MULTISTATE TAX COMMISSION

MEMORANDUM

To: Stephen Cordi, Chairman,
Executive Committee of the Multistate Tax Commission

From: Bruce Fort, MTC Counsel

Date: February 28, 2011

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

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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 debated changes to the current model statute on four separate occasions, most recently, in the Uniformity Committee meetings held on December 7 and8, 2010 in Atlanta, Georgia.

On December 7, 2010, the subcommittee agreed to an amendment to the model statute which would eliminate references to the Organization for Economic Cooperation and Development's ("OECD's") lists of tax havens and "jurisdictions with harmful preferential tax regimes." The subcommittee voted to retain the model statute's definition of a tax regime but eliminated the reference to the OECD as the source of the criteria for that definition. The subcommittee decided to eliminate references to the OECD because that institution no longer maintains lists of "tax havens" or jurisdictions with "harmful preferential tax regimes" and has instead adopted a new classification based on willingness to participate in international information-sharing agreements. The subcommittee believed the reference to prior OECD classifications could cause confusion and uncertainty in applying the model statute's tax haven criteria. The subcommittee also rejected more far-reaching changes to the model statute, as described below.

On December 8, the full Uniformity Committee voted to recommend the proposed amendments to the Executive Committee for further consideration, including scheduling a public hearing on the proposed amendments. The proposed amendments are attached hereto as Exhibit A, with the language proposed for elimination indicated by strike-throughs.

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 Cooperation and Development ("the OECD") in the current year. *This test would be eliminated under the proposed amendment.*

The second test is whether the jurisdiction imposes 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:

1. Laws and practices that prevent effective exchange of information concerning taxpayers;
2. A tax regime which "lacks transparency", that is, a tax system that is not open or which is applied inconsistently;
3. A legal system that facilitates the establishment of foreign-owned entities without a substantial local presence;
4. A tax regime which excludes the jurisdiction's resident taxpayers from certain benefits available to foreign investors;
5. 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.

As set forth above, the first test is no longer appropriate because the OECD does not currently list "tax havens" or "regimes with harmful tax practices."[1] Instead, the OECD classifies taxing jurisdictions based on their commitment to implementing the "internationally-agreed tax standards" ("IATS"). Those standards are primarily directed

[1]Although the OECD does not currently list "tax havens" or "harmful preferential tax regimes", it does continue to identify a handful of jurisdictions as "tax havens" that have not fully implemented the IATS, raising the inference that scores of jurisdictions formerly listed as "tax havens" should no longer be considered as such, even though the substantive tax policies of those jurisdictions would meet the second test in the model statute. For the most recent "IATS progress report" by the OECD, see http://www.oecd.org/dataoecd/50/0/43606256.pdf.

to protecting taxpayer confidentiality and establishing exchange agreements for sharing tax and financial information with a minimum of twelve other OECD countries.

The "IATS" criteria are not appropriate to prevent tax avoidance by multinational corporate taxpayers because corporate tax avoidance is usually accomplished by exploiting weaknesses in international tax structures, not by hiding assets. See J. Gravelle, Congressional Research Service, *Tax Havens: International Tax Avoidance and Evasion* (June 4, 2010). http://assets.opencrs.com/rpts/R40623_20100604.pdf.

The subcommittee agreed that the second test in the model statute, based on nominal or no tax rates on "relevant income" and one of the five criteria identified above, was an appropriate measure for whether a jurisdiction should be considered a tax haven. The subcommittee did consider whether it would be appropriate to supplement the definition with some sort of mechanism for identifying tax havens in advance of an audit situation, in order to increase the likelihood of achieving voluntary compliance with the model statute. Ultimately, the subcommittee decided to leave the second test as it was.

C. Alternative Approaches Considered.

The subcommittee considered several alternatives to the current "subjective" test, because concerns were raised that reliance on the second test alone would lead to a drop-off in voluntary compliance and certainty of administration.

- One alternative which was considered was reference to "tax haven" lists maintained by other governmental organizations or lists developed by tax research entities. The subcommittee rejected this alternative, perhaps concluding that reference to these lists presented the same problems with reference to the OECD lists: there is no mechanism to assure timely updating and no assurance that the policy goals of the organizations will remain constant.

- The subcommittee also considered the approach used in the state of Montana, which requires the Department of Revenue to produce a list of tax havens on a bi-annual basis with legislative approval of the list. Montana's representative reported that the system has worked well with general acceptance by the legislature. See M.C.A. Section 15-31-322. The subcommittee considered whether such a list should be developed by individual states or as part of a uniformity project of the MTC or other organization. The subcommittee ultimately rejected this approach.

- A third alternative considered was the use of low or nominal tax rates and a threshold of inter-corporate transactions with members of the water's edge group. This is the general approach used by the state of Alaska. The subcommittee rejected this approach. It should be noted that the proposal would parallel another provision of the model statute which requires inclusion of a foreign entity's income from transactions in intangible property with members of the water's edge domestic group.

- A fourth alternative considered was elimination of the entire tax haven category, with reliance on other provisions of the water's edge model statute to prevent income-sifting. 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. The subcommittee nonetheless elected to maintain the "tax haven" category.

D. Conclusion.

The subcommittee and Uniformity Committee have recommended what is the most direct response to the problems created by the OECD's change in classifications of taxing jurisdictions, removing reference to the OECD, and have recommended that the remainder of the tax haven definition remain unchanged. Please feel free to contact me with any questions or comments.

Exhibit A

Recommended Changes to the MTC's Model Statute for Combined Reporting Definitions' Section (as approved by the Uniformity Committee on December 8, 2010)[i]

Multistate Tax Commission
Proposed Model Statute for Combined Reporting
As approved by the Multistate Tax Commission August 17, 2006

Section 1. Definitions.

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I. "Tax haven" means a jurisdiction that, during the tax year in question~~:~~

~~**i.** is identified by the Organization for Economic Co-operation and Development (OECD) as a tax haven or as having a harmful preferential tax regime, or~~

~~**ii.** exhibits the following characteristics established by the OECD in its 1998 report entitled Harmful Tax Competition: An Emerging Global Issue as indicative of a tax haven or as a jurisdiction having a harmful preferential tax regime, regardless of whether it is listed by the OECD as an un-cooperative tax haven:~~

~~**(a)**~~ has no or nominal effective tax on the relevant income; and

i. ~~**(1)**~~ has laws or practices that prevent effective exchange of information for tax purposes with other governments on taxpayers benefiting from the tax regime;

ii. **(~~2~~)** has tax regime which lacks transparency. A tax regime lacks transparency if the details of legislative, legal or administrative provisions are not open and apparent or are not consistently applied among similarly situated taxpayers, or if the information needed by tax authorities to determine a taxpayer's correct tax liability, such as accounting records and underlying documentation, is not adequately available;

iii. **(~~3~~)** facilitates the establishment of foreign-owned entities without the need for a local substantive presence or prohibits these entities from having any commercial impact on the local economy;

iv. ~~**(4)**~~ explicitly or implicitly excludes the jurisdiction's resident taxpayers from taking advantage of the tax regime's benefits or prohibits enterprises that benefit from the regime from operating in the jurisdiction's domestic market; or

v. ~~**(5)**~~ has created a tax regime which is favorable for tax avoidance, based upon an overall assessment of relevant factors, including whether the jurisdiction has a significant untaxed offshore financial/other services sector relative to its overall economy.

Section 5. Water's- edge election; initiation and withdrawal.

A. Water's-edge election.

Taxpayer members of a unitary group that meet the requirements of Section 5.B. may elect to determine each of their apportioned shares of the net business income or loss of the combined group pursuant to a water's-edge election. Under such election, taxpayer members shall take into account all or a portion of the income and apportionment factors of only the following members otherwise included in the combined group pursuant to Section 2, as described below:

i. the entire income and apportionment factors of any member incorporated in the United States or formed under the laws of any state, the District of Columbia, or any territory or possession of the United States;

ii. the entire income and apportionment factors of any member, regardless of the place incorporated or formed, if the average of its property, payroll, and sales factors within the United States is 20 percent or more;

iii. the entire income and apportionment factors of any member which is a domestic international sales corporations as described in Internal Revenue Code Sections 991 to 994, inclusive; a foreign sales corporation as described in Internal Revenue Code Sections 921 to 927, inclusive; or any member which is an export trade corporation, as described in Internal Revenue Code Sections 970 to 971, inclusive;

iv. any member not described in [Section 5.A.i.] to [Section 5.A.iii.], inclusive, shall 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;

v. any member that is a "controlled foreign corporation," as defined in Internal Revenue Code Section 957, to the extent of the income of that member that is defined in Section 952 of Subpart F of the Internal Revenue Code ("Subpart F income") not excluding lower-tier subsidiaries' distributions of such income which were previously taxed, determined without regard to federal treaties, and the apportionment factors related to that income; any item of income received by a controlled foreign corporation shall be excluded if such income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in Internal Revenue Code Section 11;

vi. any member 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; and

vii. the entire income and apportionment factors of any member that is doing business in a tax haven, where "doing business in a tax haven" is defined as being engaged in activity sufficient for that tax haven jurisdiction to impose a tax under United States constitutional standards. If the member's business activity within a tax haven is entirely outside the scope of the laws, provisions and practices that cause the jurisdiction to meet the criteria established in Section 1.I., the activity of the member shall be treated as not having been conducted in a tax haven.

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[i] Because of the length of the Proposed Model Statute for Combined Reporting, only the relevant portions of the statute (Section 1.I and Section 5.A) are set forth here.