Montana Department of Revenue

Mike Kadas
Director

Steve Bullock
Governor

Memorandum

To: Revenue and Transportation Interim Committee

From: Mike Kadas, Director MK

Date: May 24, 2016

Subject: Corporate Income Tax Water's Edge Election - Tax Haven Country Update

Each biennium, the Department of Revenue (department) is required pursuant to § 15-31-322, MCA, to provide the Revenue and Transportation Interim Committee (RTIC) with an update of the countries that may be considered as tax havens. This memorandum is the department's response to this requirement. This memorandum also provides background information on how C corporations are taxed in Montana.

WORLD-WIDE COMBINED REPORTING

Properly taxing a corporation doing business in Montana and in other states and/or countries is a more complicated process than for those corporations whose only activities are in this state. For a multi-state or multi-national business with sufficient ties to Montana, Montana employs world-wide combined reporting. Montana's ability to utilize this method of reporting and ultimately apportion worldwide income and tax Montana's share is based upon the unitary business principle. For example, if a Montana taxpayer (ABC Corp.) is in a unitary business relationship with DEG Corp. (Delaware) and XYZ Corp. (Canada), then ABC will file a combined report with the Department reflecting its activities in Montana, Delaware, and Canada.

ABC's apportionable business income (or loss) is subject to an equally weighted three-factor formula consisting of property, payroll, and sales. The amount of ABC's business income attributable (or, apportioned) to Montana is calculated after considering the percentage of its property, payroll, and sales occurring in Montana versus the percentage of its activities occurring everywhere else. The apportionment formula for ABC and other multi-state/multi-national corporations, therefore, looks like this:

STEP 1: Determine Montana portion:

$$\frac{\text{ABC's Montana Property}}{\text{ABC's Total Property}} + \frac{\text{ABC's Montana Payroll}}{\text{ABC's Total Payroll}} + \frac{\text{ABC's Montana Sales}}{\text{ABC's Total Sales}}$$

STEP 2: Determine Montana factor:

ABC's Montana portion ÷ 3 = Montana factor

STEP 3: Determine business income apportioned to Montana:

ABC's Montana factor × ABC's total business income = Montana taxable income

WATER'S EDGE

In 1987, the Legislature amended the corporation license tax statutes to permit multi-national corporations to make a "water's edge" election. This election allows the exclusion from the Montana combined report any income or loss generated outside of the United States. A water's edge election is prospective in nature and lasts for a three-year renewable period. For taxpayers making this election, their respective tax rate increases from 6.75% to 7.00%.

For ABC, a water's edge election would exclude the income/loss generated by XYZ's Canadian activities. ABC's combined return in Montana, therefore, would only apportion the income or loss attributable to the activities occurring in Montana and Delaware. At the conclusion of its three-year period, ABC has the opportunity to again decide whether to elect the water's edge election for the next three years.

TAX HAVENS

What is a tax haven?

In 2003, the Legislature added the tax haven provision (subsection (f)) to § 15-31-322(1), MCA. Essentially, this provision requires the inclusion of unitary subsidiaries that are incorporated in the countries identified in the statute. The following is the list of countries designated as a tax haven in the statute.

> 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.

In our example, let's assume that LMN Corp. is also a member of ABC's unitary group and that it is incorporated in the Cayman Islands. ABC's water's edge election will continue to exclude from its Montana combined return the activities of XYZ because Canada is not among the countries listed as a tax haven in the statute. But, because the Cayman Islands are among those countries listed in the statute, ABC's water's edge election does not exclude those activities. As a result, ABC's corporate income tax return will include LMN's income/loss and apportionment factors in ABC's Montana tax return.

How does a country get identified as a tax haven?

The following five criteria were adopted by the Multistate Tax Commission which is the basic criteria that the department used to determine if any countries should be removed or added to the statute.

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

> **(i)** has laws or practices that prevent effective exchange of information for tax purposes with other governments on taxpayers benefiting from the tax regime;
>
> **(ii)** has tax regime which lacks transparency. A tax regime lacks transparency if the details of legislative, legal or administrative provisions are not open and apparent or are not consistently applied among similarly situated taxpayers, or if the information needed by tax authorities to determine a taxpayer's correct tax liability, such as accounting records and underlying documentation, is not adequately available;
>
> **(iii)** facilitates the establishment of foreign-owned entities without the need for a local substantive presence or prohibits these entities from having any commercial impact on the local economy;
>
> **(iv)** explicitly or implicitly excludes the jurisdiction's resident taxpayers from taking advantage of the tax regime's benefits or prohibits enterprises that benefit from the regime from operating in the jurisdiction's domestic market; or
>
> **(v)** has created a tax regime which is favorable for tax avoidance, based upon an overall assessment of relevant factors, including whether the jurisdiction has a significant untaxed offshore financial/other services sector relative to its overall economy.

Based generally on the above criteria and review of what other jurisdictions are finding the department recommends the following changes to the statutory list of tax havens:

1) Remove the Netherlands Antilles from the list as the jurisdiction was dissolved in 2010.
2) Remove Monaco from the list as the Department could not identify a substantial corporate tax advantage to shift income into Monaco.

3) Add The Kingdom of the Netherlands. The research conducted by the department identified an advantageous tax system that would reward tax shifting. Three jurisdictions Bonaire, Saba, and Sint Eustatius have a tax system that is based on the fair market value of real estate. The Netherlands has a minimal tax of 5% of profits derived from intellectual property.
4) Add Singapore. The research conducted by the department identified an advantageous tax system that would reward tax shifting.
5) Add Trinidad and Tobago. The research conducted by the department identified an advantageous tax system that would reward tax shifting.
6) Add Guatemala. The research conducted by the department identified an advantageous tax system that would reward tax shifting.
7) Add Hong Kong. The research conducted by the department identified an advantageous tax system that would reward tax shifting.
8) Add Switzerland. The research conducted by the department identified an advantageous tax system that would reward tax shifting.

For the most part, all of the additional countries identified above have a different tax system for domestic (resident) versus non-domestic (non-resident) companies. Most hold non-domestic income tax exempt, making them very attractive for income shifting.

Other States Tax Haven Lists

Recently other states have adopted or considered adopting tax haven lists that are virtually identical to Montana's list. In August 2013, Oregon's legislature passed tax haven legislation that provides for a list almost identical to Montana's list of tax haven countries. The other states that have a provision to include tax havens by specific criteria are Alaska, Connecticut, District of Columbia, Rhode Island and West Virginia.

Eleven additional states considered tax haven legislation in 2015, Alabama, Colorado, Florida, Kentucky, Illinois, Louisiana, Maine, Massachusetts, New Hampshire, New Jersey and Pennsylvania. Nine of these eleven states included specific lists of countries in their proposed legislation.

European Tax Haven Lists

Income shifting and the use of tax havens to avoid corporate tax has been a recent focus of a number of European countries and the European Union (EU). In fact 12 countries have created their own tax haven list; Portugal, Spain, France, Belgium, Slovenia, Croatia, Poland, Bulgaria, Greece, Finland, Latvia, and Lithuania. The EU has followed suit with its own tax haven list published in June of 2015. The list is very similar to Montana's tax haven list and contains the following familiar countries:

Andorra, Liechtenstein, Guernsey, Monaco, Mauritius, Liberia, Seychelles, Brunei, Hong Kong, Maldives, Cook Islands, Nauru, Niue, Marshall Islands, Vanuatu, Anguilla, Antiqua and Barbuda, Bahamas, Barbados, Belize, Bermuda, British Virgin Islands, Cayman Islands, Grenada, Montserrat, Panama, St Vincent and the Grenadines, St Kitts and Nevis, Turks and Caicos, and the US Virgin Islands.

Conclusion

Although the focus of this memorandum is on providing the RTIC with an update on countries that should be removed or added to the tax haven countries list, the RTIC should consider eliminating the water's edge election completely. Eliminating the water's edge election would make corporate tax filing in Montana more equitable and efficient. The ability to shift income from subsidiaries within the water's edge group to subsidiaries excluded from the water's edge group provides multi-national corporations a distinct tax advantage over domestic Montana owned corporations.

If the water's edge election is not eliminated, the department recommends that the tax haven list should be updated to remove and include the countries discussed above.