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To: Wood Miller, Chair, and Members of MTC Uniformity Committee
From: Shirley Sicilian, General Counsel
Date: November 23, 2009
Subject: Possible Project to Amend Model Combined Reporting Statute Water's-Edge Election regarding Inclusion of (1) Tax Havens, (2) 20% Deductible Income, or (3) US Source Income

I. Introduction and Summary

The MTC model statute requires world-wide combination but allows a water's-edge election.¹ The election limits the combined group to domestic, and some foreign, unitary affiliates (or a portion of their income and factors). In response to requests, the Executive Committee asked the Uniformity Committee to consider whether projects should be initiated to amend any one of the following 3 water's-edge inclusions:

- **Tax Havens:** Unitary foreign affiliates “doing business in a tax-haven...” are included in the combined group. A “tax-haven” is any jurisdiction that, during the tax year, is (1) identified as a tax-haven by the Organization for Economic Cooperation and Development (OECD), or (2) meets the description of a tax-haven developed by the OECD. The jurisdictions of Isle of Man, Isle of Jersey, and Guernsey requested review of this provision.
- **20% Deductible Income** –If a unitary foreign affiliate earn more than 20% of its income from sales of intangible property or services deductible as expenses against the business income of other combined group members, that income (and related factors) is included in combined income. The Organization for International Investment (OFII) requested review of this provision.²
- **US Source Income** –If a unitary foreign affiliate has US Source Income (under the federal code, w/o regard to federal tax treaties), that income (and related factors) is included in combined income. OFII requested review of this provision.

In July, the Uniformity Committee formed a study group to make a recommendation. Members of the group include Michael Fatale (MA), Brenda Gilmer (MT), and Dee Wald (ND). The study group held three teleconferences in August and September of 2009. The teleconferences included participation from OFII. The study group recommends a project be initiated to review the tax haven provision, but that a project is not necessary on either of the other two provisions.

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 OFII represents approximately 150 U.S. subsidiaries of companies based abroad.

II. Tax Haven Inclusion – Isle of Man, Jersey and Guernsey Request

A. Issue: Should the MTC Model be reviewed in light of OECD Developments?

Beginning in 2007, the Executive Committee heard concerns from Isle of Man, Guernsey and Jersey regarding the provision in the MTC model's water's-edge election that includes entities doing business in a tax haven in the combined group. The provision defines "tax haven" by reference to the OECD's criteria and list. Until April of 2009, each of these jurisdictions was included on the OECD's list of tax havens. The jurisdictions' most immediate concern was that, although the OECD regularly reported each jurisdiction's progress, OECD had not removed the jurisdiction from the list. The jurisdictions felt they should no longer be identified as "tax havens,"³ based on the OECD criteria.⁴ In the absence of OECD action, the jurisdictions asked that the MTC model be revised so that it did not rely on the OECD list or criteria.⁵

MTC Model: 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
- 2) "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.)

OECD Developments: In April 2009, the OECD met as part of the G20 conference in London, and produced a restructured and thoroughly updated list.⁶ At this time, OECD re-evaluated the 41 jurisdictions on its original list and Isle of Man,

³ The OECD's 2000 Progress Report reviewed 41 non-OECD jurisdictions against the 1998 criteria. In 2002, the OECD characterized 39 of the 41 jurisdictions as tax havens. Of the 39, 32 were identified as "cooperative" tax havens and 7 were identified as "uncooperative" tax havens. Starting in 2005, the OECD published annual assessments showing the extent of each cooperative tax haven's progress in implementing its commitments.

⁴ According to the 1998 OECD Report, a tax haven is a jurisdiction that imposes no or nominal direct taxes on financial or other mobile services income *and* also meets one of three criteria: (1) its regimes lack transparency; (2) it does not engage in effective information exchange; or (3) its regimes facilitate the establishment of entities with no substantial activities.⁴ These criteria, which are referenced in the MTC model (§1.I), have not changed since 1998. Indeed, they have become the internationally agreed standard. They were endorsed by G20 Finance Ministers in 2004 and by the UN Committee of Experts on International Co-operation in Tax Matters in 2008.

⁵ See, e.g., Isle of Man letters to MTC: November 2007, p.3; May 2009, p.6.

⁶ See <http://www.oecd.org/dataoecd/38/14/42497950.pdf> ; See also attached list - Appendix A)

Guernsey and Jersey were removed. 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.”

(emphasis added; See attachment A - copy of the new OECD list.)

OECD has pledged to regularly evaluate the jurisdictions’ progress through “robust reviews.”⁷

B. Recommendation: MTC Project to Revise Tax Haven Provision

The restructured OECD list may not define “tax haven” broadly enough to satisfy the original intent of the MTC model. The MTC model defines “tax haven” to include a jurisdiction that “is identified by the [OECD] as a tax haven ...”, but under the new OECD structure, the term “tax haven” is only one of the two subcategories under “jurisdictions that have committed to the internationally agreed tax standard but have not yet substantially implemented it.” Furthermore, jurisdictions that “have not committed to the internationally agreed tax standard” are set aside in a separate category altogether.

Clarification options include a simple technical correction to the language or, as recommended by the Isle of Man, elimination of the list provision altogether.⁸ If the list is eliminated, the model would define “tax haven” based only on whether the jurisdiction meets the OECD criteria. The OECD criteria could be augmented with additional requirements to reflect state concerns that are not addressed even when OECD standards are met. For example, if a jurisdiction adopts the transparency measures required by the OECD standards, state and federal tax authorities will be better able to identify entities engaged in tax shifting there. Federal authorities can use this information to apply

⁷ *Following G20 OECD Delivers on Tax Pledge* (April 2009); http://www.oecd.org/document/57/0,3343,en_2649_34487_42496569_1_1_1_1,00.html

⁸ The Isle of Man cautions that if the list provision is not eliminated, then only the most recently issued OECD list should be used. See Letter from Isle of Man, dated July 2009.

transfer pricing rules and address the income shifting. But under the MTC combined reporting model, exclusion of the jurisdiction from the list simply means the entities are now excluded from the waters-edge combined report. The state would need to find some other authority to address any income shifting that is identified.

III. 20% Deductible Income and US Source Income Inclusions – OFII Request

A. Issue: Is the MTC Model’s Inclusion of This Foreign Affiliate Income Overbroad Such that Exceptions Should be Added?

On July 20, 2009, and November 20, 2009, the Commission received letters from OFII requesting MTC review two of its water’s-edge provisions. The first provision requires a unitary foreign affiliate earning income attributable to sources in the United States to include that income, and related factors, in the apportionment calculation (§5.A.iv).⁹ The second requires a unitary foreign affiliate earning 20% or more of its income from the sale or lease of intangibles or services to other members of the combined group to include that income, and related factors, in the apportionment calculation (§5.A.vi).¹⁰ OFII suggests these inclusions result in taxation of foreign income from legitimate transactions, including income that, under federal tax law, is “non-effectively connected income.” OFII notes that California’s water’s-edge election excludes non-effectively connected income. It suggests inclusion of this income is not consistent with the “permanent establishment” concept used in the context of federal tax treaties, and “has the potential of creating significant unnecessary compliance costs, legal challenges and undefined administrative burdens for both the MTC member states and the taxpayers.” OFII asks the Commission to consider exceptions to these inclusions, similar to the exceptions allowed under the MTC’s model add-back statute.

OFII’s concerns are understandable, but for the most part they have long ago been considered and addressed. In principle, combined group income *should* include the *entire* income and factors of all affiliates participating in unitary business, both domestic and foreign. This inclusion does not amount to taxation of foreign income. It is simply inclusion of all unitary income (and loss) in the calculation for determining a state *taxpayer’s share of that income*. This is the unitary business concept. The concept, applied to multinational as well as multistate businesses, has been upheld by the U.S. Supreme Court.¹¹

⁹ §5.A.iv. requires a foreign affiliate, if not otherwise included in the combined group, to “include the portion of its income, derived from or attributable to sources within the United States, as determined under the Internal Revenue Code without regard to federal treaties, and its apportionment factors related thereto[.]”

¹⁰ §5.A.vi. includes in the combined group a foreign affiliate “that earns more than 20 percent of its income, directly or indirectly, from intangible property or service related activities that are deductible against the business income of other members of the combined group, to the extent of that income and the apportionment factors related thereto[.]”

¹¹ *Container Corp v. Franchise Tax Bd.*, 463 U.S. 159 (1983); *Barclays Bank PLC v. Franchise Tax Bd.*, 512 U.S. 298 (1994).

In upholding the unitary business principle's application to multinational income, the Court explicitly rejected an argument that the system operates to impose inordinate compliance burdens on foreign enterprises.¹² Moreover, the Court recognized that Congress has not chosen to enact any of numerous bills, or to ratify a treaty provision, that would have prohibited the states from including all foreign affiliate income in a combined report. In *Barclays*, the Court cited to its decision in *Container*, where it found no "specific indications of congressional intent" to preempt a state's use of worldwide combined reporting:

First, there is no claim here that the federal tax statutes themselves provide the necessary pre-emptive force. Second, although the United States is a party to a great number of tax treaties that require the Federal Government to adopt some form of 'arm's-length' analysis in taxing the domestic income of multinational enterprises, that requirement is generally waived with respect to the taxes imposed by each of the contracting nations on its own domestic corporations. ... Third, the tax treaties into which the United States has entered do not generally cover the taxing activities of subnational governmental units such as States, and in none of the treaties does the restriction on 'non-arm's-length' methods of taxation apply to the States. Moreover, the Senate has on at least one occasion, in considering a proposed treaty, attached a reservation declining to give its consent to a provision in the treaty that would have extended that restriction to the States. Finally, ... Congress has long debated, but has not enacted, legislation designed to regulate state taxation of income.'

Barclays at 321-322, citing *Container* at 196-197 (footnotes and internal quotation marks omitted).

The Commission's water's-edge election must be analyzed in this context. It is an election allowing taxpayers to restrict the combined group to something less than the entire unitary group. Nothing in the U.S. Constitution, federal statute, or federal treaties requires states to limit combination, or to allow taxpayers to elect to limit combination, even further to only domestic unitary affiliates.

The Commission's decision to allow a water's-edge election was not entered lightly. To the extent combination excludes any unitary affiliates, the income associated with the excluded activity can be manipulated through changes in the business's corporate structure. Foreign income could be excluded by conducting the activity giving rise to it as an affiliate, or the income (loss) could be included by conducting the activity as a division or simply part of the domestic corporation. Limiting combination to only domestic corporations re-opens the potential for income shifting through foreign, or "off-shore," affiliates. Many tax experts have noted this policy rationale supporting worldwide combined reporting.¹³ Based on this consideration, the MTC model's water's-edge

¹² *Barclays Bank PLC v. Franchise Tax Bd.*, 512 U.S. 298, 310-314 (1994)

¹³ See, *Use of Combined Reporting by Nation States*, by Michael J. McIntyre, Tax Notes International; p. 945 (Sept. 6, 2004). See also *Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana*; *Supra*, p. 732; citing to *Slicing the Shadow: A Proposal for Updating U.S.*,

provision does not go as far as excluding all foreign entities and instead retains entities doing business in a tax haven or earning significant amounts of income from sales or lease of intangibles or services to affiliates. This rationale was explained in the hearing officer's report after similar objections that the model was overbroad were raised during its public hearing. At that time, the draft model included foreign affiliate income from sales or lease of tangible goods, as well as intangibles and services. To partially address these concerns, the hearing officer recommended, and the executive committee approved, excluding the income from the sale of tangible goods.¹⁴

OFII suggests MTC can “extend [to the combined reporting statute] the same principles currently reflected in the exceptions to the model add-back statute...” and still meet its compliance policy goals.¹⁵ But the model add-back statute is a different approach to states' compliance concerns. The exceptions to the add-back are specifically designed to address the inequities that can arise from an add-back and are not relevant to the combined reporting context. Under an add-back, a deduction for certain payments is simply disallowed when the payment is to an affiliate. The disallowance rule addresses the fact that these particular types of inter-affiliate transactions are more likely to lack business purpose and to be priced higher than an arm's-length market level. The MTC add-back model recognizes this disallowance can create a potential inequity where a transaction does have a business purpose, is priced at arm's-length, and the affiliate will also be taxed on the income. It is this potential inequity under add-back that necessitates the business purposes, arm's-length pricing and affiliate taxation exceptions. Similar inequities are not anticipated under combined reporting. Under combined reporting, pricing and business purpose of inter-affiliate transactions are not relevant. Under combined reporting, the taxpayer determines its share of the *total* unitary income based on its own factors relative to the *total* factors.

OFII correctly points out a California regulation that generally excludes a foreign affiliate's non-effectively connected income, or NECI, from the combined report.¹⁶ At the Executive Committee meeting in July 2009, the representative from California explained that this California regulation was based not on a tax policy rationale, but on legislative history unique to California; and took the position that it is reasonable for states to tax this income. The federal code distinguishes effectively connected income (ECI) from NECI. ECI is income associated with the conduct of a trade or business physically in the United States. A similar and somewhat more limiting concept used in international tax treaties references a corporation having a “permanent establishment” in the source country, here, the United States. NECI is income that is not associated with an active business conducted through a physical presence or “permanent establishment” in the United States. For example, foreign affiliate income from interest or royalty payments is usually NECI. But NECI can be U.S. source income. Indeed, NECI that is

International Taxation, by Reuven S. Avi-Yonah, 58 Tax Notes 1511 (March 15, 1993); *Design of a National Formulary Apportionment Tax System*, by Michael J. McIntyre, 84th Conf. on Tax'n, Nat'l Tax Ass'n 118 (Frederick D. Stocker ed. 1991); other citations omitted.

¹⁴ See, Report of the Hearing Officer Regarding the Proposed Model Statute for Combined Reporting; pg. 17 (April 25, 2005).

¹⁵ See, OFII letter dated July 20, 2009, page 1.

¹⁶ Cal. Code Regs. 25110 (d)(2)(F)1.b.

US source income is part of federal gross income and is taxable under the federal code – it is simply taxed differently than ECI. Some, but not all, foreign countries have entered into tax treaties with the U.S. federal government that modify how the two countries will tax one or more categories of NECI. Sometimes, the modification will reduce the tax rate applied to a particular type or types of NECI (e.g., certain interest or royalty payments) – this type of treaty should have no impact on state taxation of such income. Sometimes, the modifications will result in all or part of a type of NECI being effectively removed from the federal tax base – this result may or may not “flow through” to impact the state tax base. If the modification is an exclusion, there may be an impact. But if it’s in the form of an exemption (at the federal level) then there is arguably no “flow through” impact. The point is that NECI, even NECI that is subject to federal treaties, and even NECI subject to federal treaties that exempt it from federal gross income, still may be taxable income at the state level. This is true from a technical tax standpoint, and as explained above, Congress has not taken steps to change that result.

Finally, the question OFII raises as to whether states should apply an economic presence, physical presence, or permanent establishment test in determining nexus for foreign affiliates is mostly beyond the scope of the combined reporting issue. A taxpayer’s combined report includes income and factors (in the denominator) of all combined group members, domestic or foreign, regardless of whether the group member has nexus with the state. If the entity’s income is included in the total group income subject to apportionment, lack of nexus does not cause it to be excluded.

B. Recommendation: Project to Revise These Provisions Not Needed at this Time.

Taking into account the above considerations, the study group does not recommend a project be initiated to reconsider the Commission’s water’s-edge provision on U.S. Source Income (§5.A.iv.) or on income of foreign affiliates earned from sale or lease of intangibles or services to other members of the combined group (§5.A. vi.).

A PROGRESS REPORT ON THE JURISDICTIONS SURVEYED BY THE OECD GLOBAL FORUM IN IMPLEMENTING THE INTERNATIONALLY AGREED TAX STANDARD¹

Progress made as at 16th July 2009 ([Original Progress Report 2nd April](#))

Jurisdictions that have substantially implemented the internationally agreed tax standard			
Argentina	Finland	Jersey	Russian Federation
Australia	France	Korea	Seychelles
Bahrain	Germany	Luxembourg	Slovak Republic
Barbados	Greece	Malta	South Africa
Belgium	Guernsey	Mauritius	Spain
Bermuda	Hungary	Mexico	Sweden
Canada	Iceland	Netherlands	Turkey
China ²	Ireland	New Zealand	United Arab Emirates
Cyprus	Isle of Man	Norway	United Kingdom
Czech Republic	Italy	Poland	United States
Denmark	Japan	Portugal	US Virgin Islands

Jurisdictions that have committed to the internationally agreed tax standard, but have not yet substantially implemented					
Jurisdiction	Year of Commitment	Number of Agreements	Jurisdiction	Year of Commitment	Number of Agreements
Tax Havens³					
Andorra	2009	(0)	Marshall Islands	2007	(1)
Anguilla	2002	(0)	Monaco	2009	(2)
Antigua and Barbuda	2002	(7)	Montserrat	2002	(0)
Aruba	2002	(4)	Nauru	2003	(0)
Bahamas	2002	(1)	Neth. Antilles	2000	(7)
Belize	2002	(0)	Niue	2002	(0)
British Virgin Islands	2002	(11)	Panama	2002	(0)
Cayman Islands ⁴	2000	(11)	St Kitts and Nevis	2002	(0)
Cook Islands	2002	(1)	St Lucia	2002	(0)
Dominica	2002	(1)	St Vincent and the Grenadines	2002	(0)
Gibraltar	2002	(2)	Samoa	2002	(0)
Grenada	2002	(1)	San Marino	2000	(1)
Liberia	2007	(0)	Turks and Caicos Islands	2002	(0)
Liechtenstein	2009	(1)	Vanuatu	2003	(0)
Other Financial Centres					
Austria ⁵	2009	(2)	Malaysia	2009	(0)
Brunei	2009	(5)	Philippines	2009	(0)
Chile	2009	(0)	Singapore	2009	(1)
Costa Rica	2009	(0)	Switzerland ⁵	2009	(0)
Guatemala	2009	(0)	Uruguay	2009	(0)

Jurisdictions that have not committed to the internationally agreed tax standard			
Jurisdiction	Number of Agreements	Jurisdiction	Number of Agreements
All jurisdictions surveyed by the Global Forum have now committed to the internationally agreed tax standard			

¹ The internationally agreed tax standard, which was developed by the OECD in co-operation with non-OECD countries and which was endorsed by G20 Finance Ministers at their Berlin Meeting in 2004 and by the UN Committee of Experts on International Cooperation in Tax Matters at its October 2008 Meeting, requires exchange of information on request in all tax matters for the administration and enforcement of domestic tax law without regard to a domestic tax interest requirement or bank secrecy for tax purposes. It also provides for extensive safeguards to protect the confidentiality of the information exchanged.

² Excluding the Special Administrative Regions, which have committed to implement the internationally agreed tax standard.

³ These jurisdictions were identified in 2000 as meeting the tax haven criteria as described in the 1998 OECD report.

⁴ The Cayman Islands have enacted legislation that allows them to exchange information unilaterally and have identified 12 countries with which they are prepared to do so. This approach is being reviewed by the OECD.

⁵ Austria and Switzerland withdrew their reservations to Article 26 of the OECD Model Tax Convention and announced that they have started to write to their treaty partners to indicate that they are now willing to enter into renegotiations of their treaties to include the new Article 26.