

To Blacklist or Not to Blacklist — The Trend Toward State Tax Haven Laws

by Daniel M. Dixon, Michael A. Jacobs, Michael I. Lurie, and Jack Trachtenberg



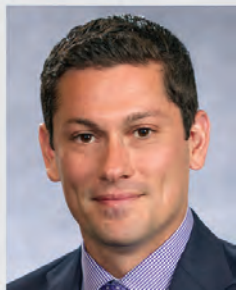
Daniel M. Dixon



Michael A. Jacobs



Michael I. Lurie



Jack Trachtenberg

Daniel M. Dixon is an associate at Reed Smith LLP. Michael A. Jacobs is a partner, Michael I. Lurie is an associate, and Jack Trachtenberg is counsel at the firm. All four focus on state tax practice. Trachtenberg previously served as the first deputy commissioner and taxpayer advocate at the New York State Department of Taxation and Finance.

In this article, the authors discuss tax havens and how states are cracking down on multinational corporations that are perceived as abusing the tax laws of tax haven nations. The authors argue that both of the tax haven tests used by states — the factor test and tax haven blacklist — have constitutional issues.

Foreign nations viewed as tax havens have been attracting increased attention from state legislatures in recent years. The result has been the passage of laws in several states and the District of Columbia that crack down on the perceived abuse of the tax laws of tax haven nations by multinational corporations. In our political and economic environment, it is easy (and in some quarters fashionable) to attack multinational corporations that lawfully structure their affairs to minimize their federal and state tax liability. One can cer-

tainly debate whether those corporations are paying their fair share, but we assert that state tax haven laws represent poor tax policy and likely violate the U.S. Constitution.

Under the tax haven laws, corporations must include the income and factors of entities formed or engaged in business in tax havens in their water's-edge returns. The intent of the laws appears to be to prevent multinational corporations from avoiding state taxation by shifting domestically earned income to tax haven affiliates.¹ Again, one can debate whether that is a worthy policy goal, but as structured, the tax haven laws that states have enacted represent poor tax policy. Taxpayers' voluntary compliance with the laws will in many cases be impossible because of the open-ended standards used by the states to define tax havens. Further, the scope of the laws is much broader than the abuse they were intended to remedy. Tax haven laws also represent a significant interference by the states in the power granted to Congress to regulate commerce with foreign nations.

In June Rhode Island became the latest state to enact a tax haven law,² joining Alaska, the District, Montana, Oregon, and West Virginia, which already had similar laws in place.³ The states have adopted two different general approaches for defining tax haven nations: (1) applying a factor test, such as that adopted by the District; or (2) incorporating a blacklist of specific tax haven nations into state law, similar to the list in Oregon's tax haven law.

The District's Tax Haven Law: The Factor Test

For tax years beginning on or after December 31, 2010, the District has required corporations conducting a unitary business to file a combined income tax return for the unitary group on a water's-edge basis. In addition to including all of

¹See, e.g., Phineas Baxandall et al., "Closing the Billion Dollar Loophole: How States Are Reclaiming Revenue Lost to Offshore Tax Havens," U.S. Public Interest Research Group Education Fund (2014).

²R.I. Gen. Laws sections 44-11-1(1)(c)(8) and 44-11-4.1(D).

³Alaska Stat. section 43.20.073(a)(5); D.C. Code Ann. section 47-1810.07(a)(2)(F)(i); Mont. Code Ann. section 15-31-322; Or. Rev. Stat. section 317.715(2); W. Va. Code sections 11-24-3a(a)(38), -3b, -13f.

the income and apportionment factors of all domestic corporations that are part of the unitary group, the return must also include all of the income and apportionment factors of any member of a unitary group doing business in a tax haven jurisdiction.⁴ A corporation is deemed to be doing business in a tax haven jurisdiction if it is engaged in activity sufficient for the jurisdiction to impose a tax under U.S. constitutional standards.⁵ As a result, a corporation formed under the laws of a tax haven jurisdiction must, in most cases, be included on a District water's-edge return.

A tax haven is statutorily defined as a jurisdiction that:

(A) for a particular tax year has no, or nominal, effective tax on the relevant income and has laws or practices that prevent effective exchange of information for tax purposes with other governments regarding taxpayers subject to, or benefiting from, the tax regime;

(B) lacks transparency regarding its legislative, legal, or administrative provisions or which has legislative, legal, or administrative provisions that are not consistently applied among similarly situated taxpayers;

(C) facilitates forming foreign-owned entities without the need for a local substantive presence or prohibits those entities from having any commercial impact on the local economy;

(D) explicitly or implicitly excludes the jurisdiction's resident taxpayers from taking advantage of the tax regime's benefits or prohibits companies that benefit from the regime from operating in the jurisdiction's domestic market; or

(E)(i) has created a tax regime favorable for tax avoidance, based on an overall assessment of relevant factors, including whether the jurisdiction has a significant untaxed offshore finance or other services sector relative to its overall economy.⁶

Similar factor tests have also been incorporated into the tax haven laws adopted by Rhode Island and West Virginia.⁷ We refer to those tax haven laws as the factor test laws throughout the rest of the article.

⁴D.C. Code Ann. section 47-1810.07(a)(2)(F)(i). The law provides an exception for a group member if its "activity within a tax haven is entirely outside the scope of the laws, provisions, and practices that cause the jurisdiction to meet the criteria of a tax haven." D.C. Code Ann. section 47-1810.07(a)(2)(F)(ii). However, given the vagueness with which the criteria of a tax haven are described, that exception appears to be of dubious value.

⁵D.C. Code Ann. section 47-1810.07(a)(2)(F)(i).

⁶D.C. Code Ann. section 47-1801.04(49)(A).

⁷As mentioned above, Alaska also has a factor test, but it is not as vague as the others and does not contain a catchall factor as discussed below. Alaska Stat. section 43.20.073(a)(5).

Oregon's Tax Haven Law: The Blacklist

Oregon requires all corporations that are part of a unitary group that files a consolidated return for federal income tax purposes to file their Oregon income tax return on a consolidated basis.⁸ The Oregon consolidated return generally must be prepared on a water's-edge basis, excluding all corporations formed under the laws of a foreign jurisdiction.⁹ However, under Oregon's tax haven law, an Oregon consolidated return must also include the taxable income or loss "of any corporation that is a member of a unitary group and that is incorporated in" a listed foreign jurisdiction.¹⁰ Oregon's blacklist comprises 39 jurisdictions, including Anguilla, Antigua and Barbuda, Aruba, the Bahamas, Bermuda, the British Virgin Islands, the Cayman Islands, Cyprus, Gibraltar, Liechtenstein, Luxembourg, Mauritius, and the U.S. Virgin Islands.¹¹ Montana has incorporated a similar blacklist into its tax haven law, although Montana law also requires the Department of Revenue to provide the State Legislature with an updated blacklist every two years.¹²

The Tax Haven Laws Cannot Be Practically Applied

The tax haven provisions are bad policy because they are either too vague (the factor test laws) or too rigid (the blacklist laws) to allow taxpayers to practically apply them in real-world situations.

The factor test laws don't provide taxpayers with any meaningful guidance. Because they generally contain a catchall factor, they are disguised "hammers" that give too much discretion to the taxing jurisdiction. For example, the District's law ultimately defines a tax haven as any jurisdiction that has created a tax regime favorable for tax avoidance, based on an overall assessment of relevant factors.¹³ Yet the law doesn't tell us who will make the overall assessment,

⁸Or. Rev. Stat. section 317.710(2).

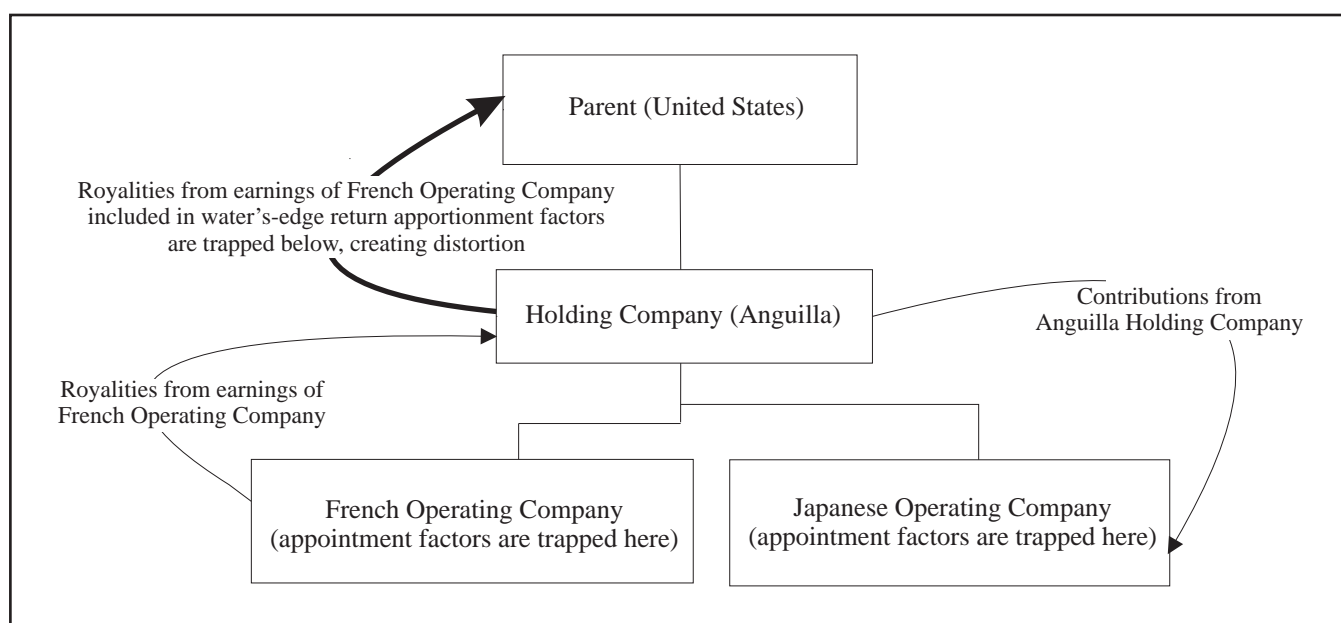
⁹Oregon generally includes only corporations that are part of the same affiliated group for federal income tax purposes. Or. Rev. Stat. section 317.710(5). Foreign corporations are not in the federal definition of an affiliated group. IRC section 1504(b)(3).

¹⁰That law is effective for tax years beginning on or after January 1, 2014. Or. Rev. Stat. section 317.715 et seq. If a foreign corporation's income is included without adjustment, its apportionment factors must also be included. Or. Rev. Stat. section 317.715(3)-(4).

¹¹Or. Rev. Stat. section 317.715(2)(b).

¹²Mont. Code Ann. sections 15-31-322(1)(f) and 15-31-322(2). For example, the Montana DOR recently suggested that the Netherlands, Trinidad and Tobago, Guatemala, and Hong Kong be treated as tax havens. Memorandum from Mike Kadas, Montana DOR, to Revenue and Transportation Interim Committee (July 16, 2014). While the DOR has requested and received legislative revisions to the tax haven list in the past, the statute could be interpreted as providing the DOR with the authority to unilaterally classify other countries as tax havens without legislative change to the list.

¹³D.C. Code Ann. section 47-1801.04(49)(E)(i).



nor does it tell us what the relevant factors are. It is practically impossible for a taxpayer to make a meaningful determination whether a foreign affiliate is operating in a tax haven without more definite guidelines. The District and the other jurisdictions that have adopted factor test laws have issued nothing formal or informal to give taxpayers guidance regarding how those catchall factors will be applied. That lack of guidance makes voluntary compliance impossible. The vagueness of the factor test laws also leaves them open to challenge on due process grounds.

The blacklist laws go too far in the other direction — they are too rigid. When the OECD attempted to maintain a similar blacklist of uncooperative tax havens, the list had to be revised, and ultimately scrapped, based on tax and regulatory reforms in the listed jurisdictions.¹⁴ The states that have adopted blacklist laws will have to constantly revise their lists or risk having the laws become hopelessly outdated. It seems unlikely that the legislative process in those states will be able to keep pace with policy changes in the foreign jurisdictions in a manner that will allow the blacklists to identify the foreign jurisdictions that are the true “bad apples” while excluding those that simply choose, as a matter of policy, to tax income at low rates.

The Tax Haven Provisions Capture Income That Should Be Excluded From State Taxation

The tax haven provisions are overreaching and actually capture foreign-source income that should be lawfully excluded from U.S. state taxation. Consider the following example, which is illustrated in the figure. A U.S. taxpayer

¹⁴See OECD, “List of Uncooperative Tax Havens,” for a brief history of the OECD’s list.

(parent) has affiliates with operations in France, Japan, and other high-tax countries. Parent holds its stock in its various foreign operating companies through a holding company organized in Anguilla. The foreign operating companies earn income from manufacturing and selling products in the overseas markets. Instead of causing the foreign operating companies to repatriate their earnings to parent, parent elects to reinvest the operating companies’ earnings in its overseas operations. As a consequence, the earnings are distributed in the form of royalties to the Anguilla holding company, which then reinvests the earnings through capital contributions to other foreign operating companies, such as the Japanese affiliate.

In that example, neither the Anguilla holding company nor any of the foreign operating companies have ever operated in the United States. They have earned no income from U.S. sources. Under a true water’s-edge return, parent would be allowed to exclude the income and apportionment factors of the Anguilla holding company from the water’s-edge group. However, under the blacklist laws, Anguilla has been specifically identified as a tax haven. It could also be deemed a tax haven under the factor test laws simply because it does not impose a corporate income tax.

If Anguilla is classified as a tax haven under a state’s tax haven law, the Anguilla holding company’s income and apportionment factors would be in parent’s water’s-edge return filed with that state even though income earned by the Anguilla holding company has no connection with the United States. This demonstrates that the tax haven statutes can be a blunt tool, with effects much broader than simply preventing multinational corporations from shifting U.S.-source income outside the water’s-edge group.

Not only do the tax haven statutes allow the states to tax income that in some circumstances has no connection with

the United States, they also can produce results that violate a taxpayer's right to fair apportionment. Going back to the Anguilla holding company example, in a state that has adopted a tax haven statute, the earnings of the foreign operating companies will be in the water's-edge return (in the form of royalties to the Anguilla holding company), but the apportionment factors (that is the property, payroll, and sales actually generating the earnings) of the foreign operating companies are not considered in apportioning the income of the expanded water's-edge group.

Justice John Paul Stevens concluded in *Mobil Oil* that apportionment factors connected to the production of income should be part of the tax calculation.¹⁵ Taxpayers required to include the earnings of foreign operating companies in their tax base, through the inclusion of royalties paid to a tax haven holding company, should be able to claim apportionment relief, based on the inclusion of the apportionment factors of the foreign affiliate that produced the earnings in the taxable income of the water's-edge group.

The Tax Haven Provisions Violate the Commerce Clause

The commerce clause of the U.S. Constitution reserves for Congress the power "to regulate commerce with foreign nations, and among the several states, and with the Indian tribes."¹⁶ The clause has been interpreted by the courts as restraining state taxing authority in both interstate and foreign commerce.¹⁷ In particular, the U.S. Supreme Court has held that the clause prohibits the enactment of state tax laws that either (1) create a substantial risk of international multiple taxation (actual multiple taxation is not required, the mere risk is enough); or (2) prevent the federal government from "speak[ing] with one voice when regulating commercial relations with foreign governments."¹⁸

In *Japan Line*, the U.S. Supreme Court held that a "substantial risk of international multiple taxation" exists if a foreign nation has the "right and the power to tax" the same income that a state includes in its tax base.¹⁹ Any state that purports to tax the same income that a foreign nation already has the power to tax creates a "substantial risk of international multiple taxation" and violates the commerce

clause.²⁰ For the tax haven laws, any foreign jurisdiction deemed a tax haven would have the right and the power to tax all of the income of any corporation formed under its laws (whether it chooses to tax that income or not). Thus, the states create a risk of international multiple taxation each time a tax haven law places the income of a foreign corporation in a water's-edge return.

However, in *Container Corp. of America v. Franchise Tax Board*²¹ and *Barclays Bank PLC v. Franchise Tax Board*,²² the Supreme Court determined that the risk of multiple taxation test was not violated when the alternative reasonably available to the state could not eliminate the risk of double taxation. Thus, in *Container Corp.* and *Barclays Bank*, the Court recognized that the inclusion of the income of foreign corporations in the tax base under worldwide combination was permissible because any alternative method of allocating the income of the unitary group to California based on an arm's-length approach could also result in double taxation. In contrast to the situations addressed in *Container Corp.* and *Barclays Bank*, an alternative is reasonably available to the states that would clearly eliminate the risk of double taxation of the income of the tax haven entities — eliminating the tax haven laws altogether.

Also, in *Japan Line*, the Court held that a state tax law violates the commerce clause if it prevents the federal government from "speak[ing] with one voice when regulating commercial relations with foreign governments."²³ No state may "tell this Nation or [any other nation] how to run their foreign policies."²⁴ The tax haven laws prevent the federal government from speaking with one voice, because under the statutes the income of a corporation incorporated or doing business in a tax haven nation is treated less favorably than the income of an otherwise identical corporation not incorporated in or doing business in a tax haven nation.

The Factor Test Laws Violate the Due Process Clause

Due process of law is violated by "a statute which either forbids or requires the doing of an act in terms so vague that men of common intelligence must necessarily guess at its

¹⁵*Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425, 449-462 (1980) (Stevens, J., dissenting); see also *American Tel. & Tel. Co. v. Wisconsin Dep't of Revenue*, 422 N.W.2d 629, 632-633 (Wis. Ct. App. 1988). The majority opinion in *Mobil Oil* declined to address the issue because the taxpayer had not argued it.

¹⁶U.S. Const., Art. I, section 8, cl. 3.

¹⁷See, e.g., *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274 (1977) (interstate commerce); *Kraft Gen. Foods Inc. v. Iowa Dep't of Revenue*, 505 U.S. 71 (1992) (foreign commerce).

¹⁸*Japan Line Ltd. v. County of Los Angeles*, 441 U.S. 434, 450 (1979).

¹⁹*Id.* at 452.

²⁰Apportionment must be ignored when performing this analysis. *Id.* at 447 ("Neither this Court nor this Nation can ensure full apportionment when one of the taxing entities is a foreign sovereign. If an instrumentality of commerce is domiciled abroad, the country of domicile may have the right, consistently with the custom of nations, to impose a tax on its full value. If a State should seek to tax the same instrumentality on an apportioned basis, multiple taxation inevitably results").

²¹463 U.S. 159 (1983).

²²512 U.S. 298 (1994).

²³*Japan Line* at 450.

²⁴*Id.* at 455.

meaning and differ as to its application.”²⁵ The U.S. Supreme Court has addressed the question whether vagueness can render a tax statute invalid. In that context, the Court determined that to survive a vagueness challenge, a statute must “afford a practical guide to permissible conduct.”²⁶ Also, in 1982 the Court held that a business regulation must afford taxpayers “fair warning” of what is proscribed.²⁷

The factor test and tax haven laws, such as that adopted by the District, do not provide taxpayers with any practical guide on how a multinational corporation is to determine which foreign affiliates are doing business in tax havens, nor do they provide any fair warning regarding which jurisdictions might qualify as tax havens. It is impossible for taxpay-

ers to apply that definition in a way that would allow them to determine which jurisdictions are tax havens and thus determine which foreign entities must be in their water's-edge return. Taxpayers have no fair warning on what activities are truly prohibited or what jurisdictions are favored or disfavored. As a result, it's possible that a court would find the factor test provisions void under the due process clause.

Conclusion

Despite the significant policy concerns surrounding tax haven laws, and even though they represent a blatant infringement on Congress's power under the commerce clause, the provisions continue to attract support in state legislatures around the country. With new laws recently enacted in Rhode Island and Oregon, and similar provisions recently considered in Maine, Massachusetts, and Minnesota, taxpayers will face serious questions about how and whether to comply with those laws for the foreseeable future. Hopefully, it is only a matter of time before a taxpayer will challenge one or more of those provisions either on due process or commerce clause grounds. ☆

²⁵*Connally v. General Const. Co.*, 269 U.S. 385, 391 (1926).

²⁶*United States v. Ragen*, 314 U.S. 513, 522-524 (1942) (The Court noted that “determination of allowable deductions by reference to a standard of ‘reasonableness’ is not unusual under federal income tax laws,” and that standard, even applied in a (proper) penal context, is not too vague to afford a practical guide to permissible conduct).

²⁷*Village of Hoffman Estates v. Flipside, Hoffman Estates Inc.*, 455 U.S. 489, 503 (1982).