Burdens.

The approach of grafting a worldwide combined reporting approach for affiliates incorporated in certain jurisdictions onto a consolidated water's edge reporting system would be unique in state taxation. It would require taxpayers to adopt new processes to compile the necessary information, including preparing pro forma federal returns for foreign corporations that may not report taxable income in a manner analogous to US reporting requirements. This provision would necessarily increase the compliance burden on affected taxpayers. While HB 2456 would require the Department of Revenue to address these issues through rulemaking, the bill's effective date -- tax years beginning on or after January 1, 2014 -- allows little time for the Department to develop rules in consultation with affected businesses, or for those businesses to prepare for reporting. We recommend a greater level of study and deliberation on this issue so as to minimize the cost to companies that are not engaged in abusive tax shelters.

Conclusion.

It is not our intent to endorse or oppose matters of tax policy. However, we are concerned that the bill raises legal issues of significant complexity and would increase compliance burdens. Because the bill is a significant departure from Oregon's historic treatment of foreign entities, we suggest that the issue might be best addressed as part of an overall review of the Oregon corporate tax system between legislative sessions. We note that HB 2464, directing the Department of Revenue to report to the Legislature on the use of out-of-state tax shelters by February 1, 2014, is currently pending before the House Revenue Committee.

We are aware that the bill passed the House unanimously. We also are aware that the bill appears to be the designated vehicle to carry any major revenue raising legislation during this session, and we are concerned that other, more politically controversial provisions may eclipse the tax haven provision. We urge the Senate to give the complex issues raised by the tax haven provision the attention they deserve.

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