MULTISTATE TAX COMMISSION

MEMORANDUM

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

From: Bruce Fort, MTC Counsel

Date: February 19, 2010

Re: Proposal to Amend Description of "Tax Haven" in Model Statute for Combined Reporting for Purposes of Including Certain Entities in Water's Edge Election

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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. A study group was formed which recommended that the uniformity committee proceed with a project to review the model statute's definition of a "tax haven" for purposes of including those entities in the "water's edge" return. 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 accepted by the subcommittee on December 2, 2009. At present, a working group looking into changes to the definition of "tax haven" includes Brenda Gilmer of Montana and Dee Wald of North Dakota, with Bruce Fort having been assigned as staff.

The purpose of this memo is to identify some options for amending the model statute's definition.

A. The Current Model Statute:

The MTC model's waters-edge election does not exclude foreign unitary affiliates from the combined group if the affiliate is "doing business in a tax haven…" (§5.A.vii.).

Under the 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

"exhibits the…characteristics established by the OECD in its 1998 report…as indicative of a tax haven…regardless of whether it is listed by the OECD as an un-cooperative tax-haven…" (§1.I.) [1]

B. Recent Activity by the OECD.

In April 2009, the OECD produced a restructured and thoroughly updated list of jurisdictions that were identified as tax havens.[2] The OECD re-evaluated the 41 jurisdictions on its original list and removed the Isle of Man, Guernsey and Jersey. OECD also expanded the scope of its review 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,"
(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), and
  (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 "1998 criteria" for determining whether a jurisdiction should be classified as a tax haven begins with an evaluation of whether the entity has no or nominal tax rates on relevant income and at least 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; and (e) a tax regime which favors tax avoidance.

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[1] The MTC Model Combined Reporting Statute is available at http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Combined%20Reporting%20-%20FINAL%20version.pdf.

[2] *See* http://www.oecd.org/dataoecd/38/14/42497950.pdf .

Significantly, the OECD now has a separate category for "financial centers" such as Switzerland which have some characteristics meeting the criteria for tax havens. The OECD has also responded to earlier criticism that its lists were not updated frequently enough by promising more frequent review.

C. Recent Activity by the Government Accounting Office.

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); (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 as potential tax havens or having "financial privacy" laws which abetted tax avoidance. The GOA report did not attempt to quantify federal revenue losses arising from the presence of subsidiaries of U.S. taxpayers in those regions. The U.S. Treasury Department responded to the GAO report by suggesting that the use of the term "tax haven" as applied to the countries on that list was unhelpful to its efforts to secure cooperation with those jurisdictions, and noted 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.

There is significant overlap among the jurisdictions listed on the three sources "tax havens" provided as Appendix I to the GOA report. The state of California references that appendix in its "water's edge" statute despite the Department of Treasury's concern that the IRS summons was not intended to establish a list of tax havens. California is now considering legislation to clarify its treatment of income from entities operating in tax havens to include income not derived from the active conduct of a trade or business in such tax haven countries. The bill would also provide that any jurisdiction listed as a tax haven by the U.S. Department of Treasury would automatically be added to the state's "tax haven" definition, and any jurisdiction de-listed by the Treasury Department would be entitled to similar treatment under California law. It is not clear that the U.S. Treasury intends to maintain a "tax haven" list given its response to the GAO report.

D. Reasons for Amending the MTC's Model Statute.

The decision by the OECD to reclassify countries which have not fully implemented international tax standards into "tax havens" and "other financial centers" could lead to a situation where income could be shifted to financial centers that do not meet the MTC's definition of a tax haven. In addition, the OECD has a new category of jurisdictions which have not committed themselves to implementing international tax standards. States and taxpayers may have difficulty in determining whether particular financial centers and no-committed jurisdictions constitute tax havens under the MTC Model's definition.

E. Some Possible Amendments to the MTC Model Statute:

One possible amendment would be to follow the California definition described above: all jurisdictions listed in the GAO report's appendix, including financial centers and tax havens listed by the OECD, the National Bureau of Economic Research list and the IRS's third-party summons. This would be the broadest possible scope for the water's edge group based on the tax haven concept and would promote certainty as to what jurisdictions were considered "tax havens."

A second approach would be to limit the "tax haven" criteria to OECD jurisdictions listed as tax havens and non-cooperating jurisdictions, eliminating inclusion of subsidiaries operating in financial centers. This approach would foster administrative simplicity, assuming the OECD continues to monitor its lists. The states would be forced to rely on federal transfer pricing controls and RAR's to prevent income-shifting to financial centers.

A third approach would be to eliminate any reference to OECD lists and rely solely on the "1998 criteria" for determining whether a jurisdiction should be classified as a tax haven. This approach would allow the states and taxpayers greater flexibility in determining what jurisdictions should be considered tax havens based on changes in the foreign entity's tax laws and cooperation with international tax standards.

F. Conclusion.

The working group assigned to this project continues to evaluate possible amendments to the MTC model combined reporting statute. Even though the OECD list has become more nuanced in its treatment of tax havens and financial centers, the current model statute should provide sufficient guidance in the meantime to taxpayers and the states through its reference to the 1998 OECD criteria.