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States Eye Tax Havens

By Jackson Brainerd

The corporate income tax, which makes up a relatively small, but significant, portion of total state tax collections, has been gradually diminishing over time. Part of the decline in this revenue source has been attributed to several factors. More businesses are electing to be taxed as pass-through entities, which means they pay individual income taxes. Tax incentives also have reduced corporations' tax liability through breaks and credits. In addition, more states are determining corporate tax liability by emphasizing the share of a multistate business's nationwide sales that occur in-state over their share of in-state payroll and property, which tends to be less burdensome. Perhaps the most common revenue drain occurs when multinational corporations avoid paying state income taxes by shifting income earned domestically to low-tax jurisdictions, or tax havens.

Very low or non-existent tax rates do not necessarily make a jurisdiction a tax haven. Tax havens also tend to lack transparency and have laws that prevent intergovernmental information-sharing about taxpayers who benefit from a tax regime. They also generally allow foreign-owned entities to establish themselves locally without substantive business activity, and preclude resident taxpayers from taking advantage of benefits provided to foreign-owned businesses. Many nations considered tax havens, such as Luxembourg and Bermuda, are noteworthy for their relatively small economies and their disproportionate share of foreign profits.

State Action

While corporate taxpayers are typically only required to report income earned domestically, a growing number of states have sought to recoup lost revenue by requiring corporate taxpayers to add all taxable income from affiliate corporations incorporated or engaged in foreign tax haven jurisdictions. In 2015, fiscal notes for proposed legislation in Colorado and Kentucky estimated that tax haven provisions would bring in $46 million and $65 million the next year, respectively.

Six states and the District of Columbia have enacted tax haven laws. Five other states—Colorado, Kentucky, Maine, Massachusetts and New Hampshire—considered tax haven legislation in 2015. The approaches vary by state, but, in general, states have adopted one of two strategies. Montana and Oregon identify specific jurisdictions as tax havens, which is known as the "blacklist" approach. Alaska, Connecticut, Rhode Island, the District of Columbia and West Virginia take a "definitional" approach by designating a nation as a "tax haven" based on certain criteria, but do not list specific tax havens. Most of these states draw directly from the model statute crafted by the Multistate Tax Commission, which promotes state tax uniformity; Alaska adopted its own definition.

Did You Know?

- The corporate income tax accounted for 5.4 percent of total state tax collections in 2014.
- Tax havens have been estimated to cost the federal and state governments up to $100 billion per year.
- The United States itself is used for international tax avoidance by providing favorable tax treatment for nonresidents at both the state and federal levels.

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Pros and cons are associated with each approach. The blacklist method benefits from clarity. Taxpayers and administrators can easily determine if an entity is incorporated in a tax haven and do not need to determine where foreign affiliates are doing business or how tax rates in those locations compare to those in the United States. However, focusing solely on where an entity is incorporated risks illegally taxing firms that have real business purposes there, and tax haven lists need to be updated regularly to remain relevant. The District of Columbia created a list of tax havens in 2015 to supplement its existing definitional approach, but the list was repealed after one week in response to negative reactions from the listed nations and the business community.

Because of the subjectivity involved in deciding what constitutes a tax haven, the Council on State Taxation (COST) argues that "neither state legislatures nor state revenue departments are equipped to make determinations that even the U.S. government has declined to exercise." COST suggests that nations designated as tax havens and businesses with activity there could implement retaliatory measures. This could have negative financial consequences in some cases, since countries such as Luxembourg and the Caribbean U.K. Islands—which have been designated as tax havens by Oregon and Montana—are some of the top providers of foreign direct investment in the United States. Whether the hostile reaction of certain nations would outweigh the revenue benefits of effective tax haven laws is unknown. Montana collected $7.2 million in additional revenue in 2010, the most recent estimate available, and Oregon anticipates an additional $18 million in FY 2015.

States that have implemented a definitional approach to identifying tax havens have mitigated the drawbacks of the blacklist approach by creating standards that focus on both the jurisdiction and where the business activity occurs. They also allow taxpayers to demonstrate that they are incorporated in a tax haven for legitimate business purposes. However, broadly defining tax havens has been criticized not only for being imprecise, but also for making voluntary compliance difficult.

Federal Action

State pursuit of tax haven legislation has arisen in part because of the perception that the federal government has not done enough to identify tax havens or reduce incentives for shifting profits offshore. Supporters of tax haven legislation perceive federal action to be vital, because states generally use federal taxable income as the starting point for calculating state taxable income. If $1 of income is not included in federal taxable income, that $1 also will not be taxed in many states.

The Foreign Account Tax Compliance Act (FATCA), which took effect July 1, 2014, established a relatively unilateral system to obtain information on U.S. taxpayers abroad. It requires foreign financial institutions to enter into an agreement with the IRS to report information about financial accounts held by U.S. taxpayers or foreign entities in which U.S. taxpayers hold a substantial ownership. It also imposes a 30 percent withholding tax on all U.S. source income in cases of non-compliance. It has led to intergovernmental pacts with more than 100 countries, including commonly cited tax havens such as the Cayman Islands and Switzerland. The effect this law will have on profit-shifting is still unknown, but the Congressional Joint Committee on Taxation estimates FATCA will generate additional federal tax revenue of approximately $8.7 billion over the next 10 years.

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Additional Resources

Gravelle, Jane G. *Tax Havens: International Tax Avoidance and Evasion*. Washington, D.C.: Congressional Research Service. 2015.

Schiefelbein, Scott. "State Tax Haven Laws: Expanding the Water's-Edge Group." *State Tax Notes* (Nov. 2, 2015): 367-374.