TAX EXECUTIVES INSTITUTE, INC.

State and Local Tax Policy Statement
Regarding State Tax Haven Laws

Combined reporting requires taxpayers to calculate their tax liability using the income and apportionment factors of affiliates engaged in a unitary business. Most combined reporting states use a water's edge report, which excludes affiliates incorporated in a foreign country or conducting most of their business outside the United States.

Several states have enacted, or are considering enacting, legislation that enables those states to include income of foreign affiliates incorporated or conducting business in "tax haven" countries in their water's edge report. Such legislation defines "tax havens" by: (1) creating a "blacklist" that identifies specific countries as such, or (2) providing criteria to guide taxpayers and taxing agencies on whether a country qualifies as a tax haven. State tax haven legislation then requires taxpayers to include unitary foreign affiliates incorporated or operating in tax havens in the water's edge unitary group or requires them to include the foreign affiliates' income in the group's tax base without permitting them to include those affiliates' apportionment data in the apportionment formula.

States enacting state tax haven legislation claim such laws are necessary to stem the erosion of their tax bases to tax haven jurisdictions. However, such laws discriminate against foreign commerce, encroach on the federal government's power to deal with foreign governments with a single voice, are unworkable, and may violate taxpayers' right to a fair apportionment of their income.

Tax Executives Institute opposes state tax haven laws. The international tax community, with the leadership of the Organisation for Economic Co-operation and Development ("OECD"), has been working to address tax planning strategies that exploit gaps and mismatches in tax rules leading to non-taxation through the OECD's base erosion and profit shifting ("BEPS") project. The BEPS project requires significant modifications to the rules governing international transactions with affiliates, including increased disclosure of affiliate operations in foreign countries, strengthened transfer pricing rules, and new treaty provisions. These changes should enable the United States to audit and make transfer pricing adjustments to such transactions, thus ensuring that income is properly allocated to the jurisdictions where earned. The U.S. government's efforts to address this problem should render state tax haven legislation unnecessary and counterproductive.

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Points:

- The United States Constitution provides that "Congress shall have Power . . . [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."[1] The United State Supreme Court also has opined foreign commerce is "preeminently a matter of national concern" and held state taxes violate the Foreign Commerce Clause if they prevent the Federal Government from "speak[ing] with one voice when regulating commercial relations with foreign governments."[2] States tax haven laws undermine the Federal Government's ability to speak with one voice because such legislation inconsistently designates countries as "tax havens" and treats commerce with such countries unfavorably, without input or guidance from the Federal Government.

- The Internal Revenue Service and state taxing agencies have the authority to adjust the pricing of transactions between affiliated entities through IRC § 482 and its state law counterparts. Transfer pricing principles ensure transactions between U.S. and foreign affiliates are properly measured and accounted for and that the states are able to tax their share of income from such transactions.

- State tax haven laws are generally unworkable.

    - State tax blacklists are impractical for states to manage and administer. To ensure a blacklist is fair, a state would be required to continuously monitor the tax and regulatory regimes of foreign countries and revise the blacklist accordingly. State legislatures cannot keep pace with constantly changing policies in foreign jurisdictions. Blacklists also ignore legitimate and substantive transactions that occur in tax haven countries.

    - State tax haven legislation based on factor tests is impractical for taxpayers to interpret and implement. Factor test laws establish criteria qualifying a country as a tax haven. Such criteria are usually ambiguous, such as tax regimes that lack transparency or are favorable for tax avoidance, making it difficult for taxpayers to identify which countries constitute tax havens. A state tax haven law that "either forbids or requires the doing of an act in terms so vague that men of common intelligence must necessarily guess at its meaning and differ as to its application''[3] violates the Due Process

[1] Art. I, § 8, cl. 3.
[2] *Japan Line Ltd. v. County of Los Angeles*, 441 U.S. 434, 450 (1979).
[3] *Connally v. General Const. Co.*, 269 U.S. 385, 391 (1926).

Clause of the United States Constitution and creates uncertainty for taxpayers. Moreover, some of the criteria, such as the existence of bank secrecy laws in a jurisdiction, should not automatically place a country on a blacklist.

- The U.S. Supreme Court has held that the "factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated."[4] Some state tax haven laws include the income of foreign affiliates incorporated or conducting business in tax havens but do not include the foreign affiliate's data in the apportionment formula. This practice distorts the income attributable to the state and violates taxpayers' right to fair apportionment.

- State tax haven legislation is out of step with the OECD and G20 global efforts to combat BEPS. The OECD has now adopted a more sophisticated, holistic, and analytical framework to ensure that income is taxed in the jurisdictions where earned. The BEPS project should largely address base erosion and profit shifting concerns, rendering state tax haven legislation unnecessary.

- In no case should states enacting state tax haven laws apply them retroactively. Retroactive tax legislation is profoundly unfair and may violate the Due Process Clause of the U.S. Constitution.

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[4] *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 169 (1983).