States moving toward tax haven laws could face legal challenges

By Kat Lucero – 10/21/16 3:35 PM ET

- A few states implemented tax haven laws long before international project began.
- Some groups argue state laws may run afoul of U.S. law and international policy.

Some states have taken matters into their own hands against so-called tax havens, but their efforts could clash with the federal laws and the U.S. government's plans to participate in a global tax transparency initiative.

Only six states and the District of Columbia have enacted legislation that intend to prevent foreign multinational companies from avoiding state taxes by moving income earned within the state to affiliates in offshore tax havens, which are often jurisdictions with low to zero tax rates and limited financial oversight.

But more states may follow suit given that around 15 over the past two years have offered similar proposals, said **Jeffrey Saviano**, director of Americas indirect tax services at EY.

"There is a tipping point in the tax policy world, and I think it wouldn't surprise me at all in the next few years" that more states will adopt anti-tax haven legislation, Saviano said. "It's a way to increase revenue in state coffers."

These laws, however, could raise "a constitutional question as to whether these laws would pass constitutional muster or not," he said.

"It will only be a matter of time until a company that is affected by these rules will litigate," Saviano said, adding that "perhaps it's not the place for states to have a voice in foreign policy."

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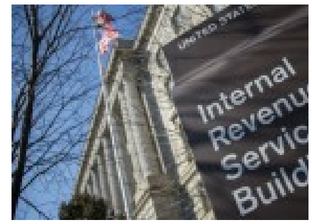

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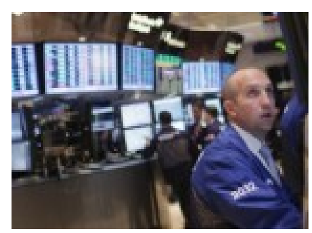

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Tax havens in the news.

Tax havens gained attention this year thanks to the Panama Papers, a massive trove of documents from a Panama law firm made public in April by the International Consortium of Investigative Journalists, that revealed thousands of offshore companies tied to questionable businesses practices.

The papers also showed that the United States could be a tax haven, too. Questionable companies in the consortium database have addresses in numerous states. Nevada, Oregon, Wyoming, Delaware and California are among them.

Meanwhile, the Treasury Department has been involved in a major global initiative called the Base Erosion and Profit Shifting (BEPS) project. It was spearheaded by the Organization for Economic Cooperation and Development in 2013 to limit tax havens and other tax avoidance practices.

Foreign investment repellant.

But even before BEPs, some states enacted laws targeting what they perceived to be companies trying to shifting profits out of their jurisdictions. Montana was the first of the seven jurisdictions to enact law more than a decade ago, followed by Oregon, West Virginia, Connecticut, Rhode Island, Alaska and the District of Columbia.

These statutes, however, send “a terrible message to those who seek to invest in the United States,” said **Joseph R. Crosby**, principal of MultiStates Associates.

Because of these laws, for example, a foreign company that wants to set up a factory in Montana, has to evaluate whether its business activity in some other country will result in “punitive” U.S. taxes, Crosby said.

Another issue: states lack strong coordination with the federal government -- and may even run afoul of the U.S. Constitution under the foreign commerce clause.

“There is a concept under the foreign commerce clause that basically [says] the federal government be permitted to speak in one voice for the United States,” said **Pilar Mata**, state tax counsel for the Tax Executives Institute, which has taken a public stance against state tax haven laws, preferring the BEPS project.

“When states start enacting laws targeting certain foreign countries and also doing it in an inconsistent and sometimes an unfair way, it doesn’t allow the United States to speak in one voice. And sometimes it’s done unfairly for [foreign companies] who have operations in those jurisdictions,” Mata said.

Two ways to limit state tax havens.

State policymakers have typically proposed tax haven measures with either a blacklist or criteria-based approach.

A blacklist bans a state from doing business with foreign companies tied to certain countries based on a now-defunct OECD list of tax haven jurisdictions that included Ireland and the Cayman Islands. Oregon and Montana have a blacklist.

The criteria-based approach examines a foreign company's business activities to determine if it's involved in tax avoidance practices. The current trend in state tax haven legislation is moving toward this approach. For example, the Multistate Tax Commission, which used to have a blacklist, now prefers a criteria method and has developed a reporting model that some states have adopted, according to the State Tax Research Institute's February report.

Part of the criteria-based method includes a “water’s edge” election, in which states could limit the taxation to a multinational business’s income earned in their jurisdiction, instead of also taxing income earned abroad. Countries, such as the United Kingdom, had threatened to retaliate against American companies if states continued to tax foreign companies on their worldwide income, Crosby said, inspiring other states to adopt this water’s edge requirement.

Elliott Dubin, the commission’s director of policy research, noted that states are free to adopt none, part or the entire model. But the case for state tax haven laws, he said, is that the IRS -- with its ongoing budget cuts and unpopularity in Congress -- may not have adequate resources to monitor all of a foreign company's business activity.

So states may step in to protect their tax base, Dubin added.

IRS Offshore Compliance.

The IRS, however, recently announced that it has collected $10 billion under the federal government's foreign disclosure laws such the Offshore Voluntary Disclosure Program, the Foreign Account Tax Compliance Act and the Swiss Bank Program.

"The IRS has passed several major milestones in our offshore efforts, collecting a combined $10 billion with 100,000 taxpayers coming back into compliance," said IRS Commissioner John Koskinen in a press release. "As we continue to receive more information on foreign accounts, people's ability to avoid detection becomes harder and harder. The IRS continues to urge those people with international tax issues to come forward to meet their tax obligations."