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The Honorable Rod Skoe
Chair of the Senate Taxes Committee

The Honorable Ann Rest
Chair of the Senate Tax Reform Division

The Honorable Ann Lenczewski
Chair of the House Taxes Committee
Minnesota State Legislature
State Capitol
St. Paul, MN

Dear Senator Skoe, Senator Rest and Representative Lenczewski:

My name is Dan Bucks. I served as Montana Director of Revenue from January 2005 until January of this year. I also served as Executive Director of the Multistate Tax Commission (MTC) from 1988 through 2004. Minnesota is a member of the MTC, and it was an honor to serve the State of Minnesota through the work of that organization. In both of these prior positions, I was actively engaged in addressing the challenge of corporate international income shifting. In Montana, I was responsible for the administration of that state's tax haven law originally enacted in 2003. In 2007, the European Commission invited me to consult on corporate tax issues specifically related to the use of formula apportionment to properly divide income among nations.

TakeAction Minnesota asked me to review the proposed Minnesota legislation, SF 1237 and HF 1440, that would counteract adverse tax effects from the shifting of corporate income to tax havens. These bills would adopt an approach similar to the Montana law of including in Minnesota corporate tax reports the income of related corporations established in listed tax havens.

Before commenting on the bills and the Montana experience in this area, this letter will briefly summarize the problems the bills would address.

Rising Concerns over International Income Shifting

The problems of international income shifting are of rising concern to officials in various nations, the U.S. Congress and several states. That concern is driven by:

1. Numerous articles in the business press reporting that many multinational corporations have unfairly reduced their overall effective tax rates to low levels, even into single digits, through aggressive income shifting strategies.
2. Economic research indicating that corporations are reporting profits to tax havens grossly out of proportion to the real size of their economies. For example, the Congressional Research Service calculates that profits of U.S. corporations reported in Bermuda were 645.7% of that nation's gross domestic product in 2008, 546.7% for the Cayman Islands, and 354.7% for the British Virgin Islands.¹
3. Academic research estimating that lost federal revenue due to international income shifting amounts to as much as \$60 billion annually. Those estimates do not include lost state revenue.²

A new report by U.S. PIRG Education Fund estimates that in 2011 states lost an estimated \$26 billion in corporate tax revenues due to tax haven abuses (and an additional \$13.8 billion in individual income tax revenues).³

The most obvious economic and fiscal effects of international income shifting include tax inequities, lost revenue, and reduced public services. When some multinationals artificially reduce their taxes, they gain an unfair competitive advantage over smaller enterprises that operate entirely within the U.S. and especially within a single state such as Minnesota. Taxes may shift to all other taxpayers, compounding the inequities. Lost revenues can also result in reduced investments in infrastructure, education, public health and safety and other services that support a growing economy and an orderly, healthy society.

The recent response to these issues by leaders in other nations is particularly noteworthy because they have previously ignored these problems. In the UK, public outcries have risen over reports of multinational firms with substantial UK business activity paying little or no taxes to the UK government. In response, Prime Minister David Cameron has promised to make curbing tax haven abuses the top subject at the June 2013 G8 Summit over which he will preside. The UK developments are ironic, because the UK led the charge in the 1980s against efforts by U.S. states to curb international income shifting. In 2012, the European Commission also

¹ Jane G. Gravelle, "Tax Havens: International Tax Avoidance and Evasion," Congressional Research Service, January 23, 2013, p. 15

² Gravelle, p. 16.

³ Phineas Baxandall, Elizabeth Ridlington, Jordan Schneider, and Dan Smith, "The Hidden Costs of Offshore Tax Havens: State Budgets under Pressure from Tax Loophole Abuse," U.S. PIRG Education Fund, January 2013.

announced strong, new initiatives to stop international tax evasion reflecting the views of a majority of the nations in the European Union.

Failure of the So-Called “Arms Length System”

In many respects these new international concerns about international income shifting are an admission of the failure of the “arms length” system championed by the U.S. and European officials stretching back over 50 years. That system attempts to adjust the reporting of income by multinationals to various nations by correcting the internal pricing of transactions among corporate subsidiaries on a case-by-case basis. The volume of such transactions—running into the billions daily—and the absence of comparable market data, among other factors, make this system unworkable and ineffective. Former North Dakota Senator Byron Dorgan frequently described the arms length system as an attempt to untangle two plates of cooked spaghetti with the goal of reconnecting each strand back together. Simply stated, the arms length system is an abject failure. It has been tried for the fifty years, and the problems of international income shifting are by any measure worse than when nations started using the arms length approach.

Superiority of the State Formula Apportionment System

The only logical, systematic alternative to the failed arms length system is formula apportionment pioneered by the U.S. states in the early 1900s and practiced by nearly all states, including Minnesota. Formula apportionment is far simpler than the arms length system. It is also far more effective in ensuring that income is reported to each jurisdiction in reasonable proportion to the real economic activity occurring there. Formula apportionment comes closer than any other system to assuring that corporate profits are reported for tax purposes to the locations where those profits were actually earned. In that way, it matches the tax payments with the costs of the public services that benefit the corporate economic activity. Further, when formula apportionment is used in conjunction with combined reporting, it effectively cancels out all of the financial and accounting manipulations that shift profits to tax havens. SF 1237 and HF 1440 would properly return the tax haven income to Minnesota where the income was earned in the first place.

One might ask if it is legitimate for the states to use formula apportionment, especially in an international context, when the federal government does not. The U.S. Supreme Court has ruled three times in the *Container*, *Barclays Bank* and *Colgate* cases that it was constitutional for states to require combined reporting and formula apportionment on a worldwide basis. After the 1983 *Container* decision, the Reagan Administration, through Treasury Secretary Donald Regan, sought a compromise between the states and multinational corporations over the use of worldwide combined reporting. Secretary Regan proposed that the states use combined reporting on a water’s edge (domestic) basis, but he also recommended that states, if they wished, require corporations to report and pay taxes on tax haven income. Thus, Secretary Regan is the official who proposed the idea embodied in Montana law and the proposed legislation pending before your committees.

The Montana Experience—Possible Relevance to Minnesota Legislation

Montana's tax haven law has been in effect since 2003. Administratively, there have been no noticeable costs or challenges associated with the implementation or enforcement of the law. As Director of Revenue, I received no complaints from corporate taxpayers about the law, its implementation and or its impact.

Montana is a worldwide combined reporting state, with an option for corporations to report on a water's edge basis. With the water's edge election comes the obligation for corporations to include tax haven income in the Montana tax calculations. If corporations viewed the tax haven law as burdensome, one would have expected not only complaints, but also a dampening of corporate interest in making water's edge elections. The opposite was the case. From TY 2004 (first year the law took effect) to TY 2011, the number of water's edge electing corporations nearly tripled from 109 to 312. On net, only two corporations dropped their water's edge status from TY 2003 to TY 2004.

The fiscal impact of the tax haven law was positive. In TY 2010, the additional revenue attributable to the tax haven law was \$7.2 million. That revenue was due to \$102.9 million of income that had been artificially shifted to tax havens, but was now reported to Montana in proportion to real economic activity in the state.

For a point of comparison, Minnesota has over five times the population of Montana and presumably roughly five times the economic activity. The \$7.2 million in revenue impact of the Montana law would suggest the potential for a proportionately higher return in Minnesota.

As to economic impacts, there is no evidence of any negative economic impact on the state from the tax haven law. From 2004 forward, the Montana economy has fared better than the rest of nation. Unemployment rates have been lower in Montana than the U.S. rates, and current Montana unemployment is at 5.7% compared to the national rate of 7.7%. The Great Recession affected Montana less than the rest of the nation and for a shorter period. General fund fiscal balances from 2005 through the present time have run at historically record levels, ending last fiscal year at about 25% of general fund expenditures.

Again, as Director I received no indications or contacts from corporations considering investments in Montana that their plans would be affected by the tax haven law. The law was also never a point of discussion with our economic development agencies as having any relevance whatsoever to any prospective investment in Montana.

The only complaints we received in recent years were from a few nations either on the list or proposed to be added to it. These nations took exception to the idea that Montana would list them as a "tax haven." They expressed concerns about a negative impact on their national reputation. They could not identify any real, substantive effect of the tax haven listing. I did not consider the complaints credible

because each of the nations had been previously listed as a tax haven in numerous governmental and press reports, including reports by the U.S. General Accountability Office, the Congressional Research Service, the U.S. Permanent Subcommittee on Investigations, the New York Times, Bloomberg News and elsewhere. Internet searches revealed that these nations were also listed on web sites critical of tax havens and on web sites advertising services to taxpayers wanting to hide income in those and other jurisdictions. How the listing by a U.S. state of a nation as a tax haven could have any further effect on the national image or reputation of one or more of these countries was difficult to understand.

I have one specific comment on the bills as drafted. The bills provide that a nation is to be deleted from the list of tax havens after entering into a sufficient exchange of information agreement with the U.S. Government. Based on my experience, the presence or absence of an exchange of information agreement between any nation and the U.S. has little or no impact on corporate income reporting to the states. That information is not shared with the states and is of no value in state administration. Further, the U.S., as noted above, does not effectively use such information to actually solve international income shifting problems. You may wish to evaluate further that provision.

A Final Note on the Damage from International Income Shifting

The idea of international income shifting and its effects can sometimes seem remote and abstract. However, the impacts of income shifting are real and have effects on people beyond what might be understood. Some of these real world impacts can be seen in the events that began to ripple through the world economy over the last few weeks arising from the small nation of Cyprus.

Cyprus is a financial center tax haven with banks that solicit enormous deposits from around the world from people and corporations avoiding taxes and perhaps other laws. The deposits in Cyprus are grossly out of proportion to the small Cyprian economy. The Cyprian banks have made unwise investments and are seeking a bailout from the EU. Because there are so few resources in the Cyprian economy to pay back the bailout, EU authorities were requiring Cyprus to impose a tax on all deposits including small deposits made by ordinary Cyprian citizens. Word of the deposit tax spread over last weekend and began to roil world financial markets on March 18. A bank run began in Cyprus and fears arose that such bank runs would spread to Europe.

The Cyprian Parliament, as of this date, has now rejected the deposit tax, placing into question the bailout. That raises the possibility of Cyprian banks failing and causing other ripple effects through the international system. Why? Well, Cyprus may be small, but its banks are flooded with disproportionately large deposits from tax evasion and avoidance. What happens next is not clear.

What is clear is that corporate international income shifting is not benign. It is unfair to ordinary taxpayers who pay the right amount taxes year after year. It creates

unfair competition for small and medium sized businesses. It reduces revenue intended by the law to be collected. To make up the difference, governments are faced with the choice of raising taxes on those already paying their share or cutting services important to economic growth and the well-being of the citizenry. Beyond those effects, we now see from the events in Cyprus that shifting huge sums of tax avoidance profits to small nations can threaten potential problems for the world economy.

While nations have begun talking about the problem, states have the right solution already at hand: returning income to the states where it was earned by applying formula apportionment to tax haven income. The Montana experience suggests that this is an effective and appropriate step to consider.

I hope this information is helpful to your deliberations. I would be pleased to help with further information if that were judged valuable. Thank you.

Sincerely,

A handwritten signature in cursive script, appearing to read "Dan R. Bucks".

Dan R. Bucks