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Research Report
Research Report # 4-17
March 2017

An Assessment of Oregon's Listed Jurisdiction Policy and its Cost Effectiveness

Introduction

This report is intended to fulfill the requirements of SB 61 from the 2015 Session. SB 61 modified the policy first established by HB 2460 in 2013. HB 2460 contained a list of jurisdictions for which a corporate taxpayer must include on its Oregon return the income reported from a listed jurisdiction by a member of the unitary group. The initial list of jurisdictions was based on a similar statute in Montana. HB 2460 directed the Department of Revenue to prepare a biennial report reviewing the status of the current list and make recommendations to the Legislature regarding additions or subtractions to/from the list. The 2017 report: "2017 Recommendations on Listed Jurisdictions" is available from the Department of Revenue. Appendix A contains the current statutory list of jurisdictions and those recommended for addition to the list by the Department of Revenue.

SB 61 makes slight changes to the list of jurisdictions, puts the criteria for determining if the jurisdiction meets the definition of a tax haven in statute and grants the Department of Revenue more latitude in determining if the income apportionment including income from listed jurisdiction is a fair representation of the corporation's income attributable to Oregon. SB 61 also directs the Legislative Revenue Office to prepare a report containing an "assessment of the cost effectiveness" of the state's policy governing the tax treatment of corporations incorporated in offshore jurisdictions.

Key Findings

- Cost effectiveness can be considered narrowly to include only the revenue raised from Oregon's tax haven law compared to the direct costs incurred by the Department of Revenue resulting from implementing the law. A tax liability of $28.4 million is estimated from the 2014 corporate returns. Of this total, $13.9 million was reported voluntarily while the remaining $14.5 million is the result of audits, some of which are on-going. Luxembourg was the largest source of revenue among the jurisdictions, accounting for $12.2 million ($3.8 million reported voluntarily) or 43% of the total. Bermuda was the second largest, accounting for $5.7 million in revenue ($4.5 million reported voluntarily) or 16% of the total. Even allowing for the possibility that a substantial portion of the $14.5 million under audit does not materialize, corporate collections appear to exceed the $20 million revenue impact estimate for the first fiscal year of the policy
- Direct Department of Revenue costs to implement the tax haven policy consist of producing the statutorily required biennial jurisdiction report and auditing costs associated with listed jurisdiction issues. Report costs, including staff preparation time, report production costs and DOJ review totaled $78,000 for the two reports issued. Based on the average hours for the completed audits, the Department of Revenue estimates that audit costs associated with tax haven issues on the 2014 returns will total $152,000. Combining report costs with audit costs leads to a total direct cost estimate

of $230,000 for the first year of the tax haven policy. Administrative costs can be expected to decline over time on an annual basis as audit staff gains more experience and taxpayers become more familiar with the mechanics of the policy. However, the large number of audits for the first year suggests that legal challenges are a definite risk for the future. Litigation has the potential to drive up costs significantly.

- Accounting for only narrowly defined direct benefits and costs to the state, the tax haven policy established in 2013 appears to have generated a positive fiscal return for the state. However, substantial legal risks remain. These legal risks have the potential to increase costs significantly and put revenue resulting from the policy in jeopardy. It is beyond the scope of this report to evaluate these legal risks but an update on direct revenue and costs for the 2019 Legislature when more is known about the extent of these risks is recommended.
- The cost effectiveness of Oregon's tax haven policy can also be evaluated from a broader perspective. Among the benefits are the simplicity of having jurisdictions listed in statute, a more accurate representation of corporate income subject to apportionment back to the states and an expansion of a corporate tax base that has experienced significant erosion caused by profit shifting. Broader costs include the bluntness of the jurisdiction listing approach, the possibility of including income not attributable to the U.S. and potential negative effects on Oregon's business climate image for international investment and trade. Finally, the policy can be viewed as either a legitimate federalist response to a failed federal corporate tax policy or an inappropriate state intrusion into foreign policy, a responsibility of the federal government.
- By their very nature, these broader costs and benefits are difficult to quantify. But they are important aspects of tax policy and should be fully considered when evaluating tax haven policy. Weighing the relative importance of these factors is largely a subjective policy decision of the Legislature. Regardless of the Legislature's current decision, these broad factors should be monitored on a regular basis to determine if the policy is continuing to work as desired. Policymakers should also be prepared to respond to potential changes in the policy environment caused by federal legislation or court decisions.

Background

The genesis for Oregon's tax haven policy, now spelled out in ORS 317.716 and 317.717 can be found in the BEPS (Base Erosion/ Profit Shifting) project conducted by the OECD (Organization for Economic Cooperation and Development) which dates to 1998 with the issuance of a report identifying a growing problem ("Harmful Tax Competition: An Emerging Global Issue"). The OECD identified countries in 2000 that had set up tax laws enabling multi-national corporations to shift the location of where their income was reported for tax purposes without making changes to where the income was generated in an economic sense. The obvious incentive for corporations is to report net income or profits in jurisdictions that have favorable tax policies. If governments choose to enact these policies, corporations conducting tax strategies to take advantage of them are not engaging in illegal activities.

In 2003, Montana became the first state to enact a tax haven law. The Montana statute established a list of tax haven jurisdictions based on the OECD 2000 list. The Montana Department of Revenue is required to report to the Legislature every two years with recommendations for additions or subtractions to the list.

Oregon's 2013 tax haven law follows Montana's law very closely. The listed jurisdictions originally matched Montana's list at the time with one exception (Panama was excluded in Oregon). As in Montana, the Oregon Department of Revenue was given the responsibility of reporting recommendations to the Legislature for changes to the list every two years. However, there are two major differences in Oregon's corporate tax structure compared to Montana. Montana's corporations report their income on a worldwide basis with the option of using a water's edge election. Water's edge corporate income is defined as the income reported on the federal tax return. In Montana, those corporations electing to use the water's edge approach must include the income reported by members of the unitary filing group from the listed tax haven jurisdictions on their Montana tax return. Oregon is exclusively a water's edge state without a worldwide reporting option. This means that all corporations with income in the listed jurisdictions must include it on their Oregon return. Another significant difference between the two states is the method they use for apportioning corporate income back to the taxing state. Montana uses a three-factor formula based equally on the corporation's payroll, property and sales in Montana. Oregon's apportionment formula is based exclusively on a sales factor.

The 2015 Legislature made slight modifications to the listed jurisdictions but also incorporated tax haven criteria, developed by the Multi-State Tax Commission, into statute. So, Oregon now has both a list of countries from which corporate income must be included but also a statutory set of criteria used by the Department of Revenue for their recommended changes to the list and by the Legislature when determining whether to change the list statutorily. Several states have followed the hybrid (listing plus criteria) approach including Maine, Colorado and the District of Columbia, while other states (West Virginia, Connecticut and Rhode Island) have established criteria in statute but have not listed individual jurisdictions.

The Mechanics Behind Oregon's Tax Haven Law

As noted earlier, Oregon uses the water's edge approach as a starting point for determining taxable income. This means that calculating a corporation's taxable income in Oregon starts with the net income reported on the federal tax return. In effect, Oregon's tax haven law augments water's edge income by requiring the income from any member of a unitary group that is reported in a listed jurisdiction on the combined return of the corporation. This additional net income is then apportioned back to Oregon based on the share of the corporate filing group's sales that are in Oregon. The policy rationale for making this adjustment to water's edge income is that the corporate filing group is shifting net income to the listed jurisdictions that was generated in an economic sense in the United States and therefore should be included in water's edge income. In other words, the corporate filing group is engaged in profit shifting across national borders. As stated earlier, this type of tax avoidance is not illegal, but it does have consequences for revenue collections for the states (and the federal government) and for the equitable distribution of corporate taxes.

Three highly simplified examples help explain the mechanics of Oregon's tax haven law.

Example 1: Consolidated Corporate Return A (in millions)

Water's Edge Total Sales	$95,000
Water's Edge Net Income	$5,000
Oregon Sales	$4,750
Oregon Sales Share	.05
Income Apportioned to Oregon	$250
Oregon Tax Bill	$19
Listed Jurisdiction Activity	
Sales in Listed Jurisdiction	0
Net Income Reported in Listed Jurisdiction	$1,000
Income Not Attributable to Activities of U.S. Affiliates	0
Oregon Sales Share	.05
Income Apportioned to Oregon	$300
Oregon Tax Bill	$22.8
Change in Oregon Tax Bill Resulting from Listed Jurisdiction	+$3.8

Example 1 can be described as a "pure" tax haven example. A member of Corporate Return A reports income in a listed jurisdiction but has no economic activity (as measured by the sales factor) in the country. The income from the jurisdiction is added to the corporation's water's edge income on the Oregon return. This increases the net income to be apportioned from $5 billion to $6 billion. The apportionment factor is unaffected since there are no sales reported in the jurisdiction. Therefore, Oregon's 5% apportionment factor is applied to net income of $6 billion instead of $5 billion. The result is tax owed to Oregon of $22.8 million, an increase of $3.8 million from the liability incurred prior to the passage of Oregon's tax haven law.

Example 2: Consolidated Corporate Return B (in millions)

Water's Edge Total Sales	$95,000
Water's Edge Net Income	$5,000
Oregon Sales	$4,750
Oregon Sales Share	.05
Income Apportioned to Oregon	$250
Oregon Tax Bill	$19
Listed Jurisdiction Activity	
Sales in Listed Jurisdiction	0
Net Income Reported in Listed Jurisdiction	$1,000
Income Not Attributable to Activities of U.S. Affiliates	500
Oregon Sales Share	.05
Income Apportioned to Oregon	$275
Oregon Tax Bill	$20.9
Change in Oregon Tax Bill Resulting from Listed Jurisdiction	+$1.9

Example 2 shows a situation where a portion of income reported in the listed jurisdiction originated from outside the U.S. Corporation B reports income of $1 billion in the listed jurisdiction but $500 million was derived from economic activity in a country other than the U.S. In this case, if Corporation B can demonstrate to the Department of Revenue that the $500 million did not originate in the U.S., including this income would result in an unfair apportionment of Corporation B's net income to Oregon. The result is that Corporation B's Oregon tax liability is increased by $1.9 million instead of the $3.8 million shown in example 1. This is the situation that the new language in SB 61 is designed to address. SB 61 gives the Department of Revenue clear authority to adjust the amount of income apportioned when warranted.

Example 3: Consolidated Corporate Return C (in millions)

Water's Edge Total Sales	$95,000
Water's Edge Net Income	$5,000
Oregon Sales	$4,750
Oregon Sales Share	.05
Income Apportioned to Oregon	$250
Oregon Tax Bill	$19
Listed Jurisdiction Activity	
Sales in Listed Jurisdiction	$5,000
Net Income Reported in Listed Jurisdiction	$1,000
Income Not Attributable to Activities of U.S. Affiliates	500
Oregon Sales Share	.048
Income Apportioned to Oregon	$261
Oregon Tax Bill	$19.9
Change in Oregon Tax Bill Resulting from Listed Jurisdiction	+$1.0

In example 3, Corporation C is in the same situation as Corporation B except that it has $5 billion in sales reported in the listed jurisdiction. These sales are added to the denominator for determining Oregon's share for the single sales factor calculation. The effect is a reduction in Corporation C's sales factor from 5% to 4.8%. Thus, the amount of income apportioned to Oregon is $261 million, compared to $275 million for Corporation B. With less income apportioned back to Oregon, Corporation C has an Oregon tax liability of $19.8 million, $1 million less than the case for Corporation B. This means that the amount of income apportioned back to Oregon for tax purposes will be reduced by the amount of the corporation's sales that take place in the listed jurisdiction.

Examining the Cost Effectiveness of Oregon's Tax Haven Law

Narrow Considerations

In this section cost effectiveness is considered narrowly to include only the revenue raised from Oregon's tax haven law compared to the direct costs incurred by the Department of Revenue resulting from implementing the law. HB 2460 first applied to the 2014 corporate tax year. Corporations choose what month their tax year begins, meaning the 2014 corporate tax year can end as late as December of 2015 for some corporations. Returns can also be audited and/or amended after they have been processed. Some audits have been completed while others remain in progress.

Revenue from Income Reported in Listed Jurisdictions Based on 2014 Returns

Jurisdiction	Revenue in Millions
Luxembourg	$12.2
Bermuda	$5.7
Bahamas/Barbados*	$2.2
Cayman Islands	$1.0
Other Listed Jurisdictions**	$1.1
Information not on return	$6.2
Total	$28.4

*Combined to avoid disclosure violation.

**Includes British Virgin Islands, Curacao, Cyprus, Liberia, Malta, Mauritius, Gibraltar, Isle of Man, Jersey, Monaco, Virgin Islands

Source: Oregon Department of Revenue

Of the $28.4 million in total revenue, $13.9 million was reported voluntarily while the remaining $14.5 million is the result of audits, some of which are on-going. Revenue from the on-going audits is at risk while revenue from completed audits and reported voluntarily is potentially at risk through the legal process. Assuming there are not significant reductions from challenged audits or court actions, revenue attributed to HB 2064 appears to have exceeded the revenue impact estimate of $20 million for the first fiscal year.

Luxembourg was the largest source of revenue among the jurisdictions, accounting for $12.2 million ($3.8 million reported voluntarily) or 43% of the total. Bermuda was the second largest, accounting for $5.7 million in revenue ($4.5 million reported voluntarily) or 16% of the total. As was the case in Montana, these two jurisdictions account for over half of the reported revenue. The rest of revenue where location can be determined was spread over a wide number of jurisdictions. A number of returns that included tax liability associated with the listed jurisdictions did not include information on the specific location of their reported income.

Direct Department of Revenue costs to implement the tax haven policy consist of producing the statutorily required biennial jurisdiction report and auditing costs associated with listed jurisdiction issues. Report costs, including staff preparation time, report production costs and DOJ review totaled $78,000. This includes both the 2015 report ($55,000) and the 2017 report ($23,000). Report costs can be expected to rise with inflation from the 2017 base unless additional statutory requirements are added.

The more significant direct cost for the Department of Revenue is the cost of auditing corporate tax returns. Since the audit process for the 2014 returns is still in progress, audit costs are estimates. 115 audit cases associated with listed jurisdictions have been identified for the 2014 corporate returns. Based on the average hours for the completed audits, the Department of Revenue estimates that the time spent auditing listed jurisdiction issues will be 25 hours. This translates into 2,875 hours auditing the 2014 returns. Listed jurisdiction audit costs are estimated at $152,000 for the 2014 returns.

Combining report costs with audit costs leads to a total direct cost estimate of $230,000 for the first year of the tax haven policy established by the 2013 Legislature. Administrative costs can be expected to decline over time on an annual basis as audit staff gains more experience and taxpayers become more familiar with the mechanics of the policy. However, the large number of audits for the first year suggests that legal challenges are a definite risk for the future. Litigation has the potential to drive up costs significantly.

Making a conservative assumption that only $6.1 million of the $14.5 million in revenue under audit materializes and adding the $13.9 million paid voluntarily leads to revenue for the 2014 corporate tax year of $20 million. Comparing this figure with the estimated direct costs of $230,000 associated with implementing the policy indicates it has initially been cost effective in a narrow sense.

Accounting for only narrowly defined direct benefits and costs to the state, the tax haven policy established in 2013 appears to have generated a positive fiscal return for the state. However, substantial legal risks remain. These legal risks have the potential to increase costs significantly and put revenue resulting from the policy in jeopardy. It is beyond the scope of this report to evaluate these legal risks but an update on direct revenue and costs for the 2019 Legislature when more is known about the extent of these risks is recommended.

Broad Policy Considerations

Evaluation from a broad policy perspective involves identifying and weighing benefits and costs associated with the tax haven policy.

Benefits

- Following Montana's example to put the jurisdictions that meet tax haven criteria in statute leads to a simple, clear implementation of the policy. Since income reported by a member of a unitary group located in a statutorily determined jurisdiction must be reported on the Oregon tax return, there is little room for ambiguity. The Department of Revenue periodically recommends changes to the list based on criteria but the decision to change the list is ultimately made by the Legislature.
- It can be argued that the tax haven policies adopted by Oregon and other states are the result of a failure in corporate tax policy at the federal level. From this perspective, states are experimenting with policies to address a growing problem at the state level in a classic case of the federalist system working.
- By including income that was economically generated by resources within the United States but not reported on the federal tax return, Oregon's policy leads to a more accurate reflection of how much income of a unitary group should be apportioned back to the state for tax purposes.
- In a related benefit, the decision of Oregon and other states to include income from tax havens helps to broaden the corporate tax base at the state level. This policy is a partial response to a series of forces that have narrowed the corporate tax base at the state and federal level for decades.

Costs

- While the listing of tax haven jurisdictions in statute has the benefit of simplicity, it does represent a blunt policy tool in the highly complex area of taxing global corporations. There is a risk that income reported in a tax haven, has a legitimate economic connection to the jurisdiction. This risk is highest for larger jurisdictions that have a significant economic base. Another risk occurs when corporations shift profits from a country where the economic activity generated income to a listed tax haven. This clearly is an example of profit shifting to avoid taxes, but in many cases the income was shifted from another country, not the U.S. and therefore should not be added back to the water's edge federal return for apportionment back to the states. It was recognition of this possibility that prompted the revenue committees to make it clear in SB 61 that the Department of Revenue has the authority to make adjustments when applying the formula does not lead to a fair apportionment of income.

- A common criticism of Oregon's tax haven policy is that by listing specific countries, the state is venturing into foreign policy, which is clearly the purview of the Federal government. This puts the state at risk of antagonizing foreign allies and trading partners.
- Oregon's tax haven policy can also be seen as inconsistent with the state's long standing commitment to international trade and a globally oriented culture as key drivers in the state's long term economic growth.
- Finally, the Legislature has received criticism of the policy by the Organization for International Investment. This organization promotes direct foreign investment in the United States. Direct foreign investment occurs when international corporations invest in plant, equipment and other facilities in the U.S. The direct impact of the state's tax haven policy on investment in the state is muted by the single sales apportionment method for tangible property. However, corporations considering an investment in the state may view the tax haven policy as a negative with potential adverse tax consequences depending on where their subsidiaries are located.

Weighing Broad Costs and Benefits

By their very nature, these broader costs and benefits are difficult to quantify. But they are important aspects of tax policy and should be fully considered when evaluating tax haven policy. Weighing the relative importance of these factors is largely a subjective policy decision of the Legislature. Regardless of the Legislature's current decision, these broad factors should be monitored on a regular basis to determine if the policy is continuing to work as desired. Policymakers should also be prepared to respond to potential changes in the policy environment caused by federal legislation or court decisions.

Appendix A

Listed Jurisdictions

Currently Listed in Statute

Andorra	Anguilla	Antigua & Barbuda	Aruba	The Bahamas
Bahrain	Barbados	Belize	Bermuda	Bonaire
British Virgin Islands	Cayman Islands	Cook Islands	Curacao	Cyprus
Dominica	Gibraltar	Grenada	Guatemala	Guernsey-Sark-Alderney
Isle of Man	Jersey	Liberia	Liechtenstein	Luxembourg
Malta	Marshall Islands	Mauritius	Montserrat	Nauru
Niue	Saba	St. Kitts & Nevis	St. Lucia	St. Vincent & The Grenadines
Samoa	San Marino	Seychelles	Sint Eustatius	Sint Maarten
Trinidad & Tobago	Turks & Caicos Islands	U.S. Virgin Islands	Vanuatu	

Jurisdictions Meeting Criteria but Not Currently on Statutory List

- Panama (2013 Original Montana List)
- Hong Kong (2015 DOR Recommendations)
- Netherlands (2015 DOR Recommendations)
- Switzerland (2015 DOR Recommendations)
- Ireland (2017 DOR Recommendations)
- Jordan (2017 DOR Recommendations)
- Lebanon (2017 DOR Recommendations)
- Macau (2017 DOR Recommendations)
- United Arab Emirates (2017 DOR Recommendations).