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Memorandum

To: Revenue and Transportation Interim Committee

From: Lee Baerlocher, Business and Income Taxes Administrator

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

Each biennium, the department is required by law 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 which includes recommended changes to the tax haven list.. This memorandum will start with a brief example of how C corporations are taxed in Montana. This example will be used to explain how tax havens work.

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 ABC Corp. (a Montana taxpayer) is in a unitary business relationship with DEG Corp. (a Delaware corporation) and XYZ Corp. (a Canada corporation), then ABC will file a combined report with the department reflecting its activities in Montana, Delaware, and Canada.

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

STEP 1: Determine Montana portion:

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

STEP 2: Determine Montana factor:

$$\text{ABC's Montana portion} \div 3 = \text{Montana factor}$$

STEP 3: Determine income apportioned to Montana:

$$\text{ABC's Montana factor} \times \text{ABC's total apportionable income} = \text{Montana taxable income}$$

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 or loss generated by XYZ’s Canadian activities. ABC’s combined return in Montana would only apportion the income or loss attributable to the activities occurring in Montana (ABC Corp) and Delaware (DEG Corp). After its three-year period, ABC can 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 to the water’s edge election. 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 or 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 in identifying tax havens. While the department does consider these criteria, the main characteristic that Montana uses to identify a tax haven is (v) below.

"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.

Generally based 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 which includes the four constituent countries of Aruba, Curacao, Sint Maarten and the Netherlands as well as the three special municipalities of Bonaire, Sint Eustatius and Saba that make up the Netherlands. Aruba is already included in statute. The research conducted by the department identified an advantageous tax system that would reward tax shifting. Three jurisdictions Bonaire, Saba, and Sint Eustatius have tax systems that are based on the fair market value of real estate.
- 4) Add Trinidad and Tobago. The research conducted by the department identified an advantageous tax system that would reward tax shifting.
- 5) Add Guatemala. The research conducted by the department identified an advantageous tax system that would reward tax shifting.
- 6) Add Hong Kong. The research conducted by the department identified an advantageous tax system that would reward tax shifting.
- 7) Add Switzerland. The research conducted by the department identified an advantageous tax system that would reward tax shifting.

For the most part, countries recommended to be added to the tax haven country list 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.