MEMORANDUM

To: Wood Miller, Chairman, Income and Franchise Tax Uniformity Subcommittee

From: Bruce Fort, MTC Counsel

Date: July 15, 2010

Re: Project to Amend “Tax Haven” Provisions in Model Statute for Combined Reporting

In July of 2009, the MTC’s Executive Committee asked the Income and Franchise Tax Uniformity Subcommittee to consider whether a project should be initiated to consider certain changes to the MTC’s 2006 Model Combined Reporting Statute pertaining to the inclusion of foreign entities in the “water’s edge” combined group and the inclusion of U.S.-source income of foreign entities in the water’s edge return.

Under Section 5.A.vii of the model statute, taxpayers utilizing the election to file a water’s edge return must include the income and apportionment factors of any related member “doing business in a tax haven” (unless the activities of the member within the taxing jurisdiction are entirely outside the scope of the “provisions and practices” that have caused the jurisdiction to be considered a tax haven). A study group was formed which recommended that the uniformity committee proceed with a project to revise the model statute’s “tax haven” provision. That recommendation was adopted by the Subcommittee on December 2, 2009 and reported to the Executive Committee on December 4, 2009.

1The study group consisted of Brenda Gilmer, MT; Dee Wald, ND; Michael Fatale, MA. The study group also reported that it would not recommend proceeding with a project to consider changes to the model statute’s inclusion of so-called “80-20 companies” in the combined group, nor would it recommend a project to consider changes to the model statute’s inclusion of U.S.-source income of foreign entities. Those recommendations were also accepted by the subcommittee on December 2, 2009 and reported to the Executive Committee on December 4, 2009.
An interim report was presented to the subcommittee for its meeting in March of 2010 outlining some possible courses of action for a proposed amendment and suggestions for further study. This project has been assisted by advice received from the original study committee members. (Because the subcommittee has so far focused on information gathering, no formal working or drafting group has been formed to date.)

I. Basis for Amending the Current Model Statute’s “Tax Haven” Provision

The current definition has two tests for determining whether a taxing jurisdiction constitutes a “tax haven.” The first test includes jurisdictions identified by the Organization for Economic Cooperation and Development (the OECD) as “tax havens” or jurisdictions identified by that organization as having a “harmful preferential tax regime” in the current year. The second test defines tax havens by reference to the definition adopted by the OECD in 1998, in particular, jurisdictions having: (1) “no or nominal effective tax on the relevant income”; and (2) one of the following characteristics:

(a) secrecy laws preventing exchange of tax information;
(b) non-transparent tax laws;
(c) facilitates establishment of shell entities by foreign taxpayers;
(d) prohibits local taxpayers from enjoying the same tax advantages extended to foreign entities; or
(e) a tax regime which favors tax avoidance.

The first test in the model statute is no longer effective because the OECD has changed its focus from identifying “tax havens” with and jurisdictions with “harmful tax policies” to focus instead on encouraging countries to make progress toward: (a) ensuring greater exchange of information between countries; and (b) protection of taxpayer confidentiality. These new criteria now constitute what the OECD refers to as the “internationally-agreed tax standards.” The OECD has not updated its original list of tax havens published in 2000 and indeed suggests that such list should be regarded in its “historical context.” The OECD’s new focus on information exchange and protecting taxpayer confidentiality, while salutary goals, are not helpful to state tax administrators concerned with the potential for international shifting of the tax base under “water’s edge” reporting.

The second test in the current statute contains excellent criteria for what constitutes a “tax haven”. The problem is that the use of these criteria alone would be subjective and not easily verified. This test was intended to allow inclusion of a jurisdiction that met the OECD criteria, even if it had not yet been added to an updated list. But the second test is not a substitute for objective criteria, such as the first test was intended to supply. Self-reporting tax systems need objective and easily verified criteria to ensure an adequate degree of voluntary compliance. Even the most objective aspect of the current model’s second definition-- whether the jurisdiction imposes more than a nominal “effective tax” on “relevant income”--calls for additional guidance and analysis.
of the purported “tax haven’s” tax system, including general tax rates, deductions, exemptions, treatment of pass-through entities and incentives and credits. Taxpayers electing to utilize the water’s edge filing election are not likely to make these analyses on their own in an impartial manner.

Any definition of countries to be included as tax havens in a water’s-edge election should include an objective and verifiable standard. Without a current OECD program to identify tax havens and jurisdictions with “harmful tax practices”, the current definition, by itself, does not fully meet these criteria.

A. Overview of the Current Model Statute:

The MTC model’s waters-edge election has seven separate categories of taxpayers included on the water’s edge return. The scope of the water’s edge return does pick up the types of entities which receive favorable tax treatment under the Internal Revenue Code (IRC) as well as entities most likely to be engaged in tax-shifting. The need for inclusion of entities operating within “tax havens” should be evaluated in the context of this comprehensive list of included entities.

Section 5.A.i calls for the inclusion of all domestically-incorporated unitary group members in the water’s edge return. Subsection ii includes members with more than 20% of their average property, payroll and sales in the U.S. Subsection iii includes DISC’s, FSC’s and export trade corporations, entities given favorable federal tax treatment and therefore natural beneficiaries of tax-shifting operations. Subsection iv includes the domestic-source income of foreign members and the factors associated with that income; Subsection v provides for inclusion of “Subpart F” corporations, controlled entities operating in low-tax jurisdictions whose income is “deemed” U.S. source income when earned, and is treated as a taxable dividend before the income is repatriated. Subsection vi of the current statute should eliminate many opportunities for international income-shifting, as it calls for inclusion of any foreign member that derives 20% or more of its income from intangible property or services in transactions which are deductible by its domestic counterparts.

The final subsection requires inclusion of members doing business in tax havens (unless the activity is unrelated to the “tax haven” aspects of that jurisdiction). Altogether, the scope of the water’s edge return should encompass most income with a U.S. source, except for problems associated with income deferral by (a) subsidiaries of domestic corporations, and (b) U.S. corporations that have reincorporated in foreign countries (so-called “inversions”). The current “tax haven” provisions may not significantly improve the scope of the anti-abuse provisions embodied in subsections ii through vi, if the difficulties of administration previously mentioned cannot be overcome.2

2 It should be noted that the definition of a domestic corporation (6.A.i) does not include Canadian and Mexican corporations that have elected to be included on a federal consolidated return. This may open up some opportunities to shift income within the consolidated group to
B. Continued Use of OECD Country Lists would be Ineffective.

Under the first test of the current model, a “tax haven” is defined as any jurisdiction that during the tax year in question:

1) “is identified by the Organization for Economic Co-operation and Development (OECD) as a ‘tax haven’ or having a ‘harmful preferential tax regime….’”

In April 2009, the OECD adopted new policy criteria for evaluating a jurisdiction’s tax policies, designated as the “Internationally-Agreed Tax Standards” (“IATS”). The IAT standards are primarily addressed to (1) disclosure of tax and financial information with other countries; and (2) protecting taxpayer confidentiality. Neither of these standards is intended to identify “tax havens” and neither is particularly helpful in preventing income shifting to foreign countries by corporations to avoid state and federal taxes.

The OECD apparently re-evaluated the 41 jurisdictions on its original list in light of the new IAT standard and removed the Isle of Man, Guernsey and Jersey. OECD also expanded the scope of its review under this new standard from the original 41 non-OECD jurisdictions to include OECD countries and countries that participate as observers in the OECD Committee on Fiscal Affairs -- 84 jurisdictions altogether. The new list is restructured into three categories, the second category containing two sub-categories:

(1) “jurisdictions that have substantially implemented the internationally agreed tax standard,” [the white list]
(2) “jurisdictions that have committed to the internationally agreed tax standard, but have not yet substantially implemented it,”
   (a) “tax havens” (non-OECD jurisdictions that meet the 1998 tax haven criteria), [the grey list] and

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4 Interestingly, the 2000 report identifying tax havens included the United States, because of its favorable tax treatment of insurance companies. The OECD web site now says that the 2000 report should be considered in its “historical context.”


6 In a recently-released report for the Congressional Research Service, author Jane Gravelle identified these three categories as the White, Grey and Black lists, respectively.
(b) “other financial centers” (OECD members and observers that have been identified as meeting the 1998 criteria), and

(3) “Jurisdictions that have not committed to the internationally agreed tax standard.” [the black list]

As of July 2010, no countries were listed on the “Black list,” nine countries were listed on the “Grey list”, with an additional five countries listed in the “other financial centers” category. The nine “tax haven” countries are Belize, Cook Islands, Liberia, Marshall Islands, Montserrat, Nauru, Niue, Panama and Vanuatu. The “other financial centers” are Brunei, Costa Rica, Guatemala, Philippines, and Uruguay. There is no longer a list of countries with “harmful preferential tax regimes.” The only difference between “tax havens” and “other financial centers” is whether the jurisdiction is a member of the OECD, the latter category being reserved for OECD members. The current progress report list is available here: [http://www.oecd.org/dataoecd/50/0/43606256.pdf](http://www.oecd.org/dataoecd/50/0/43606256.pdf).

Significantly, meeting the “IATS” does not require disclosure agreements with all OECD countries; a jurisdiction must only enter into disclosure agreements with 12 other OECD jurisdictions in order to be in compliance with the OECD’s standard. The United States and other large industrial countries may well not be included in the disclosure agreements.

Because of the OECD’s change in review from examination of substantive tax policies to consideration solely of disclosure and confidentiality policies, reliance on the OECD’s list would be ineffective for state tax policy purposes. The purpose of the “tax haven” exception to the water’s edge reporting election was to ensure that income reported by related members as having been generated in such countries will be subject to apportionment to assure that the income is correctly sourced, obviating the need for states to engage in complex transfer pricing analysis and sham-transaction/economic substance theories to prevent tax shifting. Disclosure of financial information may be helpful in preventing personal income taxpayers from hiding assets from creditors and tax authorities, but it would not be helpful in preventing most common tax-shifting techniques such as straddles, improper allocation of interest expense to high-tax jurisdictions, sale-in/lease out schemes and transfer pricing abuses. Most significantly, the OECD has completely abandoned the attempt to list countries with “harmful preferential tax regimes.” The OECD appears to have made a determination that the category of “tax haven” is a disfavored one; the current list of “tax havens” appears to be a residual classification based on the 1998-2000 review. The OECD’s publications of jurisdictions that have not yet “substantially implemented” the IATS consistently refer only to the 2000 list of tax havens, suggesting that the OECD no longer identifies or produces a list of jurisdictions using the original “tax haven” standard. Thus, it is arguable that no jurisdiction, not even the nine countries specified above, would currently meet the model statute’s second test for jurisdictions identified as tax havens “during the tax year in question.” Further, a list of “tax havens” that exempts counties like Costa Rica because it has agreed to become a member of the OECD, without including them on
the list of “harmful preferential tax regimes” suggests that the “tax haven” and “harmful preferential tax regime” lists are no longer reliable for our purposes.

C. A Recent Study Suggest that the IATS Standards Would be Ineffective for our Purposes of Preventing Income Shifting for Corporate Taxpayers

A recent research report prepared by Jane Gravelle of the Congressional Research Service attempts to estimate the federal “tax gap” arising from income-shifting to foreign jurisdictions and attempts to identify the likely mechanisms by which income is being shifted improperly. The “Gravelle Report” is available at www.mtc.gov/uniformity. It is clear from that report that the tax information exchange agreements at the heart of the IATS would do little to address income-shifting techniques among corporations. As Gravelle explains, corporate income taxpayers are more likely than individual taxpayers to engage in “tax avoidance” techniques, which rely on gaps in the tax code to allow income shifting, and less likely to engage in “tax evasion” techniques, which rely on gaps in information exchanges, e.g., non-disclosed bank accounts. Corporations are also more likely to engage in income-shifting techniques using transactions with subsidiaries low-tax jurisdictions rather than jurisdictions which might meet a narrower definition of “tax haven” based on bank secrecy laws. In particular, Gravelle notes that during the dividends-repatriation “holiday” of the Jobs Creation Act of 2004, when only 15% of dividends from deferred foreign earnings were subjected to tax, a plurality of dividends were received from the Netherlands, a country which is generally not considered a tax haven and a country which was never on the OECD’s list of tax havens. The Netherlands allows firms to reduce taxes on dividends and capital gains from subsidiaries and has a wide range of treaties that reduce taxes. There is no suggestion that the Netherlands has promoted bank secrecy or failed to cooperate on international tax exchanges. It simply has tax policies that encourage international firms to locate their ownership of intangible property within the jurisdiction.

1. Scope of Federal Tax Losses from Income-Shifting.

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<th>Country</th>
<th>Percentage of Total</th>
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<tr>
<td>Netherlands</td>
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<td>Switzerland</td>
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<td>Ireland</td>
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The Gravelle Report estimates the federal government annually loses somewhere between $10 billion to $60 billion in corporate income tax revenues from improper income-shifting techniques, with the higher number being a more likely amount. Gravelle Report, p. 2. The estimated revenue losses for individuals is higher--$40 billion to $70 billion per year.

2. Sources of Corporate Income Tax Losses from International Transactions.

The Gravelle Report identifies four primary means by which corporations can improperly shift profits overseas or defer repatriation of income for federal tax recognition.

a. **Earnings Stripping Through Interest Expense Misallocation**. Gravelle’s report suggests that the majority of the federal corporate income tax gap arises from transactions in which debt is transferred to subsidiaries in high-tax countries while the interest income is sourced to low-tax countries. The problem is compounded by the income deferral rules, which allows U.S. corporations to avoid paying tax on foreign subsidiary income until it is repatriated, allowing a current year interest expense deduction for investments in foreign subsidiaries where the income from those investments may never be realized on the U.S. return.

b. **Transfer Pricing Abuse on Intangible Property**. The Gravelle reports suggests that transfer pricing abuses are more common for intellectual property because there are not easily identified comparison amounts. Of the industry groups taking advantage of the significantly reduced taxes on dividends in the 2004 Jobs Creation Act, 38% of the dividends were reported by the pharmaceutical and medical industries with another 20% reported by the computer and electronics industries. These types of industry are heavily dependent on intellectual property, such as patents and software copyrights.

c. **Transfer Pricing Abuse on Good and Services**. There is some dispute about the degree to which revenue losses are occurring because of transfer pricing problems with services and intangibles. One report suggests that $60 billion per year of the tax gap can be attributed to this kind of avoidance; Gravelle suggests the problem with intangible pricing is far more serious.

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d. Misallocation of the Foreign Tax Credit. Gravelle reports that a major component of the tax gap arises from use of the credit for foreign taxes paid to offset taxes on current income liability with accrued foreign taxes on income which has not been repatriated. The tax gap arises from timing differences allowing credits to be taken during profitable domestic income years and through misallocation of taxes. Because the states do not follow the foreign tax credit system, this aspect of the “tax gap” should not be of direct concern to the states.


One of the primary means to achieve improper interest shifting and foreign tax credit mis-apportionment is the use of “check the box” rules to defeat the operation of Subpart F taxation of profits of controlled foreign corporations loaning to U.S. parents. According to Gravelle, many corporations use “check the box” rules to treat their foreign subsidiaries as disregarded entities for federal tax purposes but treat the same entities as separate entities for foreign tax purposes. Gravelle reports that Congress is considering legislation requiring consistent treatment of entities for federal and international purposes. The states may wish to consider a similar rule requiring corporations to treat disregarded entities similarly for federal and international purposes.

II. Considerations for a New Standard for Inclusion of Jurisdictions in MTC’s Model Combine Reporting Statute for Water’s Edge Election.

In determining what jurisdictions should be considered a “tax haven” for purposes of including entities operating within those jurisdictions on the water’s edge return, states should seek a definition which:

a. includes all or most jurisdictions to which corporate income is commonly-shifted;
b. is not so over-inclusive that it simply mimics world-wide combined reporting;
c. allows for certainty and ease of administration for both taxpayers and tax administrators;
d. allows the states the ability to consistently update and revise any published lists of jurisdictions to where profit shifting occurs;
e. complements the other anti-abuse provisions in the water’s edge election statute.

A. Use of Subjective Standards Alone to Define a “Tax Haven” is Not a Practical Method for Determining Inclusion on a Water’s Edge Return.

The MTC’s model statute’s second test provides excellent criteria for what constitutes a tax haven, but is not intended to, by itself, satisfy the requirements for tax administration identified above. Without certainty and ease of verification, taxpayers will simply take filing positions based on their view that the jurisdictions in which they operate are not tax havens, and require the states to litigate that issue in order to uphold
subsequent audit assessments. Few if any states have the tax expertise or litigation resources necessary to effectively contest such filing positions with any regularity.

B. Any List of Tax Havens Should Address How Income is Being Shifted for Corporate Income Tax Purposes.

There are several possible approaches to defining a “tax haven” for purposes of state corporate tax enforcement. The first step would be to ensuring that the right countries are covered. As the Gravelle report indicates, corporations are more likely than individuals to use “gaps” in the tax code, such as permissible inconsistent treatment of disregarded entity status, to achieve tax avoidance. Unfortunately, these schemes may involve transactions with multiple foreign jurisdictions, such that inclusion of the income of a subsidiary operating in a recognized tax haven might be ineffective if the income has been transferred elsewhere through the use of pass-through entities, property exchanges or disregarded entity status.

Any definition of a “tax haven” should include jurisdictions with (a) a low general tax rate, or (b) a low tax rate on intangible income, specifically, dividends, interest, royalties on patents and trade marks, and capital gains. Tax policy towards intangible income is a significant factor to consider, since most income-shifting occurs through improper pricing of transactions involving intangible property. The current definition uses “no or nominal effective tax on the relevant income” as the first criteria for determining what constitutes a tax haven. But taxpayers may disagree as to what is the “relevant” income in a complex transaction, and it is difficult to ascertain the “effective tax rate” on income. This type of guidance can be accomplished through regulation. The application of the other five criteria in the current model statute are more subjective and less easily defined, even by regulation. They rely more on director discretion. Falling afoul of any one of the five criteria, combined with a nominal tax rate, qualifies a jurisdiction for treatment as a tax haven. Determining whether a jurisdiction has a regime that “favors tax avoidance” is particularly difficult.

D. Objective Criteria May be Better Suited to Defining Tax Haven Status But May be Under-Inclusive.

One “middle ground” between reliance on objective and easily quantifiable third-party lists, on the one hand, and subjective criteria, on the other, would be reference to easily verifiable and quantifiable criteria. The key with using such criteria is to make sure they capture the tax attributes of a jurisdiction that allow income-shifting.

III. Options for Amendment to the “Tax Haven” Provision.

Based on the considerations outlined above, there are at least several possible approaches to amending the “tax haven” portion of the water’s edge election. The first adopts a single and very broad test for inclusion of foreign subsidiaries based on host country tax rates. The second approach retains the current mix of subjective and objective criteria but imposes a requirement on the states to make those determinations in advance. A third approach would be to adopt a very comprehensive list of countries that
have been identified as “tax havens” based on analysis by tax policy organizations or other authorities.

A. The Tax Rate Test.

One options would be to define an “includable” jurisdiction (avoiding the “tax haven” phrase) as: “a jurisdiction which:

1. has an general tax rate of less than X% of the tax rates listed in IRC Sec. 11, applicable to all persons and all income from whatever source, or,

2. has an effective tax rate on intangible income (dividends, interest, capital gains and royalties) of less than X% of the tax rates listed in IRC Section 11.

It should be noted that under Subpart F of the Internal Revenue Code, in order to meet the deemed-income recognition exception in Section 954(a)(4), the taxpayer must establish that it paid an “effective tax rate” of at least 90% of the U.S. tax rate on such income. The statute contemplates that the “effective tax rate” may be difficult to determine, and allows for some negotiation in determining that amount.

A variation would be to use model’s existing language (which has been approved by the subcommittee and the full commission): “no or nominal” tax rate on “relevant income.” “Nominal” could be defined by model regulation. The use of a near-zero tax rate may result in under-inclusion of income, however, if corporations attempt to shift income to countries with tax rates far less than the current federal rate of 35% but still more than nominal rates.

B. List Based on Existing Subjective Test, Created by the States.

Alternatively, the Subcommittee could consider retaining the six criteria of the second test in current subsection 1.I.ii unchanged, with an explicit requirement that the tax agency evaluate the tax policies of all countries on an annual basis to determine whether the jurisdiction should be considered a tax haven. Without an annual designation, taxpayers will simply ignore the requirement to include subsidiaries operating in tax havens in the combined return. The state’s determination (a task which could be delegated to a single state organization to create one list and thereby promote uniformity) puts the taxpayers on notice that these jurisdictions are considered “includable” under state law. A taxpayer would be able to contest these determinations but only after full disclosure of its filing position including a report of the tax effects of exclusion.

C. Lists Based on Alternative Criteria

1. GAO proposal.
In 2008, the GAO issued a report (GAO-09-157) on large corporations with subsidiaries in tax haven countries. The GAO noted that no single definition of tax haven was agreed upon by tax professionals but identified three possible sources for such lists: (a) the OECD tax haven list (37 countries as of 2007); (b) a 2007 report by the National Bureau of Economic Research listing 41 countries; and (c) a federal district court summons issued by the IRS directed at a third party processing credit card transactions in 34 jurisdictions which were identified by a revenue agent as potential tax havens or having “financial privacy” laws which abetted tax avoidance. But there has been some criticism of this suggestion. The U.S. Treasury Department responded to the GAO report noting that the district court which had approved the IRS summons had not agreed that the countries listed on that summons were “tax havens” or jurisdictions that encouraged income sheltering. Problems with the OECD list are discussed above. The NBER list has not been updated since 2007. The GAO report is available as a link to topic VIII on the MTC’s web-site agenda for the July 25, 2010 in-person meetings: http://www.mtc.gov/Uniformity.aspx?id=4896

2. Congressional legislation

Legislation was introduced in the 100th Congress to treat income earned in some 50 countries as deemed U.S.-source income (similar to the current Subpart F treatment of some foreign-country earnings), deriving its “tax haven” list from the 2000 OECD tax haven list (but excluding the U.S. Virgin Islands). See, S-396 (110th Cong.). If similar legislation does pass, states could consider amending their water’s edge laws to include income earned in those jurisdictions by reference to the new federal statute.

3. Other Lists.

One standard which has been suggested by some professionals is:

(i) The foreign jurisdiction has not entered into a tax information exchange agreement with the United States;

(ii) The jurisdiction is not listed as an approved ‘know your customer’ country by the Internal Revenue Service pursuant to Revenue Procedure 2000-1210; and

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10 The IRS publishes a report of countries meeting its “know your customer” criteria and can be counted upon to update that list appropriately. Under IRC Sections 1441 and 1442, a U.S. company making payments of dividends, interest, royalties, certain capital gains and other income to a foreign person must withhold tax of 30% on those payments and issue a W-9 to the recipient. These withholding requirements can be avoided if the payor knows its payee is a foreign national which has entered into a written tax agreement with the IRS (the payee becomes a “Q-1” customer). The IRS will only enter into such agreement with a Q-1 if they are from approved countries that have established exchange agreements with the U.S. and agree to obtain identify information from banking customers and others. The Internal Revenue Service’s list of approved counties with “know your customer” rules is available here:
(iii) The foreign jurisdiction has a general corporate tax rate of less than 10 percent.

All three criteria are easily verified and are objective. The first two criteria are very relevant for individual income tax compliance, but less relevant to corporate income tax income-shifting problems, which do not rely on financial secrecy laws. The reference to general tax rates is also unavailing since it is the rates on intangible income that is often the most relevant consideration. The general tax rate may be irrelevant for sophisticated tax schemes.

D. Eliminate TH provision

A fourth option would be to eliminate the “tax haven” provision entirely and rely on the other anti-abuse protections in the water’s edge election. This would be appropriate if Congress acts to reduce international tax sheltering through amendments to the “check the box” regulations, heightened scrutiny of intangible transfer pricing or enacts other reforms currently being discussed at the federal level.

http://www.irs.gov/businesses/international/article/0,,id=96618,00.html. Significantly, the list includes some countries such as Antigua which had been considered “tax havens” in the past.