MULTISTATE TAX COMMISSION

MEMORANDUM

To: Robynn Wilson, Chairman, Income and Franchise Tax Uniformity Subcommittee

From: Bruce Fort, MTC Counsel

Date: November 23, 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 ("the subcommittee") to consider a making 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. The subcommittee agreed to the project in December of 2009; since then, the subcommittee has considered the topic of possible amendments on three separate occasions, most recently on September 30, 2010.

A. The Current Model Statute's Tax Haven Provisions.

The MTC's Model Combined Reporting Statute allows taxpayers an option to file on a water's edge basis, but the model statute provides that some entities incorporated outside the United States should be included in the water's edge return, including entities operating "tax haven" jurisdictions. The model statute recognizes that some foreign–incorporated entities should be included to prevent income-shifting, especially since many states do not include foreign-source dividends in the apportioned tax base. The current model statute has two independent tests for determining whether a jurisdiction is a "tax haven."

- The first test in the model statute is whether the taxing jurisdiction is listed as a "tax haven" or a jurisdiction having a "harmful preferential tax regime" by the Organization for Economic Development and Cooperation ("the OECD") in the current year.

- The second test is whether the jurisdiction maintains no tax or a nominal rate of tax on the "relevant income", in addition to exhibiting any one of five characteristics of a tax haven. Those characteristics are:

(a) Laws and practices that prevent effective exchange of information concerning taxpayers;
(b) A tax regime which "lacks transparency", that is, a tax system that is not open or which is applied inconsistently;
(c) A legal system that facilitates the establishment of foreign-owned entities without a substantial local presence;
(d) A tax regime which excludes the jurisdiction's resident taxpayers from certain benefits available to foreign investors;
(e) A tax regime which is favorable for tax avoidance, based on an overall assessment of "relevant factors", including whether the jurisdiction has a significant untaxed financial sector.

B. Concerns with Current Model Statute's Two Tests.

1. Reference to OECD Lists May be Counterproductive as the OECD Has Changed its Focus from Substantive Tax Policy to Encouraging International Information Exchange and Cooperation.

The first test is no longer reliable because the OECD does not currently list "tax havens" or "regimes with harmful tax practices." The extent to which the OECD has abandoned these classifications is unclear, but it is apparent that the OECD no longer engaged in an effort to maintain the lists, which have not been updated since 2000. Instead, the OECD classifies taxing jurisdictions based on their commitment to implementing the "internationally-agreed tax standards" ("IATS"). Those standards are primarily directed to protecting taxpayer confidentiality and establishing exchange agreements for sharing tax and financial information with a minimum of twelve other OECD countries.

The IATS may be appropriate to discourage high net worth individuals from hiding assets, but those standards are not appropriate to prevent tax avoidance by multinational corporate taxpayers. (In a recent report by the Congressional Research Service, author Jane Gravelle explains that individuals are more likely to engage in illegal "tax evasion" behavior by hiding assets, while corporations are more likely to exploit legal loopholes in the tax code, which she terms "tax avoidance." Congressional Research Service, *Tax Havens: International Tax Avoidance and Evasion* (June 4, 2010). http://assets.opencrs.com/rpts/R40623_20100604.pdf.)

Because the OECD does maintain a current list of jurisdictions based on their commitment to meeting the IATS, continued reference to OECD standards is likely to cause confusion as to whether a jurisdiction should be considered a "tax haven." Compounding the potential for confusion, the OECD does identify six jurisdictions as "tax havens" that have not fully implemented the IATS.[1] (The OECD also lists three jurisdictions, Costa Rica, Guatemala and Uruguay, as "other financial centres" that have not fully implemented the IATS.) The OECD short list raises an inference that scores of jurisdictions which *have* agreed to the IATS should no longer be considered "tax havens"

[1] Liberia, Montserrat, Nauru, Niue, Panama and Vanuatu.

even though their substantive tax policies meet some or all of the "tax haven" criteria previously used by the OECD. For the most recent "progress report" by the OECD, see http://www.oecd.org/dataoecd/50/0/43606256.pdf.

2. Reference to a Jurisdiction's Tax Rates on "Relevant Income" and its Tax Policies May Provide Insufficient Certainty to Taxpayers, Discouraging Voluntary Compliance.

The second test employed by the model statute operates independently of the OECD's classifications, but the subjective nature of the inquiries into a jurisdiction's tax policies does not lend itself for use in a voluntary reporting system. A taxpayer with income shifted to a low tax jurisdiction will likely disagree that the jurisdiction's laws "lack transparency" or "create a regime favorable for tax avoidance." A state revenue department wishing to include the income of a foreign subsidiary on a water's edge return may be required to expend considerable resources in investigating and analyzing that jurisdiction's tax policies. The burden of demonstrating that a jurisdiction is a "tax haven" under the second test may be complicated because corporate tax shifting often involves multiple international transactions and subtle aspects of a jurisdiction's taxing system, such as exemptions for certain types of income or tax treaty exclusions. The "tax haven" aspects of a jurisdiction may not be apparent until an income-shifting plan is illuminated following an audit or investigation. For instance, Jesse Drucker's recent article about Google, Inc. showed how intellectual property (foreign licensing of Google's search engine and trademarks) was transferred from the U.S. parent to an Irish subsidiary, then licensed through a subsidiary in the Netherlands to an LLC in Bermuda, allowing the Irish subsidiary to claim a substantial deduction for royalty payments that largely escaped taxation in any country. See: http://www.washingtonpost.com/wp-dyn/content/article/2010/10/30/AR2010103000034_pf.html

Although their tax systems allowed Google to reap significant tax savings, neither Ireland nor the Netherlands are commonly thought of as tax havens. In order to effectively apply the second set of criteria, therefore, a state may need to establish its "tax haven" list through prospective regulatory action or legislation. The State of Montana uses the latter approach. MCA Section 15-31-322 includes a non-exclusive list of tax havens and directs the revenue department to provide an updated list to the revenue and transportation committee on a biennial basis. The legislature makes the final determination of whether a jurisdiction should be added to or deleted from the statute. The most recent revenue department report to the legislature is available here:

http://leg.mt.gov/content/Committees/Interim/2009_2010/Revenue_and_Transportation/Meeting_Documents/TaxHavenReport%20(2).pdf.

C. Some Considerations for a New Definition of "Tax Haven" for the Model Combined Reporting Statute.

The subcommittee has previously been provided with a memorandum (dated July 15, 2010) describing the current landscape of the federal corporate income "tax gap" arising from international transactions, estimated at some $50 billion annually. In particular, most of the tax losses appear to arise from the federal system of income deferral for the earnings of foreign subsidiaries of U.S. corporations. Income deferral rules encourage U.S. corporations to shift interest expense to the U.S. and to undervalue property and services transferred overseas. Intellectual properties in the form of patents, trademarks and industrial processes are especially subject to "transfer pricing" abuses. The owners of intellectual properties such as patents, trademarks and unique industrial processes were the biggest beneficiaries of the 2004 Jobs Creations Act, which lowered the federal tax on foreign dividends by 85%, repatriating hundreds of billions of dollars in deferred earnings. The Congressional Research Service identified the primary sources of those dividends as the Netherlands (28%), followed by Switzerland (10.4%), Bermuda (10.2%), Ireland (8.2%), Luxembourg (7.5%), Canada (5.9%) and the Cayman Islands (5.9%). (The fact that dividends were repatriated from these countries does not necessary mean that the income was initially shifted to entities operating there.)

1. The Scope of the Tax Haven Provisions Should be Politically Feasible.

Any model definition of "tax haven" should consider the subtle means by which income is shifted and deferred in multi-jurisdictional transactions, often involving countries with transparent tax systems and substantial tax rates on most income. The definition cannot be so broad, however, that it merely imposes a world-wide combined reporting system under another name.

2. The Tax Haven Provisions Should Include Easily Verifiable Criteria to Encourage Voluntary Compliance and Ease of Administration.

To ensure compliance without the need to engage in complex auditing, and to streamline administration of corporate tax impositions, any definition of a "tax haven" should allow taxpayers to easily ascertain whether a jurisdiction falls within the scope of the definition, and the definition should be based on reasonably objective standards to avoid subsequent disputes.

3. The Tax Haven Definition Should Also Maintain Enough Flexibility to Cover Unanticipated Situations.

While the states should endeavor to develop an objective and predictable set of criteria for defining tax havens, the current subjective criteria should not be abandoned entirely since states cannot know the subtleties of every country's tax laws. Some of those subtleties may only be revealed during the audit of a taxpayer taking advantage of a jurisdiction's tax structure to reduce its effective tax rates.

D. Some Suggestions for Amendments to the Current Model Statute.

1. Reliance on Published Lists of "Tax Haven" Countries.

The most easily verifiable and objective definition involves list-making, either by the states or by outside parties. In addition to the OECD, the National Bureau of Economic

Research has produced a list of tax havens, as has the Financial Stability Forum, and the Tax Justice Network. The IRS issued a subpoena in 2005 against PayPal, Inc., asking for records of bank accounts in a number of jurisdictions its revenue agent labeled as tax havens. That "John Doe" subpoena was referenced in water's edge legislation introduced in California in 2009. Legislation has been introduced in the U.S. Congress that includes lists of "tax havens." See S- 396 (110th. Cong.).

Reliance on third-party lists comes with drawbacks. The organizations charged with maintaining their lists may have political agendas or biases that are unacceptable to the states, and the objectives of those organizations may change over time. In addition, most non-governmental organizations cannot be counted upon to maintain their lists on a periodic basis. To a degree, the OECD's experience with its tax haven project from 1998 to the present underscores each of these problems.

An alternative might be the adoption of a list to be developed by each state's revenue departments, perhaps in cooperation with other states, and incorporated into each state's version of the model statute, with provision for an annual update by the revenue agencies. Using a list developed by one or more states, as Montana has done individually, presents fewer policy and administrative concerns, but it may be politically untenable in some states. Classifying foreign tax regimes does suggest a certain degree of state involvement in a subject matter that some claim lies within the sole purview of Congress. (In the unlikely event that Congress chooses to pass legislation identifying tax havens, the states would have little problem in conforming to that list for water's edge reporting purposes.) The states could avoid most of the potential for controversy simply by changing the name from "tax havens" to something more neutral, like "additional includable jurisdictions."

2. Reference to a Jurisdiction's Effective Tax Rates as the Sole Criteria for Inclusion in the Water's Edge Return.

A second means to achieve predictability and objectivity would be to adopt a test that only referenced effective tax rates on "relevant" income, especially tax rates on easily-transferred capital, including dividends, capital gains and intangible property rights. The "relevant income" test does have some drawbacks since income can be reclassified or changed in character as a result of intercompany transactions. It may still be necessary to clarify what tax rates are applicable to what types of income for each country, and to maintain a reference point for taxpayers seeking to comply with state laws.

3. Elimination of the First Test and Reliance on The Second Test (Low Tax Rates and One or More Attributes of "Tax Haven" Policies).

Certainly, the easiest solution to the problem created by the OECD's change of focus would be to eliminate the references to the OECD's list, leaving the states to rely solely on the subjective "tax haven" criteria. Because of the subjective nature of the second test, the "tax haven" provisions would probably only be utilized in an audit situation to prevent abusive transactions involving entities operating in taxing jurisdictions that clearly meet the low tax threshold of Section 1.5(a) and one or more criteria in Section 1.5(b). Entities in jurisdictions with marginal "tax haven" attributes would likely not be included on the water's edge return.

4. Elimination of the "Tax Haven" Criteria Entirely With Reliance on Other Provisions in the Model Statute Requiring Inclusion of Foreign-Source Income.

The model statute does provide that many types of unitary foreign subsidiaries must be included on the combined return, including "controlled foreign entities" subject to Subpart F income rules, entities with 20% or more of their property, payroll and sales from U.S. sources, DISC's, FSC's, and the earnings of foreign entities attributable to U.S. sources (regardless of treaties), and foreign subsidiary earnings derived from intangible property transactions and services with a U.S. counterpart. Taken together with the promise of increased federal enforcement of transfer pricing rules, the states may feel that the tax haven provisions are unnecessary to close the state portion of the current international tax gap.