Montana Department of Revenue

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Memorandum

To: Revenue and Transportation Interim Committee

From: Mike Kadas, Director

Date: June 11, 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.

Although the focus of this memorandum is on providing the RTIC an update on countries that should be removed or added to the tax haven countries list the RTIC may want eliminate the water's edge election completely, thereby removing the need to have periodic updates of the listing of tax haven countries. A proposal 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.

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.

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.

<u>How does a country get identified as a tax haven?</u>

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.

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. 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 requested to be applied 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.

The tax haven list does discourage the sheltering of income in these jurisdictions. 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.

To conclude, should RTIC decide to not go forth with legislation to eliminate the water's edge election, this committee should consider the Department's proposed update to the current tax haven list.

Table 1 (continued): Top 20 Companies with the Most Tax Haven Subsidiaries

Company	Number of Tax Haven Subsidiaries	Locations of Subsidiaries
Mondeléz International	82	Bahamas (1), Bahrain (2), Costa Rica (2), Cyprus (1), Hong Kong (2), Ireland (15), Lebanon (2), Luxembourg (3), Mauritius (1), Netherlands (27), Panama (1), Singapore (10), Switzerland (15)
Illinois Tool Works	81	Bermuda (11), British Virgin Islands (4), Costa Rica (2), Hong Kong (9), Ireland (5), Luxembourg (10), Malta (1), Mauritius (2), Netherlands (23), Singapore (11), Switzerland (3)
Ecolab	80	Antigua and Barbuda (1), Aruba (1), Bahamas (1), Barbados (1) Bermuda (1), Cayman Islands (2), Channel Islands (1), Costa Rica (1), Hong Kong (5), Ireland (4), Luxembourg (11), Malta (3), Mauritius (1), Netherlands (33), Panama (1), Singapore (4), St. Lucia (1), Switzerland (6), U.S. Virgin Islands (2)
Occidental Petroleum	80	Bermuda (59), Cayman Islands (9), Hong Kong (1), Liberia (1), Malta (1), Netherlands (4), Panama (1), Singapore (2), Switzerland (2)
Marriott International	79	Anguilla (1), Aruba (1), Bahamas (1), Bahrain (1), Barbados (1) Bermuda (6), British Virgin Islands (7), Cayman Islands (10), Channel Islands (1), Costa Rica (1), Ireland (4), Jordan (2), Lebanon (1), Luxembourg (6), Malta (1), Netherlands (17), Panama (1), Singapore (4), St. Kitts and Nevis (2), St. Lucia (1), Switzerland (6), Turks and Caicos (1), U.S. Virgin Islands (3)
National Oilwell Varco	76	Aruba (1), Bahrain (1), Barbados (2), Bermuda (1), British Virgin Islands (2), Cayman Islands (7), Channel Islands (1), Cyprus (1), Mauritius (2), Netherlands (38), Netherlands Antilles (1), Singapore (18), Switzerland (1)
TOTAL	**2,466**	

Figure 1: Percent of Fortune 500 Companies with 2014 Subsidiaries in 20 Top Tax Havens

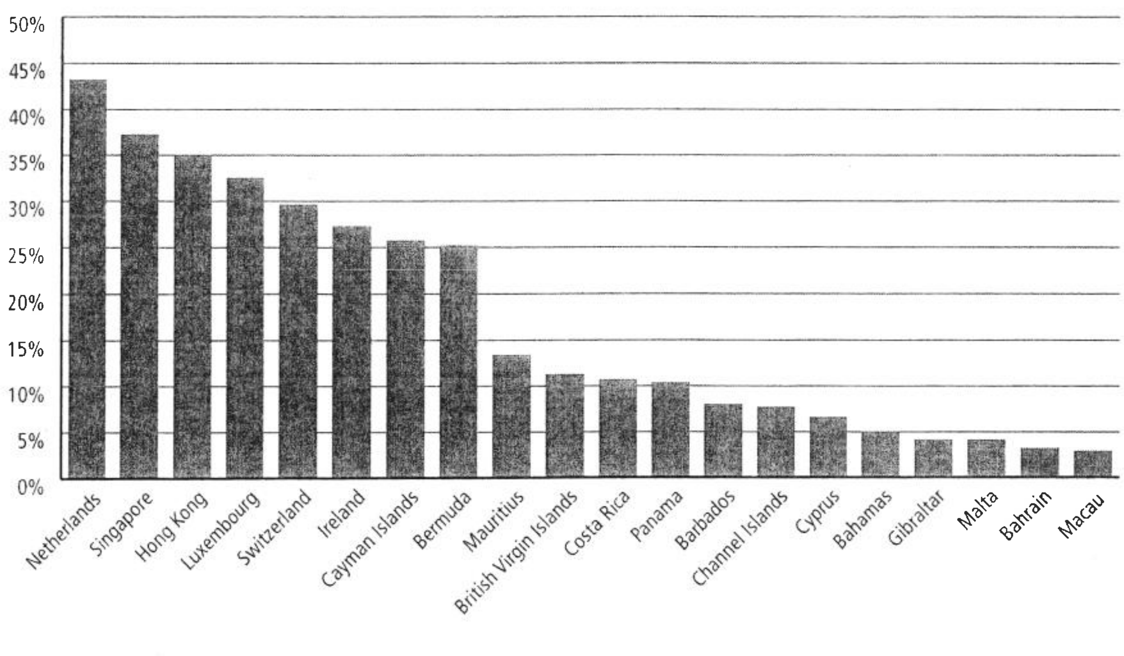

Table 2: Top 30 Companies with the Most Money Held Offshore

Company	Amount Held Offshore (Millions $)	Number of Tax Haven Subsidiaries
Apple	181,100	3
General Electric	119,000	18
Microsoft	108,300	5
Pfizer	74,000	151
International Business Machines	61,400	15
Merck	60,000	121
Johnson & Johnson	53,400	58
Cisco Systems	52,700	59
Exxon Mobil	51,000	37
Google	47,400	2
Procter & Gamble	45,000	38
Citigroup	43,800	41
Hewlett-Packard	42,900	25
Oracle	38,000	5
PepsiCo	37,800	132

Company	Amount Held Offshore (Millions $)	Number of Tax Haven Subsidiaries
Chevron	35,700	12
Coca-Cola	33,300	12
J.P. Morgan Chase & Co.	31,100	4
Amgen	29,300	8
United Technologies	28,000	28
Eli Lilly	25,700	27
Qualcomm	25,700	3
Goldman Sachs Group	24,880	20
Bristol-Myers Squibb	24,000	22
Wal-Mart Stores	23,300	75
Intel	23,300	14
AbbVie Inc.	23,000	35
Abbott Laboratories	23,000	91
Dow Chemical	18,037	92
Caterpillar	18,000	72
Total:	**1,402,117**	**1,225**

- **Nike:** The sneaker giant reports $8.3 billion in accumulated offshore profits, on which it would owe $2.7 billion in U.S. taxes. That implies Nike has paid a mere 2.5 percent tax rate to foreign governments on those offshore profits. Again, this indicates that nearly all of the offshore money is held by subsidiaries in tax havens. Nike is likely able to engage in such tax avoidance in part by transferring the ownership of Nike trademarks for some of its products to 3 subsidiaries in Bermuda. Humorously, Nike's Bermuda subsidiaries bear the names of Nike shoes such as "Air Max Limited" and "Nike Flight."[21]

The latest IRS data show that in 2010, more than half of the foreign profits reported by all U.S. multinationals were booked in tax havens for tax purposes.

In the aggregate, IRS data show that in 2010, American multinationals collectively reported to the IRS that they earned $505 billion in 12

Table 4: Profits Reported Collectively by American Multinational Corporations in 2010 to 12 Notorious Tax Havens

Tax Haven Country	Reported Profits of U.S.-Controlled Subsidiaries (dollars in billions)	Gross Domestic Product (billion dollars of GDP)	Subsidiary profits as % of GDP
Bermuda	94	$6	1,643%
Cayman Islands	51	3	1,600%
British Virgin Islands	10	1	1,102%
Bahamas	10	8	123%
Luxembourg	55	52	106%
Ireland	87	208	42%
Netherlands Antilles	1	4	25%
Netherlands	127	772	16%
Cyprus	3	23	13%
Barbados	0	4	10%
Singapore	20	217	9%
Switzerland	47	551	9%
Total:	$505	1,849	Ave: 27%
Total for all other countries in IRS Data	$424	42,363	Ave: 1%

Source for profit and tax figures: IRS, Statistics of Income Division, April 2014
Source for GDP Figures: World Bank http://data.worldbank.org/indicator/NY.GDP.MKTP.CD, United Nations Statistics Division http://unstats.un.org/

Memorandum

To: Director Kadas

From: Marla Larson, Tax Policy and Research

Date: May 24, 2016

Subject: Discussion of federal vs. state taxes and worldwide combined filing and water's edge

U.S. tax law requires U.S. based companies to report their domestic and certain foreign income (after adjustments and deductions, etc.), then calculate their tax liability based upon that income. The corporation can take a credit for foreign income taxes, or income-like taxes such as an excess profits tax, paid on the non-U.S. income. The intent of the credit is to avoid double taxation of foreign income of U.S. companies.[i]

This process worked reasonably well when the countries these companies did business in had tax rates similar to that of the U.S. Example 1 to the left shows the result when effective foreign and U.S. tax rates are the same (simplified here to the top U.S. statutory rate of 35%). The credit for foreign income taxes paid of $14 million reduces the corporation's U.S. tax liability to $21 million which is 35% of $60 million.

Example 1 - U.S. and Foreign Effective Tax Rates are the Same.

U.S. multi-national corporation	
Net taxable income from domestic business activities	$60,000,000
Net taxable income from foreign business activities	40,000,000
Total Net Taxable Income	$100,000,000
U.S. Corporate Income Tax Rate	35%
U.S. Tax Liability before credit	$35,000,000
minus credit for foreign income taxes paid	14,000,000
U.S. Tax Liability after credit	$21,000,000

Over the last decade and more, many countries have lowered their tax rates or offered other tax breaks, in part to attract more development by U.S. based or other corporations. Consequently the value of the federal credit for foreign income taxes has diminished as many multi-national corporations no longer pay as much foreign tax on their reported foreign income, (see what happens in Example 2 where the effective tax rate for the U.S. is 35% and the effective tax rate on foreign income is 17.5%).

Example 2 - Foreign Effective Tax Rates are Half U.S. Tax Rate.

U.S. multi-national corporation	
Net Income from domestic business activities	$60,000,000
Net Income from foreign business activities	40,000,000
Total Net Income	$100,000,000
U.S. Corporate Income Tax Rate	35%
U.S. Tax Liability before credit	$35,000,000
minus credit for foreign income taxes paid	7,000,000
U.S. Tax Liability after credit	$28,000,000

However the situation shown in Example 2 rarely happens in reality. This is because there is a "loophole"[ii] in federal law allowing U.S. based corporations to postpone U.S. taxes on most foreign income by postponing "repatriating" the income (by paying the income as a dividend to the parent). There is effectively no time limit on when a U.S. based corporation must repatriate much of its foreign earned income. But there is a cost because non-repatriated income is not available to pay U.S. shareholder dividends, management bonuses or invest in U.S. operations, although some corporations have found creative ways around the issue.

In 2004 Congress approved a repatriation holiday during which corporations could bring back non-repatriated foreign earned income and pay a relatively low tax rate (5.25%) on those earnings.[iii] Ever since many multi-national corporations have been waiting, and sometimes lobbying for, a repeat of the holiday or for more significant federal tax reform. Meanwhile the foreign earnings "trapped", or non-repatriated, of the corporations making up the S&P 500 has grown to an estimated $2.2 trillion.[iv] This revenue has grown to be so substantial for some companies that it has generated an increased number of high-profile tax inversions. The following information on tax inversions is from the Tax Foundation website:

> **What is an inversion?**
>
> In its simplest form, an inversion is simply the process by which a corporate entity, established in another country, buys an established American company. The transaction takes place when a foreign corporation purchases either the shares or assets of a domestic corporation or when a U.S. corporation purchases the share or assets of a foreign corporation. Some inversions involve the purchase of both the shares of ownership and the corporate assets. The shareholders of the domestic company typically become shareholders of the new foreign parent company. In essence, the legal location of the company changes through a corporate inversion from the United States to another country. An inversion typically does not change the operational structure or functional location of a company.
>
> **How does an inversion benefit the U.S. corporation?**
>
> The change in legal residence from the United States to another country allows the company to take advantage of the more favorable tax treatment of the new home country.

The most obvious benefit is that most countries do not have a worldwide corporate income tax system. The United States taxes income earned by U.S. corporations no matter where they earn that income, domestically or abroad.[v]

State taxation of corporate income takes a different approach from federal corporate income taxation when it comes to calculating taxes. At the state level if 100% of a corporation's business is done in the state, then 100% of the net income is taxable by the state. But if only 10% of a corporation's total business is done in the state, then this fact needs to be recognized in the calculation of state taxes.

Example 3 - State tax calculation

U.S. multi-national corporation - worldwide combined	
Net taxable income from domestic business activities	$60,000,000
Net taxable income from foreign business activities	40,000,000
Total Net Taxable Income (FTI)	$100,000,000
Montana Adjustments to FTI	
Additions	$10,000,000
Subtractions	-$3,000,000
Adjusted Federal Taxable Income	$107,000,000
Calculate the apportionment factor:	
Payroll Factor	10%
Sales Factor	5%
Property Factor	15%
Sum of all factors	30%
Average or apportionment factor	10%
Montana Taxable Income before NOLs	$10,700,000
Minus Net operating losses	-$5,000,000
Montana Taxable Income	$5,700,000
Montana Corporate Income Tax Rate	6.75%
Montana Tax Liability before credits	$384,750
minus any Montana Credits	-500
equals Montana Tax Liability	$384,250

But now the practical questions arise. How do we figure out what share of a multi-jurisdictional corporation's business is done in state? And is it possible to do this simply with data the taxpayer is likely to already have?

The methodology used is the apportionment factor. The factors adopted by Montana and a number of other states are payroll, sales and property. The apportionment factor is the equally weighted average of the ratios of Montana payroll to total payroll, Montana sales to total sales, and Montana property to total property.

In example 3 to the left, the starting point is the corporation's taxable income reported for federal purposes (FTI). Because it has already been calculated for federal taxes, it is more convenient and efficient, for both the taxpayer and the tax administrator, to start with FTI in calculating state taxable income. Montana requires certain additions and subtractions to FTI in order to arrive at adjusted federal taxable income.[vi]

Adjusted federal taxable income is then apportioned to Montana based upon the three factor apportionment percentage (in example 3 it is 10%). Once income apportioned to Montana is calculated, any net operating losses carried over from other years are subtracted, resulting in Montana taxable income. Montana taxable income times the tax rate yields Montana tax liability. Then if the taxpayer is entitled to any tax credits, those are subtracted, reducing tax liability.

Because the calculation at the state level <u>starts</u> with federal taxable income, there can be confusion about whether the state is over-reaching when it calculates state taxes. But as can be seen in Example 3, that's certainly not the case, since the state tax is calculated based upon the much smaller share of taxable income justified by the apportionment factors. And the elements used in the apportionment factors - payroll, sales and property - must match up with the income being apportioned.

If a multi-national corporation choses to file as a water's edge corporation, the income/expenses of certain of its non-U.S. entities are excluded (mostly) from the tax calculation. The apportionment factors need to be adjusted to align with the income (15-31-322 – 323, MCA). The state statutory tax rate also goes up to 7% from 6.75%.

Example 4 illustrates what changes in the apportionment factor calculation when a corporation moves from worldwide combined to water's edge. In this hypothetical example, the apportionment factor goes from about 10% to about 20% because while Montana sales, property and payroll remain the same, the respective totals change because some of the corporation's units are no longer included.

Example 4 - Comparison of Apportionment Factors for Multi-national Corporation filing as Worldwide Combined and as Water's Edge

Worldwide Combined

Factor	Montana	Total	Apportionment Factor
Sales	$100,000	$10,000,000	0.0100
Property	$1,500,000	$6,000,000	0.2500
Payroll	$500,000	$10,000,000	0.0500
Sum			0.3100
Average			0.1033
		or	10.3%

Water's Edge

Factor	Montana	Total	Apportionment Factor
Sales	$100,000	$5,000,000	0.0200
Property	$1,500,000	$3,000,000	0.5000
Payroll	$500,000	$5,000,000	0.1000
Sum			0.6200
Average			0.2067
		or	20.7%

So why would a company choose to file as a water's edge corporation? Because the total income the apportionment factor is multiplied by decreases too when the foreign earned income is excluded. The larger the percentage of total income is foreign earned, the more Montana taxable income is reduced.

But another contemporary business practice, profit shifting, used by some multi-nationals, can make the water's edge election much more attractive. A simple example of profit shifting, although there are many, is for a corporation to transfer its patents or other intellectual property rights out of its U.S. units, into an overseas unit it has created in a country with favorable laws. The U.S. units of the corporation pay fees to the patent-holding unit for use of the technology which means that the U.S. units can deduct those fees as expenses against income and reduce their taxable income. If the corporation is a water's edge filer the patent-holding unit's income may not be included in state taxable income. And depending upon the laws of the country where the patent-holding unit is incorporated, the unit's income from fees may be taxed lightly or not at all.[vii]

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[i] The examples and discussion here only pertain to U.S. based corporations and do not include corporations with a foreign parent. For more information on the issues see Gravelle, J.G. (2012). *Moving to a Territorial Tax: Options and Challenges*. Washington, DC: Congressional Research Service https://www.fas.org/sgp/crs/misc/R42624.pdf

[ii] Loophole is in quotes because the provision did not start out as a loophole, but reflects the principle that revenue should be taxed only when it has been realized as net income or profit by the taxpayer. But it has evolved into a way for certain corporations to postpone U.S. taxes, often indefinitely, especially when coupled with other strategies such as earnings stripping or tax inversions. (http://knowledge.wharton.upenn.edu/article/why-new-u-s-rules-wont-completely-halt-tax-inversions).

[iii] http://www.cbpp.org/research/repatriation-tax-holiday-would-increase-deficits-and-push-investment-overseas

[iv] http://www.wsj.com/articles/sheltering-foreign-profits-from-u-s-taxes-is-no-big-feat-1461627831.

[v] http://taxfoundation.org/blog/everything-you-need-know-about-corporate-inversions

[vi] Additions include federal tax exempt interest; state, local, foreign and franchise taxes based on income; income/loss of a foreign parent and foreign subsidiaries for worldwide combined filers; premiums used to calculate the Insure Montana credit; income/loss of affiliates incorporated in tax havens for water's edge filers only; and others. Reductions include certain transfers of income between corporate units; nonbusiness income; the Montana recycling deduction; income/losses from 80/20 companies for water's edge filers only; and others.

[vii] The examples and the discussion are simplified in order to illustrate certain general points and do not address many of the complexities of tax accounting and federal and state corporate tax law.