



State Tax Haven Legislation:
A Misguided Approach to
a Global Issue

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ABOUT STRI

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CONTENTS

| | |
|--|-----------|
| Executive Summary | 4 |
| Introduction | 7 |
| Figure 1. Tax Haven Legislation in States..... | 8 |
| Section 1: State Tax Haven Lists Are Arbitrary and Unmanageable..... | 10 |
| Montana’s Blacklist Approach Is Based on an Outdated OECD List | 11 |
| The Multistate Tax Commission Discards the Blacklist | 13 |
| The Experience with “Tax Haven” Blacklists in other States..... | 14 |
| States, Unequipped to Update Lists, Lack U.S. and International Guidance..... | 16 |
| Difficulties with the “Criteria” Approach..... | 18 |
| Section 2: The State Tax Revenue Loss Estimates Relating to Tax Havens Are Highly Exaggerated | 20 |
| Are the Revenue Loss Estimates Credible? | 21 |
| The Shrinking Revenue Loss Estimates..... | 23 |
| The Business Share of State and Local Taxes Is Actually Increasing | 26 |
| Figure 2. Total State and Local Business Taxes, FY 2014..... | 27 |
| Figure 3. Share of State and Local Taxes Paid by Businesses..... | 28 |
| Figure 4. State and local CIT and other business activity tax collections as share of total state and local business tax collections..... | 28 |
| Section 3: State Tax Haven Legislation Represents a Partial Return to a Mandatory Worldwide Combination Filing Method | 30 |
| Mandatory Worldwide Filing Abandoned by the States since the 1980s | 31 |
| Laying the Groundwork for the Water’s-Edge Standard | 32 |
| Adopting Tax Haven Statutes Breaks the Water’s-Edge Consensus, Invites Controversy and Business Disinvestment..... | 33 |
| Constitutional Challenges to Tax Haven Legislation..... | 35 |
| Other State Approaches to Taxing Effectively Connected Foreign Source Income..... | 36 |
| Section 4: State Tax Haven Legislation Is Out of Sync with the Global Approach to BEPS..... | 37 |
| The OECD/G20 Approach to BEPS..... | 37 |
| The Trend Toward Territorial Tax Systems | 39 |
| The Challenges of Taxing Corporate Income in an Increasingly Global and Intangible-based Economy..... | 40 |
| The Lessons from Federal Tax Policy as an International “Outlier” | 42 |
| Conclusion | 44 |
| Appendix 1: Summary of State Tax Haven Legislation..... | 45 |
| Alaska..... | 45 |
| Connecticut | 46 |
| District of Columbia | 47 |
| Montana | 48 |
| Oregon..... | 48 |
| Rhode Island..... | 49 |
| West Virginia..... | 50 |
| Multistate Tax Commission | 51 |

EXECUTIVE SUMMARY¹

This approach...
raises significant political, economic development, and constitutional concerns for states.

Tax haven legislation has recently emerged as a significant trend among states for addressing the taxation of foreign source income. There remains, however, a large gap between states that have introduced such legislation and those that have adopted such legislation. While twelve new states considered tax haven legislation in 2015, only one (Connecticut) adopted such legislation. The overall number of states that have enacted tax haven legislation remains relatively small: two states with blacklists of deemed tax haven nations (Montana and Oregon), four jurisdictions with a subjective list of tax haven criteria (Connecticut, Rhode Island, West Virginia, and the District of Columbia), and one state with a unique tax rate/intercompany transactions test (Alaska). Even this small number of state adoptions vary widely, including significant limitations on tax haven inclusion in Connecticut and Rhode Island.

At its core, state tax haven legislation seeks to expand the scope of state taxation to encompass income earned by foreign subsidiaries in countries that a state defines as tax haven jurisdictions. This approach signals at least a partial return to the mandatory worldwide combination filing method abandoned by the states in the 1980s, and raises significant political, economic development, and constitutional concerns for states.

This report analyzes state tax haven legislation and makes the following findings: 1) there is no clear evidence that profit shifting to tax havens is eroding the state corporate tax base; 2) state tax haven blacklists are arbitrary and unmanageable; and 3) states adopting tax haven legislation risk losing investments and jobs, and face constitutional challenges.

THERE IS NO CLEAR EVIDENCE THAT PROFIT SHIFTING TO TAX HAVENS IS ERODING THE STATE CORPORATE TAX BASE

According to the analysis relied on by the proponents of state tax haven legislation, the period since 2000 has been the peak of corporate base erosion and profit shifting—with 85 percent of the alleged rise in annual tax revenue loss occurring during those years. Nonetheless, during that period, the overall share of state and local taxes paid by businesses has remained remarkably stable, generally within one percentage point of 45 percent of all state and local taxes paid each year. Indeed, the share of state and local taxes paid by businesses is actually higher in FY2014 (45 percent) than it was in FY2000 (42.6 percent), and above the average for the period since FY2000. The corporate income tax (and other business activity taxes) as a share of overall state and local taxes paid by business has also been relatively stable over the last 15 years, ebbing and flowing primarily with the cycles of the U.S. economy. Thus, based on the empirical evidence, the impact on the aggregate state and local tax base of any corporate profit shifting to foreign tax havens has been limited, and more than offset by increases in other taxes paid by business.

¹ This Executive Summary summarizes the findings and supporting research contained in the body of the Report.

Similarly, the revenue loss estimates made by proponents of state tax haven legislation have been grossly inflated and are completely out of line with the states' own revenue estimates. For example, the District of Columbia estimated its proposed adoption of a tax haven list of nations would net the District \$3.7 million in FY 2017. By contrast, U.S. PIRG, a major proponent of tax haven legislation, put its original “tax haven” revenue estimate for D.C. at \$284 million and its revised revenue estimate at \$17.9 million. Likewise, New Hampshire estimated its tax haven proposal would net the state approximately \$5.1 million annually beginning in FY 2016, far less than U.S. PIRG's original revenue estimate of \$98 million or its revised revenue estimate of \$26.1 million.

STATE TAX HAVEN BLACKLISTS ARE ARBITRARY AND UNMANAGEABLE

The recent experience of states that have enacted tax haven legislation confirms that state tax haven lists are inherently arbitrary and unmanageable. Initially, state blacklists were based on a list of countries designated as tax havens by the Organization for Economic Cooperation & Development (OECD). However, the OECD lists were maintained not for tax base expansion, but for purposes of effective information exchange and transparency. Once all of the countries on the list complied with OECD rules on information sharing and transparency, they were removed, resulting in the discontinuation of the OECD list.

The OECD and G20 nations recently completed a massive international tax reform project aimed at addressing base erosion and profit shifting (BEPS). Conspicuously absent from the several thousand pages of OECD reports was any support for singling out “bad actor” countries to be placed on a blacklist of so-called “tax haven” nations. Instead, the OECD solutions target outdated tax rules applied to particular transactions and structures that do not adequately reflect where the income is earned.

Without any U.S. or international guidance, the states have struggled to determine which countries, if any, should be listed as tax haven jurisdictions. The blacklist process is undermined because states (as subnational units) generally do not have expertise in, nor responsibility for, international tax rules, tax treaties, or foreign affairs. The difficulty of creating and managing state tax haven lists is reflected in the actions of the Multistate Tax Commission, West Virginia, Connecticut and the District of Columbia—all of which abandoned their tax haven lists in favor of a less sweeping “criteria” approach, often with significant restrictions on income inclusion.

STATES ADOPTING TAX HAVEN LEGISLATION RISK LOSING INVESTMENT AND JOBS AND FACE CONSTITUTIONAL CHALLENGES

State tax haven legislation also carries significant risks for states, including reduced business employment and investment, potential foreign retaliation, and constitutional challenges. Similar to mandatory worldwide combination, which was abandoned by the states in the 1980s under pressure from the federal government and foreign nations, tax haven legislation taxes foreign source income beyond the “water's-edge” and makes no distinction between companies

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with domestic or foreign parents. During the 1980s, foreign nations actually authorized retaliatory tax treatment against U.S. multinationals in response to worldwide combined reporting. Foreign countries likewise have repeatedly and strenuously objected to inclusion in state tax haven lists. The resulting uncertainty and disincentive to invest in states considering and adopting such legislation could have profoundly negative impacts on state economic growth. For example, in 2013 alone, foreign direct investment in the 50 states totaled \$236.3 billion. The risk is magnified because any state that adopts tax haven legislation will be out of sync with both international approaches to taxing foreign source income and the tax policies of the vast majority of other states (including the largest 25 states as measured by population).

In addition, state tax haven legislation will almost certainly face legal challenges under the Foreign Commerce Clause and Foreign Affairs Powers Doctrine. With the enactment of tax haven legislation, states are meddling in foreign affairs and international relations—areas the Constitution entrusts solely to the Federal Government. While state worldwide combined reporting regimes ultimately withstood constitutional scrutiny, the result may be different with state tax haven statutes that make selective determinations about the adequacy of foreign nations' laws and arbitrarily designate certain nations for punitive treatment.

CONCLUSION

In conclusion, aggressive state policies toward taxing foreign source income—based on the premise there is a gaping hole in the state business tax base caused by profit shifting to foreign “tax haven” nations—are misguided. Over the last three decades, states have uniformly rejected worldwide combined reporting in favor of a water's-edge filing method that generally includes domestic corporations and excludes foreign corporations. To diverge from this consensus and enact state tax haven legislation reflects a fundamental misunderstanding of both the need for and efficacy of these policies.

INTRODUCTION

Over the last few years, taxing foreign subsidiary income has become a hot topic internationally, at the federal level, and at the state level in the United States. A number of converging economic and political factors have weakened international tax rules on cross border transactions, including expanding globalization, the rise in importance of intangibles and digital commerce, widespread tax competition between nations, and complex corporate supply chains and tax structures.

At the international level, the Base Erosion and Profit Shifting (BEPS) project carried out by the Organization for Economic Cooperation and Development (OECD) garnered significant attention, culminating with the October 2015 release of over two thousand pages of analysis and fifteen “actions” agreed to by the G-20 nations. This project has focused on mismatches, gaps and potential abuses in international tax rules, creating a disconnect between where value is generated and where profits are reported, and a shifting of income to lower-tax countries. By its own estimation, the OECD BEPS project is recommending the most profound changes to international tax regimes in 100 years.

At the federal government level, pressure continues to build for significant tax reform to an outdated federal tax code. The combination of U.S. reliance on a worldwide system of taxation (compared to a territorial system of taxation used by most other industrialized nations) and one of the highest corporate tax rates in the world undercuts the tax competitiveness of the U.S. compared to the other G-20 and OECD nations. The competitive tax disadvantage has created an incentive for U.S. multinationals to hold foreign earnings overseas (over \$2 trillion to date). These foreign earnings are not reinvested in a company’s domestic operations because of the high tax cost of bringing those profits home.

At the state level, the debate over foreign source income has recently focused on two policy initiatives—strengthening transfer pricing provisions and adopting state tax haven legislation. Many states have I.R.C. Section 482-like authority to impose arm’s-length standards on related party transactions, but the historic application of this transfer pricing authority has been limited.² Some states have been more aggressive in developing

² According to the Multistate Tax Commission (MTC), the reason for this is “[t]he states are currently ill equipped...to differentiate proper and improper income shifting and to address instances of improper income shifting.” Multistate Tax Commission, *Design of an MTC Arm’s-Length Adjustment Service*, May 7, 2015, at 2, available at <http://www.mtc.gov/getattachment/The-Commission/Committees/ALAS/Draft-of-Final-Design-Design-for-ALAS.PDF.aspx>.

income calculation; or (2) states adopting a list of “criteria” giving state tax agencies the discretion in audits to determine which nations may be considered tax havens, thereby including income from foreign subsidiaries operating in such nations in the tax base.

Of the states that have adopted “tax haven” statutes and regulations, only Montana and Oregon currently maintain a blacklist of specified tax haven jurisdictions. The Multistate Tax Commission, West Virginia, the District of Columbia, and Connecticut all initially favored a tax haven blacklist, but then subsequently abandoned this approach in favor of the “criteria” approach. The criteria-based approach—leaving designation of tax haven countries to the discretion of a state’s tax agency—has been adopted by Alaska (a significantly different regime),⁶ the Multistate Tax Commission, West Virginia, Rhode Island, the District of Columbia, and Connecticut.

Along with the seven states that have adopted state tax haven legislation, eleven additional states considered tax haven proposals in 2015 (see Figure 1). The clear trend among the states is toward the blacklist approach, with nine of the eleven states in 2015 including specific “lists of countries” in their proposed legislation (*i.e.*, Colorado; Kentucky; Illinois; Louisiana; Maine; Massachusetts; New Hampshire; Pennsylvania; and Vermont). While tax haven legislation has generally been confined to smaller states, new proposals in 2015 included four of the eleven largest states by gross state product (*i.e.*, Florida, Illinois, Massachusetts, and Pennsylvania). The rash of state tax haven legislative proposals has engendered considerable opposition by multinational companies, many foreign embassies and ambassadors, and business organizations.

Proponents of tax haven statutes contend such legislation is needed because of (in their words) the “manipulation” of international tax rules by U.S. and foreign incorporated multinational corporations to hide profits in “tax haven” countries; the enormous yearly state tax revenue losses attributable to profit shifting to foreign jurisdictions (*e.g.*, claims made of annual revenue losses exceeding \$20 billion); and the allegation that big business does not pay its fair share of state and local taxes. To cure these supposed ills, proponents support tax haven legislation that would sweep the income of foreign subsidiaries in certain blacklisted countries into the state tax base—regardless of any connection to domestic income-producing activities. In effect, this extends the unitary business concept used by combined reporting states to a portion of worldwide business activities.

This report analyzes state tax haven legislation in the context of the global focus on BEPS and concludes such legislation is a misguided approach doing more harm than good. In particular, the report focuses on the arbitrary criteria used in identifying and monitoring so-called “tax haven” countries; the exaggerated state tax revenue loss estimates; the lack of any clear evidence the business share of state and local taxes has declined over the last fifteen years (allegedly the peak period of revenue loss attributable to corporate base erosion and profit shifting); and the significant downside of a go-it-alone state tax approach that is out of sync with the OECD approach to BEPS.

The rash of state tax haven legislative proposals has engendered considerable opposition by multinational companies, many foreign embassies and ambassadors, and business organizations.

⁶ See Alaska Stat. § 43.20.145. The concept of listing nations or of applying tax haven criteria to determine whether a nation is a tax haven is not present in the Alaska regime.

Is it appropriate

for... (U.S. states) to act unilaterally in the absence of any U.S. or international standard or agreement regarding which countries should be penalized?

STATE TAX HAVEN LISTS ARE ARBITRARY AND UNMANAGEABLE

State tax haven legislation is based on the premise that certain nations have tax rules so favorable to business and so conducive to manipulation they should be singled out by states for special punitive measures. However, the difficult question implicated by this legislation is how to objectively identify “bad actor” nations given the many different elements of a country’s tax system that might be considered, including tax rates, tax bases, exemptions, taxpayer classifications, related party rules, jurisdictional issues, treaties, and special incentive measures.

Which factors should be considered more important by a state for inclusion of a country on a tax haven list? Is a low tax rate the most important criteria? Overly generous corporate incentive programs? A mismatch of rules with other countries? The absence of a tax treaty with the United States? A lack of transparency? Some combination of all of the above? If taken in combination, are the factors weighted by the degree of a nation’s infraction?

The OECD BEPS report illustrates the importance of carefully defining what the nature of the tax policy problem is, before adopting solutions to the problem.⁷ The OECD report acknowledges that each sovereign country has the right to determine its own statutory rates and general incentives provided to business taxpayers. The existence of these corporate income tax features reflects sovereign decisions about business tax competitiveness, not evidence that countries are “bad actors” in terms of encouraging base erosion and profit shifting. The OECD report emphasizes that real economic investments made in response to lower tax rates and general incentives are not BEPS. It is the artificial shifting of income—unrelated to real economic activity—that is the problem. State tax haven legislation ignores this distinction, claiming certainty where there is ambiguity and objectivity where there is subjectivity.

Moreover, state tax haven legislation raises several other threshold policy questions. Is it appropriate for subnational governments (such as the U.S. states) to act unilaterally in the absence of any U.S. or international standard or agreement regarding which countries should be penalized? Once included, how does a state determine if a country has changed its tax policies sufficiently to come off the list? The blacklist process is

⁷ OECD 2015, *OECD/G20 Base Erosion and Profit Shifting Project (OECD), 2015 Final Reports*, available at <http://www.oecd.org/ctp/beps-2015-final-reports.htm>.

undermined because states (as subnational units) generally do not have expertise in, nor responsibility for, international tax rules, tax treaties, transfer pricing, or foreign affairs.

A close historical review of state adoption or consideration of tax haven legislation demonstrates how arbitrary and unmanageable it is for states to create and maintain their own blacklist or set of criteria for “tax haven” country designation.

MONTANA’S BLACKLIST APPROACH IS BASED ON AN OUTDATED OECD LIST

In 2003, Montana became the first state to create a blacklist of specific “tax haven” nations by statute. Prior to that time, in the 1990s, Utah and Alaska had enacted more limited tax haven-type legislation that focused on the issue of low tax-rate foreign jurisdictions without creating a specific list of tax haven countries.⁸ The Montana legislation required inclusion under a water’s-edge election of the income and apportionment factors of unitary affiliates incorporated in specified “tax haven” jurisdictions.⁹ This “listing” approach proved a stark departure from the more limited approaches in Alaska and Utah. The Montana statute did not focus on effective tax rates or significant economic activity. Instead, it simply required the automatic inclusion of income and apportionment factors of unitary affiliates incorporated in a list of 38 foreign jurisdictions.

The Montana list was based on the list of “uncooperative tax havens” published a year earlier by the OECD in April 2002.¹⁰ No state previously had sought to create a blacklist, so it is not surprising Montana would turn to a reputable international organization for guidance. However, the 2002 OECD list of 35 countries was developed and maintained for an entirely different purpose.¹¹ When it announced its 2002 list, the OECD did not seek to establish a punitive international tax regime with respect to the listed nations for purposes of expanding the tax base of other countries.

⁸ Utah in 1993 included within its statutory water’s-edge provision “tax haven corporations”. The definition of “tax haven corporation” referenced the corporation’s effective rate in the foreign jurisdiction when compared to the U.S. top marginal rate, and further looked to whether the corporation had “substantial business activity independent of that involving [unitary] affiliates”. Utah Code Ann. § 59-7-101(32) (adopted by 1993 Utah Laws ch. 169, § 4). This provision was repealed in the following year. 1994 Utah Laws ch. 178, § 2. The former Utah provisions were similar to legislation adopted two years earlier by Alaska in 1991, which remains in Alaska’s statutes. Alaska Stat. §. 43.20.073, adopted by 1991 Alaska Laws ch. 11, §. 3, renumbered as Alaska Stat. § 43.20.145. However, the Alaskan statute never used—nor today uses—the term “tax haven”. Rather, the statute looks to whether a corporation is incorporated in, or doing business in, a low or no tax foreign jurisdiction, to certain other standards related to the level of intercompany transactions, and to whether the corporation conducts significant economic activity. It is only in such specific circumstances, and only by regulation, that Alaska references such corporations as “tax haven corporations.” In neither Alaska’s current statute, nor Utah’s prior statute, did the state seek to designate a specific list of foreign jurisdictions as tax havens.

⁹ Mont. Code Ann. § 15-31-322, as amended by 2003 Mont. Laws c. 521. See Appendix for a complete list of current tax haven nation designations by states.

¹⁰ According to the Montana Department of Revenue, “The list of tax havens in 15-31-322, MCA, was developed primarily, but not exclusively, from the Organization for Economic Co-operation and Development (OECD).” Brenda Gilmer, *Memorandum from Brenda J. Gilmer, Senior Tax Counsel to Dan R. Bucks, Director of Revenue*, Nov. 17, 2010, at 2, available at <http://leg.mt.gov/bills/2011/Minutes/House/Exhibits/tah78a04.pdf>. Montana also makes tax haven designation decisions based on the Multistate Tax Commission’s criteria (in turn also based on the prior OECD criteria – see the Appendix for a list of the MTC criteria).

¹¹ References to the OECD list are to the OECD blacklist, as opposed to the OECD “white list” of countries implementing agreed-upon standards and “gray list” of countries committed to such standards. See Jane G. Gravelle, Cong. Research Serv., *Tax Havens: International Tax Avoidance and Evasion* (2015), available at <https://www.fas.org/sgp/crs/misc/R40623.pdf>.

Rather, it “look[ed] forward to working with all the jurisdictions [on the list] towards the twin goals of transparency and effective information exchange.”¹²

The different purposes of the OECD list and the Montana list are reflected in the fact that seven of the jurisdictions included for punitive treatment by Montana in 2003 were cited by the OECD in its April 2002 release as working with the OECD to develop models for exchange of information.¹³ By 2009, the OECD found every nation on its tax haven list had made commitments to transparency and effective exchange of information sufficient to meet OECD standards.¹⁴ “As a result,” the OECD notes, “no jurisdiction is currently listed as an unco-operative tax haven by the [OECD] Committee on Fiscal Affairs.”¹⁵ Subsequently, no other international organization has actively maintained and monitored a similar standardized list—leaving Montana and other states adrift to implement tax haven blacklists on their own.

While the OECD continuously reviewed its list and worked with jurisdictions to ultimately remove all of them from it, the Montana Legislature has maintained a largely static list. Despite a requirement in the statute calling for the Montana Department of Revenue to conduct a biannual review of the countries on the list, Montana’s sole update to its 13-year-old list occurred in 2009, when its legislature added Cyprus, Malta, Mauritius, and San Marino, and removed Maldives and Tonga from its list.¹⁶ The update was “[b]ased upon Department of Revenue research on the issue,” and was scored as having no overall revenue impact to the State.¹⁷ In November 2010, the Montana Department of Revenue acknowledged its quandary: it noted that while prior list update proposals were based in large part on the OECD blacklist, “The current focus of the OECD is promoting transparency and the exchange of tax information for tax purposes...[and] the OECD is not actively updating its list of tax havens[.]”¹⁸

More recently, in 2014, the Montana Department of Revenue recommended removing the Netherlands Antilles and Monaco from the list, and adding the Kingdom of

¹² See Gabriel Makhoul, *The OECD List of Unco-operative Tax Havens—A Statement by the Chair of the OECD’s Committee on Fiscal Affairs*, available at <http://www.oecd.org/corruption/theoecdlistofunco-operativetaxhavens-astatementbythechairoftheoecdscmmitteeonfiscalaffairsgabrielmakhoul.htm>. When the OECD launched its initiative in 1998, it had a somewhat broader focus that included “to address harmful tax practices—in member and non-member jurisdictions.” *Id.* However, in 2001-2002, this focus was narrowed to the goals of transparency and effective information exchange. *Id.* For the original 1998 OECD criteria, see OECD, *Harmful Tax Competition: An Emerging Global Issue* (1998), available at <http://www.oecd.org/tax/transparency/44430243.pdf>.

¹³ See OECD, List, *supra* n. 12.

¹⁴ *Id.*

¹⁵ *Id.* Over the last ten years, several other tax haven lists have been formulated largely from the (since discarded) OECD list, but consideration of additional factors have produced significant variations. For example, the Tax Justice Network, for its list, started with all jurisdictions on the OECD list and then conducted a “reputation test” by reviewing tax planning websites and documentation of tax legislation in the jurisdiction. See Tax Justice Network, Briefing Paper, *Identifying Tax Havens and Offshore Finance Centers*, available at http://www.taxjustice.net/cms/upload/pdf/Identifying_Tax_Havens_Jul_07.pdf. The National Bureau of Economic Research (NBER) based its list on the coexistence of low business tax rates and identification of the jurisdiction as a tax haven by “multiple authoritative sources”. See Dhammika Dharmapala & James R. Hines, Jr., *Which Countries Become Tax Havens?*, NBER Working Paper No. 12802, 2006, available at <http://www.nber.org/papers/w12802.pdf>.

¹⁶ Governor’s Office of Budget and Program Planning, *Fiscal Note 2011 Biennium* (S.B. 0043), available at <http://leg.mt.gov/bills/2009/FNPDF/SB0043.pdf>.

¹⁷ *Id.*

¹⁸ Brenda Gilmer, *supra* n. 10, at 5.

the Netherlands, Trinidad and Tobago, Guatemala, and Hong Kong.¹⁹ In arriving at these recommendations, the Department relied on a hodgepodge of third-party information, for the most part, not intended to be the basis for compiling a tax haven blacklist. This information included tax summaries-by-country reports from Deloitte and KPMG, current OECD information, and U.S. PIRG publications.²⁰ The Montana Department of Revenue provided scant details on how it applied these information sources in arriving at its recommendations. Ultimately, Ireland and Switzerland also appeared on the list of tax haven amendments proposed in the Montana legislature in 2015.²¹ While the bill passed out of a Senate committee by a 7–5 vote, it was re-referred, tabled in committee and ultimately not enacted.

THE MULTISTATE TAX COMMISSION DISCARDS THE BLACKLIST

Following Montana’s 2003 enactment of a tax haven blacklist, the Multistate Tax Commission (MTC) took a similar approach in 2006.²² In that year, the MTC adopted its Model Combined Reporting Statute that included within the water’s-edge tax base the income of members doing business in a tax haven country. The Statute defined “tax haven” as a “jurisdiction that, during the tax year in question...is identified by the Organization for Economic Co-operation and Development (OECD) as a tax haven[.]”²³ At the same time, the MTC adopted a “criteria” list, adding to the tax base any income of companies doing business in a country that met the “criteria”.²⁴ However, three years later in 2009, the MTC recognized the problem of linking to an OECD tax haven list that was largely abandoned by the OECD itself. The Executive Committee of the MTC instructed its Uniformity Committee to consider whether changes should be made to the definition of “tax haven” in the MTC’s Model Combined Reporting Statute. In 2011, the MTC approved an amendment that deleted the OECD list approach and kept only the “criteria” approach (while striking references to the OECD from its model statute).²⁵ Since then, the MTC has refrained from adopting a blacklist of tax haven countries that Montana or any other state could rely on as a basis for their own lists.

The MTC hearing officer’s report on the amendment to the Model Statute made clear the rationale for the shift away from the blacklist approach:

¹⁹ See Mike Kadas, *Memorandum from Mike Kadas, Director, to the Revenue and Transportation Interim Committee*, July 16, 2014, at 1, available at https://revenue.mt.gov/Portals/9/committees/Revenue_Transportation/2013-2014/July/Tax%20Haven%20Report%20Country%20Update%20July%2016%202014.pdf. The Netherland Antilles has not been a country since 2010.

²⁰ *Id.*

²¹ See S.B. 167, 64th Leg., Reg. Sess. (Mont. 2015), available at http://leg.mt.gov/bills/2015/sb0199/SB0167_1.pdf.

²² See Multistate Tax Commission, *Proposed Model Statute for Combined Reporting*, available at http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Combined%20Reporting%20-%20FINAL%20Version.pdf.

²³ Multistate Tax Commission, *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, at 2–3, available at http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Committee_and_Subcommittees/June_6,_2011_Executive_Committee_Meeting/taxhavenhearingofficerreportfinal.pdf. Note that the water’s edge was by “election”—instead of the default worldwide reporting.

²⁴ *Id.* at 3–4.

²⁵ *Id.*; See also Multistate Tax Commission, *Resolution Adopting Amendment to Model Combined Reporting Statute; Definition of “Tax Haven” for Water’s Edge Election*, July 27, 2011, available at http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Committees/Executive_Committee/Scheduled_Events/44th_Annual_Meetings/taxhavenfinal.pdf.

“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. . . . 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 [Internationally Agreed Tax Standards for financial transparency] . . . 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.”²⁶

THE EXPERIENCE WITH “TAX HAVEN” BLACKLISTS IN OTHER STATES

Prior to the MTC’s disavowal of the blacklist approach, West Virginia in 2008 adopted unitary combined reporting based on the MTC model. As a result, it included the MTC’s reference to the OECD, which identified a tax haven as “a jurisdiction that, for a particular tax year in question. . . [i]s identified by the Organization for Economic Cooperation and Development as a tax haven or as having a harmful preferential tax regime[.]”²⁷ The statute also included reference to the MTC criteria.²⁸ However, in an amendment adopted in 2011, West Virginia significantly (but perhaps not clearly) limited its reference to the OECD list, providing retroactively that all amendments to the OECD list made between March 8, 2008 and January 1, 2011 “shall be given effect in determining whether a jurisdiction is a tax haven[.]”²⁹ Given the changes to the OECD list that took place during that time period, it is unclear what nations, if any, might still be included under West Virginia’s OECD reference.

Unlike West Virginia’s adoption of the (prior) MTC model, the next state that took the blacklist approach—Oregon—copied the Montana model of listing nations in its statute. Oregon’s experience in updating its tax haven list is instructive. Enacted in 2013, Oregon’s existing list admittedly “is modeled after Montana’s foreign tax haven list[.]”³⁰ In recommending updates to the list, the Oregon Department of Revenue stated it “used the 2011 MTC criteria in this report to identify recommended additions to or subtractions from the list[.]”³¹ However, the Department did not describe how it identified which nations to subject to its inquiry. For example, Ireland (a nation included in Montana’s 2015 legislative proposal) is not mentioned in the report.

The updated Oregon analysis appears to be based on the same subjective information gathering exercise used by Montana. For example, with respect to the Netherlands, the

²⁶ MTC, *Report of the Hearing Officer*, *supra* note 23, at 4–5.

²⁷ See 2008 W.Va. Acts, ch. 215, eff. June 7, 2008, available at http://www.legis.state.wv.us/Bill_Text_HTML/2008_SESSIONS/RS/Bills/sb680%20intr.htm.

²⁸ *Id.*

²⁹ See 2011 W. Va. Acts ch. 173, eff. March 10, 2011, available at <https://legiscan.com/WV/text/SB371/id/244568>.

³⁰ See Oregon Department of Revenue, *Recommendations on Tax Haven Jurisdictions*, 6 (Jan. 1, 2015), available at <http://library.state.or.us/repository/2015/201502051256044/>.

³¹ *Id.* at 8.

report finds “it is feasible to use hybrid financing arrangements to lower a Dutch tax bill. A recent Dutch Supreme Court decision makes clear that a financial instrument will be classified as debt or equity based on Dutch law without regard to how the financial instrument may be classified in a different country. One commentator noted this raises the possibility for profit shifting into the Netherlands.”³² The report also notes “a number of tax incentives and structures” available in the Netherlands, the percentage of profits of U.S. corporations in the Netherlands in relation to Dutch GDP, and “[m]ost notably, Netherlands law allows a company to set up using a post office box.”³³ The report further asserts, “wide publicity has been given to the role played by the Netherlands in tax avoidance schemes”, citing a New York Times article.³⁴ It is unclear the degree to which popular press and other third-party accounts influenced the Department’s judgment other than the MTC’s criteria.

Legislation was proposed in Oregon in 2015 to extend the State’s tax haven list to Guatemala, Hong Kong, the Netherlands, and Trinidad and Tobago.³⁵ However, as enacted, S.B. 61 only expanded the tax haven list to Guatemala and Trinidad and Tobago.³⁶ Neither is on the Montana list.

The District of Columbia in 2015 became the next U.S. jurisdiction to statutorily adopt a tax haven list.³⁷ The list replicated the existing Montana list, but without Panama.³⁸ The District of Columbia’s list was adopted without any tax committee hearings or public explanation regarding how the tax haven list of nations was derived. However, facing intense criticism of the arbitrary nature of the list, the District’s City Council reversed course and postponed implementation of the list.³⁹ The D.C. experience highlights states are ill equipped to judge the adequacy of individual nations’ tax structures against criteria which were developed in an entirely different context (the OECD’s efforts to increase transparency and information exchange). As noted by a commentator in response to the D.C. Chairman’s proposal, “Even assuming a state has proper criteria, the criteria would need to be applied every six months if not more frequently to take into consideration the changing circumstances... When states without professionals experienced in tax and anti-money-laundering policy try to apply the OECD 1998 criteria [for designation of tax havens], they are bound to make many mistakes... The D.C. government and U.S. states do not have the resources to effectively conduct such evaluations and make such judgments.”⁴⁰

Connecticut in 2015 experienced an outcome very similar to that in D.C. Connecticut adopted unitary combined reporting in 2015, with a delayed 2016 effective date.⁴¹

The D.C. experience highlights states are ill equipped to judge the adequacy of individual nations’ tax structures against criteria which were developed in an entirely different context...

³² *Id.* at 33.

³³ *Id.* at 33.

³⁴ *Id.* at 34, citing ‘*Double Irish with a Dutch Sandwich*’, N.Y. Times, Apr. 28, 2012, at A1.

³⁵ See H.B. 2099, 78th Leg., Reg. Sess. (Or. 2015).

³⁶ S.B. 6, 78th Leg., Reg. Sess. (Or. 2015).

³⁷ See 2015 D.C. Act A21-0148, available at <http://lirms.dccouncil.us/Download/33645/B21-0158-SignedAct.pdf>.

³⁸ *Id.*

³⁹ See Maria Koklanaris, *D.C. Council Chair to Introduce Legislation to Repeal Tax Havens List*, 2015 STT 211-(Nov. 2, 2015) (“I got some letters, I got some phone calls, my staff got some phone calls, and they got some visits.” [Chairman] Mendelson said. ‘I felt we would be better served if we pulled back and took a closer look. I want to look more carefully at the countries. I don’t want us to make a mistake’ by adding a country that shouldn’t be there, he said.”).

⁴⁰ *Id.*

⁴¹ 2015 Conn. Pub. Acts 15-244 (Reg. Sess.), available at <https://www.cga.ct.gov/2015/ACT/PA/2015PA-00244-R00HB-07061-PA.htm>.

Without...U.S. or international guidance...states...struggle to analyze international tax structures and national tax regimes to determine which countries should be listed as tax haven jurisdictions.

As part of its combined reporting adoption, it required the Department of Revenue Services to produce a tax haven list.⁴² However, business reaction to the tax package (which included an extended corporate tax “surcharge,” limits on credit and net operating loss deduction utilization, and other tax increases) was extremely negative, with headquartered companies threatening to leave the State.⁴³ As a result, Connecticut passed amendatory provisions in a December 8, 2015 special session, including significant changes to the tax haven provisions. As part of these changes, the Department of Revenue Services is no longer required to produce a tax haven nation list, and a form of “whitelist” is included in the statute excluding certain treaty nations from the reach of the tax haven criteria analysis.⁴⁴

Legislation proposed (but not enacted) in numerous additional states in 2015 generally copied the Montana blacklist approach, compounding the problem of developing a list of tax haven countries without any reasonable foundation in international tax law. Proposed legislation included bills filed in: Colorado (H.B. 1346, generally smaller/island economies); Maine (H.P. 235, including Ireland); Massachusetts (S.B. 1524/H.B. 2477, including Hong Kong, the Netherlands, Switzerland, and Singapore); and Pennsylvania (S.B. 117, including “tax havens” identified by the OECD for the taxable year, plus specifically Bermuda, the Cayman Islands, the Bailiwick of Jersey, and Luxembourg).

STATES, UNEQUIPPED TO UPDATE LISTS, LACK U.S. AND INTERNATIONAL GUIDANCE

As noted, the OECD abandoned its listing of uncooperative tax havens in 2009. The U.S. Government has not filled this gap, as it maintains no tax haven list for tax base expansion purposes. Finally, as noted above, the Multistate Tax Commission in 2011 abandoned its effort to maintain a blacklist of countries, recognizing its reliance on the OECD list was untenable. Without any U.S. or international guidance, the states with tax haven legislation struggle to analyze international tax structures and national tax regimes to determine which countries should be listed as tax haven jurisdictions.

More recently, in 2015, the European Union (EU) issued its first tax haven list. However, the EU list was not based on any criteria agreed to collectively by the EU countries, but rather reflected a consolidation of independent EU country lists.⁴⁵ These country lists themselves represent wildly differing approaches by the member EU countries.⁴⁶ Fifteen of the twenty-eight EU countries have no tax haven lists at all, including large member nations such as Germany and the United Kingdom.⁴⁷ Among the remaining thirteen EU countries, significant variations exist. For example, France

⁴² See 2015 Conn. Pub. Acts 15-5 (Spec. Sess.), available at <https://www.cga.ct.gov/2015/ACT/PA/2015PA-00005-RO0SB-01502SS1-PA.htm> (“the commissioner shall publish a list of jurisdictions that the commissioner determines to be tax havens. The list shall be applicable to income years commencing on or after January 1, [2016], and shall remain in effect until superseded by the publication of a revised list by the commissioner”).

⁴³ See Allysia Finley, *GE Escapes Connectitax*, Wall Street Journal, Jan. 13, 2016, available at <http://www.wsj.com/articles/ge-escapes-connectitax-1452730001>.

⁴⁴ See Conn. Pub. Acts 15-1 (Spec. Sess.), available at <https://www.cga.ct.gov/2015/ACT/pa/2015PA-00001-R00SB-01601SS2-PA.htm>.

⁴⁵ See European Commission Taxation and Customs Union, *Tax Good Governance in the World as Seen by EU Countries*, http://ec.europa.eu/taxation_customs/taxation/gen_info/good_governance_matters/lists_of_countries/index_en.htm.

⁴⁶ *Id.*

⁴⁷ *Id.*

has eight jurisdictions on its list; Italy has over 50 jurisdictions on its list; and Portugal has 80 countries on its list.⁴⁸ The subjective nature of the lists is highlighted by the absence of any EU countries on the EU lists—something that would not be permitted under EU rules.⁴⁹

Not only are the separate EU country lists not standardized, but they are not transparent in terms of how the national lists are created and how the national criteria are translated into the EU listing effort.⁵⁰ Further, the EU nation lists are used for varying purposes—including transparency, information sharing, and in a small number of countries for the denial of deductions for dividends received from foreign affiliates on deferred income.

As a result, the EU country “tax haven” lists provide little guidance for states having or contemplating adoption of tax haven list statutes. While the EU continues to refine its approach to a consolidated EU tax haven list, it’s not clear what form the final list will take, to what purpose it will be used, or what credibility it will have given the highly politicized process.⁵¹

Any possibility the broader international community would create a standardized list of tax havens was eliminated by the 2015 release of the OECD BEPS project actions that steered completely clear of recommending any measures aimed at creating a blacklist of so-called “tax haven” nations and automatically including their income in the current year tax base of other countries (see discussion in Section 4).

In summary, the handful of states that have thus far adopted tax haven statutes have done so without relying on any internationally accepted list or international standards for identifying which countries should be included and maintained on the blacklists. Moreover, going forward, these states (and other ones that might choose to join them) are similarly handicapped.

Left to their own designs, the states—unlike most foreign nations—generally lack in-house knowledge or expertise in foreign affairs, international tax, transfer pricing rules, permanent establishment rules, or international treaties to assist them in evaluating which countries should be included on or removed from a blacklist. Importantly, only the federal

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generally lack in-house knowledge or expertise in foreign affairs, international tax, transfer pricing rules, permanent establishment rules, or international treaties to assist them in evaluating which countries should be included on or removed from a blacklist.

⁴⁸ *Id.*

⁴⁹ The EU lists have been sharply criticized. See Joe Kirwin *EU Updates Tax Haven List But Criticism Lingers*, 198 DTR 1-1 (Oct. 14, 2015); see also *EU Hypocrites! The Naming and Shaming of Tax Havens is Fraught with Folly!*, The Economist, Aug. 22, 2015, available at <http://www.economist.com/news/finance-and-economics/21661674-naming-and-shaming-tax-havens-fraught-folly-eu-hypocrites>. The EU lists continue to include countries deemed compliant by the OECD.

As noted previously, the OECD no longer maintains its list of “uncooperative tax havens.” However, the OECD in 2009 established the Global Forum on Transparency and Exchange of Information for Tax Purposes with a mandate to promote the rapid implementation of international standards of transparency and exchange of information. The project rates countries as “compliant,” “largely compliant,” “partially compliant,” and “non-compliant” with these standards. See OECD Global Forum on Transparency and Exchange of Information for Tax Purposes, *Tax Transparency 2015. Report on Progress*, page 15, available at <http://www.oecd.org/tax/transparency/global-forum-annual-report-2015.pdf>.

⁵⁰ The European Commission website cites transparency, exchange of information, and fair tax competition as “standards of tax good governance,” but does not provide how these criteria are applied by the nations and how the criteria were applied to derive the EU list. See Press Release, European Commission, Tax Transparency: Commission Welcomes Agreement Reached by Member States on the Automatic Exchange of Information on Tax Rulings (Oct. 6, 2015), available at http://europa.eu/rapid/press-release_IP-15-5780_en.htm. This is probably because the criteria vary by nation, and, in fact, the EU provides that its list was merely a compilation of the most commonly listed nations among its members.

⁵¹ On January 28, 2016, the European Commission (EC) presented its Anti-Tax Avoidance Package (ATAP). The package is now under consideration by the EU nations, 21 of 28 of which participated in the OECD BEPS project. *European Commission proposes Anti-Tax Avoidance Package*, PWC Tax Policy Bulletin, February 5, 2016, available at <http://image.edistribution.pwc.com/lib/fe9813707560007f73/m/1/european-commission-proposes-anti-tax-avoidance-package.pdf>.

While the criteria approach may seem less offensive than the blacklist approach, it has its own set of problems that make it just as unworkable.

government has the ability to negotiate treaties with other nations. The absence of the relevant knowledge base is particularly troubling because the identification of which, if any, nations to place (and keep) on a blacklist requires not only an understanding of the rules of the so-called “tax haven” nation, but also of how other nations’ laws interact with the blacklisted nation to facilitate profit shifting. Not surprisingly, three jurisdictions (West Virginia, D.C., and Connecticut) and the MTC have backtracked and switched to the “criteria” approach after initially adopting the blacklist approach.

DIFFICULTIES WITH THE “CRITERIA” APPROACH

While the criteria approach may seem less offensive than the blacklist approach, it has its own set of problems that make it just as unworkable. Most of the states with the criteria approach follow the MTC model. Under the current MTC “criteria” model:

“Tax haven” means a jurisdiction that, during the tax year in question has no or nominal effective tax on the relevant income and:

- i. has laws or practices that prevent effective exchange of information for tax purposes with other governments on taxpayers benefiting from the tax regime;
- ii. 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;
- iii. 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. 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. 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.⁵²

In its water’s-edge provisions, the MTC model provides that “the entire income and apportionment factors of any [unitary group] member that is doing business in a tax haven” is included in the water’s-edge combined filing.⁵³ The model provides no guidance regarding how the criteria above are to be applied either by the taxpayer in determining its liability or the revenue agency in reviewing the taxpayer’s returns.

A small number of states (e.g., D.C., Connecticut, Rhode Island and West Virginia) have adopted the “criteria” approach (generally based on the MTC criteria), leaving the

⁵² Multistate Tax Commission, *Proposed Model Statute for Combined Reporting*, available at http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Combined%20Reporting%20-%20FINAL%20version.pdf.

⁵³ *Id.*

determination of tax haven jurisdictions to their state tax agencies.⁵⁴ None of these states has provided administrative guidance regarding how the criteria are to be applied either by the taxpayer or by its auditors. The only published application of the criteria has been, as previously noted, by blacklisting states in suggesting additions to their statutory lists.

Prior to the repeal of its list, the District of Columbia's tax code actually contained both the aforementioned blacklist and subjective criteria.⁵⁵ As a result, the Office of Tax and Revenue was authorized to determine a jurisdiction is a tax haven on audit even if it was not on the statutory list. This "worst of both worlds" scenario highlights the infirmities in both approaches. With the listing approach, taxpayers are bound to an inflexible standard for inclusion of foreign entities regardless of substance; with the criteria approach, taxpayers are subject to the capricious actions of revenue agencies in deeming which affiliates (likely profitable ones) are subject to a tax haven determination. The criteria approach takes the arbitrary tests for tax haven nations and pushes them from the legislature *a priori* to the revenue agency *a posteriori* to apply after the fact, on audit.

The infirmities in the criteria approach can also be seen in the numerous, and varying, carve-outs legislatures have crafted to try to avoid overreaching. In the case of the MTC (and as adopted by D.C.), an exception exists where "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[.]"⁵⁶ Rhode Island included within its tax haven provisions a carve-out for transactions at arm's length and not with the principal purpose of tax avoidance, and also a safety valve where the taxpayer shows the tax haven imposition to be unreasonable.⁵⁷ Connecticut took the unprecedented step of seeking to insulate specific nations from the criteria application: any country with a "comprehensive income tax treaty" with the U.S. that meets certain I.R.C. standards is essentially whitelisted.⁵⁸ Connecticut's recent action highlights the concern that application of the criteria would otherwise produce an arbitrary and unreasonable result not contemplated by the legislature.

As difficult as it is for state legislatures to make "tax haven" blacklist determinations, it is even more problematic for state tax agencies' audit staff to make fair and informed determinations. Instead, the auditors judge nations against very broad and ambiguous criteria (e.g., "has laws or practices that prevent effective exchange of information... has [a] tax regime which lacks transparency... has created a tax regime which is favorable for tax avoidance").⁵⁹ State tax agencies have no objective framework for distinguishing between nations that encourage real economic activity with lower tax rates and incentives and those that sponsor artificial income shifting. The lack of guidance provided by state tax agencies using the "criteria" approach increases the compliance problems for businesses that need to determine which foreign entities, if any, should be included in the water's-edge tax base in those states. This uncertainty also creates problems for companies for financial accounting and reporting purposes.

State tax agencies have no objective framework for distinguishing between nations that encourage real economic activity with lower tax rates and incentives and those that sponsor artificial income shifting.

⁵⁴ Alaska has its own unique "criteria"-like statute. See *supra* note 8.

⁵⁵ See D.C. Act A21-0148, *supra* note 37.

⁵⁶ See MTC, *Report of the Hearing Officer*, *supra* note 23, at 2.

⁵⁷ See H.B. 7133, Reg. Sess. (R.I. 2014).

⁵⁸ Conn. Pub. Acts 15-1, *supra* note 44.

⁵⁹ See MTC criteria in Appendix.

THE STATE TAX REVENUE LOSS ESTIMATES RELATING TO TAX HAVENS ARE HIGHLY EXAGGERATED

One of the key underpinnings of the “tax haven” debate at the state level has been the supersized estimates of state tax revenue losses attributable to alleged “profit shifting” to “offshore tax havens”.⁶⁰ The estimated state revenue losses from tax havens derive from widely publicized studies by the advocacy group U.S. Public Interest Research Group (U.S. PIRG). In a January 2013 study, U.S. PIRG estimated the use of offshore tax havens by U.S. multinational corporations was responsible for \$26 billion in lost state corporate tax revenues in 2011.⁶¹ A year later, U.S. PIRG claimed the use of offshore tax havens by U.S. multinational corporations resulted in the states losing approximately \$20.7 billion a year in corporate income tax revenue.⁶²

The \$20 billion plus state revenue loss estimate appears frequently both in media reports on tax haven legislation and in testimony presented at state legislative hearings.⁶³ The number was also prominently cited as a justification

⁶⁰ The language used by proponents of “tax haven” legislation is consistently couched in tones of outrage and allegations of manipulation of tax reporting rules. Among the descriptions used are “tax shell games”, “offshore shell games”, and “offshore tax dodging”. See Benjamin Davis et al., *Tax Shell Game: How Much Did Offshore Tax Havens Cost You in 2010?*, U.S. PIRG Education Fund, Apr. 2011; Robert S. McIntyre et al., *Offshore Shell Games 2015: The Use of Offshore Tax Havens by Fortune 500 Companies*, U.S. PIRG Education Fund and Citizens for Tax Justice, Oct. 2015; U.S. PIRG News Release, Dan Smith, *Camp Corporate Tax Proposal Would Make Offshore Tax Dodging Easy For Large Multinationals*, Feb. 26, 2014, available at <http://www.uspirg.org/news/usp/camp-corporate-tax-proposal-would-make-offshore-tax-dodging-easy-large-multinationals>.

⁶¹ Jordan Schneider et al., *The Hidden Cost of Offshore Tax Havens: State Budgets Under Pressure from Tax Loophole Abuse*, U.S. PIRG Education Fund, January 2013, at 10, available at http://www.uspirg.org/sites/pirg/files/reports/USPIRG_State_Tax_Havens_0.pdf. The U.S. PIRG study also estimates additional state tax revenue losses attributed to use of offshore tax havens by wealthy individuals at about \$14 billion. *Id.*

⁶² Phineas Baxadnall et al., *Closing the Billion Dollar Loophole: How States Are Reclaiming Revenue Lost to Offshore Tax Havens*, U.S. PIRG, 2014, at 7, available at <http://www.uspirg.org/sites/pirg/files/reports/Closing%20the%20Billion%20Dollar%20Loophole%20Web%20vUS%20041414.pdf>. The U.S. PIRG did not provide an explanation for the discrepancy between the estimates in the 2013 and 2014 studies—both of which focused on 2011.

⁶³ Elaine S. Povich, *Hunting Lost Revenue in Offshore Tax Havens*, The Pew Charitable Trusts: Research & Analysis: Stateline, March 10, 2014; Jaimie Woo and Dan Smith, *Picking Up the Tab 2015: Small Businesses Pay the Price for Offshore Tax Havens*, U.S. PIRG Education Fund, April 2015, at 1; Mark Niquette, *U.S. States Target Corporate Cash Stashed Overseas*, Bloomberg Business, April 17, 2014.

for the MTC's Arm's-Length Adjustment Service (ALAS) project in May, 2015.⁶⁴ As the MTC states in its ALAS Project Design, "Estimates of the federal revenue loss from international income shifting suggest that those losses approach \$100 billion annually. Assuming that is the case, state revenue losses would be nearly \$20 billion a year."⁶⁵

ARE THE REVENUE LOSS ESTIMATES CREDIBLE?

These are truly breathtaking revenue loss estimates. But the question remains—are they credible? Are they backed up by reasonable economic data on the actual behavior of multinational companies in the global marketplace and their impact on state taxation? The primary source for the U.S. PIRG estimates is a study that was done by economist Kimberly Clausing in 2009 and then updated in 2011.⁶⁶ Clausing did not attempt to break down the impact of profit shifting at the state level, but rather focused only on the federal level. Her study determined that multinational corporation income-shifting resulted in lost *federal* tax revenues in the (upper) range of about \$90 billion in 2008.⁶⁷

Clausing's methodology is designed to identify the responsiveness of reported foreign affiliate profitability to *tax rate* differentials. However, the publicly available data she uses to estimate income shifting aggregates all the affiliates of U.S. parents operating in a country. As a result, the regression analysis cannot identify and incorporate firm-specific real economic factors that may explain a significant portion of observed variations in profitability.⁶⁸ Clausing thus assumes that the explanation for higher-than-average rates of profitability of foreign affiliates of U.S. multinationals is income shifting in response to tax rate differentials. Under her approach, Clausing makes no allowance for any high-profit, real economic activity that occurs in a lower tax jurisdiction because of business investment and resource allocation decisions. Clausing derives her "income shifting" estimates from the difference between the level of profit that would have been reported in a country if U.S. corporate income tax rates were levied, compared with the profit that was actually reported.⁶⁹

⁶⁴ Multistate Tax Commission, *Design for an MTC Arm's-Length Adjustment Service*, 3 (May 7, 2015), available at <http://www.mtc.gov/getattachment/The-Commission/Committees/Executive-Committee/Executive-Committee-Agenda-5-2015/Final-Design-for-ALAS-2015-04-30.pdf.aspx>.

⁶⁵ *Id.*

⁶⁶ See Schneider et al., *supra* note 61, at 22; Baxadnall et al., *supra* note 62, at 25.

⁶⁷ Kimberly A. Clausing, *The Revenue Effects of Multinational Firm Income Shifting*, Tax Notes, 28 March 2011, 1580–86. Clausing revised these estimates to \$77 billion to \$111 billion in federal revenue loss for 2012. Kimberly A. Clausing, "The Effect of Profit Shifting on the Corporate Tax Base in the United States and Beyond", November 2015, at 1. See also Clausing's earlier study: Kimberly A. Clausing, *Multinational Firm Tax Avoidance and Tax Policy*, National Tax Journal, December 2009, 703–725. It is also important to note that Clausing's estimate of the possible reduction in U.S. corporate income tax revenue is *not* an estimate of the amount of additional taxes that could be collected from tax policy changes to address income shifting behaviors. She notes, "...it is unlikely that the entirety of those revenues losses would be recouped through policy changes." Clausing, *Revenue Effects*, at 1586.

⁶⁸ As pointed out in the OECD study, *Measuring and Monitoring BEPS*, at 99, the vast majority of more recent studies of income shifting have used firm-level data that allows researchers to simultaneously estimate the separate impacts of firm-specific tax and non-tax factors on profitability. The results from firm-level studies tend to provide lower estimates of income shifting in response to profit differentials. It should also be noted that a shortcoming of almost all of these empirical studies is that they are based on book income and not taxable income, the measure that actually determines a firm's tax liability. OECD (2015), *Measuring and Monitoring BEPS, Action 11—2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

⁶⁹ Clausing, *Revenue Effects*, *supra* note 67, at 1583. Clausing assumes that profitability within an enterprise should be the same across countries—regardless of the variations in corporate risk or value added activities—and that a deviation within a company from this average is a symptom of income shifting.

The problem with the Clausing approach...is the difficulty of separating the BEPS effect from the impact of real economic factors such as investment or resource allocation decisions made to take advantage of targeted tax incentives or lower tax rates.

The problem with the Clausing approach, as with similar studies, is the difficulty of separating the BEPS effect from the impact of real economic factors such as investment or resource allocation decisions made to take advantage of targeted tax incentives or lower tax rates. The OECD in its own efforts to measure the scale of BEPS highlighted the limitations of tax revenue loss studies and concluded, "...all analyses of BEPS are severely constrained by the limitations of the currently available data. The available data is not comprehensive across countries or companies, and often does not include actual taxes paid. **In addition to this, the analyses of profit shifting to date have found it difficult to separate the effects of BEPS from real economic factors and the effects of deliberate government tax policy choices**" (emphasis added).⁷⁰

Ironically, for all the fury and fulmination accorded the "tax haven" issue by U.S. PIRG, the Clausing analysis is not based exclusively on tax haven nations. Rather, her analysis is inclusive of approximately 60 countries worldwide where U.S. multinationals primarily operate, most with lower tax rates than the U.S., since the U.S. has one of the highest corporate tax rates in the world.⁷¹

Despite its limitations, the Clausing analysis forms the basis for the PIRG state corporate income tax loss estimates attributable to tax havens. U.S. PIRG takes the high end of the Clausing analysis of \$90 billion of losses in federal income tax revenues due to BEPS (she also has a lower range number of \$57 billion which PIRG ignores⁷²) and then extrapolates the number to create an estimate for state tax revenue loss, after taking into account differences in state and federal income tax rates, tax base and allocation of income. This ultimately results in its \$20 billion revenue loss estimate (previously \$26 billion).⁷³

The vast overstatement of state corporate income tax losses forecast by the U.S. PIRG methodology becomes apparent when the estimate is compared to the global BEPS tax revenue loss estimate provided by the OECD BEPS project. In its study, the OECD concluded (subject to qualifications about serious data limitations) that global corporate revenue losses attributable to BEPS were in the range of 4 percent to 10 percent of global corporate income tax revenues.⁷⁴ By contrast, the U.S. PIRG estimate suggests that the state corporate income tax losses attributable to profit shifting to foreign tax havens total over 40 percent of all state corporate income tax revenue. In fiscal year 2012, the combined corporate income tax revenue of all 50 states totaled \$49.1 billion. Thus, based on U.S. PIRG's revenue loss estimate of \$20.7 billion for the same year, the use of tax havens to shelter corporate income was costing states an

⁷⁰ See OECD, *Measuring and Monitoring*, *supra* note 68, at 16. See also, Dhammika Dharmapala, "What Do We Know About Base Erosion and Profit Shifting? A Review of the Empirical Literature," (Coase-Sandor Institute for Law & Economics Working Paper No. 702, 2014). The Dharmapala paper provides a survey of the empirical literature on BEPS and concludes, "A major theme that emerges from this survey is that in the more recent empirical literature, which uses new and richer sources of data, the estimated magnitude of BEPS is typically much smaller than that found in earlier studies."

⁷¹ See generally, Clausing, *Revenue Effects*, *supra* note 67, at 1585 (Analyzing tax rates throughout the world, and noting that the U.S. corporate tax rate is "more than one standard deviation higher than the average OECD country corporate tax rate").

⁷² See *id.* (stating, "(a)n alternative estimate is also provided, suggesting a \$57 billion revenue loss associated with income shifting, or about 19 percent of U.S. government corporate tax revenues.")

⁷³ Baxadnall et al., *supra* note 62, at 3.

⁷⁴ See OECD, *Measuring and Monitoring*, *supra* note 68, at 15. The OECD concluded: "Although measuring the scale of BEPS proves challenging given the complexity of BEPS and the serious data limitations, today we know that the fiscal effects of BEPS are significant. The findings of the work performed since 2013 highlight the magnitude of the issue, with global corporate income tax (CIT) revenue losses estimated between 4% and 10% of global CIT revenues, i.e. USD 100 to 240 billion annually."

amount equal to 42.2 percent of the entire state corporate income tax base—**or 4 to 10 times higher than the OECD estimate range.**⁷⁵

The credibility of the U.S. PIRG estimate is further undermined because it incorrectly purports to be attributable solely to “tax haven” countries, not to the BEPS impact in all nations where U.S. multinationals operate as measured by the Clausing study. For instance, in its June 2014 study, PIRG states, “By booking profits to subs registered in tax havens, multinational corporations are able to avoid an estimated \$90 billion in federal income taxes each year.”⁷⁶ This statement is not a correct description of Clausing’s empirical results.

THE SHRINKING REVENUE LOSS ESTIMATES

However, perhaps the best refutation of the U.S. PIRG estimate of \$20 billion in state corporate income tax revenue losses attributable to tax havens comes not from a critique of the Clausing study, but from a subsequent study by U.S. PIRG itself. In 2014, U.S. PIRG published a study of the potential for additional state tax revenues if states enacted tax haven legislation.⁷⁷ In this study, U.S. PIRG concluded that such legislation would result in additional state tax revenues of only \$1.680 billion for all states with corporate income taxes.⁷⁸ Looking only at the subset of states with existing combined reporting requirements, U.S. PIRG estimated that additional state tax revenues of \$1.015 billion would result.⁷⁹

This second study was based on the actual and estimated results of the two states (Montana and Oregon) with tax haven legislation that require income earned by foreign subsidiaries in designated tax haven countries to be included in the water’s-edge base for purposes of calculating state corporate income taxes. The results in Montana and Oregon were taken and then extrapolated across the remainder of states—with adjustments made for different corporate apportionment formulas and state tax rates.⁸⁰

Incredibly, the state revenue “gain” estimates based on the second U.S. PIRG study total only **8.4 percent** of the estimated revenue “loss” estimates in the earlier U.S. PIRG study. Even more disturbing, U.S. PIRG, to date, has made no effort to **disavow** the earlier revenue estimate. Instead, it continues to use the \$20 billion estimate in its 2014 study and in a subsequent 2015 study, with no reasonable explanation of the differences between the two estimates, and no examination of the continuing legitimacy, if any, of the

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⁷⁵ See COST and Ernst & Young, *FY13 Total State and Local Business Taxes: August 2014*, p. 13; Baxadnall et al., *supra* note 62, at 7. If one uses the earlier estimate of \$26 billion, the use of tax havens to shelter corporate tax income was costing states an amount equal to 53 percent of the entire corporate income tax base. See also Schneider et al., *supra* note 61, at 10.

⁷⁶ Richard Phillips et al., *Offshore Shell Games 2014: The Use of Offshore Tax Havens by Fortune 500 Companies*, U.S. PIRG Education Fund and Citizens for Tax Justice, June 2014, at 1.

⁷⁷ See Baxadnall et al., *supra* note 62.

⁷⁸ See *id.*, at 2.

⁷⁹ *Id.* at 21.

⁸⁰ *Id.* at 16-18.

The OECD BEPS project... is likely to result in a fundamental change in international tax rules and a significant diminution of profit shifting activities in low tax jurisdictions... state efforts to engage in self-help through adoption of tax haven lists appear increasingly out of step.

larger revenue estimate.⁸¹ U.S. PIRG continues to assert in its April 2015 study, “Corporate tax haven abuse costs state governments an estimated \$20 billion in lost tax revenue.”⁸²

The point here is not that the second and lower revenue estimate should be accepted at face value—far from it. This second PIRG study has its own set of problems. It is built upon real data from only one unique (and small population) state (Montana), and *estimated* data from a second small state (Oregon) which in turn based its estimate solely on Montana. These states rank 44th and 27th among U.S. states based on population, respectively.⁸³ Moreover, the second study attempts to determine the revenue estimate for the large number of “single sales” factor states based on the very thin foundation of Oregon’s estimated data. [Unlike Montana’s three-factor property, payroll and sales formula, Oregon only uses sales to determine the proportion of business conducted in the State.] However, even if one does not treat the second and drastically lower U.S. PIRG revenue loss estimate as entirely accurate, the second study certainly serves the purpose of highlighting the vast overstatement of revenue losses contained in the first and larger estimate.

Fiscal estimates for tax haven proposals in other states underscore the uncertainty in the fiscal effects of these measures and the unreliability of U.S. PIRG’s estimates. For example, the District of Columbia estimated its proposed adoption of a tax haven list of nations would net the District \$3.7 million in FY 2017.⁸⁴ By contrast, U.S. PIRG put its original “tax haven” revenue estimate for D.C. at \$284 million and its new, lower revenue estimate at \$17.9 million.⁸⁵ Likewise, New Hampshire estimated its tax haven proposal would net the state approximately \$5.1 million annually beginning in FY 2016, far less than U.S. PIRG’s original “tax haven” revenue estimate of \$98 million or its new, lower revenue estimate of \$26.1 million.⁸⁶

An additional problem with the second U.S. PIRG study is that the estimates are necessarily based on “old” data of prior tax years and not necessarily predictive of future tax years. Indeed, it would be an error to assume that the financial impact of BEPS is a stationary target. The OECD BEPS project—the most significant undertaking of its kind

⁸¹ *Id.* at 7, 20. See also Robert S. McIntyre et al., *supra* note 60, at 6. U.S. PIRG’s October 2015 study again approvingly references the \$90 billion Clausing estimate. It could be argued that the second and lower revenue estimate in the 2014 study is understated because Montana and Oregon do not include all of the nations U.S. PIRG considers to be tax haven countries in their statutory lists for inclusion in the water’s-edge income tax base. However, at most, this difference could only account for a modest fraction of \$18.4 billion difference between the estimates. The only half-hearted attempt U.S. PIRG makes at distinguishing the revenue estimates is by labeling its charts differently, calling the larger revenue loss estimate chart “State-by-State Tax Revenue Lost to Offshore Tax Havens”; and the smaller revenue loss estimate chart “State-by-State Potential Additional Tax Revenue Collected by Closing the Water’s Edge Loophole”. See Baxadnall et al., *supra* note 62, at 20–21. However, even though state tax haven legislation is the primary legislative solution recommended by U.S. PIRG to combat income tax shifting to foreign jurisdictions, the organization makes little effort to reconcile the drastically different revenue estimates.

⁸² Jaimie Woo & Dan Smith, *supra* note 63, at 1.

⁸³ U.S. Census Bureau, *Annual Estimates of the Resident Population for the United States, April 1, 2010 to July 1, 2015*, available at <https://www.census.gov/popest/data/state/totals/2015/index.html>.

⁸⁴ Jeffrey Dewitt, *Memorandum from Jeffrey S. Dewitt, Chief Financial Officer, to The Honorable Phil Mendelson, Chairman, Council of the District of Columbia*, June 29, 2015, at 60, available at http://app.cfo.dc.gov/services/fiscal_impact/pdf/spring09/FIS%20-%20Fiscal%20Year%202016%20Budget%20Support%20Act%20of%202015r.pdf.

⁸⁵ See Baxadnall, *supra* note 62, page 20–21.

⁸⁶ Fiscal Impact Statement, New Hampshire Department of Revenue Administration, re: H.B. 2, sent to Legislative Budget Assistant’s Office (LBAO) on March 10, 2015. See Baxadnall, *supra* note 62, page 20–21.

in the last 100 years⁸⁷—is likely to result in a fundamental change in international tax rules and a significant diminution of profit shifting activities in low tax jurisdictions.⁸⁸ Thus, even if one accepts at face value the lower estimates of potential state tax revenue losses cited in the second U.S. PIRG study, these projections will likely become outdated soon after their release. In this context, state efforts to engage in self-help through adoption of tax haven lists appear increasingly out of step.

The purpose of critiquing the U.S. PIRG and related studies is not to suggest there is no profit shifting occurring in a complex global economy characterized by significant national differences in corporate tax rates and corporate tax incentives, oft-conflicting rules on how to tax cross border commerce, and ample opportunities for companies to develop tax efficient corporate structures. The nations involved in the OECD project are in agreement that base erosion and profit shifting (BEPS) is a significant issue that must be addressed—at least at the international level. But arbitrarily and irresponsibly assigning a very large state tax revenue loss estimate to the problem does not help inform state and local tax policymakers on how to approach the issue on a going forward basis. It simply stirs up emotional rhetoric and a hue and cry for overreaching and simplistic solutions such as state tax haven legislation rather than focusing on the much thornier underlying issues of how to best align the reporting of corporate profits with where value is created.

Finally, even if one assumes a certain level of profit shifting at the international level, that still leaves open the question of whether the states have any reasonable claim to this income. The BEPS project has been driven less by the U.S. than by other large industrialized countries in Europe and Asia. These nations believe the division of multinational cross border income has adversely impacted their own tax bases. These nations are not supporting the BEPS project because they believe global income has been insufficiently sourced to the United States (at the national and subnational levels), but rather that it has been insufficiently sourced to their own countries.⁸⁹

⁸⁷ Explanatory Statement, *OECD/G20 Base Erosion and Profit Shifting Project*, OECD 2015, at 5. Given the widespread support accorded to the OECD BEPS project's recommended action measures by the OECD and G-20 nations that account for over 90 percent of the world's GNP, there is a high likelihood that international tax rules will change dramatically over the next few years. This will undoubtedly have the effect of placing a significant downward pressure on any tax revenue losses from BEPS both at the global level and at the state and local level. According to the overview provided by the OECD in its recently released 2015 summary of the OECD/ G20 Base Erosion and Profit Shifting Project:

"Out of a shared desire to address BEPS concerns, there is agreement on a **comprehensive package of measures** which are designed to be implemented domestically and through treaty provisions in a coordinated manner, supported by targeted monitoring and strengthened transparency. The goal is to tackle BEPS structures by comprehensively addressing their root causes rather than merely the symptoms...The BEPS package represents the first substantial—and overdue—renovation of the international tax standards in almost a century...The G20 and the OECD have recognized that BEPS by its very nature requires coordinated responses, which is why countries have invested the resources to participate in the development of shared solutions." *Id.* at 5.

⁸⁸ See Deloitte, *OECD's Base Erosion and Profit Shifting (BEPS) Initiative: Full Results of Second Annual Multinational Survey*, May 2015, available at <https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-beps-full-survey-results-may-2015.pdf>. Moreover, it is not just the world's leading nations that are anticipating that far-reaching changes will take place in the international tax arena because of the OECD BEPS reforms. Multinational companies are also fully expecting a major overhaul to international tax rules that will more closely align the location of taxable profits with the location of economic activities and value creation. According to a 2015 Deloitte Survey of tax and finance leaders of multinational companies:

- 87 percent of the respondents agree or strongly agree that the BEPS initiative will result in significant legislative and treaty changes in many countries.
- 96 percent of the respondents agree or strongly agree that tax authorities will apply greater scrutiny around the level of substantive business operations conducted in low tax countries as a result of BEPS initiatives.
- 58 percent of respondents agree or strongly agree that the BEPS project will have a greater impact on their organizations than they originally thought. *Id.* at 21, 22, & 24.

⁸⁹ Joe Harpaz, *Congress Girds for a Showdown Over Global Tax Plan*, *Forbes.com*, June 11, 2015.

...where is the evidence that corporate profit shifting to offshore tax havens is sharply reducing the level of state and local taxes paid by business...?

So in addressing what share, if any, the states should be entitled to, it is necessary to answer several key questions. To what extent is the problem attributable to income that is shifted among different foreign nations with minimal connection to any underlying economic activities in the U.S.? Does the income have any reasonable connection to individual states that would justify a state expanding its income tax base to include the foreign source profits? And finally, where is the evidence that corporate profit shifting to offshore tax havens is sharply reducing the level of state and local taxes paid by business and causing a gaping hole in the state and local tax base?

THE BUSINESS SHARE OF STATE AND LOCAL TAXES IS ACTUALLY INCREASING

For U.S. PIRG and other proponents of state tax haven legislation, highlighting state revenue losses allegedly caused by profit shifting to tax havens is really part of a broader criticism: businesses do not pay their “fair share” of state and local taxes. As stated by U.S. PIRG in its 2014 tax haven study, “Every person and every corporation in America benefits from government services—from schools to paved roads to courts and public health. We all should contribute our share in taxes when it comes to paying the tab. Yet even though America’s corporations use these government services, many avoid paying taxes for them by moving their profits into offshore havens.”⁹⁰

However, the assertion that businesses do not pay their fair share of state and local taxes is based on a fundamental misunderstanding (or intentional distortion) of both the composition and level of business contributions to state and local government revenues. To begin, criticism of corporations for not paying their fair share almost always focuses exclusively on state and local corporate income taxes.⁹¹ However, the corporate income tax generally makes up less than one-tenth of all state and local taxes paid by business.⁹²

In FY2014, of the \$688 billion in state and local taxes paid by businesses, only \$64.4 billion was from corporate income taxes (and other business activity taxes), representing 9.4 percent of the total.⁹³ By comparison, in that same year, property taxes on business property accounted for 36.4 percent of all state and local business taxes, and sales taxes on business inputs made up 20.7 percent of total state and local business taxes (see Figure 2).⁹⁴

⁹⁰ Baxadnall et al., *supra* note 62, at 4.

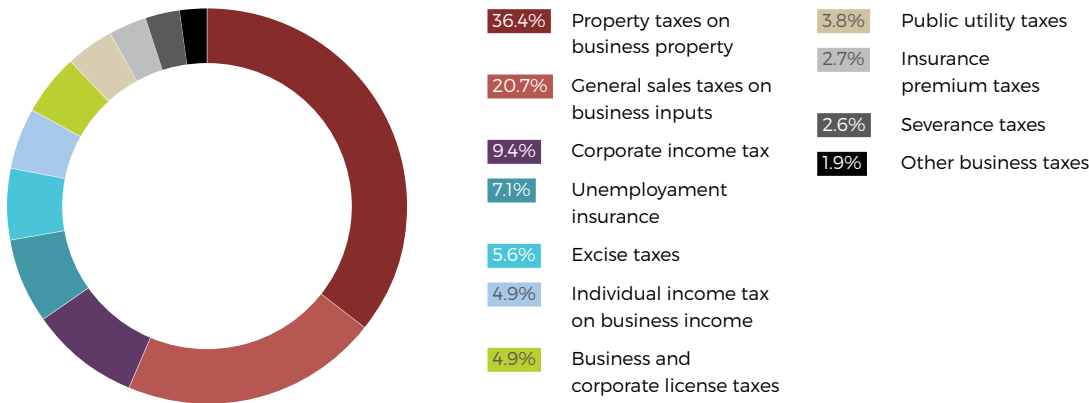
⁹¹ See generally, Council On State Taxation, *Updated Citizens for Tax Justice Report Misleads Policymakers and the Public*, Mar. 31, 2014, available at <http://www.cost.org/WorkArea/DownloadAsset.aspx?id=86913>.

⁹² State and local government are not unique in their limited reliance on corporate income taxes as a source of government revenue. Among OECD countries, the corporate income tax only accounts for 8% of all tax revenues on average. Many economists view the corporate income tax as a possible detriment to economic growth and an inefficient and cumbersome way to raise revenues for government as compared with consumption and property taxes. OECD, *Revenue Statistics 2015*, Dec. 2015, at 29 available at <http://www.oecd.org/ctp/tax-policy/revenue-statistics-19963726.htm>.

⁹³ Council On State Taxation and Ernst & Young, *Total State and Local Business Taxes: State-by-State Estimates for Fiscal Year 2014*, Oct. 2015, at 2. This total includes revenue from the Ohio Commercial Activity Tax, Washington’s B&O Tax, New Hampshire’s Business Enterprise Tax and the Texas Franchise (Margin) Tax. All serve as proxies in their respective states for a corporate income tax.

⁹⁴ *Id.* at 3.

FIGURE 2. TOTAL STATE AND LOCAL BUSINESS TAXES, FY 2014



...since 2000, the overall share of state and local taxes paid by businesses has remained stable, generally within 1 percentage point of 45 percent of all state and local taxes paid each year...

Thus, property taxes and sales taxes on business inputs are far more important sources of state and local tax revenue than corporate income taxes. Taxes on business property account for 54 percent of all state and local property taxes.⁹⁵ Taxes on business inputs make up 42 percent of all state and local sales tax revenue.⁹⁶ Overall, state and local business taxes account for 45 percent (\$688.7 billion) of all state and local tax revenue (\$1,531.4 billion).⁹⁷

Moreover, the implication that base erosion and profit shifting to foreign “tax havens” has decimated the business contribution to state and local taxes is also contradicted by the stability and even upward trend line of the business share of overall state and local taxes. According to Clausing’s analysis, the period since 2000 has been the peak period of corporate base erosion and profit shifting—with about 85 percent of the alleged rise in annual revenue loss occurring during that period.⁹⁸ Nonetheless, since 2000, the overall share of state and local taxes paid by businesses has remained stable, generally within 1 percentage point of 45 percent of all state and local taxes paid each year (see Figure 3).⁹⁹ Indeed, the share of state and local taxes paid by businesses is actually higher in FY2014 (45 percent) than it was in FY2000 (42.6 percent), and above the average for the period since FY2000 (see Figure 3).¹⁰⁰

The aggregate level of state and local taxes also increased over this 15-year period—so the rising business share was of a bigger “pie”. Total state and local taxes increased from \$370.9 billion in FY2000 to \$688.7 billion in FY2014, a real increase of about 35 percent after taking inflation into account.¹⁰¹

⁹⁵ *Id.* at 4.

⁹⁶ *Id.* at 3.

⁹⁷ *Id.* at 4.

⁹⁸ Clausing, *Revenue Effects*, *supra* note 67, at Figures 4 and 5.

⁹⁹ COST/EY, *supra* note 93, at 1.

¹⁰⁰ See generally, COST/EY, *Business Tax Burden Studies*, available at www.cost.org. Similarly, contrary to the notion that corporations do not pay their fair share of taxes relative to the benefits they receive, business taxes average 3.35 times more than net government spending that benefits businesses (or 1.2 times if 50 percent of educational expenses are allocated to business). COST/EY, *supra* note 93, at 2.

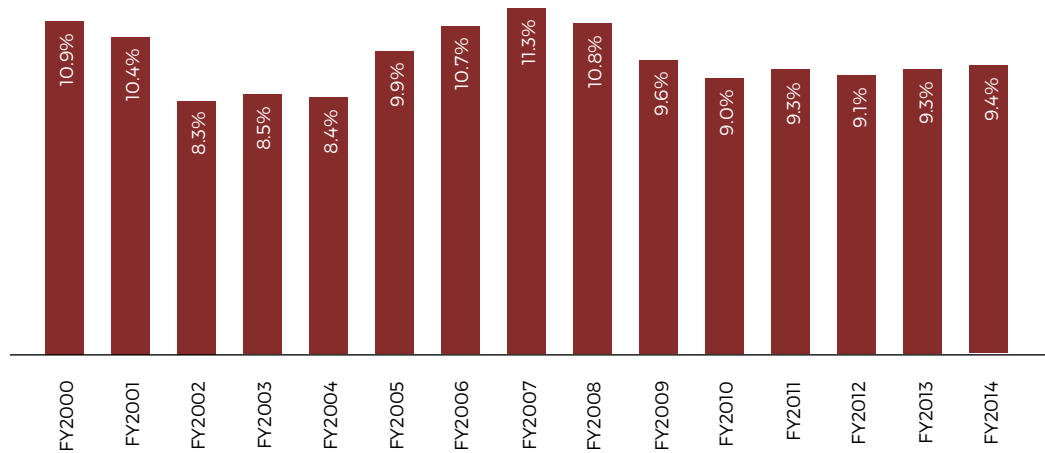
¹⁰¹ See generally, COST/EY, *Business Tax Burden Studies*, available at www.cost.org.

FIGURE 3. SHARE OF STATE AND LOCAL TAXES PAID BY BUSINESSES



The corporate income tax and other business activity taxes—although comprising less than 10 percent of overall state and local taxes paid by business—have also been relatively stable over the last 15 years, ebbing and flowing primarily with the cycles of the U.S. economy (see Figure 4).¹⁰²

FIGURE 4. STATE AND LOCAL CIT AND OTHER BUSINESS ACTIVITY TAX COLLECTIONS AS SHARE OF TOTAL STATE AND LOCAL BUSINESS TAX COLLECTIONS



Source: EY/COST Studies, "Total state and local business taxes," FY 2000–2014.

¹⁰² This statistic includes both the state corporate income tax and other business entity taxes including the Michigan Business Tax, the Ohio Commercial Activity Tax, the Texas Franchise/Margin Tax and the Washington B&O Tax. The fluctuations in the corporate income tax are attributable not only to business cycles, but also to other factors such as changes in corporate tax rates; reductions in the federal tax base (e.g., Section 199 and bonus depreciation); and the shift to pass-through entities (e.g., S Corporations and partnerships) that are taxed under the personal income tax. See generally, COST/EY, *Business Tax Burden Studies*, available at www.cost.org.

In conclusion, the impact on overall state and local taxes of any corporate profit shifting at the international level has been limited, and is more than offset by increases in other taxes paid by business. The business share of state and local tax revenues has actually increased slightly over the last fifteen years—belying the notion that corporate profit shifting to offshore havens has created a gaping hole in the state and local tax base. To be sure, it is within each state’s sovereign power to determine the overall level of taxes, the composition of taxes, and the relative share of taxes that should be paid by business and individuals. Nonetheless, tax policy decisions such as the consideration of tax haven legislation should be based on all of the relevant facts, and not on an oversimplified and distorted view of how much businesses pay in state and local taxes.

The business share of state and local tax revenues has actually increased slightly over the last fifteen years—belying the notion that corporate profit shifting to offshore havens has created a gaping hole in the state and local tax base.

...state tax haven legislation...

represents an abandonment of the prevailing consensus among the states to limit the taxation of multinational companies to the “water’s edge”.

STATE TAX HAVEN LEGISLATION REPRESENTS A PARTIAL RETURN TO A MANDATORY WORLDWIDE COMBINATION FILING METHOD

One of the biggest concerns with state tax haven legislation is that it represents an abandonment of the prevailing consensus among the states to limit the taxation of multinational companies to the “water’s edge”. Ever since the early 1980s, when the states backed away from the mandatory worldwide combination filing method, the water’s-edge principle has limited the state taxation of foreign corporations.

State corporate income tax regimes generally apply either on a separate entity or combined reporting basis (or some variation of consolidated filing). Combined reporting regimes include the unitary members of the taxpayer’s affiliated group.¹⁰³ Every state corporate income tax combined reporting regime of general application limits filing to the “water’s edge,” either as the default method or by taxpayer election.¹⁰⁴ The water’s-edge filing method generally includes domestic corporations and excludes foreign corporations.

There are, of course, variations to the water’s-edge rules. For example, some states exclude domestic corporations with less than 20 percent U.S. activity (the so-called 80/20 rule), while other states include income of foreign affiliates with more than 20 percent U.S. activity (a kind of reverse 80/20 rule). Some states include in the water’s-edge tax base Subpart F income and income of non-U.S. affiliates earning a certain percentage of income from intangible property or service-related activities. Some states require the “addback” of payments to foreign affiliates for royalties and/or interest “earned” in the United States. States may also limit the percentage deduction available for foreign dividends. None of these provisions, however, seeks to take in the income of foreign affiliates *per se* without respect to U.S. activity or income.

States that expand their combined reporting regimes to encompass foreign corporations incorporated in or doing business in “tax haven” jurisdictions generally include these foreign income streams within existing “water’s-edge” statutes. However, this rhetorical sleight of hand cannot conceal that tax haven statutes violate the water’s-edge concept—

¹⁰³ William Fox & LeAnn Luna, *Combined Reporting with the Corporate Income Tax: Issues for State Legislatures*, NCSL, November 2010, at iii & iv, available at <http://www.ncsl.org/documents/standcomm/sccommfc/combinedreportingfinaldraft.pdf>.

¹⁰⁴ *Id.* at 16-17.

operating in the same manner as mandatory worldwide combination filing statutes, albeit with the income from some but not all foreign countries included in the state's tax base.

MANDATORY WORLDWIDE FILING ABANDONED BY THE STATES SINCE THE 1980s

Approximately twelve states employed mandatory worldwide combined reporting as of 1984.¹⁰⁵ However, in a series of actions beginning in 1984 and accelerating over the next few years, these states all reverted to the water's-edge limitation, a position that has held ever since.¹⁰⁶

Pressure against mandatory worldwide combination had been building through the 1970s and early 1980s among both foreign governments and foreign and domestic multinational business enterprises, threatening to instigate an international tax war. The British and Japanese governments in particular took action to counter the trend toward mandatory worldwide combination filing. In 1985, the British Parliament passed legislation enabling the British Treasury to retaliate against U.S. corporations in response to the worldwide unitary tax regimes in California and other states.¹⁰⁷ Commentators at the time noted the retaliatory measure was adopted only after "exhaustive political efforts to persuade states to repeal their use of the worldwide unitary tax," and a Member of Parliament believed the measure would cause U.S. companies to "press and lobby hard their state...and federal government[s] to...clear up the issue of the unitary tax."¹⁰⁸

Soon after the U.S. Supreme Court in 1983 decided *Container Corp.*,¹⁰⁹ upholding California's imposition of worldwide combined reporting on a domestic parent and its foreign subsidiaries, the U.S. business and international community pressure came to a head, spurring President Ronald Reagan to convene the Worldwide Unitary Taxation Working Group. As described in the introduction to the Working Group's Final Report, "In the wake of the *Container* decision, members of the business community and major trading partners of the United States renewed their objections to the worldwide unitary tax method and urged the Administration to: (1) file a memorandum with the Supreme Court as *amicus curiae* in support of a rehearing in the *Container* case; and (2) support federal legislation that would limit or prohibit worldwide unitary taxation."¹¹⁰

Ultimately, Treasury Secretary Donald Regan announced the administration's decision to refrain from supporting the motion for rehearing in *Container* and instead to establish the Working Group composed of representatives of the federal government, state governments, and the business community. The Working Group was "charged with producing recommendations...that will be conducive to

¹⁰⁵ See Dept. of the Treasury, *The Final Report of the Worldwide Unitary Taxation Working Group*, Aug. 1984, at 1, available at <http://www.cost.org/WorkArea/DownloadAsset.aspx?id=82785>.

¹⁰⁶ See Walter Hellerstein, *Designing the Limits of Formulary Income Attribution Regimes*, 2014 STT 36-62 (2014). Professor Hellerstein's research details how, beginning in 1984, "states acted with unusual legislative speed" to repeal worldwide combined filing, ending with Alaska's adoption of water's-edge legislation for most companies in 1991. *Id.* at 57.

¹⁰⁷ Sec. 54, Finance Act 1985, reprinted in New Clause 27, 1985 Finance Bill, 1355 Parl. Deb., H.C. 1014 (1985). See Robert D. Wallingford, *British Retaliation Against the California Unitary Tax: The Needed Impetus for a Federal Solution*, 8 J. Comparative Bus. & Cap. Market L.345-371 (1986).

¹⁰⁸ *Id.*

¹⁰⁹ *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159 (1983).

¹¹⁰ Dept. of Treasury, *supra* note 105, at 3.

harmonious international economic relations, while also respecting the fiscal rights and privileges of the individual states.”¹¹¹

LAYING THE GROUNDWORK FOR THE WATER’S-EDGE STANDARD

Not surprisingly, the Working Group did not easily come to consensus. In fact, the Working Group failed to reach agreement on any of the six options drafted by a “technical-level Task Force composed of representatives of the Working Group members to thoroughly review the issues and develop options for decision by the Working Group.”¹¹² Ultimately, these “options” reflected a fundamental disagreement with respect to treatment of foreign dividends and “80/20” companies, and the disagreement proved too great to bridge.

However, the Working Group did agree “on a set of principles that should guide the formulation of state tax policy”:

- 1) “Water’s-edge unitary combination for both U.S. and foreign based companies”; 2) “Increased federal administrative assistance and cooperation with the states to promote full taxpayer disclosure and accountability”; and 3) “Competitive balance for U.S. multinationals, foreign multinationals, and purely domestic businesses.”¹¹³

The state and business members of the Working Group, predictably, did not agree on how these principles might be applied.¹¹⁴ With respect to the water’s-edge recommendation, business representatives asserted that “the water’s-edge concept is acceptable to U.S. based multinationals only if it does not result in the conversion of foreign source income received in the form of dividends into domestic income of the ‘water’s-edge’ group.”¹¹⁵

Nonetheless, the failure of the states to adhere to the water’s-edge reporting principle prompted the Treasury in 1985 to propose legislation preempting worldwide combination.¹¹⁶ The states ultimately responded to this threat by repealing their mandatory worldwide regimes. Thus, the Working Group’s Final Report and the ensuing response set in motion a consensus of water’s-edge reporting that has held for nearly 30 years.

¹¹¹ *Id.* at 3-4.

¹¹² *Id.* at 5.

¹¹³ *Id.* at 5-6.

¹¹⁴ For example, according to the Final Report, “The business group endorses the above Principles only with respect to those states whose tax practices are in compliance with Principles One and Three. The state group endorses the above Principles only with the understanding that Principle One is conditioned on compliance with Principles Two and Three.” *Id.* at 10.

¹¹⁵ *See id.*; Final Working Group Report, *Statement by the Business Representatives on the Worldwide Unitary Taxation Working Group*, Aug. 31, 1984, at 2. The concept of “tax havens” was included in certain options considered by the Worldwide Unitary Taxation Working Group in 1984. However, this concept never emerged as a consensus recommendation of the working group, and the working group specifically did not agree on how to define a “tax haven.” The business representatives were willing to at least discuss the “tax haven” concept because they were more concerned with the larger threat posed at that time by mandatory worldwide combination. *See* Dept. of Treasury, *supra* note 105.

¹¹⁶ *See* Hellerstein, *supra* note 106.

ADOPTING TAX HAVEN STATUTES BREAKS THE WATER'S-EDGE CONSENSUS, INVITES CONTROVERSY AND BUSINESS DISINVESTMENT

The rising tide of state tax haven legislation (both enacted and proposed) is proliferating a selective form of worldwide combined reporting that threatens to break the water's-edge consensus. As noted, foreign nations actually authorized retaliatory tax treatment against U.S. multinationals in response to worldwide combined reporting. Similarly, individual foreign nations, as well as groups of foreign nations (e.g., the Caribbean Community Caucus of Ambassadors), have objected vehemently to their inclusion in state tax haven legislation. California rejected tax haven proposals after thoroughly studying the issue and receiving testimony from multiple affected nations.¹¹⁷ In 2015, Ireland's Consul General testified in Augusta, Maine against Maine tax haven legislation,¹¹⁸ and the Netherlands' Consul General, members of the Ministry of Finance, and other national representatives testified against an expansion of Oregon's tax haven list in Portland, Oregon.¹¹⁹ In each case, the affected nations persuaded legislators not to include them in a tax haven list.

While states have thus far been largely unsuccessful in expanding tax haven lists to include key U.S. trading partners such as the Netherlands, Ireland, Switzerland and Hong Kong, the continued attempts to do so have heightened business concerns that state tax haven legislation is just a stalking horse for a return to mandatory worldwide combination.¹²⁰ To be sure, there is currently no substantial movement among the states for the return of mandatory worldwide combination. However, the impetus to expand the tax haven list is driven by the realization there is not enough money to be gained by just picking on island economies. According to U.S. PIRG's own estimates of the "Profits Reported Collectively by American Multinational Corporations in 2010 to 12 Notorious Tax Havens", two-thirds of these profits were booked to the following five countries: Netherlands, Ireland, Switzerland, Luxembourg and Singapore.¹²¹ This explains why some of the states are so determined to add these larger countries to their lists—despite the more controversial nature of their inclusion.

The efforts to broaden the tax haven lists to include additional countries have been criticized for some of the same reasons as those invoked in the 1970s and 1980s in relation to mandatory worldwide combination, but also for reasons unique to tax haven lists. A letter from the Organization for International Investment (OFII) to Oregon underscores the concerns these proposals have generated with respect to foreign direct investment (FDI) in the United States:

“This tax policy would misalign with economic development efforts to attract investment directly from any company based in or with affiliates in the listed nations.

¹¹⁷ *Water's Edge: California Jobs and International Investment Opportunities: Informal Hearing before the S. Select Comm. on California-European Trade*. (Cal. May 19, 2010), available at http://caleuropeantrade.senate.ca.gov/sites/caleuropeantrade.senate.ca.gov/files/Waters_Edge_CA_Jobs_and_International_Investment_Opportunities_5-19-2010.pdf.

¹¹⁸ See Douglas Rooks, *Bill Sponsor Open to Changes in Maine Tax Haven Legislation*, 2015 STT 46-3 (Mar. 10, 2015).

¹¹⁹ See *Hearing before H. Comm. on Revenue* (Or. March 25, 2015), available at http://oregon.granicus.com/MediaPlayer.php?clip_id=8822.

¹²⁰ Along these lines, the featured speaker at the 2014 Multistate Tax Commission Annual Meeting was Edward Kleinbard, a law professor who advocated mandatory worldwide combination as the best solution for addressing the BEPS problem at the state level. See Multistate Tax Commission, *47th Annual Conference & Committee Meetings: Schedule of Events*, available at <http://www.mtc.gov/Events-Training/2014/47th-Annual-Conference-Committee-Meetings>.

¹²¹ Richard Phillips et al., *supra* note 76, at 14.

...state tax haven legislation is just a stalking horse for a return to mandatory worldwide combination.

No state has ever blacklisted the Netherlands or Switzerland. . . major U.S. trading partners and sources of FDI. . . [T]he state would be erecting barriers to known sources of investment and job creation. Additionally, the uncertainty of which jurisdictions will be added to the list and the tax treatment other global companies receive in Oregon could hurt the state's outreach efforts across the globe."¹²²

The letter also asserts the proposal undermines U.S. bilateral tax treaties and invites retaliatory legislation, noting "Oregon's policy is not far removed from California's aggressive tax approach in the 1980's that pursued all income of non-U.S. companies—including that which had nothing to do with U.S. business activities."¹²³

The impact on foreign direct investment is accentuated by the overreach of state tax haven legislation in taxing foreign headquartered companies. Similar to worldwide combination, tax haven legislation makes no distinction between the taxation of corporate groups with domestic or foreign parents. Unlike the federal government, which only taxes foreign headquartered groups on their U.S. source income, states with tax haven legislation would sweep in the foreign source income of corporate groups with foreign parents.

Even a modest decline in FDI can have a significant impact on a state in terms of economic and employment growth. As of 2013, the cumulative value of FDI in the United States totaled \$2.8 trillion.¹²⁴ In 2013 alone, foreign direct investment in the 50 states totaled \$236.3 billion.¹²⁵ U.S. subsidiaries of foreign companies account for 18 percent of all U.S. manufacturing jobs, produce 21 percent of U.S. exports, and fund 15 percent of all private sector research and development.¹²⁶ According to a 2015 EY study, each dollar of foreign investment by U.S. multinational companies led to \$3.50 of additional domestic investment.¹²⁷

States adopting tax haven legislation also expose themselves to backlash from U.S. multinationals, as evidenced in the recent tax policy debates in the District of Columbia and Connecticut. Taxes do matter to multi-jurisdictional companies—this premise is one of the key underpinnings of the BEPS project. Creating an environment in which a state is an "outlier" from other states and from most other nations is not sound tax policy. For instance, one recent National Bureau of Economic Research study found, "In this paper we have estimated economic responses to state-level business taxation by multi-State firms on both the extensive and intensive margins. We find evidence consistent with substantial responses of these firms to state tax rates for the relevant tax rules. Corporate entities reduce the number of establishments per state and the number of employees and amount of capital per plant when state tax rates increase."¹²⁸

¹²² See *Hearing Before H. Comm. on Revenue on H.B. 2099* (Or. 2015) (statement of Nany McLernon, President & Chief Executive Officer, Organization for International Investment), available at <http://ofii.org/sites/default/files/OFFI%20HB%202099Testimony%20Packet.pdf>.

¹²³ *Id.*

¹²⁴ Organization for International Investment, *Foreign Direct Investment in the United States: 2014 Report*, at 2, available at <http://www.ofii.org/sites/default/files/FDIUS2014.pdf>.

¹²⁵ *Id.* at 1.

¹²⁶ Organization for International Investment, *Insourcing Facts*, accessed on Jan. 19, 2016, available at <http://www.ofii.org/resources/insourcing-facts>.

¹²⁷ Ernst & Young, *Buying and Selling: Cross-Border Mergers and Acquisitions and the US Corporate Income Tax*, Mar. 2015, at 23.

¹²⁸ Xavier Giroud and Joshua Rauh, *State Taxation and the Reallocation of Business Activity: Evidence from Establishment-Level Data*, NBER Working Paper No. 21534, September 2015, at 36.

Of course, a state business climate is the by-product of a broad range of state tax policy choices including composition of taxes, overall tax burden on business, state marginal tax rates, tax administration, and state tax incentives or exemptions. Nonetheless, it would be irresponsible to ignore the potential negative economic impacts on a state's economy of a highly visible tax policy choice that could create a tipping point, such as a departure from the prevailing water's-edge consensus and extension of the corporate tax base to encompass foreign subsidiary income that is not effectively connected with a state.

The negative ramification of tax haven legislation is exacerbated by the fact that the only states that have so far adopted state tax haven legislation are small population states. To date, only seven states with a combined 13 million in population (or about four percent of total U.S. population) have adopted state tax haven proposals.¹²⁹ Thus, any state in the near future that adopts the tax haven approach will not only be out of sync with the OECD and the international community but also with the vast majority of states (including the largest 25 states as measured by population). Indeed, many states, including California, have already considered and rejected tax haven legislation.¹³⁰ The obvious peril here for more aggressive states is the potential for a competitive disadvantage relative to nearby states that remain within the water's-edge framework.

...it would be irresponsible to ignore the potential negative economic impacts on a state's economy of a highly visible tax policy choice that could create a tipping point, such as a departure from the prevailing water's-edge consensus...

CONSTITUTIONAL CHALLENGES TO TAX HAVEN LEGISLATION

State tax haven legislation will almost certainly face legal challenges as well. The prospects for a successful constitutional challenge were analyzed in an article by a leading state tax attorney, Joseph Donovan.¹³¹ The article recognizes that under the U.S. Supreme Court's decision in *Japan Line*, two tests must be met before a state may tax foreign commerce: "whether the tax, notwithstanding apportionment, creates a substantial risk of international multiple taxation," and "whether the tax prevents the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.'"¹³² While state worldwide combined reporting regimes ultimately withstood scrutiny under these tests, their application to the selective worldwide reporting standard of "tax haven" lists may not yield the same result, particularly given the arbitrary and punitive nature of the lists.

State tax haven laws designate foreign commercial enterprises in select nations for differential treatment, with the intent of increasing in-state tax liability. Unlike the worldwide combined method, which purports to tax the in-state activity of the entire unitary enterprise (whether domestic or foreign), tax haven laws designate nations by list or allow discretion to state revenue departments to apply criteria. In either case, only portions of the unitary business are included in the filing, with the intended result to create a punitive regime for those unitary businesses more active in the targeted jurisdictions. This is in distinct contrast to the worldwide unitary regime considered in *Container Corp.* and *Barclays*.¹³³

¹²⁹ U.S. Census Bureau, *supra* note 83.

¹³⁰ See California Select Committee on California-European Trade report, *supra* note 117.

¹³¹ See Joseph X. Donovan and Anne N. Ross, *Unsafe Havens: Are Efforts to Extend State Tax Reach Beyond the Water's Edge Constitutional?*, 73 STT 661 (2014).

¹³² *Id.* at 663, quoting *Japan Line Ltd. v. Los Angeles County*, 441 U.S. 434 (1979).

¹³³ *Barclays Bank PLC v. Franchise Tax Board*, 512 U.S. 298 (1994).

As Donovan points out, the state tax haven listing actions appear to implicate the Foreign Affairs Power Doctrine, representing “an intrusion by the State into the field of foreign affairs.”¹³⁴ Unlike in the worldwide combined context, tax haven statutes involve states investigating the sufficiency of foreign nations’ laws and designating certain nations for punitive treatment under that state’s laws. An analogous scenario was struck down by the U.S. Supreme Court in *Zschernig v. Miller*, 389 U.S. 429 (1968), in which Oregon barred nonresident aliens from inheriting property unless the nation of residence met certain standards established by Oregon for inheritance rights.¹³⁵ Like state tax haven statutes, this represented more than an “incidental or indirect effect in foreign countries”, and instead is the “kind of state involvement in foreign affairs and international relations matters which the Constitution entrusts solely to the Federal Government”.¹³⁶ The Court further found, “States, of course, have traditionally regulated the descent and distribution of estates. But those regulations must give way if they impair the effective exercise of the Nation’s foreign policy.”¹³⁷ Substituting “tax” for estate regulation would appear to yield the same result reached by the U.S. Supreme Court in *Zschernig*.

OTHER STATE APPROACHES TO TAXING EFFECTIVELY CONNECTED FOREIGN SOURCE INCOME

States have employed other tools in their attempts to deal with perceived gaps in the corporate income tax base attributable to leakage to foreign countries. One common tool used by many states is an addback statute that adds back to income certain interest or intangible expense paid to a related member.¹³⁸ These statutes often contain exceptions meant to allow deductions for related party payments that do not distort reported state income. The addback statutes typically apply to payments made both to domestic affiliates and foreign affiliates, with specific exceptions (e.g., treaty income) applicable to foreign payments.

Another state tax tool is the authority to adjust items of income under state provisions similar to I.R.C. Section 482. Most states have some authority to adjust arm’s length pricing between related parties. Indeed, interest in adding resources and expertise to state transfer pricing enforcement is building among the states. Other tools available to the states to address foreign source income include alternative apportionment authority; application of common law doctrines of business purpose and economic substance; expansive jurisdictional rules that apply to foreign entities doing business in the U.S.; and 80/20 rules imposed on foreign corporations with more than 20 percent of their factors in the U.S.

These state tax mechanisms share in common a focus on particular transactions and structures that states believe may not result in an adequate reflection of where income is earned. Regardless of the deficiencies in these various approaches, they avoid the all-or-nothing approach of blacklisting countries, which carries a high risk of taxing income not effectively connected to the jurisdiction and interfering with the authority of the federal government over foreign affairs.

¹³⁴ Donovan & Ross, *supra* note 131, at 672, quoting *Zschernig v. Miller*, 389 U.S. 429 (1968).

¹³⁵ *Id.*

¹³⁶ *Id.* at 434–35, quoting *Clark v. Allen*, 331 U.S. 503, 517 (1947).

¹³⁷ *Zschernig v. Miller*, 389 U.S. 429, 440 (1968).

¹³⁸ See, e.g. N.J. Stat. Ann. §54-10A-4(k)(2)(i).

STATE TAX HAVEN LEGISLATION IS OUT OF SYNC WITH THE GLOBAL APPROACH TO BEPS

One of the biggest drawbacks of state tax haven legislation is it constitutes a “go-it-alone” approach largely inconsistent with the legislative and regulatory solutions being considered and adopted elsewhere in the world. Indeed, state enactment of tax haven legislation is completely out of sync with the approach recently taken by the OECD and G20 nations in the BEPS project. A review of the OECD/G20 analysis of the complexities of taxing corporate income on a global scale and of the recommended action steps to counteract BEPS highlights the sharp contrast with the simplistic and ultimately counterproductive approach taken by states that have enacted tax haven legislation.

THE OECD/G20 APPROACH TO BEPS

In October 2015, the OECD issued the final reports of its massive two-year effort to analyze and design international tax solutions to the problems of base erosion and profit shifting.¹³⁹ The OECD final package was endorsed by the G20 finance ministers in a meeting on October 8, 2015 in Lima, Peru; and by the G20 country leaders in a meeting on November 15–16, 2015 in Antalya, Turkey. Conspicuously absent from the several thousand pages of OECD reports was any support for a blacklist of so-called “tax haven” nations.

The OECD BEPS project focused on 15 actions, each addressing a different part of the perceived gaps in the international tax framework. The OECD divided its analytical framework into three categories: Coherence (Actions 2–5); Substance (Actions 6–10);

¹³⁹ See OECD 2015, *supra* n. 7.

and Transparency (Actions 11–14). The highlights of the OECD approach include some of the following action steps:¹⁴⁰

- Continued reliance on a transfer pricing regime for cross border transactions coupled with stronger anti-abuse rules. In other words, strengthening the separate reporting foundation of international tax and rejecting an alternative of unitary combined reporting.
- Revision of transfer pricing rules to reflect where “value creation” takes place, particularly with regard to intangibles.
- Requiring more “substance” in the use of “patent boxes” and other tax incentive mechanisms.
- Limiting interest deductions for certain arrangements.
- Limiting mismatches of entity characterization and income/expense determinations.
- Making changes to permanent establishment jurisdictional rules.
- Requiring more transparency with country by country reporting requirements and other new disclosure rules.

The OECD BEPS actions address profit shifting in so-called tax haven countries not by ring-fencing these countries and automatically including all income earned by an affiliate in a tax haven country in another nation’s tax base. Rather, the OECD solutions target outdated tax rules applied to particular transactions and structures that do not adequately reflect where value is created.

As noted previously, the OECD used the “tax haven” list approach to pressure non-compliant nations to conform to international standards of information exchange and transparency. Once that objective was largely achieved, the OECD discontinued use of its “tax haven” list. Thus, in considering different solutions to the BEPS problem, the OECD was certainly familiar with the blacklist approach, and yet chose not to adopt it. By so doing, it avoided the pitfalls facing the states, including conflicts over the criteria used to blacklist countries and difficulties in monitoring such lists on a going forward basis.

¹⁴⁰ OECD Explanatory Statement, *OECD/G20 Base Erosion and Profit Shifting Project*, OECD 2015, available at <http://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf>. The 15 OECD BEPS action plan groups included the following topics:

1. Address the Tax Challenges of the Digital Economy
2. Neutralise the Effects of Hybrid Mismatch Arrangements
3. Strengthen Controlled Foreign Company (CFC) Rules
4. Limit Base Erosion via Interest Deductions and Other Financial Payments
5. Counter Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance
6. Prevent Treaty Abuse
7. Prevent the Artificial Avoidance of PE Status
8. Transfer Pricing for Intangibles
9. Transfer Pricing for Risks and Capital
10. Transfer Pricing for Other High-Risk Transactions
11. Measuring and Monitoring BEPS
12. Require Taxpayers to Disclose their Aggressive Tax Planning Arrangements
13. Re-examine Transfer Pricing Documentation
14. Make Dispute Resolution Mechanisms More Effective
15. Develop a Multilateral Instrument

Id.

In a real sense, the 2,000 page BEPS report indicates what it may take to deal with the complexities of the global taxation of corporate income. In the OECD view, BEPS is attributable to multinational entity-specific facts and circumstances, interacting with tax system differences, not the statutory or administrative features of a single country's tax system. Thus, the OECD endorsed specific action steps aimed at fixing underlying problems rather than scapegoating listed nations.¹⁴¹

THE TREND TOWARD TERRITORIAL TAX SYSTEMS

The OECD's rejection of the tax haven approach is part of a longer term trend away from "worldwide" taxation and toward a "territorial" system for taxing the income of foreign subsidiaries. Currently, 28 of the 34 OECD member countries have adopted some type of a territorial system of taxation, including every G-7 nation except for the United States (e.g., Canada, France, Germany, Great Britain, Italy, and Japan).¹⁴² The key feature of a territorial tax system is that it exempts from taxation most of the earnings of foreign subsidiaries. By contrast, a worldwide system taxes all of the income of a domestic corporation and its foreign affiliates (the latter typically on a deferred basis) less a credit for taxes paid to other jurisdictions. Of the 28 OECD nations with a territorial tax system, 20 countries exempt 100 percent of foreign subsidiary dividends, one country (Norway) exempts 97 percent of foreign subsidiary dividends, and seven countries exempt 95 percent of foreign subsidiary dividends.¹⁴³

Indeed, the territorial tax system has rapidly gained popularity over the last 25 years. In 1989, only 10 OECD member countries had territorial tax systems and just two of the G-7 countries had this type of a tax system. In the intervening years, 18 additional OECD member countries shifted to a territorial tax system.¹⁴⁴ Just since 2000, 11 nations have switched from a worldwide taxation system to a territorial taxation system, among them Japan, the United Kingdom, Turkey and Poland. The only remaining OECD countries (beyond the U.S.) with worldwide systems of taxation are Chile, Greece, Ireland, Israel, Korea, and Mexico.¹⁴⁵

In this regard, the trend toward a territorial tax system is analogous to the long-standing consensus among the states to limit the corporate tax base to the "water's edge"—that is, to entities doing business within the United States. In both systems, the income of foreign subsidiaries is not generally taxed unless it is "domestic" source income. The OECD BEPS project is proposing major reforms to entity characterization, income sourcing, and other cross-border rules to ensure that each nation is able to effectively capture the income earned within its borders. But in doing

In the OECD view, BEPS is attributable to multinational entity-specific facts and circumstances, interacting with tax system differences, not the statutory or administrative features of a single country's tax system.

¹⁴¹ According to the overview provided by the OECD in its recently released 2015 summary of the OECD/ G20 Base Erosion and Profit Shifting Project, *Addressing Base Erosion and Profit Shifting* (OECD, 2013), "no single tax rule on its own enables BEPS; it is rather the interplay among different issues that makes it possible. Domestic laws and rules that are not coordinated across borders, international tax standards that have not always kept pace with the changing global business environment, and a pervasive lack of relevant information at the level of tax administrations and policy makers combine to provide opportunities for taxpayers to undertake BEPS strategies." OECD *Explanatory Statement*, *supra* note 140, at 5.

¹⁴² Senate Finance Committee, *International Tax Reform Working Group: Final Report*, July 7, 2015, at 5 & 72, available at http://www.portman.senate.gov/public/index.cfm/files/serve?File_id=923a866b-9c71-429a-a655-5dd0adef2caa.

¹⁴³ *Id.* at 40–41.

¹⁴⁴ *Id.* at 3.

¹⁴⁵ Philip Dittmer, *A Global Perspective on Territorial Taxation*, Tax Found., August 10, 2012, at 1; Alliance for Competitive Taxation, *Comments Submitted to the Senate Committee on Finance International Working Group*, 2015 at 7.

The rise of territorial tax systems

and retreat from worldwide taxation reflects an awareness of the underlying complexities of taxing income in an increasingly global and intangible-based economy.

so, it is steering clear from any notion that the best way to tax corporate income is on a worldwide or quasi-worldwide basis—where the income of foreign subsidiaries is included in the domestic tax base simply because the foreign entities are affiliated with domestic entities in the taxing country.

To be sure, the transition to a purely territorial system is not entirely uniform. Some of the OECD countries exclude from the dividend-received deduction income earned in countries without treaties in place, that lack adequate information exchange rules, or in more limited cases that have significantly lower tax rates. Nonetheless, even in these countries, there is no attempt to tax foreign source income on a current basis (as is the case with state tax haven legislation), but rather only on a deferred basis when the income is repatriated to the home country.¹⁴⁶ Nor is there an attempt to tax the foreign source income of foreign headquartered companies, as is the case with tax haven legislation.

THE CHALLENGES OF TAXING CORPORATE INCOME IN AN INCREASINGLY GLOBAL AND INTANGIBLE-BASED ECONOMY

The rise of territorial tax systems and retreat from worldwide taxation reflects an awareness of the underlying complexities of taxing income in an increasingly global and intangible-based economy. Indeed, even if the OECD BEPS actions succeed in reducing profit shifting opportunities, the taxation of multinational corporate income on a global basis will continue to pose significant challenges for national governments.¹⁴⁷ For the states, the important takeaway is that any new tax measures relating to foreign source income should be limited in scope and consistent with international norms.

The world is a much different place than it was in the decades following World War II. The exponential expansion of world trade and the increasing mobility of labor, capital and intangibles present new and unique challenges for allocating corporate income on a global basis.

For instance, worldwide exports as a percentage of global GDP have tripled from about 10 percent in 1960 to 30 percent in 2013 (see Figure 5).¹⁴⁸ Similarly, the value of worldwide imports (valued in constant 2005 dollars) increased from about \$877 billion in 1960 to nearly \$17.7 trillion in 2013 (see Figure 6).¹⁴⁹

Moreover, the global economy has shifted decisively from one based on tangible property and goods to one characterized by intangible property and services. According to an annual survey of intangible asset market value, the intangible assets component of the

¹⁴⁶ The one exception to this is nations that have rules similar to the US subpart F rules and tax the “passive” income of certain controlled foreign corporations on a “current” basis. Furthermore, the European Commission is currently considering other options that would impact current income. See *supra* n. 51.

¹⁴⁷ As stated by the OECD in a summary to its BEPS report, “Although some schemes used are illegal, most are not. Largely they just take advantage of current rules that are still grounded in a bricks and mortar economic environment rather than today’s environment of global players which is characterized by the increasing importance of intangibles and risk management.” OECD: Centre for Tax Policy and Administration, *BEPS—Frequently Asked Questions*, Question 118, <http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm>.

¹⁴⁸ The World Bank, *World Development Indicators, Exports of goods and services (% of GDP) (2015)*, available at <http://data.worldbank.org/indicator/NE.EXP.GNFS.ZS>.

¹⁴⁹ The World Bank, *World Development Indicators, Imports of goods and services (constant 2005 US\$) (2015)*, available at <http://data.worldbank.org/indicator/NE.IMP.GNFS.KD>.

S&P 500 market value increased from 17 percent in 1975 to 84 percent in 2015.¹⁵⁰ In addition, spending on services (as a percentage of personal consumption) has spiked in the U.S. from 53 percent in 1970 to 67 percent in 2014.¹⁵¹ Finally, the very nature of consumer spending is undergoing a radical change as exemplified by estimates that purchases by mobile devices will constitute one-half of all e-commerce sales by 2018.¹⁵²

One important outcome of the “new” global economy is that businesses can operate effectively in foreign countries with little or no physical presence—something that was not possible even 20 years ago. Advances in digital and communications technology allow businesses to operate remotely in a wide range of industries including retail, business services, health care, education and entertainment. This creates a disconnect between earned profits and traditional factors such as labor and property, and adds to the pressure to modernize international tax rules.

The activities of U.S. multinationals are a byproduct of this globalization trend. According to the Report of the Senate Finance Committee’s International Tax Overhaul Working Group, in 1982, U.S. multinationals earned only about 23 percent of their income from outside the United States.¹⁵³ In 2012, U.S. multinationals earned 54 percent of their income from outside the United States.¹⁵⁴ In terms of long-term strategy, this shift makes sense since 95 percent of the world’s consumers are located outside the United States.¹⁵⁵

Globalization has also intensified tax competition among nations, as countries compete to attract investment, jobs, and high value-added intellectual property in an increasingly mobile and transitory world economy. Corporate income tax rates among OECD countries range from 5.7 percent to 36 percent.¹⁵⁶ Many European countries, including the United Kingdom, France, Netherlands, Spain and Italy, have sharply reduced income tax rates for qualifying intangible property.¹⁵⁷ Twelve EU countries have or are in the process of obtaining “patent box” regimes that provide low tax rates, averaging less than 10 percent, for patents and other kinds of intellectual property income.¹⁵⁸ Even with BEPS reforms, international tax competition will

...the intangible assets component of the S&P 500 market value increased from 17 percent in 1975 to 84 percent in 2015.

¹⁵⁰ Kristi Stathis, *Ocean Tomo Releases 2015 Annual Study of Intangible Asset Market Value*, March 5, 2015, available at <http://www.oceantomo.com/blog/2015/03-05-ocean-tomo-2015-intangible-asset-market-value/>.

¹⁵¹ U.S. Bureau of Economic Analysis, *Advanced Download Section: Section 2, Personal Consumption Expenditures by Major Type of Product*, available at <http://www.bea.gov/national/nipaweb/DownSS2.asp>.

¹⁵² Bill Siwicki, *Mobile Commerce Will be Nearly Half of E-Commerce by 2018*, InternetRetailer.com, March 10, 2014; Alexis C. Madrigal, *Goldman: There Will Be as Much Mobile Commerce in 2018 as E-Commerce in 2013*, TheAtlantic.com, Mar. 6, 2014, available at <http://www.theatlantic.com/technology/archive/2014/03/goldman-there-will-be-as-much-mobile-commerce-in-2018-as-br-e-commerce-in-2013/284270/>.

¹⁵³ Senate Finance Committee, *supra* note 142, at 5.

¹⁵⁴ *Id.*

¹⁵⁵ *Id.* at 5–6. Viewing longer-term trends, there has been not only an acceleration of trade among nations, but also a change of relative economic fortunes as between developed and developing nations. According to PwC estimates, in 2009, the G-7 nations (US, Japan, Germany, UK, France, Italy, Canada) had \$29 trillion in combined GDP compared to \$20.9 trillion in the E-7 nations (China, India, Brazil, Russia, Indonesia, Mexico, Turkey).¹⁵⁵ By 2050, the G-7 nations will have an estimated \$69.3 trillion in GDP compared to an estimated \$138.2 trillion GDP in the E-7 nations. PricewaterhouseCoopers, *Five Megatrends and Possible Implications*, April 2014, at 8, available at <https://www.pwc.com/us/en/corporate-governance/publications/assets/pwc-corporate-governance-directors-megatrends.pdf>.

¹⁵⁶ Jack Mintz & Duanjie Chen, *The U.S. Corporate Effective Tax Rate: Myth and the Fact*, The Tax Foundation, Feb. 6, 2014, available at <http://taxfoundation.org/article/us-corporate-effective-tax-rate-myth-and-fact>.

¹⁵⁷ PricewaterhouseCoopers, *European Patent Box Regimes, Prepared for Japan External Trade Organisation*, April 2013, at 13, available at https://www.jetro.go.jp/ext_images/world/europe/ip/pdf/european_patent_box_regimes_en.pdf.

¹⁵⁸ Alliance for Competitive Taxation, *supra* note 145, at 9.

While much of the BEPS project is focused on aligning corporate profits with the place “where value is created”, there is no single, widely accepted answer to this question.

not somehow magically disappear. Indeed, the OECD is not seeking to eliminate differential tax rates and incentives among nations, but rather to regulate their rationality (e.g., require more substance in patent boxes) and transparency (e.g., require more disclosure by governments of tax incentives provided to companies).

While the OECD BEPS project represents perhaps the most comprehensive set of international tax reforms ever proposed, nations will continue to search for the most effective ways to tax multinational corporations. There is still no “one size fits all” solution for sourcing global income. Countries are likely to prioritize different factors in cross-border taxation, depending on their own geopolitical and economic interests.

While much of the BEPS project is focused on aligning corporate profits with the place “where value is created”, there is no single, widely accepted answer to this question. For instance, with regard to an intangible such as a patent, is the value created in the country where the research and development primarily took place, where the intangible is managed, where manufactured products relating to the patent are produced, where corporate financing is managed, where back office support services are located, where the customers are located, or some combination thereof? According to a 2015 Deloitte survey, three-quarters of multinational businesses agree or strongly agree that double taxation will result as countries assign differential importance to all of these factors, depending on their own economic interests.¹⁵⁹

States are certainly familiar with the inherent tension and controversy in determining where value is created (and should be taxed), with significant shifts occurring over the last three decades between three factor apportionment formulas and single sales factor apportionment formulas, and between cost-of-performance sourcing of services and intangibles and market state sourcing.

Globalization presents unique challenges to sovereign governments to find a rational way to allocate the income of multinational companies among several hundred nations. In this environment, it is more important than ever for governments, particularly subnational governments such as the U.S. states, to steer clear of overly simplistic or overly broad approaches to foreign source income that cause more harm than good.

THE LESSONS FROM FEDERAL TAX POLICY AS AN INTERNATIONAL “OUTLIER”

One of the “poster” countries for how not to tax global business is the United States. The United States operates outside international norms in tax policy, with federal tax rates and rules on taxing foreign source income which place the United States at a competitive disadvantage in world markets. The United States is currently the only developed country with both a worldwide system of taxation and a corporate income tax rate above 30 percent.¹⁶⁰ As discussed above, over four-fifths of all OECD countries now have a territorial tax system. In addition, over the last

¹⁵⁹ Deloitte, *OECD’s Base Erosion and Profit Shifting (BEPS) Initiative: Summary Results of Second Annual Multinational Survey*, May 2015, at 2, available at <http://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-beps-summary-survey-results-may-2015.pdf>.

¹⁶⁰ Ernst & Young, *Charting a Course on Tax Reform—Considerations of Moving the US to a Territorial Tax System*, January 2012, available at [http://www.ey.com/Publication/vwLUAssets/Charting_a_course_on_tax_reform_-_considerations_of_moving_the_US_to_a_territorial_tax_system/\\$FILE/EY_tax_news_2012011008.pdf](http://www.ey.com/Publication/vwLUAssets/Charting_a_course_on_tax_reform_-_considerations_of_moving_the_US_to_a_territorial_tax_system/$FILE/EY_tax_news_2012011008.pdf).

18 years, 30 industrialized nations have reduced their corporate income tax rate.¹⁶¹ In 1999, the average corporate tax rate in the OECD countries was 35 percent.¹⁶² Today it is 24 percent.¹⁶³ However, the U.S. rate has remained virtually unchanged at 35 percent—and now ranks as the highest marginal corporate income tax rate among the OECD countries.¹⁶⁴

The costs of its “outlier” status in the international tax arena are mounting. Under the current U.S. “worldwide” taxation rules, tax on “active” foreign source income is deferred until the profits are repatriated in the form of foreign dividends. However, with the high federal income tax rate there is a strong disincentive to bring the profits home, and the deferral takes on a semi-permanent status. According to a study in 2015, approximately \$2.1 trillion dollars of deferred income has accumulated offshore untaxed by the U.S., increasing at an average of eight percent yearly.¹⁶⁵

The high U.S. tax rate relative to other industrialized nations is also contributing to foreign acquisitions of U.S. companies. A 2015 Ernst & Young study for the Business Roundtable found the outdated federal tax code led to a \$179 billion net loss of American companies and business assets to foreign buyers from 2003–2013.¹⁶⁶ If the U.S. corporate tax rate had been reduced to 25 percent, U.S. companies would have acquired \$590 billion in cross border assets over the 10-year period instead of losing \$179 billion (a net shift of \$769 billion in assets from foreign countries to the United States).¹⁶⁷ A corollary of this trend is the increase in corporate inversions, with U.S. headquartered companies switching to foreign ownership to reduce U.S. federal tax bills.

A number of studies have criticized the U.S. system of taxing global revenues and opined that an approach that is so out of sync with the territorial tax rules in most other OECD nations is likely unsustainable.¹⁶⁸ There are striking parallels between

The United States operates outside international norms in tax policy, with federal tax rates and rules on taxing foreign source income which place the United States at a competitive disadvantage in world markets.

¹⁶¹ Kyle Pomerleau & Andrew Lundeen, *The U.S. Has the Highest Corporate Income Tax Rate in the OECD*, The Tax Foundation, Jan. 27, 2014, available at <http://taxfoundation.org/blog/us-has-highest-corporate-income-tax-rate-oecd>.

¹⁶² Tax Foundation, *OECD Corporate Income Tax Rates, 1981–2013*, December 18, 2013, available at <http://taxfoundation.org/article/oecd-corporate-income-tax-rates-1981-2013>.

¹⁶³ Derek Tsang, *Does the U.S. have the highest corporate tax rate in the free world?*, Politifact, Sep. 9, 2014, available at <http://www.politifact.com/punditfact/statements/2014/sep/09/eric-bolling/does-us-have-highest-corporate-tax-rate-free-world/>.

¹⁶⁴ Dittmer, *supra* note 145, at 8.

¹⁶⁵ Senate Finance Committee, *supra* note 142, at 78.

¹⁶⁶ Ernst & Young, *supra* note 127, at 3.

¹⁶⁷ Ernst & Young, *supra* note 127, at i. In the first 8 months of 2015, the value of foreign takeovers of U.S. companies rose to \$379 billion compared to \$71 billion for the same period in 2013. Liz Hoffman & John D. McKinnon, *Curbs Don't Stop Tax-Driver Mergers*, THE WALL STREET JOURNAL, Sept. 22, 2015, at C2.

¹⁶⁸ See e.g., Alliance for Competitive Taxation, *Comments Submitted to the Senate Committee on Finance International Working Group*, 2015, at 7 (discussing OECD and G-7 countries utilizing a territorial tax system); Lars P. Feld, Martin Ruf, Uwe Scheuering, Ulrich Schreiber, & Johannes Voget, *Effects of Territorial and Worldwide Corporation Tax Systems on Outbound M&A's*, Center for European Economic Research, Discussion Paper No. 13-088 (2013) (emphasizing the benefits the U.S. would receive by employing a territorial system of international taxation); Liz Hoffman & John D. McKinnon, *Foreign Takeovers See U.S. Losing Tax Revenue: Wave of tie-ups is steering more money out of Uncle Sam's coffers*, Wall St. J., March 5, 2015 (explaining the use of corporate inversions to change the citizenship of U.S. corporations to reduce their taxes).

the U.S. and other countries like UK and Japan that were forced to abandon uncompetitive and out of sync worldwide tax regimes in recent years.¹⁶⁹

The latest indication of bipartisan support in the U.S. Congress for international tax reform is the 2015 report by the Senate Finance Committee International Tax Overhaul Working Group headed by Senator Rob Portman (R-Ohio) and Senator Charles Schumer (D-NY). This report highlights the global competitiveness risks to the U.S. of its current tax policies, and calls for radical changes in U.S. international tax rules including support for 1) a quasi-territorial tax regime and 2) “patent box” legislation.¹⁷⁰ Undoubtedly, federal tax reform will face many legislative obstacles, but the pressure to conform the U.S. tax system more closely with the international tax system continues to build.

CONCLUSION

U.S. tax policy is not only a drag on U.S. international competitiveness, but it also constrains the options for state tax action. Certainly, state action is possible without federal tax reform. But since federal tax rates and tax base are a much larger determinant of international corporate behavior than state tax rates and tax base, it will be difficult to effectively address some of the underlying problems without federal tax reform.

Of equal import, the negative impact on tax competitiveness of out-of-sync federal tax rules should provide a cautionary tale—especially to subnational governments (such as the U.S. states)—about the costs of straying too far from international norms on taxing foreign source income. State “tax haven” legislation runs counter to international tax reform efforts. State tax haven blacklists are arbitrary, unmanageable, and possibly unconstitutional. Further, these measures antagonize U.S. trading partners and inhibit in-state investment. The ultimate justification for these proposals—purported state revenue lost to income shifting—is based on faulty assumptions and is belied by the relatively constant (and even growing) business contribution to state and local finances.

Over the last three decades, states have uniformly rejected worldwide combined reporting in favor of a water’s-edge filing method that generally includes domestic corporations and excludes foreign corporations. To diverge from this consensus and enact state tax haven legislation reflects a fundamental misunderstanding of both the need for and efficacy of these policies.

¹⁶⁹ In a paper prepared for the Tax Foundation entitled “A Global Perspective on Territorial Taxation”, Philip Dittmer concludes: “Like Japan before 2009, American companies’ foreign profits are stockpiling abroad, locked out by a secondary tax penalty. Like the UK before 2009, many U.S. companies have explored or gone forward with moving legal residence into business-friendly tax systems. Like both countries before reform, the U.S. system is complex, **out of sync** with its major trading partners, and imposes heavy, uncompetitive burdens...It is not by accident that 27 of 34 OECD members have territorial systems [now 28], and that every independent government tax advisory group has encouraged Congress to discard the current worldwide system in favor of a sleeker territorial model...Territorial taxation has been called “a pragmatic response to the practicalities in a world where competition is fast moving and truly global”. Philip Dittmer, *supra* note 145, at 25-28, quoting Martin A. Sullivan, *The Economic Case for Unlocking Foreign Profits*, 136 Tax Notes 11 (2012).

¹⁷⁰ Senate Finance Committee, *supra* note 142, at 40-42.

APPENDIX 1: SUMMARY OF STATE TAX HAVEN LEGISLATION

ALASKA

Criteria: Regulation (15 AAC 20.900) defines “tax haven” corporation by reference to statute to mean “a corporation that is incorporated in or does business in a country that does not impose an income tax, or that imposes an income tax at a rate lower than 90 percent of the United States income tax rate on the income tax base of the corporation in the United States, if

- A. 50 percent or more of the sales, purchases, or payments of income or expenses, exclusive of payments for intangible property, of the corporation are made directly or indirectly to one or more members of a group of corporations filing under the water’s-edge combined reporting method;
- B. the corporation does not conduct significant economic activity.”

Inclusion Rule: A corporation that is a member of an affiliated group shall file a return using the water’s-edge combined reporting method. A return under this section must include [tax haven] corporations if the corporations are part of a unitary business with the filing corporation.

Exceptions: None.

Adoption/Amendments: Adopted by 1991 Alaska Laws. C. 11, Sec. 3 (Alaska Stat. Sec. 43.20.073, renumbers as Alaska Stat. Sec. 43.20.145).

CONNECTICUT

Criteria: A jurisdiction that:

- A. has laws or practices that prevent effective exchange of information for tax purposes with other governments on taxpayers benefiting from the tax regime;
- B. has a tax regime which lacks transparency;
- C. 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;
- D. explicitly or implicitly excludes the jurisdiction's resident taxpayers from taking advantage of the tax regime benefits or prohibits enterprises that benefit from the regime from operating in the jurisdiction's domestic market; or
- E. 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 or services sector relative to its overall economy.

Further, "tax haven" does not include a jurisdiction that has entered into a comprehensive income tax treaty with the United States, which the Secretary of the Treasury has determined is satisfactory for purposes of Section 1(h)(11)(C)(i)(II) of the Internal Revenue Code.

Inclusion Rule: Includes within the water's-edge return any member that is incorporated in a jurisdiction that is determined by the commissioner to be a tax haven as defined.

Exceptions: If "proven to the satisfaction of the commissioner that such member is incorporated in a tax haven for a legitimate business purpose[.]" Also, a "whitelist" of protected jurisdictions applies: "Tax haven" does not include a jurisdiction that has entered into a comprehensive income tax treaty with the United States, which the Secretary of the Treasury has determined is satisfactory for purposes of Section 1(h)(11)(C)(i)(II) of the Internal Revenue Code.

Adoption/Amendments: Adopted by Public Act 15-244 (H.B. 7061), as amended by Public Act 15-5 (S.B. 1502) and Public Act 15-1 (Dec. 2015 SS) (S.B. 1601) (repealed list requirement).

DISTRICT OF COLUMBIA

Criteria: Any jurisdiction that:

- i. For a particular tax year in question has no, or nominal, effective tax on the relevant income and has laws or practices that prevent effective exchange of information for tax purposes with other governments regarding taxpayers benefitting from the tax regime;
- ii. Lacks transparency, which, for the purposes of this definition, means that the details of legislative, legal, or administrative provisions are not open to public scrutiny and apparent or are not consistently applied among similarly situated taxpayers;
- iii. 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. 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. Has created a tax regime that is favorable for tax avoidance, based upon an overall assessment of relevant factors, including whether the jurisdiction has a significant untaxed offshore financial or other services sector relative to its overall economy.

List: Andorra, Anguilla, Antigua and Barbuda, Aruba, Bahamas, Bahrain, Barbados, Belize, Bermuda, British Virgin Islands, Cayman Islands, Cook Islands, Cyprus, Dominica, Gibraltar, Grenada, Guernsey-Sark-Alderney, Isle of Man, Jersey, Liberia, Liechtenstein, Luxembourg, Malta, The Marshall Islands, Mauritius, Monaco, Montserrat, Nauru, The islands formerly constituting the Netherlands Antilles, Niue, Samoa, San Marino, Seychelles, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Turks and Caicos Islands, U.S. Virgin Islands, and Vanuatu. [Repealed by Fiscal Year 2016 Second Budget Support Clarification Emergency Amendment Act of 2015].

Inclusion Rule: Income and apportionment factors of unitary affiliated corporations included in water's edge return if affiliate is doing business in a tax haven jurisdiction.

Exceptions: 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 of a tax haven, the activity of the member shall be treated as not having been conducted in a tax haven.

Adoption/Amendments: Adopted by 2011 DC Laws 19–21 (DC Code Sec. 47-1801.04 & 1810.07), amended by 2015 Laws 21–36 to add a tax haven list (deleted by Fiscal Year 2016 Second Budget Support Clarification Emergency Amendment Act of 2015).

MONTANA

List: Andorra, Anguilla, Antigua and Barbuda, Aruba, the Bahamas, Bahrain, Barbados, Belize, Bermuda, British Virgin Islands, Cayman Islands, Cook Islands, Cyprus, Dominica, Gibraltar, Grenada, Guernsey-Sark-Alderney, Isle of Man, Jersey, Liberia, Liechtenstein, Luxembourg, Malta, Marshall Islands, Mauritius, Monaco, Montserrat, Nauru, Netherlands Antilles, Niue, Panama, Samoa, San Marino, Seychelles, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Turks and Caicos Islands, U.S. Virgin Islands, and Vanuatu.

Inclusion Rule: Income and apportionment factors of unitary affiliated corporations included in water's edge return if affiliate is incorporated in a listed tax haven jurisdiction.

Exceptions: None.

Adoption/Amendments: Adopted by 2003 Montana Laws Ch. 521 (H.B. 721), amending Mont. Code Ann. Sec. 15-31-322. Further amended in 2009 to add Cyprus, Malta, Mauritius, and San Marino to the list of tax havens, and remove Maldives and Tonga (2011 S.B. 43).

OREGON

List: Andorra, Anguilla, Antigua and Barbuda, Aruba, the Bahamas, Bahrain, Barbados, Belize, Bermuda, Bonaire, the British Virgin Islands, the Cayman Islands, the Cook Islands, Curacao, Cyprus, Dominica, Gibraltar, Grenada, Guatemala, Guernsey-Sark-Alderney, the Isle of Man, Jersey, Liberia, Liechtenstein, Luxembourg, Malta, the Marshall Islands, Mauritius, Montserrat, Nauru, Niue, Saba, Samoa, San Marino, Seychelles, Sint Eustatius, Sint Maarten, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Trinidad and Tobago, the Turks and Caicos Islands, the U.S. Virgin Islands and Vanuatu.

Inclusion Rule: The taxable income or loss of any corporation that is a member of a unitary group or that is a corporation that files a separate return and that is incorporated in [a tax haven] shall be added to the federal consolidated taxable income of the unitary group filing a consolidated Oregon return or to the federal taxable income of the corporation filing a separate return.

Exceptions: Taxpayer is not precluded from asserting alternative apportionment should apply. Also, the income of the foreign corporation is not to be double taxed by the state, and the taxpayer may subtract any portion of the tax haven income previously included in Oregon taxable income (Regulation 150-317.715(5)).

Adoption/Amendments: Adopted by 2013 Oregon Laws Ch. 707 (H.B. 2460), amending O.R.S. Sec. 317.715). 2015 S.B. 61 replaced Netherlands Antilles with Bonaire, Curaco, Saba, Sint Eustatius and Sint Maarten; deleted Monaco; added Guatemala and Trinidad and Tobago (among other changes, including repeal of apportionment factor representation).

RHODE ISLAND

Criteria: A jurisdiction that, during the tax year in question has no or nominal effective tax on the relevant income and;

- i. has laws or practices that prevent effective exchange of information for tax purposes with other governments on taxpayers benefiting from the tax regime;
- ii. 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;
- iii. 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. explicitly or implicitly excluded the jurisdiction's resident taxpayers from taking advantage of the tax regime benefits or prohibits enterprisers that benefit from the regime from operating in the jurisdiction's domestic market; or
- v. 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.

Inclusion Rule: If a non US corporation is includible as a member in the combined group, to the extent that such non US corporation's income is subject to the provisions of a federal income tax treaty, such income is not includible in the combined group net income. *However*, "federal income tax treaty" does not include an income tax treaty between the United States and a foreign jurisdiction which is defined as a tax haven.

Exceptions: If the tax administrator determines that a combined group member non US corporation is organized in a tax haven that has a federal income treaty with the United States, its income subject to a federal income tax treaty, and any expenses or apportionment factors attributable to such income, shall not be included in the combined group net income or combined report if:

- i. the transactions conducted between such non US corporation and other members of the combined group are done on an arm's length basis and not with the principal purpose to avoid the payment of taxes due under this chapter; or
- ii. the member establishes that the inclusion of such net income in combined group net income is unreasonable.

Adoption/Amendments: Adopted by P.L. 2014, ch. 145 (R.I. Gen. Laws Secs. 44-11-1 & 44-11-4.1).

WEST VIRGINIA

Criteria: A jurisdiction that has no, or nominal, effective tax on the relevant income and:

- i. That has laws or practices that prevent effective exchange of information for tax purposes with other governments regarding taxpayers subject to, or benefitting from, the tax regime;
- ii. that lacks transparency. For purposes of this definition, a tax regime lacks transparency if the details of legislative, legal or administrative provisions are not open to public scrutiny and apparent or are not consistently applied among similarly situated taxpayers;
- iii. 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. 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. 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 or other services sector relative to its overall economy.

List: A jurisdiction that, for a particular tax year in question is identified by the Organization for Economic Cooperation and Development as a tax haven or as having a harmful preferential tax regime; provided that all amendments made to the most recent list or compilation of jurisdictions identified as a tax haven or as having a harmful preferential tax regime that were issued, published or adopted by the Organization for Economic Cooperation and Development after March 8, 2008, but prior to January 1, 2011, shall be given effect in determining whether a jurisdiction is a tax haven.

Inclusion Rule: Water's-edge return includes the income and factors of any member that is doing business in a tax haven.

Exceptions: 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 set forth in the definition of a tax haven, the activity of the member shall be treated as not having been conducted in a tax haven.

Adoption / Amendments: Adopted by Acts 2008, c. 215 (S.B. 680), (W.Va. Code Secs. 11-24-3a & -3b; 11-24-13f). Amended by Acts 2011, c. 173, to retroactively include all OECD list changes made after March 8, 2008, but prior to January 1, 2011.

MULTISTATE TAX COMMISSION

Criteria: “Tax haven” means a jurisdiction that, during the tax year in question has no or nominal effective tax on the relevant income and:

- i. has laws or practices that prevent effective exchange of information for tax purposes with other governments on taxpayers benefiting from the tax regime;
- ii. 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. 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. 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. 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.

Inclusion Rule: Includes within the water’s-edge return the entire income and apportionment factors of any member that is doing business in a tax haven, where “doing business in a tax haven”.

Exceptions: 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 of a tax haven, the activity of the member shall be treated as not having been conducted in a tax haven.

Adoption/Amendments: Adopted by Multistate Tax Commission on August 17, 2006, amended on July 29, 2011 to remove reference to OECD list and references to OECD with respect to the criteria.



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