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Montana Department of Revenue

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Director

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Governor

MEMORANDUM

To: Revenue and Transportation Interim Committee

From: Mike Kadas, Director

Date: July 16, 2014

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

Each biennium the Department of Revenue is required to provide the Revenue and Transportation Interim Committee (RTIC) with an update of the countries that may be considered tax havens. The following information provides the RTIC with a short background on Montana's corporation income tax system and the department's recommendation on tax havens.

SUMMARY RECOMMENDATION

The department recommends removing the Netherlands Antilles and Monaco from the tax haven list of countries. The department recommends adding the Kingdom of the Netherlands, Trinidad and Tobago, Guatemala, and Hong Kong to the list of tax haven countries.

COMBINED UNITARY 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 what is known as combined unitary reporting.

Combined unitary reporting is a method of apportioning the business income of a corporation that is a member of a commonly controlled group of corporations engaged in a unitary business. Generally, a taxpayer member apportions its business income by multiplying the combined business income of all the members of the unitary business group by an apportionment percentage.

Combined unitary reporting is based on the premise of the unitary business principle. The theory of the unitary business principle is that to effectively tax the income of a business enterprise whose operations span numerous states or countries, all of the activities constituting that single trade or business must be viewed as a whole, rather than as separate activities conducted in a given state. The unitary business principle ignores the separate legal existence of separately incorporated affiliates, and instead focuses on the practical reality that affiliated corporations often function as a single business enterprise.

The major benefit of combined unitary reporting is that it limits the ability of large business enterprises to erode the state's income tax base by using related party transactions to shift income from in-state affiliates to out-of-state affiliates.

WORLDWIDE AND WATER'S EDGE COMBINATION

Montana's corporation income tax provisions require multi-national corporations to file on a worldwide combination basis. This means that the combined unitary reporting discussed above must include all members of the unitary business group regardless of the country in which the member is incorporated or the country in which the member conducts business. In 1987, the Legislature amended Montana's corporation income tax statutes to permit multi-national corporations to make an election to file on a water's edge combination basis. By electing a water's edge combination filing method certain members of the unitary business group can be excluded from the combined unitary report if they are incorporated in a foreign country or conduct most of their business outside of the United States provided that certain criteria are met.

When a business group elects to file water's edge combined unitary report, the election is for a three year renewable period. For taxpayers making this election, their apportioned Montana income is taxed at 7.00% instead of the 6.75% that is in place for those entities that do not make the election.

TAX HAVENS

The 2003 Legislature added the tax haven provision to the water's edge statute. The concern the legislation was addressing was that large multi-national corporations were shifting large amounts of income to countries with laws providing a disproportionate tax advantage over other countries' laws. The legislation was not aimed at legitimate foreign business activity, but targeted various "shell-games" perpetuated by certain corporations to avoid taxes. Certain countries tax laws enabled this behavior to occur. For example, some corporations had begun creating holding corporations that lacked any real operative purpose other than to hold the rights to a company's intellectual property. A corporation would associate large amounts of income to the intellectual property thereby shifting income to the holding company in the tax haven country. By creating these types of corporations and organizing them in certain tax advantaged jurisdictions, a taxpayer could reduce its state tax burden.

Essentially, the tax haven statute disregards a water's edge election for corporations that have a unitary relationship with the taxpayer and that are incorporated in the countries identified in § 15-31-322(1)(f), MCA. Currently, 40 countries are designated as a tax haven.

TAX HAVEN CRITERIA

The original list of tax haven countries included in the 2003 legislation primarily came from the Organization for Economic Co-operation and Development (OECD). The OECD is a group of countries sharing a commitment to democratic government and fair economies. The United States is a member of the organization. The OECD recognized that there was a growing problem with some jurisdictions developing tax laws that enabled tax planning that was harmful to other jurisdictions. The OECD discussed these concerns and developed criteria used to determine if a jurisdiction is a tax haven. Based on this criteria OECD identified jurisdictions most of which were the countries included in the 2003 legislation.

The following criteria are the criteria considered by the OECD at the time the list of countries were developed.

1. No or only nominal taxes
No or only nominal taxation on the relevant income is the starting point to classify a jurisdiction as a tax haven.

2. Lack of effective exchange of information
Tax havens typically have in place laws or administrative practices under which businesses and individuals can benefit from strict secrecy rules and other protections against scrutiny by tax authorities thereby preventing the effective exchange of information on taxpayers benefiting from the low tax jurisdiction.

3. Lack of transparency
A lack of transparency in the operation of the legislative, legal or administrative provisions is another factor in identifying tax havens.

4. No substantial activities
The absence of a requirement that the activity be substantial is important since it would suggest that a jurisdiction may be attempting to attract investment or transactions that are purely tax driven.

DEPARTMENT RECOMMENDATION

The department generally used the above criteria, public information and state tax information in reviewing the list of tax haven countries to determine if countries should be removed or added to the tax haven list. The department's review included:

a) The department reviewed the countries currently on the tax haven list. The list of countries was compared to published government reports, Deloitte tax summaries by country report, KPMG tax summaries by country report and other public information.

b) Reviewed current OECD information. The OECD information used was posted on their web site.

c) Reviewed current Montana tax filings of companies. The review focused on identifying holding companies and how they were being used.

d) Reviewed the US PIRG publication "Offshore Shell Games 2014" and other US PIRG information. The report provided the jurisdictions that companies transfer profits to in order to avoid taxation.

Based on this review described above, the department makes the following recommendation:

- Remove the Netherlands Antilles from the list as the jurisdiction was dissolved in 2010 and replace it with the Kingdom of the Netherlands. The Kingdom of the Netherlands is a sovereign state that includes; Netherlands, Bonaire, Sint Eustatius, Saba, Aruba, Curacao, Sint Maarten (Saint Martin).

- Remove Monaco from the list as the department could not identify a substantial tax advantage to shift income into Monaco.

- Add Trinidad and Tobago. The research conducted by the department identified an advantageous tax system that would reward tax shifting. In addition the transparency report published in November 2013 by the OECD identified Trinidad and Tobago as a jurisdiction that is not transparent.

- Add Guatemala. The research conducted by the department identified an advantageous tax system that would reward tax shifting. In addition the transparency report published in November 2013 by the OECD identified Guatemala as a jurisdiction that is not transparent.

- Add Hong Kong. The research conducted by the department identified an advantageous tax system that would reward tax shifting.