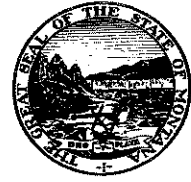




Dan Bucks
Director

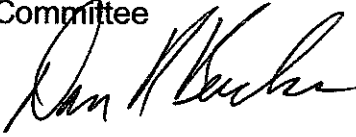
Montana Department of Revenue



Brian Schweitzer
Governor

MEMORANDUM

To: Revenue and Transportation Interim Committee

From: Dan R. Bucks, Director of Revenue 

Date: September 10, 2008

Subject: Corporation Tax Water's Edge Election – Tax Haven Countries

Each biennium the department is required to provide the Revenue and Transportation Interim Committee an update of the countries that may be considered tax havens. The following information provides the Committee the required update along with a recommendation on changing the tax haven status of certain countries. This report also provides the Committee with a general background discussion on tax havens.

Summary Recommendation

In a September 2006 report to this committee, the department recommended the addition of Cyprus, Malta, Mauritius and San Marino to the list of tax havens in 15-31-322, MCA. The department again recommends that these countries be added to the list of tax havens.

The September 2006 report indicated that additional research would be required for Luxembourg, Maldives, and Tonga. Based on the department's research we recommend that the Maldives and Tonga be removed from the list of tax havens.

The department recommends that Luxembourg remain on the list of tax havens in 15-31-322, MCA.

These recommendations are explained in more detail in the final section of the report.

Tax Haven: General Background

The tax haven law in Montana was enacted by the 2003 Legislature. Even though it has been in effect for only a few years, the law has resulted in major benefits in terms of greater equity in taxation for Montana taxpayers and preventing unfair competition for Montana businesses who do not use tax havens to improperly avoid taxes. For example, under this law three multinational corporations have properly reported to Montana \$57.4 million in income for tax years 2005 through 2007 that would otherwise have been reported to tax haven countries. The Montana corporate tax on this income

was \$4.0 million. Absent the 2003 law, this income that is properly attributable to having been earned in Montana would have been shifted elsewhere.

The first recognition that it was proper for states to include corporate affiliates established in foreign tax havens came from a report from then Treasury Secretary Donald Regan who issued a report in August 1984 on state corporate tax practices related to multinational corporate operations.¹ While he recommended that states generally used water's edge reporting, he also recommended that it was proper to include foreign tax haven entities in a combined report. With the adoption of the 2003 tax haven law, Montana essentially conformed to these recommendations.

The tax havens listed in 15-31-322, MCA, was developed primarily, but not exclusively, from the Organization for Economic Co-operation and Development (OECD). The OECD is a group of countries, including the US, which shares a commitment to democratic government and fair market economies. The OECD's identification of tax havens was part of a harmful tax practices initiative launched in 1996. In 1998 it adopted a framework in an attempt to stop the spread of harmful tax competition,² drawing a distinction between tax havens and harmful preferential tax regimes and applying different recommendations and guidelines to each.³ The 1998 report recognized three principal purposes of tax havens and identified four key factors.

The three recognized principal purposes for tax havens are:

- 1) They provide a location for holding passive investments ("money boxes");
- 2) They provide a location where "paper" profits can be booked; and
- 3) They enable the affairs of taxpayers, particularly their bank accounts, to be effectively shielded from scrutiny by tax authorities of other countries.

¹ *Worldwide Unitary Taxation Working Group – Chairman's Report and Supplemental Views* (August 1984)

² *Harmful Tax Competition: An Emerging Global Issue*, ("1998 Report")

³ "42. The first two categories, which are the focus of this report, are dealt with differently. While the concept of "tax haven" does not have a precise technical meaning, it is recognised that a useful distinction may be made between, on the one hand, **countries** that are able to finance their public services with no or nominal income taxes and **that offer themselves as places to be used by non-residents to escape tax in their country of residence** and, on the other hand, countries which raise significant revenues from their income tax but whose tax system has features constituting harmful tax competition.

43. **In the first case, the country has no interest in trying to curb the "race to the bottom" with respect to income tax and is actively contributing to the erosion of income tax revenues in other countries.** For that reason, these countries are unlikely to co-operate in curbing harmful tax competition. By contrast, in the second case, a country may have a significant amount of revenues which are at risk from the spread of harmful tax competition and it is therefore more likely to agree on concerted action." 1998 Report, p. 20 [emphasis added].

The four key identifying factors are:

- 1) No or only nominal taxes - No or only nominal taxation on the relevant income is the starting point to classify a jurisdiction as a tax haven.
- 2) Lack of effective exchange of information - Tax havens typically have in place laws or administrative practices under which businesses and individuals can benefit from strict secrecy rules and other protections against scrutiny by tax authorities thereby preventing the effective exchange of information on taxpayers benefiting from the low tax jurisdiction.
- 3) Lack of transparency - A lack of transparency in the operation of the legislative, legal or administrative provisions is another factor in identifying tax havens.
- 4) No substantial activities - The absence of a requirement that the activity be substantial is important since it would suggest that a jurisdiction may be attempting to attract investment or transactions that are purely tax driven.

In 2000 the OECD Committee on Fiscal Affairs issued a report⁴ identifying tax havens and countries with "potentially harmful" preferential tax regimes.⁵ The 2000 tax haven list excluded certain jurisdictions that made "advance commitments" to eliminate their harmful tax practices and to comply with the principles of the 1998 report even if they currently met the tax haven definition. In response to other jurisdictions' expressed willingness to start discussing cooperative elimination of harmful tax practices, the OECD list of tax havens was to be further divided into cooperative and uncooperative tax havens. The 2000 Report provided that jurisdictions could be put on the "cooperative" list by making a commitment to adopt a schedule of progressive changes to eliminate its harmful tax practices by the end of 2005. In 2001 the standard for being placed on the "cooperative tax shelter" list was significantly lowered and jurisdictions could be categorized as "cooperative" by merely committing to transparency and limited information exchange.

Tax Haven Update

Several activities and events related to tax havens have occurred since the department's last report.

In the fall of 2006, the Multistate Tax Commission adopted a Model Combined Reporting Statute that includes a water's edge election and addresses tax havens. The Hearing Officer's Report provides context for an update of tax haven developments and

⁴ *Towards Global Tax Co-operation, REPORT TO THE 2000 MINISTERIAL COUNCIL MEETING AND RECOMMENDATIONS BY THE COMMITTEE ON FISCAL AFFAIRS, Progress in Identifying and Eliminating Harmful Tax Practices (2000) (the "2000 Report").*

⁵ 2000 Report, pp. 12-14.

succinctly describes why tax havens must be included in the combined group when the tax base is not world-wide combined income:

Whether or not, or the extent to which, foreign affiliates are included in the combined group is one of the most significant policy issues addressed in the proposed model statute. In principle, a combined group should include all affiliates participating in the group's unitary business, domestic and foreign. If combination includes only domestic corporations, then the apportionment of income associated with the foreign activity of a multinational unitary business can be manipulated through changes in the corporate structure. The income (or loss) and apportionment factors associated with the foreign activity could be excluded by conducting the activity as a foreign affiliate, or it could be included by conducting the activity as a foreign division of the domestic corporation.⁶

The MTC Model incorporates tax havens identified by the OECD by reference, rather than listing them individually as is done in 15-31-322. The following is the current MTC model:

- I. "Tax haven" means a jurisdiction that, during the tax year in question:
 - i. is identified by the Organization for Economic Co-operation and Development (OECD) as a tax haven or as having a harmful preferential tax regime, or
 - ii. exhibits the following characteristics established by the OECD in its 1998 report entitled Harmful Tax Competition: An Emerging Global Issue as indicative of a tax haven or as a jurisdiction having a harmful preferential tax regime, regardless of whether it is listed by the OECD as an un-cooperative tax haven:
 - (a) has no or nominal effective tax on the relevant income; and
 - (b) (1) has laws or practices that prevent effective exchange of information for tax purposes with other governments on taxpayers benefiting from the tax regime;
 - (2) has tax regime which lacks transparency. A tax regime lacks transparency if the details of legislative, legal or administrative provisions are not open and apparent or are not consistently applied among similarly situated taxpayers, or if the information needed by tax authorities to determine a taxpayer's correct tax liability, such as accounting records and underlying documentation, is not adequately available;
 - (3) facilitates the establishment of foreign-owned entities without the need for a local substantive presence or prohibits these entities from having any commercial impact on the local economy;
 - (4) explicitly or implicitly excludes the jurisdiction's resident taxpayers from taking advantage of the tax regime's benefits or prohibits enterprises that benefit from the regime from operating in the jurisdiction's domestic market; or

⁶ Report of the Hearing Officer regarding the proposed Model Statute for Combined Reporting, pp. 9-10, April 25, 2005.

(5) has created a tax regime which is favorable for tax avoidance, based upon an overall assessment of relevant factors, including whether the jurisdiction has a significant untaxed offshore financial/other services sector relative to its overall economy.⁷

In January 2007, S 396 was introduced in the U.S. Senate that would have treated controlled foreign corporations that are established in tax havens as domestic corporations that are subject to full tax in the U.S.. That bill defined the following countries as tax havens for the purposes of the legislation:

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

The jurisdictions not included in 15-31-322 that were included in S 396's definition of tax haven were the countries the department recommended for inclusion in 2006 – Cyprus, Malta, Mauritius and San Marino. Jurisdictions included in 15-31-322 that were omitted from the bill were Aruba and the U.S. Virgin Islands. It is notable that this legislation followed Montana's approach establishing a list of tax havens in law.

Later in 2007, separate bills were introduced in the U.S. Senate and U.S. House (S 681 and HR 2136, respectively) that defined not "tax havens" but rather "secrecy jurisdictions," which were defined solely with reference to the availability of information:

DETERMINATION OF JURISDICTIONS ON LIST- A jurisdiction shall be listed under paragraph (A) if the Commissioner determines that such jurisdiction has corporate, business, bank, or tax secrecy rules and practices which, in the judgment of the Commissioner, unreasonably restrict the ability of the United States to obtain information relevant to the enforcement of this title, unless the Commissioner also determines that such country has effective information exchange practices.

These bills created rebuttable presumptions in proceedings to determine or collect tax that (1) assets in these jurisdictions are controlled by the person(s) who directly or indirectly transferred or benefited from them; and (2) anything received from an account or entity in these jurisdictions represents untaxed income. The jurisdictions not in 15-31-322 that were listed in these bills' as "secrecy jurisdictions" are Costa Rica, Hong Kong, Latvia, Singapore, and Switzerland, as well as Cyprus and Malta. Mauritius and San Marino were not included. Other jurisdictions not included were Andorra, Bahrain, Liberia, Maldives, Marshall Islands, Monaco, Montserrat, Niue, Seychelles, and Tonga.

⁷ MTC Model Combined Reporting Statute, Section 1.1.

Tax havens have also been the subject of congressional study and debate. Some of the recent discussions include:

- On August 1, 2006 the Senate Permanent Subcommittee on Investigations held hearings on tax haven abuses. A staff report, *Tax Haven Abuses: The Enablers, The Tools And Secrecy*, was issued for the hearing.
- On July 17 and 25, 2008, the Permanent Subcommittee on Investigations held hearings on tax haven banks. A staff report, *TAX HAVEN BANKS AND U. S. TAX COMPLIANCE*, prepared for the July 17, 2008 hearing, reviewed the OECD development of obtaining commitments, and found that a number of jurisdictions that committed to implementing standards failed to do.⁸
- The Senate Finance Committee held a hearing on the Cayman Islands and Other Off Shore Tax Issues on July 24, 2008. While much of the hearing focused on high income individuals secreting assets in tax havens, transfer pricing abuses that shift income to low and no tax jurisdictions were also briefly discussed.

Recommendations for Tax Haven Updates

The department has determined that the OECD categorization of tax havens into "cooperative" tax havens and "uncooperative" tax havens should have no bearing on whether a particular tax haven should be included in the 15-31-322 list. There are a number of reasons for this conclusion.

- In general, whether or not a nation agrees to cooperate in giving information to another nation, that nation remains a "tax haven." The information even if shared among nations is of little or no value to Montana in preventing corporations from improperly shifting income earned in Montana and properly taxable here to a tax haven. The opportunity for multinational corporations to shift Montana income improperly to "cooperative" tax havens is every bit as real and damaging to other Montana taxpayers as is the opportunity to shift Montana income to "uncooperative" tax havens.
- Taking a tax haven off the list of jurisdictions required to be included as part of a water's edge election merely because it has agreed to commit to give other countries information would amount to sanctioning state tax avoidance. As mentioned previously and noted by the MTC hearing officer in connection with MTC's Model Statute for Combined Reporting, "[i]n principle, a combined group should include all affiliates participating in the group's unitary business, domestic and foreign. If combination includes only domestic corporations, then the apportionment of income associated with the foreign activity of a multinational unitary business can be manipulated through changes in the corporate structure."

⁸ Tax Haven Bank Report, p. 28, citing an OECD report, *Tax Co-operation: Towards a Level Playing Field – 2007 Assessment* by the Global Forum on Taxation.

- The tax haven factors that relate to why assets are parked in tax havens—no or nominal tax rates and no substantial business activity—are important to the states. Information about income in a jurisdiction the state has agreed not to tax (through allowance of the water's edge election) is of little use to the states unless states have the authority to include the tax haven entities in a combined unitary group for income apportionment purposes.⁹
- The information shared by a "cooperative" tax haven with other nations is not practically available to and usable by states. OECD tax sharing agreements are between countries. States have no ability to enter into tax sharing agreements or treaties with these tax havens (or their mother countries). Moreover, the OECD model agreements do not contemplate or provide for broad "matching" of information; they contemplate discrete requests for information in individual cases or suspected tax evasion—and there is no assurance that the IRS will request information for corporations relevant to Montana. While a state could theoretically obtain information from the IRS in a limited number of cases if and when the IRS entered into a tax sharing agreement and if and when information were provided, in practice it is very difficult to, in fact, secure that information from the IRS. Further, the specific content of the information may be relevant to the federal government, but not to states, including Montana, because of differences in federal and state income division laws. Finally, even if received from the IRS, the Montana statute of limitations would have long since run by the time information were obtained and analyzed.
- Retaining countries that meet the OECD definition of tax haven is consistent with the MTC model statute, and acknowledges the anti-abuse purpose of the tax haven provision:

It should be noted that Section 1.1.ii. could include jurisdictions that were once, but are no longer, on the OECD list of uncooperative tax havens. The OECD recognizes that removal of a jurisdiction or regime from its list does not mean that that jurisdiction or regime is no longer a tax haven under its definition, only that it has become a "cooperative tax haven" as opposed to an "uncooperative tax haven." As long as a "cooperative tax haven" is still a "tax haven," the jurisdiction will continue to meet the OECD definition in Section 1.1.ii. This is not inconsistent with the OECD's own caveat that a conclusion that a regime is not actually harmful does not in any way preclude the application of any domestic measure (such as CFC, FIF or any anti-abuse provisions) of a country to that or any other

⁹ The MTC Hearing Officer addressed the notion that "just as combined reporting is critical to addressing income shifting across states, it is also critical for addressing the serious problem of income shifting to foreign tax-haven jurisdictions. ... The [MTC] proposed model's requirement that foreign corporations doing business in a tax haven jurisdiction be maintained as members of the combined group is necessary to avoid re-opening the foreign tax-haven opportunity through the water's-edge election." Hearing Officer Rpt., p. 12.

regime in *OECD's Project on Harmful Tax Practices: The 2004 Progress Report, Part II* ¶18.¹⁰

In conclusion, whether or not an "uncooperative" tax haven becomes a "cooperative" tax haven under OECD definitions has no practical relevance to a decision by Montana to include entities created in a tax haven in a combined unitary report for corporate income tax purposes. Indeed, excluding "cooperative" tax havens from those named in Montana law will merely open the door to income reporting tax abuses by a few corporations to the disadvantage of all other Montana individual and corporate income taxpayers.

In a September 2006 report to this committee, the department recommended the addition of Cyprus, Malta, Mauritius and San Marino to the list of tax havens in 15-31-322, and reported that additional research would be required for Luxembourg, Maldives, and Tonga.

The department again recommends that Cyprus, Malta, Mauritius and San Marino be added.

The department recommends that Maldives and Tonga be removed from the Montana list of tax havens. We make this recommendation for these reasons:

1. The OECD determined that Maldives was incorrectly characterized as a tax haven and that Tonga has made changes to its practices that takes it outside the definition of a tax haven,¹¹ and
2. The department has no information that evidences either the Maldives or Tonga "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."¹²

The department does not recommend the removal of Luxembourg at this time. The country continues to be marketed as a tax haven, it abstained from the substantive OECD tax haven reports, and continues to maintain a regime favorable for tax avoidance.

¹⁰ Report of the Hearing Officer regarding the proposed Model Statute for Combined Reporting, p. 10, fn. 25.

¹¹ 35 Jurisdictions Committed to Improving Transparency and Establishing Effective Exchange of Information in Tax Matters, OECD, December 12, 2003.

¹² MTC Model Combined Reporting Statute, Section 1.1.