State "Tax Haven" Designations and Punitive Treatment of Multinational Businesses

Policy Position

Position: *State "tax haven" designations are arbitrary and overly broad, reflect a discarded "worldwide" approach to state taxation, and are inappropriate to address income shifting or other tax avoidance concerns. Punitive treatment of multinational businesses with affiliates in countries designated by states as "tax havens" interferes with the U.S. Government's ability to "speak with one voice" on foreign affairs and is constitutionally suspect. States should limit their income tax base to the domestic "water's edge" and not tax foreign income with little or no connection with the United States.*

Explanation: A small number of states have adopted statutory language that targets corporations with affiliates incorporated or doing business in so-called "tax haven" jurisdictions for punitive tax treatment. These states list either subjective criteria or specific countries in their statutes and require corporate filers to include in their state corporate tax base the income of affiliated corporations doing business in those countries. The blacklisting of foreign countries as "tax havens" and the arbitrary inclusion in the state tax base of income from businesses operating in these countries contravenes the approach taken by the vast majority of states and virtually all of the nations in the world.

Arbitrary and Overly Broad Approach. Branding foreign nations as "tax havens" has been widely rejected as a legitimate means for dealing with tax avoidance. The "tax haven" lists are derived largely from a list created over 20 years ago by the Organization for Economic Co-operation and Development (OECD) to encourage countries to adopt greater transparency and information sharing about tax issues, not to broaden the tax base of member countries. No country, including the United States, has ever adopted the "tax haven" list approach as a means for defining its income tax base. Rather than providing a viable solution to the issue of international income sourcing, the adoption of a tax haven list creates new problems by arbitrarily targeting sovereign nations ranging from island economies to major U.S. trading partners such as the Netherlands, Ireland, and Switzerland. Neither state legislatures nor state revenue departments are equipped to make determinations that even the U.S. Government has declined to make.[1]

[1] For a detailed discussion of the administrative and policy defects of "tax haven" lists, see, *State Tax Haven Legislation: A Misguided Approach to a Global Issue*, by Karl Frieden and Ferdinand Hogroian, (February 2016). Available at www.cost.org.

The Slippery Slope to Worldwide Unitary Combination. Tax haven lists impose, on a selective country-by-country basis, the discredited "worldwide" combination method for the state taxation of multinational businesses. State attempts in the 1970s to tax the income of the worldwide unitary group, including entities with no U.S. presence, created considerable apprehension among both foreign governments and foreign and domestic multinational business enterprises, instigating what many thought would be an international tax war. Indeed, in 1985, the United Kingdom took the unprecedented approach of approving legislation that would have allowed the U.K. Treasury to penalize multinational companies with operations in any U.S. state that employed worldwide combination. A Presidential Working Group agreed to forestall federal intervention if states limited mandatory unitary combination to a domestic water's-edge approach.[2] Tax haven legislation undermines the consensus among the states that has prevailed for 40 years to limit mandated income tax bases to the "water's-edge" and to avoid the taxation of income earned outside the United States. The blacklisting of designated "tax haven" countries also interferes with U.S. foreign relations, threatening our nation's ability to "speak with one voice" in its dealings with our key trading partners. This interference in foreign affairs raises constitutional concerns as well, and state tax haven statutes likely will be subject to judicial challenge in the coming years.

Tax Haven Lists Unsuitable to Address Tax Avoidance Concerns. The international tax community, led by the OECD's project on base erosion and profit shifting (BEPS), is making considerable headway in its quest to minimize global tax avoidance and profit shifting through implementation of a global minimum tax through its Pillar 2 directive.[3] The U.S. federal government has also taken steps to minimize global profit shifting by adopting a tax on global intangible low-taxed income (GILTI), a base erosion anti-abuse tax (BEAT), and a 15% corporate alternative minimum tax on financial statement (book) income. Further, U.S. states have extensive experience in shoring up the corporate tax base and addressing tax avoidance. These methods include participating in information-sharing with the IRS, adjusting intercompany income (*e.g.*, I.R.C. Section 482 powers), asserting alternative apportionment, and applying common-law doctrines and state statutory standards of business purpose and economic substance. These methods reflect a focus on specific transactions or corporate arrangements, rather than blacklisting entire nations and their international trade. Tax haven designations invite retaliatory action by other countries and, at a minimum, work to decrease investment in adopting states both by foreign-based businesses and U.S. domestic businesses engaged in multinational operations. While the desire by states to address the complexities of global commerce and instances of tax evasion are understandable, tax haven lists are a clumsy and ineffective method that are detrimental to states' own interests.

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[2] Final Report of the Worldwide Unitary Taxation Working Group, Chairman's Report and Supplemental Views (August 1984). For a detailed discussion of the harmful impact of mandatory unitary combined reporting imposed on a worldwide group of companies, see *Mandatory Worldwide Combined Reporting: Elegant in Theory but Harmful in Implementation*, by Douglas L. Lindholm and Marilyn A. Wethekam, (March 2024). Available at www.cost.org.

[3] See, e.g., PricewaterhouseCoopers' Pillar 2 Country by Country Tracker, available at https://www.pwc.com/gx/en/services/tax/pillar-two-readiness/country-tracker.html