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RECENT DEVELOPMENTS

Initiative Petition 28—Changing the Oregon Corporate Excise Minimum Tax

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Oregonians will soon vote on the latest voter-initiated tax increase—Initiative Petition 28 (IP28)—that would dramatically increase the tax burden on some businesses operating in the state. The lobby group "A Better Oregon" has proposed increasing the state corporate minimum tax for corporations that have more than $25 million of annual gross receipts from Oregon sales. The proposed minimum tax would be imposed if greater than the corporate excise tax that would otherwise apply.

Under current law, the minimum tax is $150 for corporations with Oregon sales of less than $500,000 and tops out at $100,000 for corporations with Oregon sales of $100 million or more. A Better Oregon's proposal would increase the minimum tax for sales above $25 million to $30,001 plus 2.5 percent of Oregon sales in excess of $25 million. Under the proposal, the minimum tax imposed on a corporation with $50 million of Oregon sales would increase from $50,000 to $655,001.

The state has estimated that the proposal would increase state revenues by roughly $6.1 billion per biennium, which obviously would be a significant contribution to the state's general funds budget. For comparison, the corporate excise tax currently generates approximately $1.1 billion per biennium. The state estimates IP28 will result in a loss of 20,500 jobs by adding 17,700 public sector jobs and eliminating 38,200 private sector jobs. According to its backers, additional revenue generated by the proposal will be used for public early childhood and K-12 education, healthcare, and services for senior citizens, though it is unclear how IP28 would direct that other than by filling the state coffers. Additional information on the state's estimates can be found at https://olis.leg.state.or.us/liz/2015I1/Downloads/CommitteeMeetingDocument/90402.

The proposed measure would apply both to Oregon corporations and to foreign corporations subject to Oregon income taxation. However, the measure would affect only businesses taxed as C corporations, not sole proprietorships, partnerships, S corporations, LLCs taxed as partnerships or corporations that qualify as "benefit companies" as defined in Or. Rev. Stat. 60.750. The existing minimum tax rates would continue to apply to such businesses. Businesses seeking to avoid the impact of IP28 by becoming a benefit company should proceed with caution. Governor Kate Brown has released an IP28 implementation plan which includes a proposal which “preserves the integrity of Benefit Corporations” and seeks to prohibit companies “from becoming a benefit company for the primary purpose of avoiding the corporate minimum tax.”

Oregon companies become Oregon benefit companies when they include language in their articles of incorporation or organization indicating the company is a benefit company subject to Or. Rev. Stat. 60.750 through 60.770. Additionally, companies must (1) adopt a third-party standard, (2) prepare an annual report, and (3) distribute an annual benefit report on the company's website.

The materials posted online by A Better Oregon do not explain why the proposal applies only to C corporations that are not benefit companies, and not, for example, to large S corporations or LLCs taxed as partnerships. Presumably the petition drafters wanted to exempt such "small businesses" to reduce criticism from opposing business groups.

Corporations expecting a significant tax increase if IP28 is enacted should work with their Oregon counsel to assess the benefits and burdens imposed by benefit company status. However, only benefit companies organized under Oregon law would be exempt, which raises constitutional concerns under the Due Process Clauses of the U.S. Constitution. Query whether a foreign corporation may form an Oregon corporate subsidiary to operate as a benefit company and conduct business in Oregon.

Critics of the proposal have expressed concern (legitimate in the eyes of these authors) that high-revenue, low-margin businesses may be unable to embed the added cost associated with the minimum tax in the prices charged to their customers. A 2014 study by Sageworks and reported by Forbes analyzed financial statements of privately held companies across more than 1,000 industries and found several industries with net profit margins below 2.5 percent (before tax). These industries included gas stations, grocery stores, appliance stores, and retirement and assisted living facilities.

IP28 qualified for the November 2016 ballot on June 6 after receiving more than 95,000 valid signatures. Early polling indicated that the measure will pass. However, efforts to defeat the measure have been launched and its passage is uncertain.

A Better Oregon asserts that taxes need to be raised on large and out-of-state corporations because Oregon's corporate taxes are the lowest in the country and these businesses are not paying their "fair share." They go on to suggest causation between low corporate taxes and large class sizes, short school years, lack of access to early education, and rising health care premiums. Critics of IP28 note that Oregon ranks low on corporate taxes due to its lack of a sales tax. Those critics further note that Oregon does not fare as poorly when data is adjusted to exclude the impacts of sales taxes.

The Tax Foundation has analyzed IP28 and offers several criticisms in their key findings. First, Oregon's corporate tax climate would become the worst in the nation. Second, the gross receipts minimum tax results in tax pyramiding or cascading as the gross receipts minimum is imposed multiple times as goods make their way through the production process. The Tax Foundation cites a study on Washington business and occupation (B&O) taxes indicating they cascade on average 2.5 times.

However, the authors are unaware of any evidence supporting the proposition that cascading under IP28 would be as significant an issue as it is with the Washington B&O tax. Indeed, it seems that the Oregon corporate minimum tax is less likely to have such cascading impacts given its narrow application to a specific class of businesses, in contrast to the Washington B&O tax which applies to most businesses. Specifically, cascading under the Oregon corporate minimum tax would require transactions between multiple businesses taxed as C Corporations which are not benefit companies, have Oregon source sales in excess of $25 million, and the applicable minimum tax is greater than the regular tax.

Not surprisingly to SALT practitioners, the application of IP28 is contrary to the Council On State Taxation's (COST) policy position on gross receipts taxes. The COST policy disfavors gross receipts taxes generally because they undermine the tax policies of fairness, economic neutrality, and competitiveness.

COST considers a tax to be fair when it treats similarly situated businesses similarly. Gross receipts taxes are generally viewed as unfair taxes because they impose a tax burden on start-up businesses and low-margin businesses. IP28 obviously does not treat similarly situated businesses similarly since larger C corporations (other than Oregon benefit companies) would be taxed while smaller businesses and those organized differently would be exempt. The authors note that an unintended consequence of IP28 might be that Oregon businesses may find it less expensive to acquire their inputs from out-of-state suppliers that are not subject to the minimum tax.

COST considers a tax to have economic neutrality when it does not influence business choices such as the selection of the operational entity. IP28 creates significant incentives affecting the choice of operational entity. Entities taxed as C Corporations with more than $25 million in Oregon sales will consider changing their operational entity by converting to an LLC taxed as a partnership, making a subchapter S election, or becoming an Oregon benefit company in order to avoid the effect of IP28.

COST considers all gross receipts taxes to violate the tax policy of competitiveness. This is because gross receipts taxes generally impose a tax at all stages of the production process. As noted above, the risk of cascading gross receipts tax is reduced by IP28 given its limited application to a narrow set of businesses. However, businesses will be incentivized to vertically integrate when suppliers are subject to the gross receipts minimum tax.

Observations

Oregon voters will find it hard not to approve an increase in the *minimum* tax imposed on large (and mostly out-of-state) corporations. Obviously, the drafters of this voter initiative understand their target audience.

The authors offer no opinion as to the wisdom of increasing the state's tax base. However, voter initiatives that tinker with systemic tax policy ought to concern all practitioners because such initiatives are usually born out of frustration or vested interests. Thus, they lack the benefit of considered input by affected parties.

IP28 is a little different from many other tax initiatives because it increases taxes, whereas many Oregon voter initiatives focused on restraining government spending or reducing taxes (*e.g.,* Oregon Measures 47 and 50). Further, IP28 proposes to enact a statute rather than to amend the Oregon Constitution. Query whether the voters will appreciate the distinction and whether future Oregon legislatures will feel the need to change the statutory language adopted by voters.

Just because voters may be ignorant of the niceties of tax policy doesn't mean that they make poor decisions. Many Oregon voters are disappointed with their legislature's inability to raise sufficient tax revenue to support the level of services those voters desire. Unions similarly prefer a financially solid state for their own reasons. Out of that frustration, IP28 was born, and it is a classic example of what happens when voters feel compelled to enter the fray of setting tax policy.

That is not to say that IP28 is misguided. In addition to being easier for Oregon voters to accept, a minimum tax based on gross receipts has the advantage of reducing the volatility of tax receipts. Those of us who care about rational tax policy, however, cringe at the prospect of imposing such taxes on businesses with low-profit margins. We also worry about the integrity of a tax system that would impose disparate tax burdens on (1) businesses having different forms of organization but similar revenues, (2) businesses having the same form of organization but different revenues, and (3) domestic C corporations that can adopt Oregon's benefit company requirements and those domestic and foreign corporations that cannot.

If adopted by voters this fall, IP28 will no doubt force affected businesses to consider restructuring to minimize its impact. Those taxpayers unable to restructure will no doubt turn to the Oregon Legislature, and possibly the courts, for relief from real or alleged competitive disadvantages. It will be interesting to see how close to reality the revenue projections on IP28 are given these dynamics.