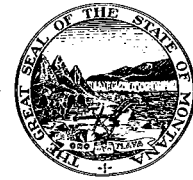




**Dan Bucks**  
Director

# Montana Department of Revenue



**Brian Schweitzer**  
Governor

## MEMORANDUM

To: Dan R. Bucks, Director of Revenue  
From: Brenda J. Gilmer, Senior Tax Counsel  
Date: July 16, 2012  
Subject: Corporation Tax Water's Edge Election – Tax Haven Jurisdictions

Each biennium the department is required to provide the Revenue and Transportation Interim Committee with an update of the countries<sup>1</sup> that may be considered tax havens. The following memorandum provides information to enable you to provide the required update. This report also provides a general background discussion about Montana's corporation license tax system and how the identification of tax havens is related to it.

### Summary Recommendation

1. The list of jurisdictions in § 15-31-322(1)(f), MCA, should be expanded to include additional jurisdictions with low effective tax rates that have been identified as sources of significant income shifting. This includes Hong Kong, Ireland, the Netherlands, Singapore, and Switzerland.
2. The October 2010 dissolution of the Netherlands Antilles should be addressed. The Netherlands Antilles should be removed from the list of tax haven jurisdictions and either:
  - the Kingdom of the Netherlands should be added (this includes the Netherlands, Aruba, Curacao, St. Maarten, Bonaire, St. Eustatius, and Saba), or
  - Curacao, St. Maarten, Bonaire, St. Eustatius, and Saba, the jurisdictions formerly comprising the Netherlands Antilles, should be substituted.

Because Aruba, which is separately listed, is a part of the Kingdom of the Netherlands, if the Kingdom is included, the separate listing of Aruba should be deleted.

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<sup>1</sup> The list of tax havens in 15-31-322(1)(f), MCA, includes not only countries but also territories, dependencies, parts of "kingdoms" or other sub-country designations. The Department has always interpreted the direction to recommend "countries" to encompass all jurisdictions to which income is shifted. Subsection 15-31-322(2), MCA, would be more accurate if "jurisdictions" were substituted for "countries."

## Water's Edge, Tax Havens, and Proportionality

The Montana tax base of a multinational corporation doing business in Montana is its unitary worldwide combined business income. Unitary worldwide business income includes the income of all controlled entities that are engaged in a unitary business, whether formed or located in the United States or a foreign jurisdiction. A business is unitary when operation of the business within Montana is dependent on or contributory to the operation of the business outside the state or if units of the business are closely allied and not capable of separate maintenance as independent businesses.<sup>2</sup> A portion of their unitary worldwide combined business income is attributed to Montana based on the proportionate amount of their Montana sales, property, and payroll.

Each multinational corporation has the option, however, to elect to have its business combination generally stop "at water's edge,"<sup>3</sup> by making the water's edge election provided for in §§ 15-31-321 to -326, MCA. If a multinational corporation makes the water's edge election, the income from a foreign entity that is part of its unitary operations is not included in the Montana tax base unless it is formed in a jurisdiction listed in § 15-31-322(1)(f), MCA, denoted as a "tax haven."<sup>4</sup>

States are not required to offer multinational corporations a water's edge election. The U.S. Supreme Court confirmed the power of states to tax multinational corporations with a U.S. parent on a world-wide combined basis in *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159, 193 (1983) and to similarly tax multinational corporations with a foreign parent in *Barclays Bank PLC v. Franchise Tax Board*, 512 U.S. 298, 331 (1994). Most multinational corporations doing business in Montana do not make water's edge election. For tax year 2010, 31 multinational corporations that elected water's edge filing status reported \$102.9 million in income from the countries listed as tax havens in § 15-31-322, MCA. The Montana corporate tax on this income was \$7.2 million. The income from the foreign countries required to be included in water's edge returns for 2010 is nearly double of that reported in 2008.<sup>5</sup>

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<sup>2</sup> §15-31-301(2), MCA.

<sup>3</sup> "Water's edge" is a misnomer. All foreign countries, including Canada, Mexico, and the Central and South American countries, are included in a water's edge election.

<sup>4</sup> Section 15-31-322(1)(f), MCA (2011), requires that the income and apportionment factors be included for "a corporation that is in a unitary relationship with the taxpayer and that is incorporated in a tax haven, including 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."

<sup>5</sup> As the 2010 report reflected, in 2008 26 multinational corporations reported \$60.3 million in tax haven income and payment of \$4.2 million of corporation tax. The 2010 income is 1.7 times as much as the 2008 income.

As noted in prior reports, the list of tax havens in § 15-31-322, MCA, was initially developed primarily, but not exclusively, from Organization for Economic Co-operation and Development (OECD) information that was part of a harmful tax practices initiative launched in 1996 that culminated in a 1998 framework (*Harmful Tax Competition: An Emerging Global Issue*) that drew a distinction between tax havens and harmful preferential tax regimes and applied different recommendations and guidelines to each.<sup>6</sup>

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The U.S. federal tax concepts of the subpart F income of controlled foreign corporations, of income "effectively connected" with a U.S. trade or business or, for countries with which the U.S. has a tax treaty, of income attributable to a U.S. "permanent establishment," are not relevant to determining Montana tax -- income is not included in the tax base used to determine Montana tax unless it is derived from a group's "unitary business operations." An entity, whether domestic or foreign, is part of a unitary business operation only when it is dependent upon or contributory to the business conducted in Montana or if units within and outside of Montana are closely allied and not capable of separate maintenance as independent businesses. See §15-31-312(1),MCA.

<sup>6</sup> The 1998 OECD framework recognized three principal purposes of tax havens and identified four key factors.

The three recognized principal purposes for tax havens were:

- (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.

The four key identifying factors are:

- (1) no or only nominal taxation on the relevant income, and;
- (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); or
- (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); or
- (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).

The Multistate Tax Commission adopted a Model Combined Reporting Statute in the fall of 2006 that includes a water's edge election and addresses tax havens. The model contains some clarification and additional factors that the department incorporates in its analysis and report:

- [the jurisdiction] has no or only nominal effective tax on the relevant income, and
- 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; or
  - 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
  - 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.

The role of the OECD information has declined in importance in the Department's recommendations as the OECD's attention has since shifted almost exclusively to money laundering and terrorist financing and more sources of information and expanded information have become available.

### Interim Developments

From the time of the last report, tax havens and the income of foreign affiliates have continued to be the subject of study and debate and proposed federal legislation.

1. The top 10 countries where subsidiaries of U.S. multinational corporations earned profits in 2008, as reported by Kimberly A. Clausing in *The Revenue Effects of Multinational Firm Income Shifting*, Tax Notes, March 28, 2011, 1580-1586, is closely correlated with the top 10 countries from which dividends were repatriated as part of the 2004 one-time dividend enacted in 2004.<sup>7</sup>

Top 10 Countries where U.S. multinational subsidiaries reported profits in 2008	Effective tax rate
<b>Netherlands</b>	2.1%
<b>Luxembourg</b>	0.4%
<b>Ireland</b>	4.0%
<b>Canada</b>	13.2%

Top 10 Countries from which dividends were repatriated by U.S. multinational corporations	By amount
<b>Netherlands</b>	\$89,912,245
<b>Switzerland</b>	\$32,421,610
<b>Bermuda</b>	\$31,798,882
<b>Ireland</b>	\$25,580,241

MTC Model Combined Reporting Statute, Section 1.1.

The 2006 MTC model specifically referenced the OECD its definition of "tax haven." In 2011 the definition in the model statute was amended to delete references to the OECD).

The MTC hearing officer's report explains the policy reason for including tax havens:

"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."

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

<sup>7</sup> The IRS conducted an analysis of the 2004 foreign earnings repatriation enacted as part of the American Jobs Creation Act (P.L. 108-357) that was published in an article by Melissa Redmiles in the IRS Spring 2008 Statistics of Income Bulletin. Table 3 shows most countries from which the dividends were repatriated. Melissa Redmiles, *The One-Time Received Dividend Deduction*, available at <http://www.irs.gov/pub/irs-soi/08codivdeductbul.pdf>.

<b>Bermuda</b>	0.6%
<b>Switzerland</b>	3.4%
<b>Singapore</b>	3.4%
Germany	17.8%
Norway	38.4%
Australia	20.1%

<b>Luxembourg</b>	\$23,466,908
<b>Canada</b>	\$21,435,573
Cayman Islands	\$18,453,692
United Kingdom	\$15,924,015
<b>Singapore</b>	\$ 5,401,243
Hong Kong	\$ 5,180,664

[The countries that appear on both lists are bolded; money amounts in thousands of dollars]

A Congressional Research Service study found that the 2004 repatriation led corporations to expect another and that unrepatriated earnings grew in anticipation of that, by 72% to \$958 billion for all corporations, and by 81% to \$639 billion for companies that repatriated under the 2004 law. Donald J. Marples and Jane G. Gravelle, "Tax Cuts on Repatriation Earnings as Economic Stimulus: An Economic Analysis, Congressional Research Service Report for Congress," R40178, p. 5 (May 27, 2011).<sup>8</sup> The report cited another study that estimate that a second repatriation would generate short-term revenue of about \$26 billion, but would be followed by a revenue loss of \$105 billion within the 10-year budget horizon, for a net revenue loss within that period of \$79 billion.<sup>9</sup>

2. Martin Sullivan reflected different measures of income shifting in January 20, 2011 written testimony to the House Ways and Means' Committee on the current federal income tax and the need for reform for five countries he identified as tax havens:

Profits and Profitability of Foreign Affiliates of U.S. Multinationals in 2008						
	Before-tax Profits (millions)	Effective Tax Rate	Profit as % of Sales	Profit as % of Property	Profit as a % Employee Compensation	Profit per Employee
Ireland	\$ 46,337	7.3%	18.6%	117%	708%	\$ 520,640
Switzerland	\$ 16,352	11.5%	5.9%	141%	189%	\$ 200,638
Bermuda	\$ 8,354	4.8%	14.3%	132%	2,234%	\$ 2,610,625
Barbados	\$ 4,263	6.9%	38.0%	251%	11,218%	\$ 4,263,000
Singapore	\$ 12,255	8.1%	4.3%	84%	227%	\$ 103,157
Five Tax Haven Total	\$ 87,561	7.9%	10.0%	119%	417%	\$ 298,334
Worldwide Total	\$ 408,720	35.2%	7.9%	42%	93%	\$ 40,372

Source: Author's calculations using latest data from the Bureau of Economic Analysis of the U.S. Department of Commerce. The BEA data do not include banks.

The testimony is available at

[http://waysandmeans.house.gov/UploadedFiles/sullivan\\_written\\_testimony\\_WM\\_Jan\\_20.pdf](http://waysandmeans.house.gov/UploadedFiles/sullivan_written_testimony_WM_Jan_20.pdf).

<sup>8</sup> The report is available at [http://www.ctj.org/pdf/crs\\_repatriationholiday.pdf](http://www.ctj.org/pdf/crs_repatriationholiday.pdf).

<sup>9</sup> U.S. Congress, Joint Committee on Taxation, Revenue Estimates for Two Dividends-Received Deductions Proposals, 112th Sess., April 15, 2011, available at [http://doggett.house.gov/images/pdf/jct\\_repatriation\\_score.pdf](http://doggett.house.gov/images/pdf/jct_repatriation_score.pdf).

3. For tax year 2010, the top 5 tax havens, by income apportioned to Montana<sup>10</sup>, were:

Jurisdiction	Income apportioned to Montana	Additional Montana tax
Luxembourg	41,490,000	2,900,000
Bahamas	36,670,000	2,570,000
British Virgin Islands	11,120,000	780,000
Bermuda	8,080,000	570,000
Liberia	4,560,000	320,000
	\$101,920,000	7,140,000

4. The Internal Revenue Service continues to address unreported income of individuals in tax haven and secrecy jurisdictions with voluntary disclosure compliance initiatives. The first, in 2009, closed with 15,000 disclosures. After a second initiative in 2011, total federal collections were \$4.4 billion and 33,000 disclosures were made.<sup>11</sup> In January 2012, the IRS announced it was indefinitely reopening the disclosure initiative to individuals with undisclosed foreign accounts,<sup>12</sup> and on June 26, 2012, it announced that collections exceeded \$5 billion.<sup>13</sup>

The voluntary initiatives have been coupled with criminal investigations and prosecutions. Thirty-eight offshore account holders have been convicted (at trial or because of guilty pleas),<sup>14</sup> as have one banker<sup>15</sup> and one advisor<sup>16</sup>. Criminal

<sup>10</sup> Income and tax are rounded to the nearest \$10,000.

<sup>11</sup> IR-2011-14, Feb. 8, 2011, available at <http://www.irs.gov/newsroom/article/0,,id=235695,00.html>.

<sup>12</sup> IR-2012-5 available at <http://www.irs.gov/newsroom/article/0,,id=252162,00.html>.

<sup>13</sup> IR-2-12-64 available at <http://www.irs.gov/newsroom/article/0,,id=258430,00.html?portlet=108>.

<sup>14</sup> Harry Abrahamsen, Oradelle, NJ; Steven W. Allen, Mesa, AZ; Mauricio Cohen Assor, Miami Beach, FL; Jack Barouh, Golden Beach, FL; Josephine Bhasin, Huntington, NY; Jeffrey Chatfield, San Diego, CA; Jeffrey P. Chernick, Sanfordville, NY; Robert Cittadini, Bellevue, WA; Leon Cohen-Levy, Miami Beach, FL; Vaibhav Dahake, Somerset, NJ; Arthur Joel Eisenberg, Seattle, WA; Anton Ginzburg, New York; Allen P. Goodmansen, Mesa, AZ; Robert E. Greeley, San Francisco, CA; Edward Gurary, Orange Village, OH; Kenneth Heller, New York, NY; Federico Hernandez, New York, NY; Juergen Homann, Saddle River, NJ; Lucille Abrahamsen Jackson, Hilldale, NJ; Jack McCarthy, Malibu, CA; Robert Moran, Lighthouse Point, FL; Igor Olenicoff, Santa Ana, CA; Michael Reiss, Princeton, NJ; Jules Robbins, Jerico, NY; Sean Roberts, Tehachapi, CA; Nadia Roberts, Tehachapi, CA; Steven Michael Rubinstein, Boca Raton, FL; Gregory Rudolph, Brookline, MA; Pete Schober, Boston, MA; Andrew Silva, Sterling, WA; Samuel Phineas Upham, New York, NY; Sybil Nancy Upham, Manhattan, NY; Ernest Vogliano, Manhattan, NY; Richard Werdiger, Purchase, NY; Paul Zabczuk, Woodlands, TX; Leonid Zaltsberg, Milltown, NJ; Humberto Gomez, Miami Lakes, FL; Wolfgang Roessel, Ft. Lauderdale, F; Robert Moran, FL.

indictments were brought against more account holders,<sup>17</sup> against 18 bankers or advisors<sup>18</sup> and two attorneys<sup>19</sup> as facilitators of offshore tax fraud, and against Wegelin & Co., a Swiss private bank. Information is available at the U.S. Department of Justice website, Offshore Compliance Initiative, [http://www.justice.gov/tax/offshore\\_compliance\\_initiative.htm](http://www.justice.gov/tax/offshore_compliance_initiative.htm). Thirteen banks are currently under investigation. An online publication, PR Web, announced on the first of May that on April 27, 2012, an executive at Credit Suisse confirmed that it had turned over client data to U.S. tax investigators. Many attorneys are apparently now advising individuals still holding unreported offshore accounts that there is probably no hope they will not be discovered.

Individual income tax evasion that is premised on hiding foreign accounts is not, in general, relevant to the issue of including or not including a jurisdiction on the list of tax havens for water's edge reporting purposes. The former is principally concerned with secrecy (with or without the use of entities) while the latter is almost wholly concerned with the use of entities to artificially lower taxable income. The OECD and the MTC model reporting statute definitions of "tax haven" encompass both, disjunctively.

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<sup>15</sup> Former UBS banker Bradley Birkenfeld of Weymouth, MA.

<sup>16</sup> Attorney Renzo Gadola, a resident of Switzerland. Tax preparers of a California headquartered national tax preparation company United Revenue Service Inc, David Kalai, Nadav Kalai and David Almog, were indicted July 15, 2012, for conspiring to defraud the U.S., and are accused of preparing false tax returns for clients, incorporating offshore companies in Belize and elsewhere, and helping them open secret accounts at the Luxembourg locations of two Israeli banks.

<sup>17</sup> Including Bernard Goldstein of Carlsbad, CA;; Shmuel Sternfield of Tel Aviv, Israel; Amir Zavieh of San Francisco, CA; Stephen M. Kerr of Phoenix, AZ; Michael Quiel of Phoenix; Christopher M. Rusch of San Diego, CA; Ashvin Desai of San Jose, CA; Arvind Ahuja of Greendale, WS; Michael Schiavo of Westford, MA.

<sup>18</sup> Marco Parenti Adami, Italy (Credit Suisse); Emanuel Agustino, Switzerland (Credit Suisse); Adreas Bachmann, Switzerland (Credit Suisse); Christos Bagios, Switzerland (UBS/Credit Suisse)(senior private banker); Michele Bergantino, Switzerland (Credit Suisse); Michael Berlinka, Switzerland (Wegelin & Co.) client advisor); Josef Dorig, Switzerland (Dorig Partner AG); Urs Frei, Switzerland (Wegelin & Co.)(client advisor); Gian Gisler, Switzerland (Former USB banker, then independent financial advisor)(client advisor); Robert Keller, Switzerland (Wegelin & Co.) (client advisor); Martin Lack, Switzerland (UBS)(senior banker); Susanne Rugg Meier, Switzerland (Credit Suisse)(former manager); Hansruedi Schumacher, Switzerland (Neue Zuercher Bank)(executive manager); Roger Shaerer, Switzerland (Credit Suisse); Beda Singenberger, Switzerland (Sinco Treuhand AG)(financial advisor); Mario Staggl, Liechtenstein (New Haven Trust Company Ltd.); Markus Walder, Switzerland (Credit Suisse)(head of Credit Suisse's North American offshore banking business); Raoul Weil, Switzerland (UBS)(Chairman and CEO of UBS's Global Wealth Management & Business Banking Division).

<sup>19</sup> Attorneys Felix M. Mathis and Matthias Rickenbach, both of Switzerland.

5. Individual income tax evasion is also addressed by FATCA (the Financial Account Tax Compliance Act),<sup>20</sup> federal legislation scheduled to take effect January 1, 2013.<sup>21</sup> Under FATCA, foreign financial institutions are required to report information about U.S. account holders and the accounts to the IRS.<sup>22</sup> To prevent noncompliant institutions from using complaint banks as conduits, the act also requires participating financial institutions to withhold 30% of payments made to noncompliant institutions.<sup>23</sup>

FATCA address the “secrecy” prong of the definition of tax havens, requiring automatic exchange of information; it does not address the use of entities to artificially lower taxable income.

6. At the federal level, bills that purport to address “tax havens” continue to be proposed.<sup>24</sup> Unlike many earlier bills, however, the latest ones do not contain a list of

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<sup>20</sup> 26 U.S.C. §§1471-1474. FATCA was enacted as part of the 2010 Hiring Incentives to Restore Employment Act (the HIRE act), P.L. 111-147, March 18, 2010.

<sup>21</sup> An original January 1, 2013 effective date was modified in Notice 2011-53, which established a phased implementation schedule.

<sup>22</sup> In a February 2012 joint statement from the U.S., and France, Germany, Italy, Spain and the UK, the countries announced that the U.S. would negotiate with countries for the information exchange that would enable individual financial institutions to avoid entering into separate agreements with the IRS (<http://www.treasury.gov/press-center/press-releases/Documents/020712%20Treasury%20IRS%20FATCA%20Joint%20Statement.pdf>)

On June 21, 2012, joint statements were issued from the U.S. with Switzerland (<http://www.treasury.gov/press-center/press-releases/Documents/FATCA%20Joint%20Statement%20US-Switzerland.pdf>) and with Japan (<http://www.treasury.gov/press-center/press-releases/Documents/FATCA%20Joint%20Statement%20US-Japan.pdf>).

<sup>23</sup> The OECD is undertaking the Treaty Relief and Compliance Enforcement (TRACE) project to develop a single standardized information system through which participating governments can offer streamlined procedures for investors claiming treaty-withholding rates on portfolio investments that would also enable governments to report and obtain limited information about the recipients of portfolio income.

<sup>24</sup> H.R. 62 and S. 1373, the “International Tax Competitiveness Act of 2011, introduced in January of 2011, would treat large or publicly traded corporations that are incorporated outside the U.S., but managed and controlled in the U.S., as domestic corporations. U.S. managed investment entities like hedge funds and securitization vehicles and other pooled investment funds with U.S. sponsors would be treated as engaging in a trade or business under the bills, subjecting them to U.S. income tax. The bills would also currently tax a controlled foreign corporation’s royalty and other income from intangibles and would use all earnings and profits when computing taxable reorganization boot.

H.R. 64, introduced January, 2011, would limit treaty benefits on deductible payments for U.S. subsidiaries whose parent companies are located in countries that don’t have a tax treaty with the United States.

The “Offshoring Prevention Act,” H.R. 2280 and S. 45, was introduced in June 2011 and proposed currently taxing the income of controlled foreign corporations attributable to certain



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property imported into the U.S. (rather than deferring tax until the profits were repatriated to the U.S.).

Two identical bills designated the "Stop Tax Haven Abuse Act," H.R. 2669 and S. 1346, were introduced in July of 2011. The proposal did not list countries that are "tax havens" or provide a mechanism for identifying tax haven jurisdictions. Instead, it would treat foreign corporations that are managed and controlled from the U.S. as domestic corporations, it would source credit default swap payments to the location of the payor, and it would treat the income of controlled foreign corporations that are deposited in accounts located in the U.S. as if it were constructively distributed to its U.S. shareholder. It also required SEC financial performance reporting on a country-by-country basis, including a list of every entity and every country where it does business, along with the number of employees physically working in the country, the total sales and purchases by members of the group to third parties and to members, the total financing payments made by members of the group to third parties and to members, pretax gross and net revenues of each group member, and the tax paid by each member to each country in which it operates. The act would also create securities penalties and increase and expand the Internal Revenue Code §6700 (promoting abuse tax shelters) and 6701 (aiding and abetting understatement of tax) penalties.

H.R. 3157 and S. 1693 were introduced in October 2011 and would "defer" deductions of the U.S. subsidiaries of foreign reinsurance companies for premiums paid to their foreign affiliates that are not subject to U.S. tax (the foreign affiliates could elect to be treated as if they were U.S. permanent establishments for tax treaty purposes). One of the sponsors, Richard Neal, a representative from Massachusetts, described it as closing a loophole that allows foreign insurance groups to strip their U.S. income into tax havens to avoid U.S. tax:

"Many foreign-based insurance companies are using affiliate reinsurance to shift their U.S. reserves overseas into tax havens, thereby avoiding U.S. tax on [sic] their all investment income. This provides these companies with a significant unfair competitive advantage over U.S.-based companies, which must pay tax on their investment income. To take advantage of this loophole, several U.S. companies have "inverted" into tax havens and numerous other companies have been formed offshore. And, absent effective legislation, industry experts have predicted that capital migration will continue to grow and other insurers will be forced to redomesticate offshore.

Congressional Record, 112<sup>th</sup> Congress (2011-2012), October 12, 2011, page E1822 (only Bermuda and Switzerland are mentioned).

In February 2012 Senator Levin introduced SB 2075, which is substantially similar to the 2011 Stop Tax Haven Abuse Act. The 2012 bill was retitled "CUT Unjustified Tax Loopholes Act," and it added some new provisions. One requires securities and financial service regulators to notify the IRS if they discover prohibited tax shelter use. Another limits corporate deductions for stock option grants. It amends the definition of "foreign base company income" that is a component of Subpart F income subject to U.S. tax, to include "excess" income from intangibles that was not subject to an effective foreign tax rate of at least 5%. The bill also defers deductions related to deferred income and extends money-laundering sanctions against jurisdictions and financial institutions that impede U.S. tax enforcement.

The Senate adopted an amendment on March 8, 2012, to the Surface Transportation bill that would expand Treasury's money laundering measures under 31 U.S.C. 5318A against countries or institutions that impede tax enforcement. The special measures proposed or taken are listed at [http://www.fincen.gov/statutes\\_regs/patriot/section311.html](http://www.fincen.gov/statutes_regs/patriot/section311.html). See Marie Saphirie,

tax havens. Senate bill 2075, "CUT Unjustified Tax Loopholes Act," somewhat indirectly defines a tax haven by imposing U.S. tax on certain income from transferred intangibles that are not subject to foreign tax at an effective rate of at least 5% (bill section 132).<sup>17</sup>

7. Calls for broad federal "tax reform"<sup>25</sup> have served as the basis for testimony about and legislative proposals for changes to:

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"New Analysis: An Arms Race Against Offshore Tax Havens," 2012 TNT 117-1 (June 18, 2012). The provision had been included in the CUT Unjustified Tax Loopholes Act introduced in February 2012.

<sup>25</sup> In *Across the Great Divide: A Central Tax Reform Proposal*, Tax Analysts, Tax Notes Today, TNT 40-7 (March 1, 2011), Philip R. West describes the history of the current system, provides an overview of the system, and summarizes reform proposals from the 2005 President's Advisory Panel on Federal Tax Reform, the Wyden-Gregg Bipartisan Tax Fairness and Simplification Act of 2010, the 2010 President's Economic Recovery Advisory Board tax reform subcommittee, the Ryan "Roadmap for America's Future," the "Restoring America's Future" report by the Debt Reduction Task Force of the Bipartisan Policy Center, the report of the National Commission of Fiscal Responsibility and Reform (Bowles-Simpson commission), and the Aurbach "modern corporate tax" proposal.

The U.S. House of Representatives Committee on Ways and Means maintains a web page at which hearings with testimony in favor of lower corporate tax rates is located: <http://waysandmeans.house.gov>. Hearings included "Hearing on the Need for Comprehensive Tax Reform to Help American Companies Compete in the Global Market and Create Jobs for American Workers (May 12, 2011); "Hearing on Tax Reform and Consumption-Based Tax Systems (July 26, 2011); "Hearing on Economic Models Available to the Joint Committee on Taxation for Analyzing Tax Reform Proposals (Sept. 21, 2011); "Hearing on Ways and Means International Tax Reform Discussion Draft" (Nov. 17, 2011) (Select Revenue Measures Subcommittee (Tax)); "Interaction of Tax and Financial Accounting on Tax Reform (Feb. 8, 2012); "Hearing on the President's Fiscal Year 2013 Budget Proposal with U.S. Department of the Treasury Secretary Timothy F. Geithner" (Feb. 15, 2012); and "Hearing on the Treatment of Closely Held Businesses in the Context of Tax Reform" (Mar. 7, 2012). The U.S. House of Representatives maintains a small business web-page at which testimony in favor of lower corporate tax rates is also located: <http://smbiz.house.gov/>; hearings included "The Path to Job Creation: The State of American Small Business" (Feb. 1, 2012); "Large and Small Businesses: How Partnerships Can Promote Job Growth" (March 28, 2012); and "The Tax Outlook for Small Businesses: What's on the Horizon?" (April 18, 2012).

The Joint Committee on Taxation issued:

- "Background and Selected Issues Related to the U.S. International Tax System and Systems that Exempt Foreign Business Income" on May 20, 2011, in connection with a House Ways and Means Committee hearing on May 24, 2011 (JCX-33-11): <https://www.jct.gov/publications.html?func=startdown&id=3793>
- Present Law and Issues in U.S. Taxation of Cross Border Income, on September 6, 2011 (JCX-42-11) in connection with a September 8, 2011 Senate Committee on Finance hearing "Tax Reform Options: International Issues." The hearing testimony is available at: <http://www.finance.senate.gov/hearings/hearing/?id=85bf3d89-5056-a032-5289-d0bff7d57faa>

a. the federal corporate income tax rate (testimony emphasizing the high 35% statutory U.S. corporate tax rate (relative to other countries)<sup>26</sup> is contrasted with testimony emphasizing that few corporations pay the 35% statutory rate (in part because of the ability to divert income to tax havens),<sup>27</sup> and

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- “Present Law and Issues Related to the Taxation of Financial Instruments and Products,” JCX-56-11, Dec. 2, 2011, for the Senate Finance and House Ways and Means joint hearing on Tax Reform and the Tax Treatment of Financial Products on December 6, 2011:

<http://www.finance.senate.gov/imo/media/doc/12062011%20Barthold%20Testimony.pdf>.

The hearing testimony for which is available at:

<http://www.finance.senate.gov/hearings/hearing/?id=7210f220-5056-a032-5253-25d3c011126f>.

The Senate Committee on Finance held a hearing on March 6, 2012 on “Tax Reform Options: Incentives for Capital Investment and Manufacturing,” the testimony for which is available at <http://www.finance.senate.gov/hearings/hearing/?id=7ef25099-5056-a032-52a2-7e15cca1ba5d>.

<sup>26</sup> Kevin a. Hassett, the Director of Economic Policy Studies for the American Enterprise Institute testified before the Joint Economic Committee on April 17, 2012, that the high statutory rate is one feature of our “suboptimal” tax system. Testimony on “How the Taxation of Capital Affects Growth and Employment, p. 5. The written testimony is available at [http://jec.senate.gov/public//index.cfm?a=Files.Serve&File\\_id=a3c28459-af3c-430e-a7e7-3547bd634fe4](http://jec.senate.gov/public//index.cfm?a=Files.Serve&File_id=a3c28459-af3c-430e-a7e7-3547bd634fe4).

A PricewaterhouseCoopers LLP survey for the Business Roundtable dated April 14, 2012, found that from 2006 to 2009 U.S.-headquartered companies paid an average tax rate of 27.7%, 5% higher than the average for companies headquartered in other OECD countries. Global Effective Tax Rates, available at [http://businessroundtable.org/uploads/studies-reports/downloads/Effective\\_Tax\\_Rate\\_Study.pdf](http://businessroundtable.org/uploads/studies-reports/downloads/Effective_Tax_Rate_Study.pdf).

<sup>27</sup> Reuven Avi-Yonah testified before the U.S. Senate Committee on Finance on September 8, 2011, that there is no good evidence that the effective rates faced by U.S.-based multinationals is significantly higher than that faced by multinationals based in European Union countries, citing his own research and that of Jane G. Gravelle, in “International Corporate Tax Rate Comparisons and Policy Implications,” Congressional Research Service Report (March 31, 2011). His written testimony is available at <http://www.finance.senate.gov/imo/media/doc/Testimony%20of%20Reuven%20Avi-Yonah.pdf>.

Jane G. Gravelle, Senior Specialist in Economic Policy for the Congressional Research Service testified before the Senate’s Committee on Finance on March 6, 2012, that the differences in the U.S. and OECD countries’ statutory tax rates “virtually disappear when measures of effective tax rates are considered.” Testimony on “Tax Reform Options: Incentives for Capital Investment and Manufacturing,” p. 2, and that countries lowering their rates have made other changes, including reducing depreciation deductions, p.3. Her written testimony is available at <http://www.finance.senate.gov/imo/media/doc/Testimony%20of%20Jane%20Gravelle.pdf>.

Martin Sullivan testified before the House Ways and Means committee November 17, 2011 hearing on international tax reform that the effective tax rates of U.S. corporations significantly declined over the previous decade. The written testimony is available at <http://waysandmeans.house.gov/UploadedFiles/Sullivansrm1117.pdf>.

b. the federal corporate income tax base (proposals to limit the tax base of domestic corporations to income from U.S. operations, sometimes called a "territorial system,"<sup>28</sup> are contrasted with proposals to prevent erosion of the existing "world-wide" tax base by addressing income diverted to no tax or low tax jurisdictions, mismatch of income and deductions, mismatch of income and credit, and other offshore structuring techniques.<sup>29</sup> Georgetown Professor John Buckley characterized differences between the administration's proposal to retain the worldwide system and impose a minimum tax on foreign subsidiaries and House Ways and Means Committee Chair Dave Camp's territorial proposal as "mere labeling," maintaining they would have the same effect.<sup>30</sup> The current federal tax system is commonly described as a "world-wide system," but because the business profits of controlled foreign subsidiaries are not taxed by the U.S. until the subsidiary declares and pays out a dividend to its U.S. parent, U.S. tax on much of the income attributed to a controlled foreign entity can be deferred so long as the parent's need for cash can be supplied by intercompany borrowing or third-party lenders.<sup>31</sup>

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<sup>28</sup> Lawrence Lokken in *Territorial Taxation: Why Some U.S. Multinationals May be Less than Enthusiastic About the Idea (and Some Ideas They Really Dislike)*, 59 SMU L. Rev. 751 (2006), explains that "territorial" is a misnomer because the proposals exempt only foreign business profits -- other foreign income continues to be taxed and the foreign tax credit regime is retained to prevent double taxation of that income.

<sup>29</sup> See proposed legislation at note 17, and Joint committee on Taxation, Present Law and Background Related to Possible Income Shifting and Transfer Pricing" (JCX-37-10), July 20, 2010, available at <https://www.ict.gov/publications.html?func=startdown&id=3692>.

<sup>30</sup> 2012 TNT 94-6, ABA Meeting: Opposing International Tax Proposals are Similar, Buckley Says (May 15, 2012).

Obama proposed to maintain the worldwide system of taxation with deferral plus a minimum tax on the income earned by foreign subsidiaries of U.S. parent companies. "I would say it's kind of halfway between no deferral and deferral, depending on the rate of that minimum tax," said Buckley, a member of Tax Analysts' board of directors.

Camp proposed to move to a territorial system of taxation, "but would expand subpart F to require current taxation of all foreign income that is not subject to a fairly robust foreign tax," Buckley said. He added that Camp's definition of intangibles "is so broad that it is hard to imagine that there would be much income overseas that would not be currently taxed."

<sup>31</sup> The "Subpart F" income of controlled foreign subsidiaries is currently taxed. IRC §§ 951-965. An exception to current taxation of "active financing income" is scheduled to expire for tax years beginning in 2012 (the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, P.L. 111-312, most recently extended this exception, which was first enacted in 1997 by the Taxpayer Relief Act of 1997, P.L. 105-34). The identity of "tax havens" was taken from the list compiled by the GAO in GAO-09-157, Table 1, "U.S. corporations with Foreign Subsidiaries," Dec. 2008.

8. The Homeland Security & Government Affairs Permanent Subcommittee on Investigations (PSI), which issued tax haven related reports in 2006<sup>32</sup> and 2008<sup>33</sup> continues to address the issue of taxes havens and abusive tax schemes. It's report, "Report: Dividend Tax Abuse: How Offshore Entities Dodge Tax on U.S. Stock Dividends," available for download at <http://www.hsgac.senate.gov/subcommittees/investigations/issues/tax-havens-and-abusive-tax-schemes>, was followed by 2010 legislation<sup>34</sup> intended to prevent avoidance of tax on dividends using structured finance techniques known as "dividend equivalents," Treasury temporary regulations for which were proposed in January 2012.<sup>35</sup>

An October 11, 2011 PSI majority staff report, "Repatriating Offshore Funds: 2004 Tax Windfall for Select Multinationals,"<sup>36</sup> determined that most funds repatriated under the 2004 American Jobs Creation Act were from tax haven or low tax countries, specifically citing the Bahamas, Bermuda, British Virgin Islands, Cayman Islands, Costa Rica, Hong Kong, Ireland, Luxembourg, Netherlands Antilles, Panama, Singapore and Switzerland. Report at p. 30. A follow-up December 14, 2011 PSI majority Staff Report, "Offshore Funds Located Onshore, Majority Staff Report Addendum, Dec. 14, 2011 to Repatriating Offshore funds: 2004 Tax Windfall for Select Multinationals, Majority Staff Report, Oct. 11, 2011"<sup>37</sup> determined that the 27 U.S. corporations it had surveyed had \$538 billion in undistributed accumulated foreign earnings at the end of fiscal year 2010 and that an average of 46% of those funds were held in U.S. bank accounts and invested in U.S. treasury bonds or shares of related U.S. corporations.<sup>38</sup>

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<sup>32</sup> Report: Tax Haven Abuses: the Enablers, The Tools & Secrecy, Aug. 1, 2006 is available for download at <http://www.hsgac.senate.gov/subcommittees/investigations/issues/tax-havens-and-abusive-tax-schemes>.

<sup>33</sup> Report: Tax Haven Banks and U.S. Tax Compliance, July 17, 2008 is available for download at <http://www.hsgac.senate.gov/subcommittees/investigations/issues/tax-havens-and-abusive-tax-schemes>.

<sup>34</sup> The Hiring Incentives to Restore Employment Act (HIRE), P.L. 111-147.

<sup>35</sup> T.D. 9572, FR Doc. 2012-1234, <https://www.federalregister.gov/articles/2012/01/23/2012-1234/dividend-equivalents-from-sources-within-the-united-states>,

<sup>36</sup> The report is available for download at <http://www.hsgac.senate.gov/subcommittees/investigations/issues/tax-havens-and-abusive-tax-schemes>.

The amount and percent repatriated from the tax haven controlled foreign corporations is included in Table 5, located on page 50. The aggregated amounts are not shown by country.

<sup>37</sup> The addendum is available for download at <http://www.hsgac.senate.gov/subcommittees/investigations/issues/tax-havens-and-abusive-tax-schemes>.

<sup>38</sup> The addendum showed the percent varied significantly by company, with Adobe, Apple, Broadcom, Cisco, Google, EMC, Microsoft, Johnson & Johnson, and Qualcomm having between 76% and 100% of their foreign earnings or cash in the U.S. Addendum at 5.

9. The additional detail that Schedule M-3 provides enables the IRS and scholars to examine four measures of corporate income -- two measures of financial reporting income (pre-tax world wide book income of the entities included in calculating taxable income, pretax domestic book income of the entities included in calculating taxable income) and two measures of tax reporting income (tax net income and taxable income). See Caitlin Bokulic, Erin Henry, and George Plesko, "The Distribution of Corporate Income: Tabulations from the Schedule M-3, 2004-2008," *Statistics of Income Bulletin*, Spring 2012. The additional detail should enable the Department of Revenue to provide more detailed information about corporate income shifting in the future.

10. Representative David Camp, chairman of the House Ways and Means Committee, issued a discussion draft of a "territorial system" in October 2011 that includes provisions that would lower the corporate tax rate to 25%, provide a 95% dividends received deduction to 10% U.S. corporate shareholders for dividends from controlled foreign corporations whose stock they've held for at least a year, and provide a thin-capitalization formula that would result in interest deduction disallowance. It included three options for discourage tax base erosion -- (A) treating excess profits from transfers of intangibles to low taxed affiliates as subpart F income, (B) treating income that is earned outside a CFC's home country at an effective tax rate of less than 10% as subpart F income, and (C) including foreign intangibles income as subpart F income and taxing it at 15% when the foreign jurisdiction imposes a tax rate of less than 13.5%.

11. The Administration's 2013 budget proposal<sup>39</sup> contains a number of proposals to reform the international tax system. The proposals included limiting deductions for interest expense, limiting the foreign tax credit, currently taxing "excess income" from intangibles transferred to low tax jurisdictions, clarifying the definition of intangible property for sections 367(d) and 482 purposes (including specifying that workforce in place, goodwill, and going concern value are included), disallowing deductions for reinsurance premiums paid to untaxed foreign affiliates, tightening the limits on deductions for interest paid by expatriated entities to related parties, changing the foreign tax credit that would be allowed to taxpayers that also receive an economic benefit from the foreign country, providing that gain or loss from the sale of a partnership interest is sourced to the U.S. (i.e., effectively connected with the conduct of a U.S. trade or business) to the extent the transferor partner's distributive share of the partnership's unrealized gain or loss is attributable to effectively connected property, preventing foreign corporation earnings and profits manipulation to avoid dividend characterization of a distribution, extending the covered asset acquisition rules, and providing that an elimination of foreign earnings and profits results in a corresponding reduction in the associated foreign taxes.

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<sup>39</sup> General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals, available at <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf>. See pages 85 through 100.

12. President Obama and the Department of Treasury issued a joint February 2012 report, "the President's Framework for Business Tax Reform"<sup>40</sup> that purported to address the statutory tax rate, the effective marginal tax rate, and the tax base. The report called for lowering the corporation tax rate from 35% to 28% and broadening the tax base by taxing large partnerships at the same rate as corporations, enacting a minimum tax on foreign earnings, preventing the use of LIFO accounting for inventory, eliminating oil and gas tax preferences, eliminating the interest deduction for company owned life insurance policies, eliminating the preferential tax rate for carried interest, and eliminating the shorter depreciable life of noncommercial aircraft.

13. World-wide formulary apportionment<sup>41</sup> as a third alternative to federal business tax reform continues to be advocated<sup>42</sup>:

a. Reuven S. Avi-Yonah, Kimberly A. Clausing and Michael Durst, "Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split," Paper 95, The John M. Olin Center for Law & Economics Working Paper Series, University of Michigan Law School (2008) and 9 Florida Tax Review 497 (2009).

b. Reuven S. Avi-Yonah, "Closing the International Tax Gap Via Cooperation, Not Competition, and Joel Huddleston, "Adopt Formulary Apportionment and Combined Reporting," both articles that were included in Tax Analysts' publication "Toward Tax Reform: Recommendations for President Obama's Tax Force (2009).

c. Kimberly A. Clausing and Yaron Lahav, "Corporate Tax Revenues Under Formulary Apportionment: Evidence from the Financial Reports of 50 Major U.S. Multinational Firms," 20 Journal of International Accounting, Auditing and Taxation 97 (2011).<sup>43</sup> The authors examine the effect of equally weighted 3-

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<sup>40</sup> The report is available at <http://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-02-22-2012.pdf>.

<sup>41</sup> IDEAS, a service hosted by the Economic Research Division of the Federal Reserve Bank of St. Louis provides access to various papers, including a number related to formula apportionment. See e.g., R. Pethig and A. Wagener, "Profit Tax Competition and Formula Apportionment" at <http://ideas.repec.org/p/sie/siegen/106-03.html#refs> and J. Martini, R. Niemann, and D. Simons, "Transfer Pricing or Formula Apportionment? Tax-Induced Distortions of Multinationals' Investment and Production Decisions," at [http://ideas.repec.org/p/ces/ceswps/\\_2020.html](http://ideas.repec.org/p/ces/ceswps/_2020.html)

(the "References" section contains links to transfer pricing and formula apportionment research at [http://ideas.repec.org/p/ces/ceswps/\\_2020.html#biblio](http://ideas.repec.org/p/ces/ceswps/_2020.html#biblio)).

<sup>42</sup> The Department of Revenue's Director Dan R. Bucks, in a prior professional role, proposed federal use of formulary apportionment to combat transfer-pricing abuse. "Will the Emperor Discover He has No Clothes Before the Entire is Sold?", 44 National Tax Journal 311 (1991). In D. Bucks and M. Mazerov, "The State Solution to the Federal Government's International Transfer Pricing Problem, 46 National Tax Journal 395 (1993), the relative low administrative costs of formula apportionment as compared to a federal §482 audit

<sup>43</sup> The paper updates earlier work by Douglas Shackelford and Joel Slemrod, "The Revenue Consequences of Using Formula Apportionment to Calculate U.S. and Foreign-source Income: A Firm-level Analysis, 5 International Tax and Public Finance, 41(1998), who used 1989-1993

factor apportionment and a single-factor utilizing 2005 -2007 data. The authors note that a similar system was proposed for the EU under the proposed "Common Consolidated Corporate Tax Base." *Id.* at 98.

d. According to François Vincent, in *Global Systematic Profit-Splits (Formulary Apportionment)*, in François Vincent, *TRANSFER PRICING IN CANADA: 2011 Ed.*, Carswell, Toronto (2011), pp. 457-464,<sup>44</sup> "transfer pricing has moved many tax jurisdictions worldwide to a state of taxation by negotiation rather than taxation by legislation," He concludes, ultimately, that "[t]he benefits of having a formula based global profit-split method applicable in all jurisdictions and to all situations, including transfer pricing and the attribution of profits to PEs [permanent establishments], would arguably include substantial savings in compliance and tax administration costs, the elimination of double taxation not by negotiation but by system, guaranteed parity of treatment between branches and subsidiaries and between similarly situated taxpayers, and the elimination of the need for various other international tax regulations such as withholding taxes, foreign tax credits as well as controlled foreign corporations provisions, noting that the rules would no longer be needed "because all of the profits attributable to a given jurisdiction would be taxed on a year-by-year basis in that jurisdiction as a result of the use of the systematic global residential profit-split [and] thus rules meant to deal with the deferral of recognition of income associated with passive income or with the payment in advance of an approximate amount would not longer e necessary in an international context."

e. In Reuben S. Avi-Yonah and Kimberly A. Clausing, "A Proposal to Adopt Formulary Apportionment for Corporate Income Taxation: The Hamilton Project," (March 6, 2012), available at <http://taxblog.com/rsaviyonah/a-proposal-to-adopt-formulary-portionment-for-corporate-income-taxation-the-hamilton-project/>, the authors recommend a single, sales destination factor.

f. Michael J. McIntyre argues in favor of combined reporting with formulary apportionment in "Challenging the Status Quo: The Case for Combined Reporting," 20 Tax Management Transfer Pricing Report, No. 22, pp. 8-9 (March 22, 2012):

If the goal is simply to eliminate double taxation, then the OECD can claim success. That goal, however, is rather unambitious. A far more worthy goal would be to make multinational enterprises report something close to the income they actually earn in each country in which they operate. The OECD's arm's-length approach does not come close to achieving that goal, as is clear from the trillions of dollars that multinational enterprises have deflected to tax havens over

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data. Reuven Avi-Yonah and Kimberly Clausing earlier addressed a destination based single-factor formula in "Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment," in J. Forman & J.E. Bordoff (eds.), *Path to Prosperity: Hamilton Project Ideas on Income Security, Education, and Taxes* (pp. 319-344) (Washington: Brookings Institution Press (2008).

<sup>44</sup> The article is not available online. Extracted portions are available at <http://taxjustice.blogspot.com/2012/06/another-expert-slams-oecd-transfer.html>.



the years. In contrast, a combined reporting system with formulary apportionment is designed specifically to achieve that goal.

g. Lee Sheppard reports on various counties' growing concern with the OECD's transfer pricing initiatives (and some support for formulary apportionment) in her coverage of a seminar in Helsinki on alternatives to transfer pricing hosted by the Tax Justice Network, the government of Finland, and KEPA in 2012 TNT 117-9 News Analysis: Transfer Pricing Rubric Questioned (June 18, 2012).

h. Tax Justice Network's web-page contains a discussion about transfer pricing that includes a section about unitary taxation with formula apportionment as a transfer pricing alternative, available at [http://www.taxjustice.net/cms/front\\_content.php?idcat=139](http://www.taxjustice.net/cms/front_content.php?idcat=139)

i. The contrast between a 1994 article by William J. Wilkins and Kenneth W. Gideon, "Congress: You Wouldn't Like Worldwide Formula Apportionment," republished in the June 11, 2012, issue of Tax Notes Today (2012 TNT 112-19) and an article by Martin Sullivan, "Eaton Migrates to Ireland: Will the U.S. Now Go Territorial?" (2012 TNT 112-2, June 11, 2012) prompted Martin Lobel, chairman of Tax Analysts' Board of Directors, to conclude that Sullivan's article "shows why we need to go to a worldwide formula apportionment of taxes on multinational business, if only to stop discriminating against domestic corporations." 2012 TNT 117-21 Worldwide Apportionment Would Stop Export of Jobs and Profits. (June 13, 2012).

Although the Supreme Court ruled in *Barclays v. FTB*, 512 U.S. 298 (1994), that formulary apportionment was at least as accurate a means of allocating profits as any other, the best argument that Wilkins and Gideon could put forth against it that same year was that it was a "design for disagreement" among taxing countries.

History has proven them wrong. As globalization has raced forward, the ability of multinational corporations to avoid taxes by shifting profits to low- or no-tax countries has increased geometrically. The OECD is actively considering worldwide apportionment as a solution to the increasingly important tax-shifting problem. What form the apportionment will take is open to discussion but the importance of preventing this shifting of income is not. Given the importance of the issue, it would not be all that difficult to negotiate some worldwide apportionment guidelines. It just takes a desire to level the playing field and stop encouraging the export of profits and jobs. Of course that might cost those who voted for it some significant campaign contributions, but the country would be much better off.

• In "Taxing GE and Other Masters of the Universe," 211 TNT 133-6 (June 20, 2011) Calvin H. Johnson discusses a number of solutions to shifting income to tax havens but concludes, "[a]n even simpler solution would be to compute income for the entire multinational corporation on a worldwide, consolidated basis and then allocate the total income among national jurisdictions by sales [citation omitted]. Formulary apportionment has the advantage of not needing to

respect the transactions among wholly owned mailboxes as if they were real transactions. . . . changing to a formulary apportionment system, given our network of treaties with our trading partners would work. A tax on market capitalization would prove faster, more flexible, more efficient and more effective.”

- Papers addressing the European Commission’s 2001 proposed common consolidated tax base include:
  - Thomas A. Gresik, “Separate Accounting v. Formula Apportionment: A Private Information Perspective,” 54 *European Economic Review* (2010), available at <http://ssrn.com/abstract=892786>
  - Peter Muller, “Formula apportionment – Approaches to reduce tax planning incentives” (March 2010), available at <http://ssrn.com/abstract=1730178>
  - Thomas Rixen, “Tax Competition and Inequality – The Case for Global Tax Governance” (Dec. 2010), 17 *Global Governance: A Review of Multilateralism and International Institutions* x, available at <http://ssrn.com/abstract=1488066>
  - Ulrich Schreiber and Gregor Führich, “European Group Taxation – Formula Apportionment versus Current Inclusion,” (Feb. 2007), available at <http://ssrn.com/abstract=964009>
  - Jan Thomas Martini, Rainer Niemann, and Dirk Simons, “Transfer Pricing or Formula Apportionment? Tax Induced Distortions of Multinationals’ Investment and Production Decisions” (June 2007), CESifo Working Paper Series No. 2020, Arqus Quantative Tax Research Discussion Paper No. 27, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=995412](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=995412)
  - Johannes Becker and Clemens Fuest, “Tax Enforcement and Tax Havens under Formula Apportionment” (Sept. 2007), FiFo-CPE discussion Paper No. 07-8, available at <http://ssrn.com/abstract=1016115>.

14. Various studies and papers were released that address tax havens, transfer pricing, and structured finance,

- a. Davis S. Miller, in *Unintended Consequences: How U.S. Tax Law Encourages Investment in Offshore Tax Havens*,<sup>45</sup> NYU School of Law Colloquium on Tax Policy and Public Finance, Spring 2011 addresses transfer pricing;<sup>46</sup> contract manufacturing and commissionaire arrangements;<sup>47</sup> hybrid

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<sup>45</sup> The paper is available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1684716](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1684716).

<sup>46</sup> Transferring assets from high-tax jurisdictions to low-tax jurisdictions.

<sup>47</sup> Treasury regulations describe CFC income that is excluded from Subpart F income, and include income from the sale of personal property manufactured in the CFC’s place of formation (under 2008 regulations, regardless of whose employees do the manufacturing) and from personal property manufactured by the CFC outside its place of formation (under 2008 regulations, if the CFC is “involved in” but not itself “doing” the manufacturing (known respectively as the “same country” and “manufacturing” exceptions. Miller states that these rules “expressly permit a CFC to shift income to a low tax jurisdiction and avoid current U.S. tax

entities;<sup>48</sup> hybrid financial instruments;<sup>49</sup> organizing overcapitalized offshore reinsurance companies issuing low-risk policies to avoid part F current taxation; using a foreign corporation to avoid the limits on itemized deductions; creating foreign taxable mortgage pools in tax havens to avoid REMIC residual interest holders' tax on phantom income (explaining why collateralized debt obligations of mortgage-backed securities were and had to be organized as foreign corporations); a private equity funds' using an Irish "section 110 company" to avoid realizing cancellation of debt income when purchasing the discounted debt of its wholly-owned portfolio company; using reductions of foreign company earning and profits to obtain otherwise unallowed deductions, to avoid limits on interest deductions for loans obtained to purchase or carry life insurance and annuity contracts, and to avoid the rule for applicable high yield discount obligations that interest cannot be deducted until actually paid; to avoid FBAR (Foreign Bank and Financial Accounts Report) reporting; and to enable pension funds, universities, foundations and other tax-exempt entities to avoid UBTI (unrelated business taxable income).

He discusses the use of equity swaps to avoid dividend withholding, and the use of an Irish "section 100 company" or Irish "investment unit trust" that qualifies for the benefits of the U.S.-Irish tax treaty to avoid both U.S. and Irish tax on death benefits paid on a U.S. life.

b. The Policy Institute, issued a report in January 2012 titled *"Tax" is Not a Four-Letter Word: Ideas for a More Progressive Taxation System in Montana*, one part of which, authored by Montana state senator Ron Erickson, addresses tax havens and Montana's water's edge election.<sup>50</sup> He suggests that Singapore

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through a contact manufacturing agreement with a manufacturer in a high-tax jurisdiction," and that they "sanction the use of a tax haven company to reduce U.S. taxes in the name of competitiveness."

The notice listed factors that would be considered in satisfying the "substantial contribution test," including oversight and direction of the activities or process (including management of the risk of loss); performance of activities that are considered in determining whether a purchased product is substantially transformed or the operations on purchased components are substantial; control of the raw materials, work-in-process and finished goods; management of the manufacturing profits; material selection; vendor selection; control of logistics; quality control; and direction of the development, protection, and use of trade secrets, technology, product design and design specifications, and other intellectual property used in manufacturing the product. *Id.*

<sup>48</sup> Entities that are disregarded by some jurisdictions but not others.

<sup>49</sup> Instruments treated as debt by some jurisdictions and as equity in others.

<sup>50</sup> *Tax Not Four-Letter Word*, Pages 15-17. The paper is available at [http://www.thepolicyinstitute.org/prog\\_tax.pdf](http://www.thepolicyinstitute.org/prog_tax.pdf).

and Switzerland should be considered for inclusion in the list of tax haven countries.<sup>51</sup>

c. ActionAid UK,<sup>52</sup> using the GAO “International Taxation: Large U.S. Corporations and Federal Contractors with Subsidiaries in Jurisdictions Listed as Tax Havens or Financial Privacy Jurisdictions,” to which it added the Netherlands and the state of Delaware in the U.S., published an October 2011 report *Addicted to tax havens: The secret life of the FTSE 100*, examining the 100 largest groups listed on the London Stock Exchange. It found that the top tax havens were Delaware in the U.S., the Netherlands, Ireland, Jersey, Hong Kong,<sup>53</sup> the Cayman Islands, Luxembourg, Singapore, Switzerland, and the British Virgin Islands.

d. In November 2011 the Institute on Taxation and Economic Policy and Citizens for Tax Justice issued a report, “Corporate Taxpayers & Corporate Dodgers 2008-2010,” that looked at federal income taxes paid or not paid by 280 of the largest and most profitable American corporations in 2008, 2009, and 2010.<sup>54</sup>

e. The 2008 GAO report, “Large U.S. Corporations and Federal Contractors with Subsidiaries in Jurisdictions Listed as Tax Havens or Financial Privacy Jurisdictions,” GAO-09-157, Dec. 2008, was updated in August 2011 by The Greening Institute<sup>55</sup> in “Corporate America Untaxed -- Tax Avoidance on the Rise.” Key findings included:

- i. U.S. corporations avoided about \$60 billion in United States corporate income taxes by shifting profits to foreign subsidiaries
- ii. the share of the federal budget funded by corporate income taxes dropped significantly since the 1940s (from 28.8% to 10.3%)
- iii. the U.S. collects less in corporate taxes as a share of gross domestic product than 24 out of 26 industrial countries

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<sup>51</sup> Id. at 17.

<sup>52</sup> Actionaid International is an international development organization headquartered in Johannesburg, South Africa. The report is available online at: [http://www.actionaid.org.uk/doc\\_lib/addicted\\_to\\_tax\\_havens.pdf](http://www.actionaid.org.uk/doc_lib/addicted_to_tax_havens.pdf).

<sup>53</sup> The report lists “Hong Kong SAR China” as a tax haven. SAR, as used in the report, is an abbreviation for “special administrative region.”

<sup>54</sup> The paper is available at <http://www.booksindex.eu/free-book/845512/corporate-tax-dodgers-report>. The Institute on Taxation and Economic Policy, or ITEP, is a non-partisan research organization based in Washington D.C. that focuses on federal and state tax policy; Citizens for Tax Justice is a public interest research and advocacy organization based in Washington D.C. that focuses on federal, state and local tax policies and their impact on the United States.

<sup>55</sup> The Greening Institute is a California based national policy, research, organizing and leadership institute working for racial and economic justice.

f. In "Stateless Income," Edward D. Kleinbard addresses stateless income -- "income derived for tax purposes by a multinational group from business activities in a country other than the domicile of the group's ultimate parent company, but which is subject to tax only in a jurisdiction that is not the location of the customer or the factors of production through which the income was derived, and is not the domicile of the group's parent company." 11 Fla. Tax Rev. 699, 701 (2011).<sup>56</sup> "The pervasive presence of stateless income tax planning," he says, "changes everything," *Id.* at 701-701, including "the dissolution of any coherence to the concept of geographic source." *Id.* at 702. He attributes its flourishing to "nations' collective failure to agree on other criminal international tax norms that would determine the 'source' of income -- that is, the mechanical rules by which income is attributed to one jurisdiction or another, based on the perceived economic contribution in that jurisdiction to the generation of that income . . . [reflecting] the fundamental commercial and economic ambiguity surrounding the locus of the value added through the exploitation of intangible assets." *Id.* at 705-706.

g. In "The Lessons of Stateless Income," Edward D. Kleinbard, explores a "territorial tax system with teeth" and a worldwide consolidation system as possible responses to stateless income. 65 Tax Law Rev. 99 (2011).<sup>57</sup>

h. In "Using Financial Accounting Data to Examine the Effect of Foreign Operations Located in Tax Havens and Other Countries on U.S. Multinational Firms' Tax Rates," Scott D. Dyreng and Bradley P. Lindsey examine the effect that tax havens and other foreign jurisdictions have on the tax rates of U.S.-based multinational corporations. 47 *Journal of Accounting Research* 1283 (2009). The countries they used is located in table 1 of their paper and include Andorra, Anguilla, Antigua and Barbuda, Aruba, Bahamas, Bahrain, Barbados, Belize, Bermuda, Botswana, British Virgin Islands, Brunei Darussalam, Cape Verde, Cayman Islands, Cook Islands, Costa Rica, Cyprus, Dominica, Gibraltar, Grenada, Guernsey and Alderney, Ireland, Isle of Man, Jersey, Kitts and Nevis, Latvia, Lebanon, Liberia, Liechtenstein, Luxembourg, Macao, Macau, Maldives, Malta, Marshall Islands, Mauritius, Monaco, Montserrat, Nauru, Netherlands Antilles, Niue, Palau, Panama, Samoa, San Marino, Seychelles, Singapore, St. Lucia, St. Vincent and the Grenadines, Switzerland, U.S. Virgin Islands, Uruguay, and Vanuatu. A jurisdiction was included if it was identified in at least 3 of 4 sources reported at <http://www.globalpolicy.org> on March 4, 2008 (the sources were the OECD, the U.S. Stop Tax Havens Abuse Act, The International Monetary Fund, and the Tax Research Organization). The Global Policy Forum is "an independent policy watchdog that monitors the work of the United Nations and scrutinizes global policymaking."

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<sup>56</sup> The paper is available at Electronic copy available at: <http://ssrn.com/abstract=1791769>.

<sup>57</sup> A copy is available at Electronic copy available at: <http://ssrn.com/abstract=1791783>.

The list of tax havens that Dhammika Dharmapala and James R. Hines, Jr. used in "Which Countries Become Tax Havens?"<sup>58</sup> was also used in a later paper by Mihir A. Desai and Dhammika Dharmapala, "Do Strong Fences Make Strong Neighbors?," Illinois Public Law and Legal Theory Research Papers Series No. 10-22, June 2010.<sup>59</sup> The list of tax havens in both papers<sup>60</sup> was obtained from Appendix A to "Fiscal Paradise: Foreign Tax Havens and American Business," by Hines and E.M. Rice, Quarterly Journal of Economics, 109, p178 (1994),<sup>61</sup> which included 41 countries and territories with a low business tax rate that were identified as a tax haven by the IRS, Beauchamp,<sup>62</sup> or Doggart,<sup>63</sup> and from the 2000 OECD list.<sup>64</sup>

15. Media coverage of "tax havens" continues:

- A New York Times article by Charles Duhigg and David Kocieniewski, "How Apple Sidesteps Billions in Taxes," discusses that company's use of entities in Nevada, Ireland, the Netherlands, Luxembourg and the British Virgin Islands to avoid tax.<sup>65</sup>

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<sup>58</sup> Electronic copy available at: <http://ssrn.com/abstract=952721>.

<sup>59</sup> The paper can be downloaded at <http://papers.ssrn.com/abstract=1651620>.

<sup>60</sup> Andorra, Anguilla, Antigua and Barbuda, Aruba (only in 2000 OECD list), Bahamas, Bahrain, Barbados, Belize, Bermuda, British Virgin Islands, Cayman Islands, Channel Islands, Cook Islands, Cyprus, Dominica, Gibraltar, Grenada, Hong Kong (only in the 1994 Hines and Rice list), Ireland (only in the 1994 Hines and Rice list), Isle of Man, Jordan (only in 2000 OECD list), Lebanon (only in 2000 OECD list), Liberia, Liechtenstein, Luxembourg (only in the 1994 Hines and Rice list), Macao (only in the 1994 Hines and Rice list), Maldives, Malta, Marshall Islands, Mauritius (only in 2000 OECD list), Monaco, Montserrat, Nauru (only in 2000 OECD list), Netherlands Antilles, Niue (only in 2000 OECD list), Panama, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, Samoa (only in 2000 OECD list), San Marino (only in 2000 OECD list), Seychelles (only in 2000 OECD list), Singapore (only in the 1994 Hines and Rice list), Switzerland (only in the 1994 Hines and Rice list), Tonga (only in 2000 OECD list), Turks and Caicos Islands, Vanuatu, Virgin Islands (U.S.) (only in 2000 OECD list).

<sup>61</sup> The paper is available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=236565](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=236565).

<sup>62</sup> A. Beauchamp, Guide Mondial des Paradis Fiscaux, (Paris: Editions Grasset & Fasqualla: 1983)

<sup>63</sup> C. Doggart, Tax Havens and Their Uses, (London: Economist Intelligence Unit, 1983)

<sup>64</sup> 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, OECD 2000, available at <http://www.oecd.org/dataoecd/9/61/2090192.pdf>.

<sup>65</sup> The ambassador to the U.S., Jean-Paul Senninger, related to the Department of Revenue that the article is incorrect with respect to Luxembourg and that the Apple iTunes company was formed in Luxembourg to sell (and collect sales tax for) EU downloads. He stated it was his belief that credit card transactions from the U.S. could not be processed; Director Bucks disagreed, relating to the ambassador that he had recently purchased items from Ireland using a credit card.

- A British BBC television program and related article describe how two UK companies, GlaxoSmithKline and media company Northern & Shell, advised by PricewaterhouseCoopers, negotiated a low tax rate in Luxembourg.
- A CBS "60 Minutes" program examined tax havens on a March 25, 2011. "A look at the world's news corporate tax havens," available at [http://www.cbsnews.com/2100-18560\\_162-20046867.html](http://www.cbsnews.com/2100-18560_162-20046867.html).

16. The IRS is variously attacking abuses of the federal tax system:
- a. The IRS adopted final regulations shutting down corporate reorganization schemes (nicknamed "Killer Bs" and "Deadly Ds") that utilized cross-border reverse triangular reorganizations to repatriate foreign subsidiary earnings tax-free.<sup>66</sup>
  - b. The IRS was unsuccessful in challenging cost-sharing agreements. In December 2011, following its nonacquiescence in *Xilinx, Inc. v. Comm'r*, 598 F.3d 1191 (9<sup>th</sup> Cir. 2010), *aff'g* 125 T.C. 37 (2005) and *Veritas Software Corp. v. Comm'r*, 133 T.C. 297 (2009),<sup>67</sup> the IRS issued final, temporary, and proposed costs-sharing regulations under IRS §482.<sup>68</sup>
  - c. The IRS's was unsuccessful in sourcing to the U.S. guaranty fees made by a U.S. subsidiary to its Mexican parent. The Tax Court rejected the IRS position that the fees were like interest and adopted the taxpayer's position that they were like more like payment for services. *Container Corp. v. Comm'r*, 134 T.C. 122 (2010, *aff'd* 2011 U.S. App. LEXIS 8961 (5<sup>th</sup> Cir. 2011)).
  - d. The IRS was successful in two large dollar transfer-pricing settlements. It settled with GlaxoSmith Kline in 2006 for \$3.4 billion and with Western Union in 2011 for \$1.2 billion.<sup>69</sup>
  - e. The IRS identified transfer pricing as the most "popular" uncertain tax position reported on the first 1900 Schedule UTPs filed (according to IRS Chief Counsel William Wilkins in December 2011 at a George Washington University conference.

<sup>66</sup> Treas. Reg. §§ 1.367(a)-3, 1.367(b)-10, T.D. 9526, IRB 2011-24, 76 F.R. 28890 (May 19, 2011). See also "The Empire Strikes Back (Again) -- Killer Bs, Deadly Ds and Code Sec. 367 As the Death Star Against Repatriation Rebels," 34 International Tax. Journal 37 (May-June 2008), a copy of which can be downloaded [http://www.skadden.com/content/Publications/Publications1406\\_0.pdf](http://www.skadden.com/content/Publications/Publications1406_0.pdf).

<sup>67</sup> Action on Dec. 2010-33 and Action on Dec. 2010-49, respectively. In *Xilinx* the court determined that the cost-sharing participants did not have to include the value of stock options granted to the participants' employees in the pooled costs to be shared under regulations in effect 1997 to 1999. In *Veritas* the court rejected the IRS determination that the payment an Irish affiliate paid to the U.S. party for its pre-existing intangibles was too low.

<sup>68</sup> Final regulation, T.D. 9568, 76 FR 80082; temporary regulations, T.D. 9569, 76 FR 80249; and proposed regulations REG-145474-11, FR doc. 2011-32730.

<sup>69</sup> The issue is *Glaxo* was whether profits from the U.S. sale of its drugs (Zantac) were principally derived from U.S. marketing and distribution or from UK research and development.

f. The IRS has made a variety of changes to attempt to be more effective in the international tax arena:<sup>70</sup> Its large corporation unit, the “Large and Medium Sized Business Division (LMSB) was changed in October 2010 to the “Large Business and International Division” (LB & I) and plans were announced to more than double the staff, including economists, technical staff, and auditors specializing in international issues. The new international unit included a transfer-pricing director<sup>71</sup> and a chief economist to oversee IRS economic positions taken on transfer pricing. The division was also assigned responsible for FATCA implementation. In May 2012, the IRS announced it was replacing its tiered issue program with an “international practice network.” In July 2011, the IRS announced that the advance pricing agreement program and the mutual agreement program would move from the Office of Chief Counsel to an office under the transfer-pricing director. The 60 person transfer pricing staff is expected to be hired by the end of this summer.

g. The IRS and other countries are undertaking joint audits: As we envision it, the joint audit will be more sensible and efficient for the participating business because the business will not have the burden of two exam teams conducting two audits, and it will make sure both countries receive the same information and presentations from the taxpayer. If fully realized, the joint audit could have the potential of both boosting international tax compliance and improving service. In theory, if all the parties were in the same room, two or more tax authorities would hear the same facts, agree on the issues more quickly, jointly characterize a transaction, and agree on a treatment. It could reduce taxpayer burden – especially for large multinational corporations that must face audits in multiple jurisdictions on the same set of transactions.

Prepared remarks of IRS Commissioner Doug Shulman before the 23rd Annual Institute On Current Issues in International Taxation, Washington, D.C., IR-2010-122, Dec. 9, 2010.

h. On July 13, 2012, the IRS announced that it will be adopting regulations to prevent attempts to repatriate foreign earnings without recognizing income.

The IRS and the Treasury Department are aware that certain taxpayers are engaging in transactions intended to repatriate earnings from foreign corporations without the appropriate recognition of income. In one such transaction, USP, a domestic corporation, owns 100 percent of the stock of UST, a domestic corporation. USP's basis in its UST stock equals its value of \$100x. UST's sole asset is a patent with a tax basis of zero. UST has no liabilities. USP also owns 100 percent of the stock of TFC, a foreign corporation. UST transfers the patent to TFC in exchange for \$100x of cash and, in connection with the transfer, UST distributes the \$100x of cash to USP and liquidates.

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<sup>70</sup> In a 2008, audit the Treasury Inspector General for Tax Administration (TIGTA) questioned the ability of LMSB to cope with growing transfer pricing and other international tax compliance risks. 2008-30-114 (May 30, 2008).

<sup>71</sup> Samuel Maruca was named director in May, 2011.



The taxpayer takes the position that neither USP nor UST recognizes gain or dividend income on the receipt of the \$100x of cash. USP then applies the section 367(d) regulations to include amounts in gross income under §1.367(d)-1T(c)(1) in subsequent years. USP also applies the 367(d) regulations to establish a receivable from TFC in the amount of USP's aggregate income inclusion. USP takes the position that TFC's repayment of the receivable does not give rise to income (notwithstanding the prior receipt of \$100x in connection with the reorganization). Accordingly, under these positions, the transactions have resulted in a repatriation in excess of \$100x (\$100x at the time of the reorganization and then through repayment of the receivable in the amount of USP's income inclusions over time) while only recognizing income in the amount of the inclusions over time.

The IRS and the Treasury Department understand that other transactions may be structured to have the same or similar effect, including, for example, transactions that involve TFC's assumption of liabilities of UST. Similar results may also be achieved in cases in which a controlled foreign corporation uses deferred earnings to fund an acquisition of all or part of the stock of a domestic corporation from an unrelated party for cash, followed by an outbound asset reorganization of the domestic corporation to avoid an income inclusion under section 956. The IRS and the Treasury Department believe that these transactions raise significant policy concerns, and accordingly, intend to revise the regulations under section 367(d) in the manner described in this notice.

Notice 2012-39, 2012-31-IRB 1 (July 13, 2012).

17. As noted in the Department's 2010 tax haven report, the OECD stopped identifying countries as "tax havens"<sup>72</sup> in favor of encouraging countries to adopt a universally agreed standard for transparency and exchange of information for tax purposes through the framework of the global forum.<sup>73</sup> Two-part peer reviews are

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<sup>72</sup> The history of that change is discussed by Martin Sullivan in "Lessons From the Last War on Tax Havens, Tax Notes, July 30, 2007, P. 327), which is also reprinted in Mr. Sullivan's "Tax Analysts' Briefing Book, 2008 Presidential Election, Potential Issues, Background Articles, Multinational Corporations, Individual Tax Evasion & Offshore Tax Havens," pp. 70 – 73..

<sup>73</sup> The Global Forum on Transparency and Exchange of Information for Tax Purposes. The forum derived from the G20's leaders' 2008 call for countries to adopt transparency and tax information exchanges. Information on the forum's website states that in 2009 it became a "consensus-based organization in which all members are on equal footing."

In June 2010, Lee Sheppard wrote scathingly of the forum in an article for Tax Analysts, reviewing *Treasure Islands: Uncovering the Damage of Offshore Banking and Tax Havens* (Palgrave Macmillan, 2011), a book by Nicholas Shaxson. 2011 TNT 113-1 NEWS ANALYSIS: A TAX HAVEN BY ANY OTHER NAME. (Release Date: JUNE 08, 2011) (Doc 2011-12283):

"International financial centers." That's Orwellian Newspeak for tax havens. . . .

We mustn't call them tax havens, according to the OECD Centre for Tax Policy and Administration, because they're pretending to cooperate with information-sharing

conducted under the global forum, with a country's legal and regulatory framework examined under phase 1, and the actual implementation of the standard examined under phase 2. The forum produced a report that was presented at the November 2011 G20 summit in Cannes, France, "Tax Transparency 2011: Report on Progress."<sup>74</sup>

As noted in the Department's 2010 report, the Department does not recommend that countries that agree to the standard be removed from the list of countries in § 15-31-322, MCA. To the extent even a fully compliant, transparent jurisdiction establishes itself as a no- or low-tax place where a multinational corporation can park its cash or situs intangible assets, the "place" where income is earned will be artificially distorted and a Montana tax, based on its proportionate share of the unitary entity's income, will be understated.

18. The OECD announced a new tax avoidance project at the June 2012 G20 summit in Los Cabos, Mexico initiated to "tackle the issue of tax base erosion and profit shifting by some multinational firms,"<sup>75</sup> but it is limited to addressing transfer-pricing abuses.<sup>76</sup> The OECD and the Financial Action Task Force (FATF)<sup>77</sup> had been working on the use of entities by criminals for money laundering.

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initiatives via the Global Transparency Forum, a mini-United Nations of tax administrators that is about as efficient as the real U.N.

The forum recently met in Bermuda, an international financial center with no income tax and light insurance regulation. What is going on? Since the failure of its much-criticized harmful tax competition initiative a decade ago, the OECD has attempted to treat tax havens as equals and enter into constructive discussion with them.

This is ridiculous. There is no such thing as a constructive discussion with any government the very existence of which is predicated on an escape hatch from developed-country taxation and financial regulation.

<sup>74</sup> The report is available online at: <http://www.oecd.org/dataoecd/52/35/48981620.pdf>.

<sup>75</sup> The announcement was included in OECD Secretary-General Gurría's supplemental report "Tackling Offshore Tax Evasion, The G20/OECD Continued to Make Progress" (June 2012), available at <http://www.oecd.org/dataoecd/19/9/50630916.pdf>. The supplemental report principally deals with the OECD's proposal for a uniform method of automatic information exchange. The report the OECD report is "supplementing" is the progress report of the Global Forum on Transparency and Exchange of Information for Tax Purposes prepared for the Los Cabos G20 summit. That report describes progress on peer reviews and information exchange agreements, noting that Lithuania, Latvia, and Tunisia had joined, bringing membership to 109. It is available at <http://www.oecd.org/dataoecd/19/8/50630814.pdf>.

<sup>76</sup> As noted previously, Lee Sheppard criticized the OECD's efforts in Tax Analysts' article, 2012 TNT 117-9 News Analysis: Transfer Pricing Rubric Questioned (June 18, 2012).

<sup>77</sup> FATF is an inter-governmental body established in 1989 by a Group of Seven (G-7) summit in Paris to combat money laundering. It has 34 member jurisdictions, including the U.S., and 2 regional organizations (the European Commission and the Gulf Co-operation Council), including the U.S., which represent most world financial centers.

19. On May 16, 2012 President Obama recommended that the Senate ratify a 2010 protocol amending the international tax sharing convention<sup>78</sup> to conform to the U.S. Model Income Tax Convention<sup>79</sup> and the OECD Model Tax Convention on Income and Capital. Interest on deposits of foreign corporations and foreign branches of domestic corporations and dividends from foreign corporations are not sourced to the U.S. unless they are “effectively connected “ with the conduct of a trade or business in the U.S. For those countries with which the U.S. has entered into a bilateral treaty, however, the OECD concept of “permanent establishment” applies -- (1) nonresidents are not subject to U.S. tax on their business profits unless they have a “permanent establishment” in the U.S, and (2) nonresidents get preferential withholding tax rates on dividends, interest and royalties only when the income is not attributable to a permanent establishment the recipient has in the U.S.

20. The Netherlands Antilles dissolved on October 10, 2010.<sup>80</sup> It had consisted of three islands and part of a fourth -- Curaçao (the main island with its numerous mailbox companies), and Bonaire, St. Eustatius, Saba, and Sint Maarten, the south part of Saint Martin. Curacao and Sint Maarten remained autonomous territories of the Kingdom of the Netherlands. Bonaire, St. Eustatius and Saba became special Dutch municipalities, but they have their own tax structure that enables foreign companies to pay virtually no tax and encourages financial entities to locate assets there, giving them a 1% tax rate on their assets if they employ 3 people and have commercial property of at least \$50,000.

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<sup>78</sup> The United States signed the PROTOCOL AMENDING THE CONVENTION ON MUTUAL ADMINISTRATIVE ASSISTANCE IN TAX MATTERS in Paris on May 27, 2010. It amends the January 25, 1988 Strasbourg CONVENTION ON MUTUAL ADMINISTRATIVE ASSISTANCE IN TAX MATTERS entered into force for the U.S. on January 4, 1995. It was opened for signature on May 27, 2010 and the other countries that signed that date were Denmark, Finland, France, Iceland, Italy, Korea (R.O.K.), Mexico, Netherlands, Norway, Portugal, Slovenia, Sweden, Ukraine, and United Kingdom. It was later signed by Poland (July 9, 2010), Georgia (November 3, 2010), Moldova (January 27, 2011), Spain (March 11, 2011), Canada and Japan (November 4, 2011), and India (January 26, 2012).

<sup>79</sup> The model is used by the Department of Treasury as a starting point in bilateral treaty negotiations with other countries. It includes a provision for eliminating double taxation (by credit or income exclusion) and provisions for dual residency issues.

<sup>80</sup> The history of the Netherland Antilles is described in “Change, Dependency, and Regime Plasticity in Offshore Financial Intermediation: The Saga of the Netherlands Antilles,” by Craig Boise and Andrew Morriss, Illinois Law and Economic Research Papers Series Research Paper No. LE-08-020, 45 Texas International Law Journal 377 (2009), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1368489](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1368489). Professor Boise also addressed tax shifting in “Regulating Tax Competition in Offshore Financial Centers,” in Offshore Financial Centers and Regulatory Competition (Andrew P. Morriss, ed., 2010), Case Legal Studies Research Paper No. 08-26, (2008), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1266329](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1266329).

21. By letter dated April 30, 2012 to Director Dan Bucks, the U.S. Ambassador of Luxembourg requested that legislation be enacted removing it from the list of tax havens, asserting it now meets OECD tax standards for sharing tax information.<sup>81</sup> The Ambassador, Jean Paul Senninger, spoke by telephone with Director Bucks and staff, on June 14, 2012. During the phone call, the ambassador related that he believed the Montana list of included tax haven countries in § 15-31-322(1)(f), MCA, was either too long (if facilitating pure shell companies was the criteria, because his country required at least some activity) or too short (because not all financial centers were included). Director Bucks explained the worldwide unitary apportionment system used by Montana and related that the list was included to prevent large departures from Montana's system of proportional taxation.

As noted in the 2010 tax haven report, the OECD is now focusing exclusively on information exchange and, for reasons stated in that report and in this report, the fact that countries have agreed to enter into information exchange agreements, or that they have entered into the agreements, should not be a basis for removing any jurisdiction from the list of jurisdictions that must be included when a water's edge election is made.<sup>82</sup>

The jurisdictions that are not currently included in the Montana water's edge tax haven list but which are included in many tax haven lists (and compete with Luxembourg) are commonly known as "financial centers." They include Hong Kong, Ireland, the Netherlands, Singapore, and Switzerland. The Department agrees with Ambassador Senninger that the list is too short and that it should include these additional financial centers.

### **Recommendations for Tax Haven Updates**

1. The 2010 report recommended adding the Netherlands and Ireland to the list of tax havens and to expand the scope of entities included to corporations treated as headquartered or managed in tax havens (currently only corporations incorporated in tax havens are included).<sup>83</sup> As described and quantified above, disproportionate income is diverted to these countries and they should be added to the list of countries in § 15-

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<sup>81</sup> Luxembourg committed to implement international standards of transparency and exchange of information in March of 2009 (Article 26 of the 2004 OECD Model Tax Convention with respect to Taxes on Income and on Capital requires contracting states to "exchange such information as is foreseeably relevant, including bank and fiduciary information)."

As of May 8, 2012, the OECD reflected that Luxembourg had entered into 69 tax sharing agreement, 20 of which met its standards, 46 of which did not, and 3 of which were unreviewed (see <http://www.eoi-tax.org/jurisdictions/LU#agreements>).

<sup>82</sup> See Interim Developments, ¶17.

<sup>83</sup> Memorandum to Dan R. Bucks from Brenda J. Gilmer, dated November 10, 2010, included in materials in the Revenue and Transportation Interim Committee for November 19, 2010.

31-322(1)(f), MCA. In addition, because the Netherlands Antilles was dissolved in 2010, unless its removal from the list is paired with the addition of the Kingdom of the Netherlands or at a minimum the four jurisdictions that formerly comprised the Netherlands Antilles, these Dutch income shifts will cause future, continuing erosion to Montana's tax base.

2. The following countries should also be added:  
Hong Kong  
Switzerland  
Singapore

As described and quantified above, each of these jurisdictions actively competes with other financial centers already included in the list and disproportionate income is diverted to them. Each is also included in most contemporary lists of tax havens.<sup>84</sup>

3. Amend § 15-31-322(2), MCA, to replace "countries" with the more accurate "jurisdictions."

The following proposed amendment to § 15-31-322, MCA, incorporates these recommendations:

**15-31-322. Water's-edge election -- inclusion of tax havens. (1)**

Notwithstanding any other provisions of law, a taxpayer subject to the taxes imposed under this chapter may apportion its income under this section. A return under a water's-edge election must include the income and apportionment factors of the following affiliated corporations only:

(a) a corporation incorporated in the United States in a unitary relationship with the taxpayer and eligible to be included in a federal consolidated return as described in 26 U.S.C. 1501 through 1505 that has more than 20% of its payroll and property assignable to locations inside the United States. For purposes of determining eligibility for inclusion in a federal consolidated return under this subsection (1)(a), the 80% stock ownership requirements of 26 U.S.C. 1504 must be reduced to ownership of over 50% of the voting stock directly or indirectly owned or controlled by an includable corporation.

(b) domestic international sales corporations, as described in 26 U.S.C. 991 through 994, and foreign sales corporations, as described in 26 U.S.C. 921 through 927;

(c) export trade corporations, as described in 26 U.S.C. 970 and 971;

(d) foreign corporations deriving gain or loss from disposition of a United States real property interest to the extent recognized under 26 U.S.C. 897 ;

(e) a corporation incorporated outside the United States if over 50% of its voting stock is owned directly or indirectly by the taxpayer and if more than 20% of the average of its payroll and property is assignable to a location inside the United States; or

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<sup>84</sup> See attached Addendum A. Most of the information in the addendum was also included in the 2010 tax haven report at Exhibit A. Addendum B is attached to reflect all jurisdictions for purposes of comparison.

(f) a corporation that is in a unitary relationship with the taxpayer and that is incorporated in a tax haven, including 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, Hong Kong, Ireland, Isle of Man, Jersey, Liberia, Liechtenstein, Luxembourg, Malta, Marshall Islands, Mauritius, Monaco, Montserrat, Nauru, the Kingdom of the Netherlands-Antilles, Niue, Panama, Samoa, San Marino, Seychelles, Singapore, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Switzerland, Turks and Caicos Islands, U.S. Virgin Islands, and Vanuatu.

MEMORANDUM – JULY 16, 2012  
CORPORATION TAX WATER'S EDGE ELECTION – TAX HAVEN JURISDICTIONS

ADDENDUM A – TAX HAVEN LISTS

Jurisdiction	OECD <sup>1</sup>	NBER <sup>2</sup>	IRS "JOHN DOE" <sup>3</sup> SUMMONS	FINANCIAL STABILITY FORUM <sup>4</sup>	TAX JUSTICE NETWORK <sup>5</sup>	15-31-322, MCA (2009)
Andorra	X <sup>a</sup>	X		X	X	X
Anguilla	X	X	X	X	X	X
Antigua and Barbuda	X	X	X <sup>b</sup>	X	X	X
Aruba	X		X <sup>b</sup>	X	X	X
Bahamas	X	X	X <sup>b</sup>	X	X	X
Bahrain	X	X		X	X	X
Barbados	≠	X	X <sup>b</sup>	X	X	X
Belgium	□				X	
Belize	X	X	X	X	X	X
Bermuda	X	X	X <sup>b, c</sup>	X	X	X
British Virgin Islands	X	X	X <sup>d</sup>	X	X	X
Cayman Islands	X	X	X <sup>b</sup>	X	X	X
Cook Islands	X	X	X	X	X	X
Costa Rica			X <sup>b</sup>	X	X	
Cyprus	X	X	X <sup>c</sup>	X	X	X
Dominica	X	X	X <sup>b</sup>	X	X	X
Dubai					X	
Gibraltar	X	X	X	X	X	X
Grenada	X	X	X <sup>b</sup>	X	X	X
Guernsey	X	X <sup>d</sup>	X <sup>b, e</sup>	X	X	X
<b>Hong Kong</b>		X	X	X	X	
Hungary	□				X	
Iceland	□				X	
<b>Ireland</b>	□	X		X	X	
Isle of Man	X	X	X <sup>b</sup>			X
Jersey	X	X <sup>d</sup>	X <sup>b</sup>	X	X	X
Jordan		X				
Latvia			X <sup>c</sup>			
Lebanon		X		X	X	
Liberia	X	X			X	X
Liechtenstein	X <sup>a</sup>	X	X	X	X	X
Luxembourg	□	X	X <sup>c</sup>	X	X	X

<sup>1</sup> OECD 2000. The symbol □ denotes an OECD member country identified in 2000 as having a potentially harmful preferential tax regime. The symbol ≠ denotes a country subsequently determined not to meet the definition of "tax haven."

<sup>2</sup> National Bureau of Economic Research 2006 working paper.

<sup>3</sup> The United States filed an ex parte petition for leave to serve a "John Doe" summons on PayPal, Inc. and its affiliates and subsidiaries in the U.S. District Court for the Northern District of California on October 14, 2005, and the court issued an order granting the leave in February 2006 (In the Matter of Tax Liabilities of John Does, et al., No. 5:05-cv-04167-JW (N.D. Cal. 2006). The petition was supported by a declaration of an IRS revenue agent who stated that the 34 jurisdictions were "all recognized as principal offshore tax haven or financial privacy jurisdictions by industry analysts and are actively marketed as such by promoters of offshore schemes."

<sup>4</sup> 2000 list of the Financial Stability Forum.

<sup>5</sup> 2005 list of the Tax Justice Network.

Macao		X		X	X	
Maldives		X			X	
Malta	X	X	X	X	X	X
Marshall Islands	X	X		X	X	X
Mauritius	X			X	X	X
Monaco	X <sup>a</sup>	X		X	X	X
Montserrat	X	X		X	X	X
Nauru	X		X	X	X	X
<b>Netherlands</b>	□				X	
Netherlands Antilles	X	X	X <sup>b</sup>	X	X	X
Niue	X			X	X	X
Northern Mariana					X	
Palau				X		
Panama	X	X	X	X	X	X
Samoa	X		X	X	X	X
San Marino	X					X
São Tomé e Príncipe					X	
Seychelles	X			X	X	X
<b>Singapore</b>		X	X	X	X	
Somalia					X	
South Africa					X	
St. Kitts and Nevis	X	X	X	X	X	X
St. Lucia	X	X	X <sup>f</sup>	X	X	X
St. Vincent and the Grenadines	X	X	X	X	X	X
<b>Switzerland</b>	□	X	X <sup>c</sup>	X	X	
Tonga	≠				X	
Turkish Rep. of					X	
Turks and Caicos	X	X	X	X	X	X
Uruguay					X	
U.S. Virgin Islands	X				X	X
Vanuatu	X	X	X	X	X	X

<sup>a</sup> This was used in GAO-09-157, U.S. Corporations with Foreign Subsidiaries, pages 12-13 to denote countries identified as "uncooperative tax havens" (contrasted with "committed jurisdictions").

<sup>b</sup> This was used in GAO-09-157 to denote when a Tax Information Exchange Agreement (TIEA) was in force between the United States and this jurisdiction.

<sup>c</sup> This was used in GAO-09-157 to denote that a double tax treaty was in force with an exchange of information provision.

<sup>d</sup> This was used in GAO-09-157 to explain that "NBER's list included the Channel Islands. Jersey and Guernsey are part of the Channel Islands. The two other sources we used to identify tax havens listed Jersey and Guernsey as two separate tax havens and did not include the Channel Islands on their lists of tax havens. To be consistent, we are including Jersey and Guernsey as tax havens on the bureau's list rather than the Channel Islands."

<sup>e</sup> This was used in GAO-09-157 to explain that "[t]he John Doe summons lists Guernsey/Sark/Alderney. OECD only included Guernsey. Since Sark and Alderney are part of the Bailiwick of Guernsey, to be consistent, we are only including Guernsey on our list of tax havens.

<sup>f</sup> This was used in GAO-09-157 to explain that "[t]he TIEA signed by the United States and St. Lucia on January 30, 1987, is not in effect within the meaning of section 274(h)(6)(A)(i) of the Internal Revenue Code because the government of St. Lucia has not enacted legislation to implement the agreement.



MEMORANDUM – JULY 16, 2012  
CORPORATION TAX WATER'S EDGE ELECTION – TAX HAVEN JURISDICTIONS

ADDENDUM B – WORLD JURISDICTIONS

Afghanistan	Cape Verde	French Southern and
Akrotiri	<b>Cayman Islands</b>	Antarctic Lands
Albania	Central African Republic	Gabon
Algeria	Chad	Gambia, The
American Samoa	Chile	Gaza Strip
<b>Andorra</b>	China	Georgia
Angola	Christmas Island	Germany
<b>Anguilla</b>	Clipperton Island	Ghana
Antarctica	Cocos (Keeling) Islands	<b>Gibraltar</b>
<b>Antigua and Barbuda</b>	Colombia	Glorioso Islands
Argentina	Comoros	Greece
Armenia	Congo, Democratic Republic	Greenland
<b>Aruba</b>	of the	<b>Grenada</b>
Ashmore and Cartier Islands	Congo, Republic of the	Guadeloupe
Australia	<b>Cook Islands</b>	Guam
Austria	Coral Sea Islands	Guatemala
Azerbaijan	Costa Rica	<b>Guernsey</b>
<b>Bahamas, The</b>	Cote d'Ivoire	Guinea
<b>Bahrain</b>	Croatia	Guinea-Bissau
Bangladesh	Cuba	Guyana
<b>Barbados</b>	<b>Curaçao<sup>1</sup></b>	Haiti
Bassas da India	<b>Cyprus</b>	Heard Island and McDonald
Belarus	Czech Republic	Islands
Belgium	Denmark	Holy See (Vatican City)
<b>Belize</b>	Dhekelia	Honduras
Benin	Djibouti	Hong Kong
<b>Bermuda</b>	<b>Dominica</b>	Hungary
Bhutan	Dominican Republic	Iceland
Bolivia	Ecuador	India
Bosnia and Herzegovina	Egypt	Indonesia
Botswana	El Salvador	Iran
Bouvet Island	Equatorial Guinea	Iraq
Brazil	Eritrea	Ireland
British Indian Ocean	Estonia	<b>Isle of Man</b>
Territory	Ethiopia	Israel
<b>British Virgin Islands</b>	Europa Island	Italy
Brunei	Falkland Islands (Islas	Jamaica
Bulgaria	Malvinas)	Jan Mayen
Burkina Faso	Faroe Islands	Japan
Burma	Fiji	<b>Jersey</b>
Burundi	Finland	Jordan
Cambodia	France	Juan de Nova Island
Cameroon	French Guiana	Kazakhstan
Canada	French Polynesia	Kenya

Kiribati  
Korea, North  
Korea, South  
Kuwait  
Kyrgyzstan  
Laos  
Latvia  
Lebanon  
Lesotho  
**Liberia**  
Libya  
**Liechtenstein**  
Lithuania  
**Luxembourg**  
Macau  
Macedonia  
Madagascar  
Malawi  
Malaysia  
Maldives  
Mali  
**Malta**  
**Marshall Islands**  
Martinique  
Mauritania  
**Mauritius**  
Mayotte  
Mexico  
Micronesia, Federated  
States of  
Moldova  
**Monaco**  
Mongolia  
**Montserrat**  
Morocco  
Mozambique  
Namibia  
**Nauru**  
Navassa Island  
Nepal  
Netherlands  
**Netherlands, Caribbean<sup>ii</sup>**  
New Caledonia  
New Zealand  
Nicaragua  
Niger

Nigeria  
**Niue**  
Norfolk Island  
Northern Mariana Islands  
Norway  
Oman  
Pakistan  
Palau  
**Panama**  
Papua New Guinea  
Paracel Islands  
Paraguay  
Peru  
Philippines  
Pitcairn Islands  
Poland  
Portugal  
Puerto Rico  
Qatar  
Reunion  
Romania  
Russia  
Rwanda  
Saint Helena  
**Saint Kitts and Nevis**  
**Saint Lucia**  
**St. Maarten<sup>iii</sup>**  
Saint Pierre and Miquelon  
**Saint Vincent and the  
Grenadines**  
**Samoa**  
**San Marino**  
Sao Tome and Principe  
Saudi Arabia  
Senegal  
Serbia and Montenegro  
**Seychelles**  
Sierra Leone  
Singapore  
Slovakia  
Slovenia  
Solomon Islands  
Somalia  
South Africa

South Georgia and the  
South Sandwich Islands  
Spain  
Spratly Islands  
Sri Lanka  
Sudan  
Suriname  
Svalbard  
Swaziland  
Sweden  
Switzerland  
Syria  
Taiwan  
Tajikistan  
Tanzania  
Thailand  
Timor-Leste  
Togo  
Tokelau  
Tonga  
Trinidad and Tobago  
Tromelin Island  
Tunisia  
Turkey  
Turkmenistan  
**Turks and Caicos Islands**  
Tuvalu  
Uganda  
Ukraine  
United Arab Emirates  
United Kingdom  
United States  
Uruguay  
**U.S. Virgin Islands**  
Uzbekistan  
**Vanuatu**  
Venezuela  
Vietnam  
Wake Island  
Wallis and Futuna  
West Bank  
Western Sahara  
Yemen  
Zambia  
Zimbabwe

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<sup>i</sup> When Netherland Antilles was dissolved, Curaçao became an autonomous country that is a part of the Kingdom of the Netherlands.

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<sup>i</sup> When Netherlands Antilles was dissolved, Curaçao and St. Maarten became autonomous countries within the Kingdom of the Netherlands. The remaining Netherlands Antilles jurisdictions (Bonaire, St. Eustatius, and Saba) became special municipalities of the Netherlands, and are known as the "Caribbean Netherlands."

<sup>iii</sup> When Netherland Antilles was dissolved, St. Maarten became an autonomous country that is a part of the Kingdom of the Netherlands.