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Are Tax Havens Pushing States To Worldwide Combined Reporting?

by Brian Strahle

Organizations such as the U.S. Public Interest Research Group and others claim that states lose approximately $40 billion annually in state income taxes as a result of abuse of offshore tax havens.[1] Although the groups understand that it's not illegal, they argue that it isn't right. States agree and are beginning to act.

Oregon recently passed a new corporate tax law (H.B. 2460) intended to capture corporate income that is believed to escape Oregon taxation through the use of offshore tax havens and income-shifting tactics.[2] It is the fifth state to include a tax haven provision (following Alaska, the District of Columbia, Montana, and West Virginia). The law requires corporations filing Oregon consolidated returns to include income from affiliated entities incorporated in one of 42 countries. It also requires the Department of Revenue to submit a report by February 1, 2014, to the Legislative Assembly on the use of out-of-state tax shelters and to recommend ways the state can address noncompliance. Oregon expects to receive an additional $20 million a year in corporate tax revenue under the law.

Identifying foreign countries as tax havens and implementing a hybrid of worldwide combined reporting (water's-edge election with the obligation to include offshore tax haven income) can keep income from escaping state taxation. Opponents of the hybrid model say it may not meet constitutional standards because it extends the tax base beyond U.S. corporations without also allowing the rest of the worldwide tax base to be counted — meaning that states that allow only water's-edge combined reporting with a tax haven provision should also allow taxpayers the option of using worldwide combined reporting.

The Multistate Tax Commission's model combined reporting statute provides a water's-edge election with a requirement to include "the entire income and apportionment factors of any member that is doing business in a tax haven." It defines the phrase "doing business in a tax haven" as being engaged in activity sufficient for that jurisdiction to impose a tax under U.S. 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."[3]

The MTC model statute defines a tax haven as a jurisdiction that during the tax year in question has no or a nominal effective tax on the relevant income and (1) has laws or practices that prevent effective government exchange of tax information on taxpayers benefiting from the tax regime; (2) facilitates the establishment of foreign-owned entities without the need for a local substantive presence or prohibits those entities from having any commercial impact on the local economy; (3) 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; (4) has created a tax regime that is favorable for tax avoidance, based on an overall assessment of relevant factors, including whether the jurisdiction has a significant untaxed, offshore services sector relative to its overall economy; or (5) whose tax regime

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[1]U.S. PIRG Education Fund, "The Hidden Cost of Offshore Tax Havens — State Budgets Under Pressure From Tax Loophole Abuse" (Jan. 2013).

[2]Maria Koklanaris, "Oregon's New Tax Haven Law Expected to Pad State Coffers, DOR Official Says," *State Tax Notes*, Oct. 14, 2013, p. 96. The law applies to tax years beginning on or after January 1, 2014.

[3]Multistate Tax Commission, "Proposed Model Statute for Combined Reporting," section 5A, vii (amended July 29, 2011).

lacks transparency.[4] A tax regime lacks transparency if the details of legislative, legal, or administrative provisions are not open and apparent or are inconsistently applied among similarly situated taxpayers. There also is no transparency if the information that tax authorities need to determine a taxpayer's correct tax liability, such as accounting records and underlying documentation, is not adequately available.

The Council On State Taxation submitted comments in 2011 to the MTC stating that any attempt by the states to classify jurisdictions as tax havens violates the foreign commerce clause. COST argued that the MTC should eliminate the tax haven provision from its water's-edge reporting standard. It also pointed to the negative effect on international relations caused by states labeling countries as tax havens and the lack of uniformity that could result from the subjective nature of the tax haven definition.[5]

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In July the MTC adopted several changes to its policy statement on state income tax systems,[6] some of which involved language regarding worldwide combined reporting. Previous versions of the policy statement reflected the federal government's request for states to refrain from using worldwide combined reporting to allow the federal government to handle international division of income issues. In return, the states were promised improved federal efforts to solve international income reporting problems, which were to include a federally administered domestic disclosure spreadsheet to document the state income tax reporting practices of corporations. The revision to the policy statement notes that federal efforts to resolve international reporting problems remain inadequate because they are based on an arm's-length method of accounting. The MTC has recommended that Congress:

- Enact legislation to convert to formula apportionment on a worldwide basis using the unitary business principle as the correct approach to properly dividing the income of multinational enterprises.
- Enact legislation that eliminates the tax benefits from corporate inversions under which U.S. companies incorporate in offshore tax havens to escape federal and state corporate income taxes while continuing to operate in the United States. That legislation would be a transition measure until the federal government can fully convert to a formula apportionment system applied worldwide.
- Study methods to more closely align statements of book income and taxable income and then implement the most promising of them. Sophisticated accounting methods are increasingly used to inflate book income and deflate taxable income. Strengthening links between book and taxable income will help restore integrity to accounting for both.

Although the MTC's policy statement and request are intended for the federal government, Dan Bucks argues that worldwide combined reporting is needed at the state and federal levels — and that the states should lead.[7] He describes how the tax planning industry has created a system of shifting income that has become destructive and should be reversed. His conclusion may or may not be true, but I agree that the global economy has become smaller and more complex. Thus, large corporations are able to plan and source income in various jurisdictions, similar to what they used to do more extensively at the state level in the 1990s. Over the past decade, most of the so-called domestic tax planning loopholes have been closed through the enactment of combined reporting and addback statutes — leaving income shifting to foreign countries or through foreign operations as the next frontier or loophole to close using worldwide combined reporting.

Bucks explains that states and the federal government should adopt worldwide combined reporting because it works; is simpler than the arm's-length approach; fits with the nature of the global economy; is constitutional, fair, and equitable; and restores democratic governance to corporate taxation. I mostly agree with his reasoning and conclusions. Worldwide combined reporting would eliminate most of the complexity and litigation surrounding transfer pricing, earnings stripping, and other income-shifting transactions. It also would allow states to stop worrying about what a tax haven is and allow them to increase revenue without raising taxes on local businesses.

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[4]Id. at section 1, I.

[5]Bruce J. Fort, "Proposed Amendment to MTC Model Statute for Combined Reporting-Inclusion of Companies Doing Business in Tax Havens, Under Water's Edge Election," MTC hearing officer's report (May 27, 2011).

[6]MTC, "Policy Statement 2002-02" (July 24, 2013).

[7]Dan Bucks, "Making State Corporate Taxes Work, Part 3: Reversing the Plunder Economy," *State Tax Notes*, June 3, 2013, p. 767.

However, if worldwide combined reporting is the solution, why is a water's-edge election allowed? Montana tried to repeal its water's-edge election and require worldwide combination, but failed during its last legislative session. Opponents of repeal argue that it would invite federal intervention.

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Worldwide combined reporting can also lower a corporation's taxable income through the dilution of the apportionment factor and income distortion aused by the complexities of determining unitary income on a worldwide basis. Compiling the necessary information, including preparing pro forma federal returns for foreign corporations that may not report taxable income similar to U.S. reporting requirements, can also be a challenge. Regardless of the opposition, the worldwide combined reporting method has been upheld by the U.S. Supreme Court in *Container Corp. of America v. Franchise Tax Board,* 463 U.S. 159 (1983), and *Barclays Bank PLC v. California FTB*, 512 U.S. 298 (1994), and could be a state's sole method of combined reporting.

Conclusion

The discussion of tax havens and their effects on state tax revenue has increased lately. Oregon's recent enactment of a tax haven provision may prompt other states to consider similar legislation. Further, states may find increasing taxes on large corporations through worldwide combined reporting or tax haven provisions to be a politically acceptable option that favors their residents. ✰

The SALT Effect is written by Brian Strahle, a state and local tax researcher, writer, blogger, and consultant. He provides research, writing, and help-desk services to accounting firms, law firms, and news organizations, and is also the author of the state tax blog LEVERAGE SALT (www.leveragestateandlocaltax.com). He welcomes comments at Strahle@leveragesalt.com.