# The Tax Haven Tradeoff:

## How Offshore Tax Haven Abuse Hurts Wisconsin Businesses and Taxpayers

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**Executive Summary**

Wisconsin could recoup an estimated $28.8 million annually from offshore tax havens by passing a simple, proven reform already on the books in other states. The so-called "water's edge" loophole allows multinational companies to use foreign subsidiaries to make it appear as if income earned in the United States was instead earned in offshore tax havens like the Cayman Islands that charge no taxes and have traditionally failed to disclose information to U.S. tax authorities. The companies who exploit this loophole dodge the taxes they owe; Wisconsin businesses and taxpayers foot the bill.

When companies take advantage of Wisconsin's markets, educated workforce, and infrastructure, but use offshore subsidiaries to avoid paying taxes, the bill does not simply disappear. Instead, the bill gets divided among other companies and individuals that pay higher taxes or experience cuts to public programs and services. For example, revenue lost from offshore tax haven abuse may directly impact the level of funding municipalities receive from the state. When state aid gets cut, municipalities are forced to either cut the services they provide (like repairing potholes and maintaining other local infrastructure) or raise property taxes to meet those needs. Wisconsin businesses without offshore subsidiaries also suffer because they must compete against multinational companies that have an artificial cost advantage due to their tax dodging.

Ultimately, all taxpayers and corporations in Wisconsin rely on public infrastructure and services, including education, public health, police, fire, sanitation, parks and recreation, and transportation, for a healthy economy and a successful business. Nobody should be able to play by different rules, and exploit the tax code to reduce their share of taxes, which supports the services and infrastructure they use.

Closing the "water's edge" loophole would prevent corporations from using foreign subsidiaries in known tax haven jurisdictions to hide taxable income. Recouping $28.8 million each year would mean a lot to Wisconsin taxpayers. It could, for instance, be returned to taxpayers in the form of a $10 annual tax cut for all state household tax filers, or be used to support education, funding the equivalent of 531 additional teachers for Wisconsin schools. This report examines the tradeoff that Wisconsin taxpayers and businesses must face when multinational companies can exploit the tax code and get out of paying the taxes they owe.

**Tax Loopholes and Offshore Tax Haven Abuse**

All corporations and individuals owe taxes to the states where they earn that income. Unfortunately, some businesses avoid taxes by using accounting tricks to make income earned in Wisconsin appear to have been earned by a subsidiary in a tax haven.

Tax havens are countries or jurisdictions that levy little to no tax on income.[1] Tax haven abuse occurs when corporations exploit loopholes in the tax code that permit them to delay tax payments on profits earned abroad in subsidiary companies until the money has been returned to the United States through dividend payments, repurchasing stock, or investments. Through these loopholes, corporations label profits actually earned in the United States as "foreign" profits made by subsidiary companies (which are located in tax haven countries with very low or no taxes) to avoid tax liability in the United States.[2]

While Wisconsin-based companies are not the only ones who exploit offshore tax havens, a number of Wisconsin-based companies have subsidiaries in tax havens. Of the Wisconsin-based companies that appear on the Fortune 500 list, there were eight companies that had a total of 57 foreign subsidiaries in tax haven countries.[3]

By using offshore tax havens, multinational corporations avoid an estimated $90 billion in federal income taxes and $20 billion in state income taxes.[4] Because most state tax codes are so closely tethered to the federal one, states simultaneously lose billions in tax revenue from these loopholes.[5]

Based on an analysis of how much income is federally reported from each state, and on state tax rates, U.S. PIRG estimated in a report titled *"Closing the Billion Dollar Loophole"* that states cumulatively lost $20 billion in revenue last year as a result of multinational corporations abusing tax havens.[6] The report further breaks down revenue lost to tax havens by state and estimates that Wisconsin loses $406 million in state income tax revenue to corporate tax haven abuse, including but not limited to the "water's edge" loophole, every year. In other words, closing the water's edge loophole represents only a fraction of the total amount of estimated state revenue lost to offshore tax haven abuse.[1]

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[1] The reclaimed revenue from closing the water's edge loophole would bolster government coffers in Wisconsin, but it represents only a fraction of the total amount of estimated state revenue lost to offshore tax haven abuse for several reasons:

• Closing the water's edge loophole does not address illegal tax evasion from companies that fail to report income to the U.S. as booked in any jurisdiction;

• The lists of known tax haven countries used by Montana and Oregon include only the most egregious examples, and do not restrict tax haven abuse conducted through other countries;

• Closing the water's edge loophole does not address transfer pricing that makes profits (in all jurisdictions) appear smaller or nonexistent; and

• Companies sometimes shift U.S. profits to related corporate entities that don't count as subsidiaries or

**The Rest of Us Pick Up the Tab**

When corporations and wealthy individuals exploit offshore tax loopholes, their burden is shifted to other taxpayers. Wisconsin businesses and individuals are stuck picking up the tab through coping with cuts to public services or paying higher taxes themselves.[7] Wisconsin businesses face a competitive disadvantage because they are forced to pick up the tab for other corporations, many of which are not based in Wisconsin.

Every year, corporations and wealthy individuals avoid paying an estimated $184 billion in both state and federal income taxes by using complicated accounting tricks to shift their profits to offshore tax havens. Of that $184 billion, $110 billion is avoided specifically by corporations.[8] These companies still benefit from the services paid for by taxes, yet contribute less than their share.

A new study released by WISPIRG in April 2014 revealed that the average Wisconsin taxpayer in 2013 would have to shoulder an extra $1,054 in taxes to make up for the revenue lost due to the use of offshore tax havens by corporations and wealthy individuals. The report additionally found that the average Wisconsin small business would have to pay $3,966 to cover the cost of offshore tax dodging by large corporations.[9]

**Closing Wisconsin's "Water's Edge" Loophole**

One simple and proven way to recapture revenue lost to tax havens is to treat the income booked to corporate subsidiaries in known tax havens as domestic income for tax purposes. This option is available to at least the 24 states that have enacted combined reporting, including Wisconsin.[10] States use combined reporting to obtain a more complete picture of where companies apportion their income, and to prevent companies from improperly claiming that income is earned in other states. A multistate company and all of its affiliates are treated as a single, unitary company for tax purposes. The state then uses a formula to apportion the share of the company's total nationwide income subject to state taxes. This calculation is based on how much business the company does in that state.[11]

Most combined reporting states have a "water's edge" loophole that excludes the income a company books to its foreign affiliates when calculating its total income. Therefore, companies can simultaneously avoid state and federal taxes by using accounting tricks to shift income to their foreign subsidiaries in tax havens. States can recoup some of the revenue lost from offshore tax dodging by changing the law so that income booked to a company's subsidiaries in known tax havens will no longer be considered beyond the "water's edge."

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affiliates either because the IRS or state definitions are too narrow, or because the true corporate owners remain hidden behind shell companies.

Closing the "water's edge" loophole would generate $28.8 million each year for Wisconsin, according to a Wisconsin Legislative Fiscal Bureau memo, "Corporate Income/Franchise Tax: Treatment of Income or Loss from Corporations in Certain Jurisdictions," assembled for Representative Cory Mason (LRB 3545/P2). This estimate is derived from data regarding similar provisions in other states, including: "corporate income tax collections under the Montana law, the estimates used in enacting the Oregon law, and estimates for bills that would repeal the Montana law, and enact similar laws in Minnesota, and California. This information was adjusted to reflect differences between Wisconsin corporate income/franchise tax provisions and the corporate income tax provisions of the other states."[12]

**Montana is Leading the Way**

Other states that have already enacted combined reporting are taking action to close the "water's edge" tax loophole. In 2003, in a bipartisan vote of 79-20 in the state legislature, Montana enacted a policy to tighten the "water's edge" loophole.[13] The policy required that companies with subsidiaries in known tax havens include that income on their combined report. As a result, Montana recouped $7.2 million from corporations in 2010 that were previously exploiting this loophole.[14]

The state of Oregon also adopted a similar tax provision in 2013 with unanimous, bi-partisan support.[15] Like Montana's policy from 2003, Oregon's bill requires companies reporting their profits in known tax havens to treat this income as domestic for state tax purposes.[16] Oregon estimates that this will save taxpayers $18 million in the 2013-15 biennium, $42 million in the 2015-17 biennium, and $49 million in the 2017-19 biennium.[17]

**The Tax Haven Tradeoff: How Wisconsin Taxpayers Could Benefit from Closing the "Water's Edge" Loophole**

Either we will continue to provide special treatment for a select few corporations, and stick Wisconsin businesses and individuals with the tab, or we will close this loophole so that everyone plays by the same rules. The following are ways that Wisconsin taxpayers and businesses could benefit by simply closing the 'water's edge' loophole:

**TAX & ECONOMY**

- Provide a tax cut of $10.06 for every person who filed a Wisconsin tax return, in tax year 2010.[18]
- Give a $1,168 Homestead Credit to 24,657 Wisconsin taxpayers.[19]
- Increase Wisconsin's rainy day fund by 10.3%, based on the balance as of February 2014.[20]

**EDUCATION**

- Increase state education funding and add 531 teachers, based on the average teacher salary in Wisconsin.[21]

- Cover in-state undergraduate tuition and fees at the University of Wisconsin-Madison for 2,768 students for one year.[22]
- Give a $3000 Wisconsin Higher Education Grant to 9,600 undergraduate Wisconsin students for one year.[23]

**PUBLIC SAFETY**

- Increase funding for public safety and hire an additional 531 police or sheriff's patrol officers.[24]

**TRANSPORTATION**

- Reimburse local governments for 13,604 miles worth of road-related costs, such as constructing roads, filling potholes, plowing snow, grading shoulders, marking pavement, and repairing curbs and gutters.[25]
- Increase the state highway rehabilitation budget by 7% over the approved 2013-15 biennial budget allocation.[26]
- Increase state assistance for mass transit by 27% over the approved 2013-15 biennial budget allocation.[27]

**Conclusion**

All taxpayers rely on public infrastructure and services, including education, transportation, police, fire, sanitation, parks and recreation, and public health. Therefore, all Wisconsin corporations and taxpayers should operate by the same rules and follow the same tax code, not one riddled with loopholes for a small minority of taxpayers and corporations to exploit. Other states have passed laws to close tax loopholes; Wisconsin should also. To that end, we urge state leaders in Wisconsin to close the "water's edge" loophole in Wisconsin's tax code, one of many loopholes that companies use to avoid state income tax liability. Like Montana, Wisconsin should require companies to include income information for companies in known tax havens.

The vast majority of Wisconsin businesses and taxpayers should not be disadvantaged and have to pick up the tab for a small minority of businesses and wealthy individuals who are able to exploit the tax code through tax loopholes. The bottom line is that everyone should play by the same rules to keep Wisconsin moving forward.

[1] http://www.wispirg.org/reports/wip/hidden-cost-offshore-tax-havens
[2] *Picking Up the Tab 2014: Average Citizens and Small Businesses Pay the Price for Offshore Tax Havens* (U.S. PIRG, April 2014), http://wispirg.org/reports/wip/picking-tab-2014.

[3] These findings were based on 10-k reports public companies file with the U.S. Securities and Exchange Commission.

[4] *Picking Up the Tab 2014: Average Citizens and Small Businesses Pay the Price for Offshore Tax Havens* (U.S. PIRG, April 2014), http://wispirg.org/reports/wip/picking-tab-2014.
[5] *Closing the Billion Dollar Loophole*, (U.S. PIRG, February 2014). http://wispirg.org/reports/wip/closing-billion-dollar-loophole.

[6] *Closing the Billion Dollar Loophole*, (U.S. PIRG, February 2014). http://wispirg.org/reports/wip/closing-billion-dollar-loophole.
[7] http://wispirgfoundation.org/news/wif/offshore-tax-dodging-blows-814-million-hole-wi-budget
[8] *Picking Up the Tab 2014: Average Citizens and Small Businesses Pay the Price for Offshore Tax Havens* (U.S. PIRG, April 2014), http://wispirg.org/reports/wip/picking-tab-2014

[9] *Picking Up the Tab 2014: Average Citizens and Small Businesses Pay the Price for Offshore Tax Havens* (U.S. PIRG, April 2014), http://wispirg.org/reports/wip/picking-tab-2014

[10] McIntyre, Robert S., Matthew Gardner and Richard Phillips. Citizens for Tax Justice and Institute on Taxation and Economic Policy. March 2014. http://ctj.org/90reasons/91ReasonsFull.pdf.

**[11]** Mazerov, Michael. Center on Budget and Policy Priorities. **"**A Majority of States Have Now Adopted a Key Corporate Tax Reform — 'Combined Reporting'"
April 2009. http://www.cbpp.org/cms/?fa=view&id=246.

[12] Legislative Fiscal Bureau, *Corporate Income/Franchise Tax: Treatment of Income or Loss from Corporations in Certain Jurisdictions,* January 22, 2014.

[13] Conversations with the Montana Department of Revenue, March 2013.
**[14]** Chokshi, Niraj. "How Maine hopes to recover $10 million a year from tax havens." Washington Post, April 3, 2014. http://www.washingtonpost.com/blogs/govbeat/wp/2014/04/03/how-maine-hopes-to-recover-10-million-a-year-from-tax-havens/

[15] http://gov.oregonlive.com/bill/2013/HB2460/
[16] https://olis.leg.state.or.us/liz/2013R1/Downloads/MeasureAnalysisDocument/22133
[17] https://olis.leg.state.or.us/liz/2013R1/Downloads/MeasureAnalysisDocument/22133

[18] http://www.revenue.wi.gov/ra/10intxst.pdf pg. 2, table 1; In tax year 2010, 2,862,420 individual tax returns were filed in Wisconsin
[19] http://www.revenue.wi.gov/taxpro/fact/hc.pdf This figure assumes the taxpayer would receive the current maximum credit of $1168.
[20] http://www.wisconsinbudgetproject.org/of-a-surplus-of-nearly-1-billion-not-a-dime-is-going-to-the-rainy-day-fund. The rainy day fund in February 2014 was $279,000,000.

[21] http://www.teacherportal.com/salary/Wisconsin-teacher-salary This figure was calculated using the 2011 approximate average teacher salary of $54,195.

[22] http://www.finaid.wisc.edu/undergraduate-cost.htm This figure was calculated using the 2013-14 academic year tuition and fees, not including summer. This figure does not include other figures normally included in the total cost of attendance, such as books and supplies, room and board, miscellaneous or travel fees.

[23]. http://www.heab.state.wi.us/programs.html This figure assumes students are receiving the current $3000 annual maximum. Students must be enrolled at least halftime to receive this award.

[24] http://www.bls.gov/oes/current/oes_wi.htm Estimated average annual salary for Wisconsin police/sheriff's patrol officers is $54,170.

[25] http://www.dot.wisconsin.gov/localgov/docs/gta.pdf Reimbursements are calculated at a rate of $2117 per mile for Calendar Year 2013 & 2014. The General Transportation Aid fund offsets the cost of county and municipal road construction, maintenance, traffic, and police costs

[26] Based on a "Budget Deconstruction" memo by Ash Anandanarayanan of 1000 Friends of Wisconsin, which sourced information from http://legis.wisconsin.gov/lfb/publications/budget/2013-15%20Budget/Documents/Joint%20Finance/dot.pdf

[27] Based on a "Budget Deconstruction" memo by Ash Anandanarayanan of 1000 Friends of Wisconsin, which sourced information from http://legis.wisconsin.gov/lfb/publications/budget/2013-15%20Budget/Documents/Joint%20Finance/dot.pdf

# Table of Countries Listed on Various Tax Havens Lists[1]

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|---|---|
| Caribbean/West Indies | Anguilla, Antigua and Barbuda, Aruba, Bahamas, Barbados,[d,e] British Virgin Islands, Cayman Islands, Dominica, Grenada, Montserrat,[a] Netherlands Antilles, St. Kitts and Nevis, St. Lucia, St. Vincent and Grenadines, Turks and Caicos, U.S. Virgin Islands[a,e] |
| Central America | Belize, Costa Rica,[b,c] Panama |
| Coast of East Asia | Hong Kong,[b,e] Macau,[a,b,e] Singapore[b] |
| Europe/Mediterranean | Andorra,[a] Channel Islands (Guernsey and Jersey),[e] Cyprus,[e] Gibralter, Isle of Man,[e] Ireland,[a,b,e] Liechtenstein, Luxembourg,[a,b,e] Malta,[e] Monaco,[a] San Marino,[a,e] Switzerland[a,b] |
| Indian Ocean | Maldives,[a,d] Mauritius,[a,c,e] Seychelles[a,e] |
| Middle East | Bahrain, Jordan,[a,b] Lebanon[a,b] |
| North Atlantic | Bermuda[e] |
| Pacific, South Pacific | Cook Islands, Marshall Islands,[a] Samoa, Nauru,[c] Niue,[a,c] Tonga,[a,c,d] Vanuatu |
| West Africa | Liberia |

Sources: Organization for Economic Development and Cooperation (OECD), Towards Global Tax Competition, 2000; Dhammika Dharmapala and James R. Hines, "Which Countries Become Tax Havens?" Journal of Public Economics, Vol. 93, 0ctober 2009, pp. 1058-1068; Tax Justice Network, "Identifying Tax Havens and Offshore Finance Centers: http://www.taxjustice.net/cms/upload/pdf/Identifying_Tax_Havens_Jul_07.pdf. The OECD's "gray" list is posted at http://www.oecd.org/dataoecd/38/14/42497950.pdf. The countries in Table 1 are the same as the countries, with the exception of Tonga, in a recent GAO Report, International Taxation: Large U.S. Corporations and Federal Contractors with Subsidiaries in Jurisdictions Listed as Tax Havens or Financial Privacy Jurisdictions, GAO-09 157, December 2008.

Notes: The Dharmapala and HInes paper cited above reproduces the Hines and Rice list. That list was more oriented to business issues; four countries—Ireland, Jordan, Luxembourg, and Switzerland—appear only on that list. The Hines and Rice list is older and is itself based on earlier lists; some countries on those earlier lists were eliminated because they had higher tax rates.

St. Kitts may also be referred to as St. Christopher. The Channel Islands are sometimes listed as a group and sometimes Jersey and Guernsey are listed separately. S. 506 and H.R. 1245 specifically mention Jersey, and also refer to Gurensey/Sark/Alderney; the latter two are islands associated with Guernsey.

a. Not included in S. 506, H.R. 1245.
b. Not included in original OECD tax haven list.
c. Not included in Hines and Rice (1994).
d. Removed from OECD's List; Subsequently determined they should not be included.
e. Not included in OECD's "gray" list as of August 17, 2009; currently on the OECD "white" list. Note that the "gray" list is divided into countries that are tax havens and countries that are other financial centers.
The latter classification includes three countries listed in Table 1 (Luxembourg, Singapore, and Switzerland) and five that are not (Austria, Belgium, Brunei, Chile, and Guatemala). Of the four countries moved from the "black" to the

* Jane G. Gravelle, Congressional Research Service, Tax Havens: International Tax Avoidance and Evasion (January 23, 2013)