



REPORT OF THE HEARING OFFICER

Proposed Amendment to MTC Model Statute for Combined Reporting—Inclusion of Companies Doing Business in “Tax Havens” Under Water’s Edge Election May 27, 2011

I. Introduction and Summary.

In July of 2009, the Executive Committee of the Multistate Tax Commission (“the Commission”) instructed the Uniformity Committee to consider whether changes should be made to the definition of “tax haven” in the MTC’s Model Combined Reporting Statute. 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” or doing business in a jurisdiction having a “harmful preferential tax regime.” Currently, those terms are defined by two separate tests. The first test is whether the Organization for Economic Development and Cooperation (“OECD”) has classified the jurisdictions under either category, that is, as a “tax haven” or jurisdiction with a harmful preferential regime.” The second test is whether the jurisdiction should be considered a “tax haven” or having a “harmful preferential tax regime” independently of any OCED determination, where the jurisdiction (a) has a low or nominal tax rate and (b) exhibits at least one other characteristic suggesting the jurisdiction could be used to shelter income from taxation.

After considerable study and deliberation over an 18 month period, the Income and Franchise Tax Uniformity Subcommittee voted on December 7, 2010 to eliminate references to the OECD (which no longer attempts to maintain its “tax haven” or “harmful preferential tax regime” classifications) but to retain the substantive provisions of the second test in defining a tax haven. The full Uniformity Committee voted to approve the changes on December 8, 2010. The Executive Committee considered and approved the Uniformity Committee’s recommendation without change on March 10, 2011 and authorized a public hearing on the proposed amendment.

Bruce J. Fort was appointed as the hearing officer and a public hearing was held on April 22, 2011 after being duly noticed. Written comments were received from the Council on State Taxation on April 21, 2011. Those comments are attached hereto as Exhibit A. No other written or oral comments were received. Having considered the public comments received from COST, the undersigned hearing officer recommends adoption of the proposed amendment to the model statute without additional changes or modifications.

II. Description of Current Model and Proposed Changes.

A. The Combined Reporting Statute's Water's-Edge Reporting Provisions.

On August 17, 2006, the Commission adopted its Model Combined Reporting Statute after a lengthy deliberative process. The model statute is based on a world-wide unitary combination system but allows a taxpayer to elect to report its income on a unitary "water's edge" basis, with seven specified categories of entities or income sources included in the water's edge return.¹ The seventh category of included income or entity under Section 5(a)(vii) of the model statute is:

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.

The "water's-edge" provisions of the model statute are designed to ensure that the majority of income generated in the United States is included on the combined report, together with the apportionment factors associated with that income, while minimizing the compliance burdens arguably imposed by world-wide combined reporting systems. Thus, the water's edge group includes "deemed" income from passive activities of

¹ The other categories are:

- 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.

controlled foreign corporations operating in low tax countries (“Subpart F” income) and the income and factors associated with intangible property transfers to foreign corporations deriving at least 20% of their income from transactions subject to a deduction by their U.S. counterparts and income generated in “tax havens”, at least to the extent that income is non-operational. (For instance, a U.S. corporation operating a restaurant franchise in a tax haven jurisdiction through a foreign subsidiary would not be required to include the income and factors of that foreign subsidiary in its water’s edge return.) These categories of includable entities or income were chosen because of the ease by which income can be shifted to them from domestic operating companies, and the well-documented difficulties tax authorities have had in preventing such income shifting using arms-length accounting methodologies.

The model statute strikes a balance between ensuring a minimum of income shifting and reducing the purported compliance burdens associated with worldwide combined reporting.

B. The Current “Tax Haven” Definition’s References to OECD Classifications is Inappropriate Because the OECD no Longer Maintains Lists Based on Such Classifications.

The Model Combined Reporting Statute currently defines a “tax haven” with two separate tests as follows:

- 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
 - (b) (1) has laws or practices that prevent effective exchange of information for tax purposes with other governments on taxpayers benefiting from the tax regime;
 - (2) has [a] 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;
 - (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;
 - (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

(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.

In late 2007, the Commission was approached by the Isle of Man with the request that the Commission reconsider its references to the OECD's lists of "tax havens" and "jurisdictions with harmful preferential tax regimes" in the model combined reporting statute for several reasons, including a concern that the OECD had not kept its lists current. The Isle of Man held further meetings with the Commission's Executive Committee on May 8, 2008 and April 2, 2009. The Isle of Man noted that by 2009, as a result of its efforts to improve information sharing and eliminating some bank secrecy laws, it was recognized by the OECD as a country that had "substantially implemented" the OECD's "Internationally Agreed Tax Standards." The Commission's Executive Committee agreed to forward the matter to the Uniformity Committee for review of the model statute's "tax haven" definition.

The Isle of Man's request for review of the references to the OECD in the model statute's "tax haven" definition was understandable in light of changes in OECD practices and policies. In fact, as several commentators noted, in response to concerns expressed by the United States and others, as early as 2001 the OECD was beginning to move away from the task of classifying jurisdictions as "tax havens" or as having "harmful preferential tax regimes" in favor of a new classification system based on a jurisdiction's commitment to and progress in improving financial transparency laws and in protecting taxpayer confidentiality. This effort culminated in recognition of the "Internally Agreed Tax Standards" in 2004. The OECD describes the substance and genesis of the "IATS" as follows:

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

Although the OECD has not entirely abandoned its "tax haven" classification, the phrase now only appears with reference to jurisdictions which were originally listed as tax havens in the OECD's 2000 report and which have not achieved compliance with IATS; three other non-compliant jurisdictions are listed as "other financial centres", apparently because they were not included on the 2000 tax haven list, and no jurisdictions

² <http://www.oecd.org/dataoecd/50/0/43606256.pdf>.

are listed as uncommitted to the IATS.³ **There is no current list of “tax havens” on the OECD’s web site, apart from the limited reference to the classification from 11 years ago set forth in footnote 3, above.**

The highly ambiguous nature of the relationship between the current classification of jurisdictions conforming to the IATS and the original 2000 lists of tax havens and regimes with “harmful preferential tax regimes” is brought home by a “Q&A” published by the OECD’s Global Forum on Transparency and Exchange of Information for Tax Purposes, the group given responsibility for assessing compliance with the IATS:

“23. Where jurisdictions listed as tax havens by the OECD have done well on the peer review, does this mean they should no longer be considered “tax havens”?”

The list of tax havens published in 2000 is comprised of those jurisdictions that met the criteria described in the OECD’s 1998 Report Harmful Tax Competition: An Emerging Global Issue. The list of uncooperative tax havens was comprised of tax havens identified by the OECD under criteria it established in 1998 and which have not made formal commitments to the OECD, after being requested to do so. There have been many positive changes in jurisdictions’ transparency and exchange of information practices since that time. Following the removal of Andorra, Liechtenstein and Monaco from the list, no jurisdiction is currently listed as an uncooperative tax haven by the OECD. *While these lists are not replaced by the progress report, they should be seen in their historical context and the OECD will have to reassess their relevance in light of current developments.*”

The Global Forum On Transparency And Exchange Of Information For Tax Purposes , Information Brief (May 25, 2011) (emphasis supplied)⁴

It should be beyond dispute that the model combined reporting statute’s reference to an organization’s “historical” lists is untenable, especially where the organization has developed new classifications based on a new set of criteria. It should also be noted that

³ “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 |
|--------------------------------|--------------------|----------------------|--------------|--------------------|----------------------|
| <i>Tax Havens</i> | | | | | |
| Montserrat | 2002 | (11) | Niue | 2002 | (0) |
| Nauru | 2003 | (0) | Panama | 2002 | (11) |
| | | | Vanuatu | 2003 | (11) |
| <i>Other Financial Centres</i> | | | | | |
| Costa Rica | 2009 | (4) | Uruguay | 2009 | (8) |
| Guatemala | 2009 | (0)” | | | |

⁴ <http://www.oecd.org/dataoecd/32/45/43757434.pdf>.

the new IATS would not be an appropriate standard for states to adopt in preventing income shifting outside the water's edge group. The IATS are focused on increasing financial transparency laws and exchanges of banking information between taxing jurisdictions. As economist Jane Gravelle has noted, the so-called international "tax gap" in federal revenues has different sources for individuals and corporations. Individuals are more likely to engage in "tax evasion" by hiding income and assets from taxing authorities, while corporations more frequently engage in legal "tax avoidance" by designing complex transactions that exploit statutory weaknesses in taxing systems. Gravelle, *Tax Havens: International Tax Avoidance and Evasion*, Congressional Research Service, Report No. 7-5700 (6/4/2010), p. 1.⁵ The IATS provisions for exchanging bank information would do nothing to combat the problem of income-shifting by related corporations.

C. The Uniformity Committee's Recommendation for Amendment of the Model Statute.

The Income and Franchise Tax Uniformity Subcommittee considered several alternatives for amending the current model combined reporting statute in light of the OECD's change of criteria.

One option which was considered was amending the model statute to reference one or more "tax haven" lists maintained by other organizations. In 2008, the Government Accounting Office (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; (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. The subcommittee rejected the option of incorporating lists drawn up by third parties.

A second option which was considered and rejected was to have the states create their own list collectively, with an established procedure for updating and maintaining the list.

A third option which was also considered and rejected was to eliminate the reference to "tax havens" altogether, relying on other provisions in the water's-edge definition to prevent income shifting.

In the end, the Subcommittee voted to eliminate the first test, which referenced the OECD lists, and to retain the second test, which is based primarily on the presence of no or nominal tax rates in the jurisdiction, while eliminating any reference to the OECD in that test. The full Uniformity Committee voted to approve the Subcommittee's proposed amendment of the "tax haven" definition. The Executive Committee

⁵ http://assets.opencrs.com/rpts/R40623_20100604.pdf.

subsequently endorsed the amendment, attached hereto as Exhibit B, and directed that a public hearing be held on the proposal.

III. Evaluation of the Proposed Amendment in Light of Comments Received at the Public Hearing.

A telephonic Public Hearing was held on April 22, 2011. The only comments received at the hearing were submitted in written form by the Council on State Taxation (“COST”) (attached hereto as “Exhibit A”). The gravamen of COST’s comments is that any attempt by the states to classify jurisdictions as “tax havens” violates the Foreign Commerce Clause (Art. I, Sec. 8, cl.3) of the U.S. Constitution, and accordingly, the Commission should entirely eliminate the “tax haven” provision from its water’s-edge reporting standard.⁶ According to COST, the Foreign Commerce Clause violation arises from several factors. First, taxpayers will be “penalized” for doing business in tax haven jurisdictions because the income generated in those jurisdictions will be included in the water’s edge return. Second, labeling a jurisdiction as a “tax haven” carries a negative connotation by implying that a taxpayer has done something wrong by doing business in that jurisdiction, which could in turn affect international relations. Third, the subjective nature of the definition may cause different states to reach different conclusions of whether particular jurisdictions are tax havens, preventing the federal government from “speaking with one voice” in regulating foreign commerce. *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 450-451 (1979). Exhibit A, p. 3.

As evidence of the potential negative effects on international relations, COST’s submission includes letters from the Republic of Ireland’s U.S. embassy addressed to the Montana Senate and House of Representatives protesting proposed legislation that would have added Ireland to Montana’s list of “tax havens” in its water’s edge definition, and letters from the embassies of the Republic of Singapore, Switzerland, Luxembourg and the United Kingdom’s Consulate-General objecting to proposed legislation in California that would have included income from operations in a number of listed jurisdictions in that state’s water’s edge provisions.

The hearing officer appreciates the sincerity of the comments offered by COST but cannot agree that the “tax haven” provisions of the model statute’s “water’s edge” election would violate the Foreign Commerce Clause if adopted by the states, either as currently written or under the proposed amendment.

First, the hearing officer strongly disagrees with the contention that the inclusion of income (and presumably losses) from unitary entities operating in “tax havens” on a water’s edge return would “penalize” taxpayers for operating there. Formulary apportionment and its application to the legal divisions of a unitary business is a long-recognized means for fairly and accurately determining the income generated by entities operating within a taxing jurisdiction. See, e.g., *Bass, Ratcliff & Gretton, Ltd., v. State Tax Commission*, 266 U.S. 271 (1924); *Mobil Oil Co. v. Commissioner of Taxes*, 445

⁶ COST agrees that the deletion of references to the OECD standards is “a step in the right direction.” Exhibit A, page 1.

U.S. 425 (1980); *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983). To contend that taxpayers would be “punished” if their in-state income is accurately gauged for tax purposes may say more than was intended about the limitations of arms-length accounting, but fair taxation is not “punishment” in any reasonable sense of the word.

COST’s second contention, that a state’s decision to classify a jurisdiction as a “tax haven” could disrupt international relations because the phrase carries some stigma, is at least a colorable complaint. The argument fails for a number of reasons, however. First and foremost, the U.S. Supreme Court had repeatedly held that Commerce Clause determinations cannot turn on the labels attached to a tax imposition but must instead be evaluated by the substance of the underlying tax scheme. See, e.g., *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977); *Associated Industries v. Lohman*, 511 U.S. 641 (1994). Presumably, COST would have fewer Foreign Commerce Clause concerns if the “tax haven” provisions were re-labeled to refer to “jurisdictions with extremely low tax rates with policies that could allow excessive profit reporting” or some even more neutral phraseology. If different labeling is all that is necessary to fix a tax scheme, it seems extremely unlikely that a Commerce Clause challenge to that scheme could be sustained.

With respect to the substance of the decision to include entities deriving income from jurisdictions with low tax rates, there is the directly analogous federal treatment of income from controlled foreign corporations deriving income from countries with low tax rates, that is, Subpart F income rules. The states have important policy reasons for choosing to apply formulary apportionment principles in situations where arms-length accounting has failed to protect against income shifting.

COST’s third contention is that the “subjective” nature of the tax haven definition will cause states to reach different conclusions as to what jurisdictions fall within the definition of a “tax haven”, thus preventing the federal government from “speaking with one voice” in regulating foreign commerce. The U.S. Supreme Court has of course twice already rejected the idea that the application of formulary apportionment systems in world-wide unitary combined reporting to U.S. and foreign corporations violates the “once voice” principle enunciated in *Japan Lines. Barclays Bank PLC v. Franchise Tax Board*, 512 U.S. 298 (1994); *Container Corporation of America v. Franchise Tax Board*, 430 U.S. 159 (1983). In both cases the Court noted that the federal government had not chosen to “speak with one voice” through treaty provisions or otherwise. There is no indication that the federal government has chosen to opine on the issue of what countries might be considered tax havens, and it follows that this is not yet an areas where a unified national position is apparent or that any states would be in conflict with that position. In addition, in *Container Corp, supra*, the Court noted that the “unitary business principle is not, so to speak, unitary; there are variations on the theme, and any number of them are logically consistent with the underlying principles motivating the approach.” 463 U.S. at 167. If the Court contemplated that different states might make different unitary determinations in applying world-wide unitary apportionment principles without fear of embarrassment under the Foreign Commerce Clause, it follows that the Court would be

undisturbed by states reaching different conclusions as to the appropriate degree of inclusion of income on a water's-edge combined return.

COST also argues that the “subjective nature” of the “tax haven” definition will defeat the Commission’s stated goal of uniformity, since states could easily disagree on what constitutes a “tax haven.” The lack of uniformity, COST notes, will result in greater administrative costs for both taxpayers and the states. The hearing officer shares COST’s concerns about administrative costs for taxpayers but he believes that the “subjective” aspects of the tax haven definition are nonetheless necessary and appropriate. A less subjective definition of a “tax haven” might include reference to specific tax policies and regulations in addition to specified tax rates, but those policies change over time and could never be complete enough to anticipate all avenues which might be used to shift income. References to published lists maintained by third parties raise concerns if the lists are not maintained accurately, consistently and in a timely manner. Uniform application of a tax haven definition, therefore, must be balanced with the states’ need to retain flexibility to respond to changes in jurisdictions’ tax policies, both positive and negative, and to unanticipated changes in tax planning strategies.⁷

III. Conclusion.

The hearing officer recommends that the Executive Committee approve the proposed amendment to the water’s edge election’s “tax haven” definition in the Model Combined Reporting statute originally adopted in 2006, as set forth in attached Exhibit B.

Respectfully submitted,

Bruce J. Fort
Hearing Officer

May 27, 2011

⁷ For instance, as outlined in the Congressional Research Service paper referenced above, the majority of dividends repatriated under the 2004 Jobs Creation Act’s “amnesty” provisions were paid from the Netherlands, a jurisdiction which had not previously been listed as a “tax haven” by any academic or regulatory group. Gravelle, *Tax Havens: International Tax Avoidance and Evasion*, Congressional Research Service, Report No. 7-5700 (6/4/2010), pp. 18-19. The Netherlands’ exclusion of many types of intangible-property sourced income from its tax base may have made it an ideal locus for tax-shifting strategies, as evidenced in a recent article in Bloomberg News about the “Double-Dutch” royalty strategy. Jesse Drucker, *Bloomberg News*, *Google’s 2.4% Tax Rate Shows How \$60 Billion Lost to Tax Loopholes* (10/21/2010). <http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html>.

Attachments:

Exhibit A (Comments of Council on State Taxation)

Exhibit B (Proposed Amendments to Tax Haven Definition in Model Combined Reporting Statute.

Exhibit C (Notice of Hearing).