

U.S. ON THE BLACKLIST – IS DELAWARE A TAX HAVEN?

Authors

Christine Long
Beate Erwin

Tags

Beneficial Owner
Blacklist
CbC Reporting
Delaware
Tax Haven
Tax Avoidance

In reaction to the Panama Papers revelations, many European countries have increased what were already fierce actions towards combatting global tax evasion. Notably, the European Commission has gone so far as to draft a blacklist of tax havens based on the O.E.C.D.'s Common Reporting Standard ("C.R.S.") – informally also referred to as "G.A.T.C.A.", *i.e.*, the globalization of F.A.T.C.A. – and Base Erosion and Profit Shifting ("B.E.P.S.") initiatives.

The European Parliament and several E.U. Member States contended that if the U.S. does not implement the C.R.S. and B.E.P.S. Project recommendations, the country should be declared a tax haven and added to the European Commission's new blacklist. E.U. Member States have even demanded that Delaware and Nevada be required to disclose the beneficial owners of the companies formed in those states.¹

The blacklist is expected to be finalized by the end of 2016. Under the European Commission's proposed country-by-country ("CbC") reporting requirements, any company with business activities in a country on the blacklist would be required to disclose profits earned and taxes paid in that jurisdiction.² If the U.S. is blacklisted, this would impose an even greater administrative burden on U.S. companies, which are already subject to numerous reporting requirements under U.S. domestic tax law, by requiring them to provide additional reporting to the E.U. Other E.U. proposals include the creation of a beneficial ownership registry, to be exchanged amongst the E.U. Member States, and the expansion of the E.U.'s Anti-Tax Avoidance Directive and Anti-Money Laundering Directive.³

U.S. REACTION TO THE PANAMA PAPERS – BENEFICIAL OWNERSHIP REGISTRY

In comparison, the U.S. reaction to the Panama Papers has not been so bold,⁴ and the revelations did not appear to affect the country's stance vis-a-vis the international rush towards corporate public reporting. While roughly 100 nations have agreed

¹ Joe Kirwin, "E.U. Ministers Back Exchanging Beneficial Ownership Registries," *Bloomberg BNA, International Tax Monitor*, April 25, 2016.

² See in detail Kenneth Lobo and Michael Peggs, "Country-by-Country Reporting – Where Are We Going?," *Insights* 3, no. 4 (2016).

³ *Id.*

⁴ While the acting assistant attorney general in the Department of Justice's Tax Division declined to comment on the consequences of the Panama Papers, the deputy chief in the Internal Revenue Service's Criminal Investigation Division made clear that scrutinizing international tax evasion cases will be given absolute priority. See *Bloomberg BNA, International Tax Monitor*, May 10, 2016.



to implement the C.R.S., the U.S. has yet to sign on. At this stage, there does not seem to be much Congressional support for adopting the C.R.S. and B.E.P.S. Project recommendations, and the adversarial situation is further compounded by the fact that many congressmen view the E.U. State Aid investigations as unfairly targeting U.S. multinational companies.

Even if it is not following the lead of the O.E.C.D. or the E.U., the U.S. has taken its own actions to fight tax evasion: In his May 5 letter to Congress, U.S. Treasury Secretary Jacob Lew referred to F.A.T.C.A. as the “critical tool in the fight against tax evasion,” which resulted in the creation of the C.R.S. on an international level. Nevertheless, Treasury Secretary Lew acknowledged that current U.S. measures were not without their flaws, and he called upon Congress to pass proposed legislation, which would require states to report beneficial ownership, to further counter money laundering and tax evasion.⁵ Currently, the U.S. government does not require any U.S. states to report the beneficial owners of entities within their jurisdictions.

It is unclear how much Congressional support there is for such beneficial ownership registries, as previous proposals by the Obama Administration have been blocked by Congress and other U.S. agencies. For example, instead of having states require companies to disclose their beneficial owners during the registration process, the Obama Administration has proposed legislation that would apply to all states and would require every U.S. business entity to obtain a tax identification number that could be shared with the Treasury Department and other law enforcement agencies.⁶

Independent of the Treasury Department’s actions, Senator Ron Wyden (D-OR) of the Senate Finance Committee has requested that the state secretaries of Nevada and Wyoming provide a specific list of information about the beneficial owners of entities linked to the law firm Mossack Fonseca through the Panama Papers. The senator cited his growing concern about anonymous shell companies concealing illegal activities and requested the information be provided by June 3. This would be no small feat, as there are over 1,000 entities registered in Nevada that appear in the Panama Papers, and an additional 24 entities registered in Wyoming.⁷

THE U.S. IS A TAX HAVEN? – FEDERAL REPORTING REQUIREMENTS

The E.U. contention that the U.S. should be blacklisted as a tax haven seems to be no more than an overreaction to the Panama Papers. Not only has the U.S. Federal government spearheaded the global movement towards financial information sharing with initiatives like F.A.T.C.A., but the U.S. has some of the most extensive reporting requirements in the world.

⁵ Kevin Bell, “Treasury Targets Foreign-Owned LLCs to Battle Tax Evasion,” *Bloomberg BNA, International Tax Monitor*, May 6, 2016. Further proposed measures include providing full reciprocity with F.A.T.C.A. partners, rules on disregarded entities, a final rule requiring banks to obtain more information on account owners, and approval of bilateral tax treaties currently pending in the Senate.

⁶ David Kocieniewski, “Delaware’s Opacity Industry Provides U.S. Onshore Tax Haven,” *Bloomberg BNA, Daily Tax Report*, April 27, 2016.

⁷ “Nevada & Wyoming Asked to Provide Information on Entities Linked to ‘Panama Papers,’” *Checkpoint, International Taxes Weekly*, May 17, 2016.

“Not only has the U.S. Federal government spearheaded the global movement towards financial information sharing with initiatives like F.A.T.C.A., but the U.S. has some of the most extensive reporting requirements in the world.”

There is a low monetary threshold that triggers a U.S. person's requirement to file certain forms that disclose connections with foreign entities or assets. The most commonly used forms are described below.

Form 5471

Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*, must be filed by certain U.S. persons that acquire or own interests in foreign corporations. Generally, Form 5471 must be filed annually if the U.S. person owns at least 10% of the voting power of a foreign corporation that is a controlled foreign corporation (“C.F.C.”). The penalties for failing to file Form 5471 can be substantial.

Form 8938

Any individual with an interest in one or more specified foreign financial assets that have a value greater than (i) \$50,000 on the last day of the taxable year or (ii) \$75,000 at any time during such year (with higher amounts applying based on tax filing status and residency) is obligated to disclose those interests on Form 8938, *Statement of Specified Foreign Financial Assets*.

Applicable foreign financial assets generally include any depository or custodial accounts that are maintained by a foreign financial institution and any other financial instrument or contract that is held for investment purposes, including stock and securities. The penalties for failing to file Form 8938 can also be substantial.

FinCEN Form 114

U.S. persons who have a financial interest in or signature or other authority over a financial account in a foreign country must report the account annually to the Treasury Department, if the aggregate value of all foreign financial accounts exceeds \$10,000 at any time during the calendar year. An individual is deemed to have a financial interest in a foreign financial account held by a corporation in which the individual owns, directly or indirectly, more than 50% of the total value of shares of stock or more than 50% of the voting power of all shares of stock. Reporting is effected on FinCEN Form 114, commonly known as the F.B.A.R., which is due by June 30 following the close of the calendar year.

Form 8621

Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or a Qualified Electing Fund*, reports ownership of, or certain transactions with, a passive foreign investment company (“P.F.I.C.”).

Under Code §1298(f), each U.S. person who is a P.F.I.C. shareholder must file an annual report containing such information as the Secretary may require. Individuals who own at least 50% of the value of the stock of a foreign corporation are considered to own a proportionate amount (by value) of any stock owned directly or indirectly by the foreign corporation.

Form 926

Form 926, *Return by a U.S. Transferor of Property to a Foreign Corporation*, is used to report certain transfers of property to a foreign corporation required by Code

§6038B. A U.S. person that transfers cash to a foreign corporation must report the transfer on Form 926 if (i) immediately after the transfer the person holds, directly or indirectly, at least 10% of the total voting power or the total value of the foreign corporation, or (ii) the amount of cash transferred by the person to the foreign corporation during the 12-month period ending on the date of the transfer exceeds \$100,000.

DELAWARE TAX HAVEN DEBATE

For years, tax professionals have debated whether the state of Delaware is a tax haven. The over 200,000 “offshore” tax avoidance structures revealed in the Panama Papers have rejuvenated this debate.

That Delaware is attracting businesses cannot be denied. Notably, over 285,000 companies are currently registered with the same address at 1209 North Orange Street in Wilmington, Delaware. This address is the most popular address in the world and home to some of America’s biggest companies, including Walmart, General Electric, American Airlines, and PepsiCo; and it is even home to entities owned by U.S. presidential candidates Hillary Clinton and Donald Trump.⁸

One of the reasons that Delaware is attractive to businesses lies in its state tax system. While Delaware imposes an income tax of 8.7% on corporations doing business in or deriving income from property located in Delaware,⁹ corporations are generally exempt from corporate income tax if the activities within Delaware are limited to the maintenance and management of intangible investments.¹⁰ While entities incorporated in Delaware that do not conduct business in the state are not subject to corporate income tax, they must pay the franchise tax to the Delaware Department of State.¹¹ Delaware does not impose a sales tax.

Delaware has a fast and simple incorporation process that has allowed for more than one million entities to be registered in the state. The process merely requires registering the entity’s name and address, and paying a fee. As is the case for all U.S. states under current law, Delaware does not require the beneficial owners of its entities to be registered. Delaware law protects the confidentiality of its entities’ owners.

While many shell companies in Delaware are created for legitimate reasons, including buying real estate without alerting competitors and creating business holding companies, Delaware’s relaxed disclosure rules may also attract illegitimate shell companies. A company registered in Delaware can take advantage of business-friendly courts, strict secrecy rules, lack of sales tax, and corporate tax exemptions. The combination of these factors results in Delaware treading the line between allowing companies to be tax efficient and enabling tax evasion.

⁸ Rupert Neate, “Trump and Clinton Share Delaware Tax ‘Loophole’ Address with 285,000 Firms,” *The Guardian*, May 25, 2016.

⁹ Del. Code Ann. tit. 30, §1902(a). Delaware has a physical presence test to determine whether an entity has sufficient nexus to be subjected to its tax.

¹⁰ Del. Code Ann. tit. 30, §1902(b)(8).

¹¹ Del. Code Ann. tit. 30, §1902(b)(6).

However, in view of extensive Federal reporting obligations and the high Federal income tax rate,¹² Delaware and other low-tax states¹³ do not compare with international tax havens such as Hong Kong, Monaco, or Guernsey. Moreover, if the Treasury recommendations are pursued and Congress implements a Federal standard for reporting beneficial ownership information, it will be hard to consider Delaware a tax haven because the owners of Delaware entities will be known and unable to untraceably shift income.

The Delaware Loophole

Under the Delaware state income tax regime, the “Delaware loophole” structure has allowed U.S. companies to shift income from states with high corporate tax rates. This tax loophole is also referred to as a “passive investment company,” an “intangible holding company,” and a “Geoffrey the Giraffe structure” (after the corporate mascot of children’s retailer Toys“R”Us, which famously uses its Delaware subsidiary to avoid state income taxes).

Subsidiary Structure

The Delaware loophole is often a subsidiary structure in which a passive investment company is formed in Delaware and the parent company transfers all of its intangible property into the Delaware subsidiary. The Delaware subsidiary then licenses its intangible property back to the parent company, or affiliated sister companies, in exchange for royalty payments, which are tax-free in Delaware. The parent company claims the royalty payments as a business expense and deducts the expense from its state income tax. Thus, the company effectively reduces its taxable income, and no state income tax is paid on the royalties.¹⁴

Since interest payments are also tax-free, the Delaware loophole structure enables the Delaware subsidiary to loan money to its parent or sister companies. Again, this results in the parent or sister company taking a deduction on its state income tax return for the interest paid on the loan, and the Delaware subsidiary is not taxed on the interest income it receives.

Real Estate Structure

The real estate investment trust (“R.E.I.T.”) structure is also used by large companies to avoid state income tax. Under Federal law, the dividends distributed from the R.E.I.T. to its investors are exempt from tax. Chain retailers have commonly used the R.E.I.T. to buy land on which to build their stores. The parent company pays rent to the R.E.I.T. and deducts the rent, as a business expense, from its state income tax. The R.E.I.T.’s income is distributed as a dividend, which is tax-exempt, back to the parent company. Delaware, Nevada, and Wyoming are all popular states to set



¹² The U.S. has one of the highest Federal income tax rates in the world, which applies to U.S. entities irrespective of the state of formation.

¹³ Other U.S. states that offer a low or zero corporate tax rate include Nevada, Wyoming, and South Dakota.

¹⁴ Institute for Local Self-Reliance, “Closing State Corporate Tax Loopholes: Combined Reporting,” December 2015.

up R.E.I.T.'s because rental income is not subject to state income tax.¹⁵

Closing the Loophole

It is difficult to determine how much state income tax has been diverted to states like Delaware because the foregoing structures are legal and U.S. companies are not required to report transfers to their U.S. subsidiaries.¹⁶ Smaller companies that do not operate in multiple states are left with a bigger state income tax burden because they do not have the means to create a Delaware subsidiary into which they could shift income. However, many states have closed the Delaware loophole by requiring corporations with sufficient nexus to file combined tax returns with their associated entities.¹⁷ These combined tax returns require all of the companies' income earned within the U.S. and a worldwide basis to be reported on one state return.

CONCLUSION

The claim that Delaware is a tax haven is misplaced. Arguably, Delaware is a U.S. domestic, but not an international, tax haven. Whereas Delaware's advantageous state income tax regime directs millions of dollars in revenue away from other U.S. states, Federal income tax must still be paid – at one of the highest tax rates worldwide. Furthermore, Delaware-based entities must comply with extensive Federal reporting requirements. The main reason companies are formed in Delaware is due to its business-friendly corporate law. The corporate income tax exemptions provide an ancillary benefit.

Although no U.S. state is currently required to maintain beneficial ownership information, the proposals by the Treasury Department and the Senate Finance Committee suggest that a registry of certain beneficial owners may be implemented at the state level in the not too distant future. In view of these developments, the contention that any U.S. state, or the country as a whole, is a tax haven may soon be obsolete.

“Arguably, Delaware is a U.S. domestic tax haven – but it is not an international one.”

¹⁵ *Id.*

¹⁶ According to one source, the cost to such states is estimated at more than \$9 billion in lost revenue. See Neate, “Trump and Clinton.”

¹⁷ “Closing State Corporate Tax Loopholes: Combined Reporting.”