state tax notes

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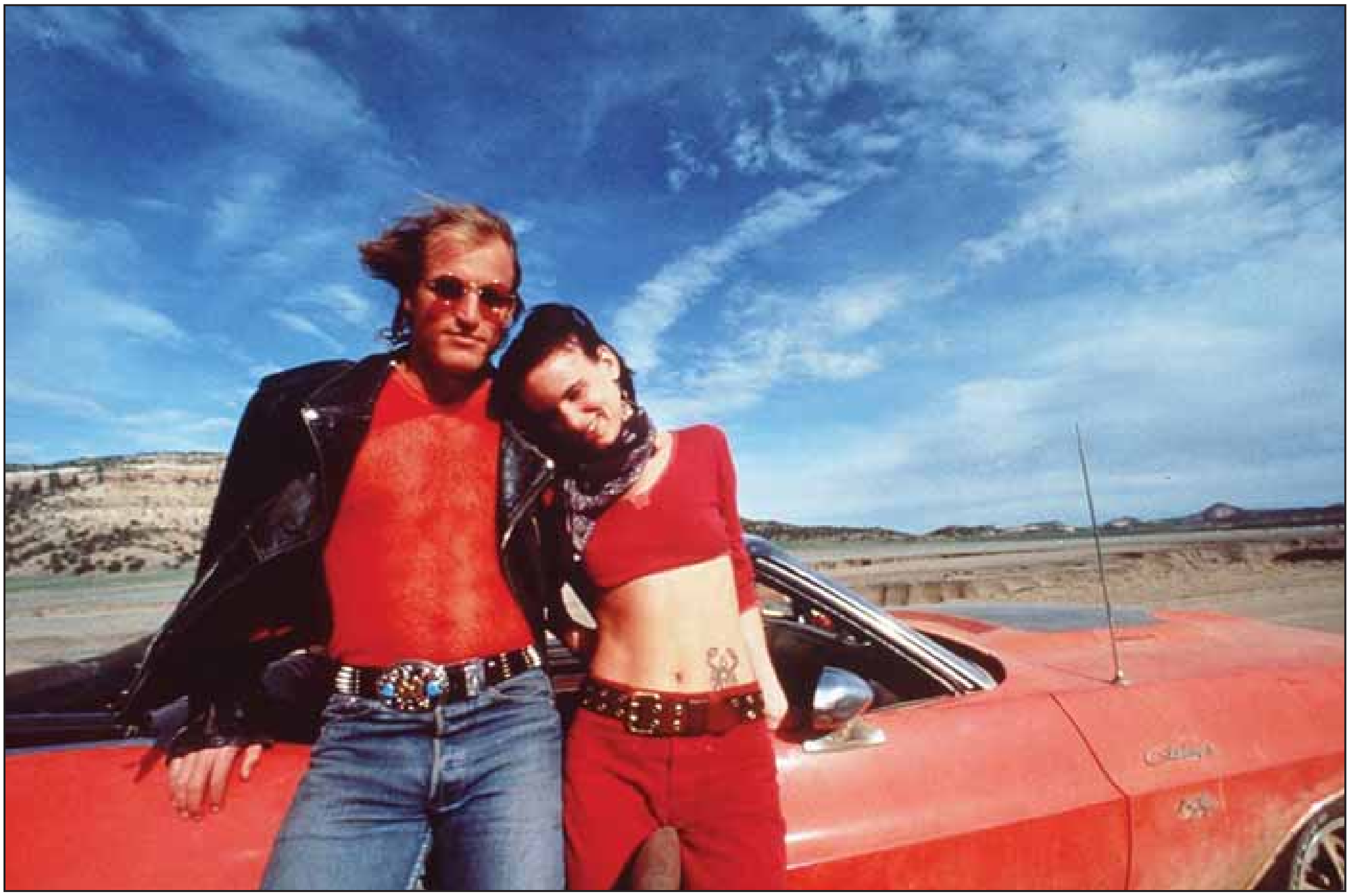
Natural-Born Job Killers



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ON THE COVER

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Delaware: Tax Haven or Scapegoat?

by Sheldon D. Pollack

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At the annual G-8 summit in Northern Ireland in June, leaders of the world's financial powerhouses focused on how to reduce tax evasion by large multinational corporations and how to put a damper on international money laundering.

The United States and the United Kingdom have been leading the campaign against international tax havens, which allow multinational corporations to reduce their tax liabilities in their high-tax "home" jurisdictions — which essentially include all G-8 nations (Canada, France, Germany, Italy, Japan, Russia, the United States, and the United Kingdom) — by shifting income to accommodating low-tax jurisdictions. As a consequence, the United States and the United Kingdom have seen their corporate tax bases eroded through complicated revenue-shifting arrangements, and they are fighting back. Likewise, the U.S. Department of the Treasury has been aggressively attacking the use of secret bank accounts in places like Switzerland, Luxembourg, Bermuda, and the Cayman Islands. Secret bank accounts allow scofflaws to hide assets from the tax authorities and criminals to stash ill-gotten gains from illegal activities such as the drug trade and offshore gambling. A handful of jurisdictions conveniently provide the benefits of both low taxes and bank secrecy.

Because the U.S. Treasury has been aggressive in its campaign against international tax havens and bank secrecy (more or less tradition in places like Switzerland and Luxembourg), there is rising resentment (not necessarily new) against Uncle Sam's policies in some parts of Europe. That resentment has been fueled of late by stories in the American press proclaiming Delaware a tax haven and purveyor of clandestine shell corporations used for illegal money laundering.

In 2009 and 2012, *The New York Times* published a series of articles that purportedly revealed Delaware as a major facilitator of tax evasion.[1] Based on a misunderstanding of specific features of Delaware's tax law, those exposés portray the First State as a leading international tax haven. Journalists commonly cite the large number of publicly traded corporations organized under Delaware law as evidence that the state is a haven for corporate tax cheats. Why else would there be so many Delaware corporations? Similarly, they point to the relative privacy afforded to the owners of Delaware closely held corporations (as well as the ease and low cost in setting up such entities) as evidence that Delaware is the ideal place to launder the profits from illicit enterprises through the use of shell corporations.[2]

Taking the cue from their U.S. brethren, European journalists point to Delaware as confirmation of American hypocrisy — namely, the U.S. government campaigns against European tax havens and bank secrecy while the prime culprit is actually within its own borders. They contend that Americans, as the worst sinners, should not cast stones at Switzerland, Luxembourg, or the Isle of Man. In recent months, reporters from the U.K. print media, the BBC, and Swiss TV have traveled to the First State looking to expose American hypocrisy based on Delaware's supposedly lax corporate statute and favorable tax climate for multinational corporations.

To validate their claims and add a touch of authority, European muckrakers commonly seek out local "experts" to rail against Delaware. Academics are perfect for these purposes, and so the reporters come to the University of Delaware. As a faculty

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[1]Lynnley Browning, "Critics Call Delaware a Tax Haven," *The New York Times*, May 29, 2009; Leslie Wayne, "How Delaware Thrives as a Corporate Tax Haven," *The New York Times*, June 30, 2012.

[2]Indicative of reports on Delaware shell corporations as a vehicle for illegal activities is Lynnley Browning, "Delaware Laws, Helpful to Arms Trafficker, to Be Scrutinized," *The New York Times*, Nov. 4, 2009; Nick Mathiason, "Delaware — a Black Hole in the Heart of America," *The Observer*, Oct. 31, 2009. Interestingly, no one ever explains why a shell corporation is evil per se or in some way more prone to criminal activity than a corporation with assets.

member there with some minimal expertise on U.S. tax law, I have spent considerable time of late explaining to European reporters the subtle, but important, differences between Delaware as a domestic tax haven, which costs other state's some tax revenue, and jurisdictions such as Ireland, the Isle of Man, Jersey, Bermuda, and the Cayman Islands — which are international tax havens that cost the U.S. and U.K. treasuries billions of dollars in tax revenue annually. Invariably, European journalists are disappointed by that narrative, which contradicts everything they take for granted.

Last year, when a Swiss television crew interviewing me on this topic realized that I was never going to provide a hot quote denouncing Delaware as an international rogue state, they simply turned off the camera and abruptly ended our interview in midstream. More recently, a BBC reporter sat politely through an hour-long lecture on Delaware corporate and tax law — and why the First State is not an international tax haven or facilitator of money laundering — and then went ahead with history proclaiming Delaware an international tax haven and facilitator of money laundering.[3]

So what is it about Delaware tax and corporate law that creates the impression that it is a renegade state? And what aspects of Delaware law actually do make the state a domestic tax haven? There are four things to consider.

Delaware Is a Domestic Tax Haven

As is widely known among tax lawyers, Delaware is a domestic tax haven. The state provides an infamous exemption from its corporate income tax for so-called Delaware investment holding companies whose activities are limited to holding and managing intangible assets.

Long story short, this is a time-honored sham (oops, I mean "tax planning strategy") perpetrated by the Delaware General Assembly — doing the bidding of the Wilmington tax bar and accounting firms — at the expense of its fellow states. How does it work? A corporation physically located and doing business in another state (say, in Pennsylvania) establishes a Delaware investment holding company as a subsidiary to hold its intangible assets (for example, intellectual property such as patents, trademarks, and trade names). These intangible assets are contributed tax free to the subsidiary, which is then the legal owner of the property. The Pennsylvania parent then shifts revenue (and hence, profits) to its Delaware subsidiary by paying licensing fees for the right to use that intangible property (for example, use the trade name or trademark).

To be sure, it is a bit more complicated than that, but fortunately there is no shortage of attorneys and accountants in Wilmington who are willing to explain all the subtleties and set up the arrangement for a fee. What is the result of this legal tax planning? The earnings derived from the intangible assets escape Pennsylvania corporate income tax (which reaches a 9.99 percent maximum rate), while Delaware graciously forgoes taxing the same income under its own corporate income tax. Why? What's in it for Delaware, which collects no corporate income tax from the subsidiary on the diverted same revenue? Some franchise tax is collected by the state on the investment holding company subsidiary, but the real benefit is the fees generated for Delaware lawyers and accountants, who enjoy the favor of the legislature.

Not surprisingly, the tax authorities in places like Harrisburg view the arrangement as entirely at their expense — and they are right. Some states have responded, looking to end the practice. For its part, after suffering for decades, Pennsylvania recently enacted legislation (HB 465, or Act 52), which takes a stab at closing the "Delaware loophole." Such measures may help a bit but are unlikely to completely address the issue or stifle resentment against its neighbor to the south.

It does not help that Delaware does not impose a retail sales tax and publicly advertises as much — looking to lure shoppers off I-95 who might otherwise spend their hard-earned dollars in neighboring states such as Pennsylvania. This only reinforces the perception that Delaware does not play fair.

Delaware Is Not an International Tax Haven

It is hard for Europeans to understand that states such as Delaware are free to impose their own laws and taxes, even those that offend other states, the federal government, or President Obama. Different provinces in France do not make their own tax law. Likewise, Europeans find it hard to believe that Delaware's tax system is independent of federal tax law, which they conveniently forget applies everywhere in the United States. As such, a domestic corporation will pay the same federal income tax (which theoretically reaches a maximum rate of 35 percent) regardless of whether it is located in Delaware or across the border in Maryland or Pennsylvania. In fact, with a top rate of 8.7 percent for its corporate income tax and 6.75 percent for its personal income tax, Delaware is hardly a tax haven for domestic businesses physically located in the state. Simply put, the First State is not an international tax haven, despite what reporters for Swiss National TV and the BBC seem to believe.

[3]Much the same thing happened with a reporter for the *Financial Times*, who insisted that Delaware is a tax haven despite my protests to the contrary. *See* James Politi, "Delaware State Turns Defensive as Tax Debate Heats Up," *Financial Times*, June 11, 2013.

Corporations Do Not Organize in Delaware for Tax Benefits

Foreign journalists commonly cite well-known statistics that more than half of publicly traded corporations in the U.S. are organized as Delaware corporations. A lot of small privately held businesses physically located in other states are also organized as Delaware corporations — although for no obvious reason or benefit. Journalists take this as definitive proof that Delaware is a tax haven. Why else would all these corporations organize under Delaware law? Must be the tax benefits, they conclude.

The real reason, however, is more complicated. Delaware has a modern corporate statute, settled case law, and a specialized court (Chancery) that routinely deals with issues of corporate governance. The Delaware Supreme Court's published decisions on corporate governance matters are also widely read, respected, and followed. There is disagreement among scholars as to whether the corporate law is itself more favorable to management than the corporate law of other jurisdictions or whether the benefit is that legal outcomes are more predictable. Regardless, a corporation organized under Delaware's corporate statute is subject to Delaware law, and many observers think that is beneficial. That is why so many public corporations are organized under Delaware's corporate statute. It has nothing to do with reducing federal or state taxes.

And certainly no multinational corporation will want to shift taxable income from Europe to Delaware — where it will be exposed to the 35 percent federal corporate income tax and the inhospitable Delaware corporate income tax. Indeed, a lot of American and European multinational corporations bend over backward to shift income out of the reach of the United States and states such as Delaware to offshore tax havens such as Bermuda, the Cayman Islands, or the Isle of Man. Or perhaps to Ireland, where Apple moves a lot of the income it earns from selling millions of iPods and iPhones. But never to Delaware. That tells you something.

There is no tax benefit to a European corporation in shifting income from Europe to Delaware. Has anyone ever seen evidence that Apple or Starbucks engages in tax planning to shift revenue from their European operations to Delaware? That would be a major tax boner, to say the least.

Confidentiality Does Not Necessarily Facilitate Money Laundering

Finally, it is true that Delaware provides some greater privacy as to the identity of the owners of privately held corporations than do most states — except for Nevada and Wyoming, which ask even fewer questions. But does that facilitate money laundering?

State authorities and law enforcement can always gain access to that information. Further, states that require the names of the owners of a new corporation to be disclosed on their corporate charters do no further investigation beyond that and certainly do not monitor the subsequent comings and goings of shareholders. Anyway, you can always use a Bermuda or Cayman Islands corporation to hold the shares of a Pennsylvania or New York corporation, thereby shielding the true identity of the owners. It isn't hard to keep that information secret in any state.

True, it is a bit easier in Delaware, but that does not necessarily facilitate illegal money laundering. Rather, because Delaware corporations are easy and relatively cheap to organize, a would-be money launderer is more likely to use a Delaware corporation for nefarious purposes.

Pointing fingers at Delaware makes a good story for the foreign media and lends credence to the claim that the U.S. government is hypocritical in criticizing Swiss and Cayman Island banks for aiding and abetting tax cheats and money laundering. So expect more stories about Delaware as an international tax haven and the perfect place to launder cash. But don't believe everything you read — especially if I am cited in the article. It ain't necessarily so. ✰