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February 22, 2018

Delivered by Electronic Transmission

The Honorable Phil Barnhart, Chair
The Honorable Barbara Smith Warner, Vice-Chair
The Honorable Greg Smith, Vice-Chair
Members of the House Revenue Committee
Oregon House of Representatives
State Capitol
Salem, Oregon

RE: Why Oregon Should Retain Its Corporate Tax Haven Law (SB 1529A)

Dear Chair Barnhart, Vice-Chair Smith Warner, Vice-Chair Smith and Members of the House Revenue Committee:

I am writing to encourage you to retain Oregon's tax haven law that protects Oregon citizens and businesses from multinational corporations avoiding their fair share of Oregon taxes by improperly shifting income to overseas tax havens. That law is simple, fair and effective. It also helps reduce the volatility and unpredictability of Oregon's corporate tax revenues and helps creates a level playing field among businesses of all sizes that operate in Oregon.

Unfortunately, Senate Bill 1529A would repeal this excellent law in favor of relying on the international tax provisions of a new federal tax law this is overly complex, arbitrary, and likely to fail. This letter will explain why that change would be a bad trade that will hurt Oregon taxpayers and the stability and equity of your state's tax system.

<u>Qualifications</u>
Before discussing the issues, you deserve to know my background in this area. I am the former Executive Director of the Multistate Tax Commission (MTC) (1988-2004). During that time, the MTC developed its first recommendations to the states to include tax haven income within a combined report for corporation income taxes to prevent profit shifting abuses. I am also the former Director of the Montana Department of Revenue (2005-2013). In that capacity, I administered a tax haven law which is similar to the Oregon law. In more recent years, I also consulted with the MTC on a project to help states that do not have the benefit of combined reporting—commonly referred to as "separate entity" states—to cope with profit shifting abuses. In that project, I saw directly how corporations defeat the type of measures being touted as a solution to profit shifting under the new federal law.

The views I am expressing in this letter are entirely my own.

The Problem of Tax Avoidance through Profit Shifting

Multinational corporations avoid federal and state taxes by shifting profits overseas, typically to tax havens, through various methods involving transactions among jointly owned and controlled affiliates. Those methods include transfer pricing by selling goods or services at too low a price to the overseas affiliate or paying too high a price in purchasing goods or services from the affiliates. They also include transferring intangible assets—money, patents, copyrights, trademarks and the like—to overseas affiliates and then paying affiliates for the use of those assets. Transfer pricing abuses also get entangled in these payments for intangibles.

The most important thing that legislators need to know about these transactions is corporations have been successful in stashing trillions of dollars of cash overseas in the last decade beyond the reach of federal and most state taxes—except not beyond the reach of Oregon's and Montana's tax haven laws. That is why corporations are targeting the Oregon and Montana laws for repeal. These tax haven laws work fairly and effectively to correct the worst abuses in the global system of corporate income taxation.

The trillions of dollars shifted overseas is evidence of the abject failure of the federal government to correct transfer pricing abuses over the last 50 years. The IRS mostly loses its transfer pricing cases. Further, the agreements that the IRS has approved with corporations for the transfer of intangible assets in past years have actually facilitated the shifting of income overseas.

Why the New Federal International Tax Provisions Will Fail

Claims are now being made that the new federal tax law will correct these problems—but that is wrong. The new tax law is a complex contraption of several measures that address only some of the problems—and often only partially. The most significant failing of the new law is that it does nothing to stop profit shifting through transfer pricing abuses involving the sale of ordinary goods among related corporations. Whatever the law does or does not do through its provisions to ostensibly addressed intangible income shifting (BEAT and GILTI), it leaves in place the escape hatch of profit shifting by transfer pricing for goods—a giant loophole the IRS has never been able to solve. So, many companies may simply switch much of their tax avoidance activity from intangibles, back to tangible goods.[1]

We have evidence of just such a switch from the experience of "separate entity" states that do not use combined reporting. Their corporate income taxes have been vulnerable to profit shifting with the United States through intangibles held in domestic tax havens, such as Delaware. Some states have adopted laws requiring a 100% "addback" of royalties and intangible income to stop this profit shifting. However, the corporate response has been to

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[1] The BEAT provision of the federal tax law affects depreciable goods (equipment) transactions, but the bulk of transactions are ordinary goods and are not affected by that law.

move their profit shifting away from explicit intangible payments and, instead, to avoid taxes through its intercompany transactions involving goods.

The new federal international tax provisions are variations of these state addback procedures. So, accounting firms and their corporate clients, based on this state level experience, are already well-equipped with transfer pricing tools for goods to defeat the impact of the new federal law!

These goods-based profit shifting methods—left in place by the new federal law—can be implemented in powerful, sophisticated, and surreptitious ways. In the 1990s, I was a witness to a sales pitch by a major accounting firm to corporate tax managers in the electronics industry for a software product that would use "bots" to adjust on a daily basis transfer prices for goods across company financial software to achieve whatever tax results the corporation might want in the nations where it does business. The large accounting firms also have in place a robust infrastructure of economists and statisticians to produce voluminous "transfer pricing studies" justifying the tax avoiding prices set for these intercompany transactions.

So the first major shortcoming of the federal law is that leaves in place avenues for profit shifting through goods transactions that corporations can substitute, if they wish, for previous methods involving intangibles.

The second major shortcoming of the federal law is that is not even clear how much the federal law will discourage the use of intangible profit shifting. The tough-sounding GILTI provision taxes requires inclusion of only half of the calculated "intangible low-taxed income" and allows a partial foreign tax credit to further reduce its impact. So, this intangible income ends up being taxed at half the rate (or less after the credit) of the 21% tax on regular profits. Corporations might not be able to cut their taxes to zero, but 10.5% compared to 21% is still a hefty incentive to shift income overseas through intangibles. Even if corporations are subject to the separate BEAT provision of the law, shifting income through intangibles may still be profitable.

The third major shortcoming of the federal law is that its impact is unpredictable. Almost all the new provisions interact in complex ways with other provisions. Thus, if a corporation is at risk for increased taxes under GILTI or other new provisions, there are ways to change legal entities and transactions among those entities in ways to minimize their effect. A further factor of concern is that the IRS is ill-equipped to implement the new, complicated law. In recent years, the budget for the IRS has been cut, and Congress has criticized, curtailed and discouraged its enforcement activities. These circumstances to do not bode well for the effective implementation of a complex law. That reality only adds to the future uncertainty of revenues under this law.

The federal government handles the risk of unpredictable revenues by printing more money. States don't have that luxury; they must balance their budgets. It is simply a bad idea to hitch

the fiscal fortunes of a state to an untested and unpredictable federal corporate tax law that is likely to fail because it leaves open major loopholes for corporate tax avoidance that the IRS cannot correct.

A Better Course of Action

It is a far better course for Oregon to stick with its tax haven law that uses the tried and proven method of combined reporting and formula apportionment to counter abusive profit shifting to overseas tax havens. The law is simple and effective because it cancels out all the intercompany transactions and combines the net profit of all the corporations operating in the U.S. with its related parties in tax havens. It is fair, because Oregon only taxes the portion of this income apportionable to the state by formula.

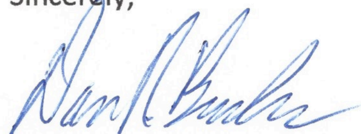
The only immediate tax adjustment needed is to allow corporations to deduct the portion of its calculated GILTI income directly attributable to their affliates in the tax haven nations listed under Oregon law. If not already authorized, the Oregon Department of Revenue should be given authority to define the calculation of the deductible portion of the GILTI income by rule. Such a process should address any corporate concerns of double taxation due to GILTI.

The Oregon Legislature should also enact a requirement for corporations to report to the Department of Revenue for a defined period what their tax payments to Oregon would be if the state a) adopted worldwide combined reporting or b) relied entirely on the federal tax law for state tax purposes without tax haven or worldwide combined reporting. The department should be asked to compile a report providing information to the legislature on the impact of the three alternative approaches: the federal law, tax haven combination, and worldwide combination. With an untested federal law and prospects that corporations will change their tax avoidance activity to exploit new avenues of profit shifting, the Oregon Legislature should secure the information needed to make well-informed and careful decisions about how it might tax corporations fairly and effectively in the future.

There certainly should be no rush to judgment by Oregon to repeal its tax haven law when the ink is barely dry on the federal tax law and not single corporate tax return has been filed on the basis of that law.

Thank you for your consideration of these observations.

Sincerely,



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