CORPORATE INVERSIONS

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED SEVENTH CONGRESS

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CORPORATE INVERSIONS

THURSDAY, JUNE 6, 2002

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The Committee met, pursuant to notice, at 10:53 a.m., in room 1100 Longworth House Office Building, Hon. Bill Thomas (Chairman of the Committee) presiding.

[The advisory and revised advisory announcing the hearing follow:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
May 30, 2002
No. FC–19

CONTACT: (202) 225–1721

Thomas Announces a Hearing on Corporate Inversions

Congressman Bill Thomas (R–CA), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing on corporate inversions. **The hearing will take place on Thursday, June 6, 2002, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses. Also, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

During recent months, several corporations have either changed their principal place of incorporation to a foreign country or announced their intention to do so. On May 17, 2002, the U.S. Department of the Treasury released its Preliminary Report on Inversion Transactions that sets out the mechanics of and reasons for U.S. companies to undertake these transactions. The study also highlights the disadvantages that the U.S. Tax Code imposes on U.S. companies as compared to their foreign competitors.

In announcing the hearing, Chairman Thomas stated, "The fact that companies are leaving the United States for tax reasons is a serious problem. Inversions are one symptom of the larger problems with our Tax Code, particularly in the area of international competitiveness. As we address the inversion issue, we must be careful not to take action that will facilitate the foreign acquisition of U.S. companies or encourage investment capital to flee the United States."

FOCUS OF THE HEARING:

The focus of this hearing is to examine the mechanics of inversion transactions and examine policy options that will deter inversions and enhance U.S. international competition. The Committee will also hear testimony from the U.S. Department of the Treasury concerning its May 17, 2002, Inversion Study.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Due to the change in House mail policy, any person or organization wishing to submit a written statement for the printed record of the hearing should send it electronically to *hearingclerks.waysandmeans@mail.house.gov,* along with a fax copy to (202) 225–2610, by the close of business, Thursday, June 20, 2002. Those filing written statements that wish to have their statements distributed to the press and interested public at the hearing should deliver their 300 copies to the full Committee in room 1102 Longworth House Office Building, in an open and searchable package 48 hours before the hearing. The U.S. Capitol Police will refuse sealed-packaged deliveries to all House Office Buildings.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. Due to the change in House mail policy, all statements and any accompanying exhibits for printing must be submitted electronically to *hearingclerks.waysandmeans@mail.house.gov,* along with a fax copy to (202) 225–2610, in Word Perfect or MS Word format and MUST NOT exceed a total of 10 pages including attachments. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. Any statements must include a list of all clients, persons, or organizations on whose behalf the witness appears. A supplemental sheet must accompany each statement listing the name, company, address, telephone and fax numbers of each witness.

Note: All Committee advisories and news releases are available on the World Wide Web at *http://waysandmeans.house.gov/*.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

* * * NOTICE—CHANGE IN TIME * * *

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
June 5, 2002
No. FC–19–Revised

CONTACT: (202) 225–1721

Change in Time for Hearing on Corporate Inversions

Congressman Bill Thomas (R–CA), Chairman of the Committee on Ways and Means, today announced that the full Committee hearing on corporate inversions scheduled for Thursday, June 6, 2002, at 10:00 a.m., in the main Committee hearing room, 1100 Longworth House Office Building, **will now be held at 10:45 a.m.**

All other details for the hearing remain the same. (See Committee Advisory No. FC–19, dated May 30, 2002.)

Chairman THOMAS. I appreciate our guests finding seats. We probably are not going to be able to accomplish the hearing in one setting based upon activities that will occur on the Floor. My apologies at the beginning to those of you who plan on testifying. It may not be as orderly or sequential as most of us would prefer in dealing with a subject matter that, at once seems fairly simple, and at additional examinations perhaps is a bit more complex than we might have appreciated.

Obviously, the emphasis is that during recent months, many U.S. companies have announced that they will move their principal place of incorporation to a foreign jurisdiction. Principal among those are low-tax countries such as Bermuda. In fact, many companies have already taken this step.

Today, the Committee on Ways and Means will examine, one, the causes behind the reincorporations, but we also want to explore policy options to reduce the incentive for inversions while, if possible, enhancing U.S. international competitiveness. This, of course, builds on the initial hearings we had on the World Trade Organization (WTO) decision involving foreign sales corporations (FSC) and the Extraterritorial Income Exclusion Act (ETI) debate.

Members have introduced bills, beginning with a Member of this Committee, Scott McInnis, for example, on March 6, Mr. Neal of this Committee, Mr. Maloney, and Mrs. Johnson. They range from an attempt to punish behavior to a moratorium so that we could suspend behavior and examine options.

The Chair has no idea at this point what is the most appropriate way to go. I think that is one of the reasons we are supposed to hold hearings. Oftentimes, people believe the primary purpose of holding hearings is to provide an arena for political shenanigans or for points scored, not in terms of advancing a legislative purpose, but for even as far-ranging an activity as attempting to influence elections.

The Chair wants to announce at the beginning of this, this is serious business. This is obviously not the only hearing that we will hold. We must hold additional hearings based upon the information that Members, having received the U.S. Department of the Treasury testimony in advance, realize that Treasury has gone so far as to provide us with very specific examples of potential law change.

Those of us who reside in States with high taxes oftentimes, and perhaps properly, blame State legislatures when companies flee our State to go to low-tax jurisdictions in surrounding States. California has a number of examples. Historically, the inventory tax, and we thought California was so attractive, these large companies like Sears and others would stay in California forever. We woke up and found out that they had built warehouses in Nevada. I was in the State legislature at the time. They repealed the inventory tax and expected people then to simply move from Sparks, Nevada, where they had invested significant money in the warehouses and come back to California, and guess what, they did not.

So, we cannot ignore the fact that the U.S. Tax Code creates essentially the same phenomena internationally. Corporate inversions, I think, are a symptom of a larger underlying problem with our tax code, and if the corporate tax code has driven many companies to move their mailboxes to other jurisdictions, then I think we need to examine the tax code for suggested changes.

Now, the problem obviously is easily stated. As I said, the solution may be more complex. As we have noted in our foreign sales corporation hearings, competitiveness is sometimes in the eye of the beholder, and it is not as easily assessed as we would like. The United States has some of the world's most complicated rules on international taxation. These rules originate in part, I think, from a misguided belief that we can keep capital in the United States if we just have enough restrictive tax regimes.

We are still—the system we impose on American-based firms sometimes provides advantages to foreign companies that want to buy up American companies, and perhaps one of the reasons American companies want to become foreign companies on their own, on their own volition, is because they do not want to become foreign companies through hostile takeovers.

First today, we will hear from the Treasury Department, which has released a study which I would recommend to anyone as a very useful primer on what we are talking about in terms of corporate inversions. Beyond that, the written testimony submitted by the Treasury, as I said, provides us with very specific tax change suggestions.

We are then going to have a panel to, in part, give us a practical real-world perspective on how the tax system affects business decisions, and we have someone from State government for their reaction, as well.

The questions before us, to a certain extent, are is there something we can do in the short term while we are looking at the long term? Will it be better to move what we believe to be the long term with enough notice that, in fact, we are going to engage in this discussion? Whether is this just one symptom of an international tax code that probably needs to be looked at far more extensively? The problem of inversions being simply one example, which means perhaps, then, something like a moratorium might be appropriate, or perhaps specific legislation addressing the inversion question sooner rather than later, perhaps then looking at other tax aspects on a broader basis.

All of those are questions that are open right now as far as the Chair is concerned. The goal, of course, is to resolve what appears to be an immediate problem but which is symptomatic of the more complex and broader problem initiated by the WTO decision on the foreign sales corporation ETI subsidy, subsequently provided additional reinforcement by the inversion question.

So today, the Chair's hope is to lay the predicate, listen to the concerns, focus on some of the specific suggestions, and assure everyone that there will be more questions raised today than answers and that we will move forward in as expeditious a fashion as possible, perhaps utilizing the Subcommittee on Select Revenue to allow for further expansion of concerns that various corporations might have, foreign-based or domestic, based upon the questions raised today as we look forward to a solution to this problem.

With that, it is my pleasure to recognize the gentleman from New York for any comment he might wish to make. Mr. Rangel?

[The opening statement of Chairman Thomas follows:]

Opening Statement of the Hon. Bill Thomas, a Representative in Congress from the State of California, and Chairman, Committee on Ways and Means

During recent months, many U.S. companies have announced that they will move their principle place of incorporation to a foreign jurisdiction, including such low-tax countries as Bermuda. Many companies have already taken this step. Today, the Committee on Ways and Means will examine the causes behind reincorporations. We will also explore policy options to reduce the incentive for inversions while also enhancing U.S. international competitiveness.

It is worth noting that a Republican Ways and Means Member, Rep. Scott McInnis, introduced one of the first legislative fixes for inversions. He introduced H.R. 2857 on March 6, 2002. Most recently, Rep. Nancy Johnson—another Republican Committee Member—offered a moratorium bill, H.R. 4756 on May 16, 2002. Her moratorium is an appropriate step in the absence of a legislative solution. However, I want to be clear. This Chairman plans to introduce and move a thoughtful, reasonable approach to address corporate inversions, and I plan to do so sooner rather than later. Today's hearing will help us gather needed information to craft such a product.

Those of us who represent States with high taxes properly blame state legislatures when companies flee to low-tax jurisdictions in surrounding states. We can't ignore that the U.S. tax code creates the same phenomenon internationally. Corporate inversions are a symptom of a larger underlying problem with our tax code. The corporate tax code has driven many companies to move their mailboxes to other jurisdictions.

What changes must we make to keep America's competitive edge? Competitiveness is not easily assessed, as our extensive examination of the Foreign Sales Corporations has shown. The U.S. has some of the world's most complicated rules on international taxation. These rules originate, in part, from a misguided belief that we can keep capital in the United States through restrictive tax regimes. Worse still, the system we impose on American-based firms provides advantages to foreign companies that want to buy up American companies.

Today, we will first hear from the Treasury Department, which recently released a preliminary report on inversions. They are now developing options for addressing the competitiveness issues that inversions signal. To get a practical, real-world perspective, we will also hear from private sector witnesses about how our tax system influences business decisions.

This hearing is an opportunity for us to work together to develop modern tax systems suited to a growing global economy. I hope all of us will put aside shrill rhetoric and work in a cooperative effort to keep our economy as competitive as possible so that we can preserve American jobs. Before introducing our witnesses, I yield to Mr. Rangel from New York.

Mr. RANGEL. Thank you, Mr. Chairman. Some housekeeping questions. Mr. Chairman, one of the most important tax issues that has come before this Committee is to make permanent the estate tax repeal. Could you share with us whether you intend to manage this bill on the Floor, and how do you see we are going to maintain our attendance here at the hearing on this most important issue and at the same time the Members be allowed to express their concern about the bill on the Floor?

Chairman THOMAS. I appreciate the gentleman's concern. He might have expected that the Chair expressed that same concern to the leadership. Just let me say, it is difficult to try to get this Committee's work done on the shortened work weeks that are currently in front of us.

The Chair intends to continue the hearing as best we are able during whatever events may occur on the Floor, with the exception of multiple votes, as you know, which makes it difficult for us to determine when we come back. If there is a single vote, the Chair would like to try to continue the hearing.

It is the Chair's understanding at this time that the debate will begin, dependent upon the current procedural discussion and probably subsequent vote on the decision of the Chair currently going on, that the estate tax debate would begin somewhere in the 12:30 to 1:00 vicinity. The Chair intends to initiate the debate on the Floor, but not to be there during the entire debate. The structure of the debate is 1 hour, equally divided, and then my understanding is the rule made in order a substitute, which would be 1 hour, and then the minority has, as a right of the rules under this new Republican majority, a motion to commit, which I assume you will utilize. That will be occurring in the 2:00 to 3:00 range.

If we can move expeditiously through this hearing, we can lay the foundation for the additional hearings on more of the specific alternatives, as I indicated, the direction that we will probably go. To the degree, our goal here is to score points beyond trying to understand what the problem is and looking at specific legislative decisions, the Chair does not have control over that. Perhaps the gentleman from New York has a better idea of how long those activities would consume Committee time.

Mr. RANGEL. Mr. Chairman, I might suggest that you might consider recessing for 5 minutes until you and I have an opportunity to discuss the problem that we have. I will outline the degree of the problem.

First, the minority believes that both of these issues, the one before this full Committee and the one on the Floor, has a deep-seated political as well as economic significance, and while we recognize that the decision to put these important legislative issues in conflict was not yours, we are not prepared to accept the leadership's position.

Second, during this 5 minutes, the question of multiple votes, I will be glad to share with you that we might expect multiple votes, and I do not want to put witnesses nor those attending this hearing at ill ease, but I might just share with you, if we do not find our way able to recess this hearing until after the proceeding on the Floor, then I have every reason to believe that our Members will be spending a lot of time on procedural issues on the Floor.

In addition to that, it is my understanding, even though I am not certain, that the Chair unilaterally decided that a Member of the U.S. House of Representatives who sponsored a piece of legislation which this hearing is about would not be allowed to testify, and while this is certainly not a Democrat or Republican issue, certain Members of my caucus believe that, from an institutional point of view, they are not prepared to allow that to go by.

I want to list these things to see whether or not you might think that it is wise for you and I to just discuss these things for 5 or 10 minutes to see whether there can be any resolved, and I yield back to you for purpose of response.

Chairman THOMAS. I will tell the gentleman, I have been here since 8:30. My phone number is listed. My presence is known, but if the gentleman wants to take 5 minutes out of the time we now have to try to move forward on this hearing, the Chair, in recognition of the gentleman's presentation of this offer, which the Chair appreciates the way in which it was presented, will certainly take 5 minutes.

Mr. RANGEL. I might add that——

Chairman THOMAS. The Committee stands in recess for 5 minutes.

[Recess.]

Chairman THOMAS. If I could have your attention, please, there is just one vote on the Floor. We will run over, cast that vote, come back, and the Committee will resume. My goal is to resume at 11:30.

[Recess.]

Chairman THOMAS. If our guests can find seats, please. The first panel this morning will consist of Treasury representatives, including Pamela Olson as the Acting Assistant Secretary for Tax Policy at the U.S. Department of the Treasury. My understanding is that Barbara Angus will be with her at the table.

First of all, thank you for joining us. Thank you for the written testimony. It will be made a part of the record and you may address us in any way you see fit. Ms. Olson?

STATEMENT OF PAMELA F. OLSON, ACTING ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY; ACCOMPANIED BY BARBARA ANGUS, INTERNATIONAL TAX COUNSEL

Ms. OLSON. Thank you. Mr. Chairman, distinguished Members of the Committee, I appreciate the opportunity to appear at this hearing on corporate inversion transactions. I commend the Committee Members for your interest in and commitment to addressing this important issue. I also want to thank the Committee for allowing the Treasury Department the time to study, consider, and report on this matter to the Committee. We look forward to working with the Committee to implement the proposals I will outline and any other proposals we or you identify in the course of our ongoing evaluation of the issues presented.

I have attached to my written testimony today a copy of the Treasury study that we released last month on the tax policy implications of corporate inversions and I appreciate the Committee's including that in the record for today.

This Committee is well aware of the facts that precipitated our study and the hearing today: a series of announcements by U.S. companies of their intent to reincorporate outside the United States. The key reason cited for the transactions: Substantial reductions in overall corporate taxes. Corporate inversion transactions are not a new phenomenon, but there has been a marked increase in the frequency, size, and profile of the recently announced transactions. Moreover, rumors of other companies considering the transactions abound.

The Administration has concluded an immediate response is required that addresses the income minimization strategies associated with inversion transactions, strategies that can be employed to reduce the inverted company's U.S. tax on its income from its U.S. operations. An immediate response is required for two reasons. First, these strategies unfairly advantage inverted or other foreign-based companies over U.S.-based companies. Second, these strategies have a corrosive effect on the public's confidence in the U.S. tax system.

We cannot just address strategies that inappropriately minimize U.S. income, however. We must also address the tax disadvantages imposed by our international tax rules on U.S.-based companies with foreign operations. Relative to the tax systems of our major trading partners, the U.S. tax rules can impose significantly heavier burdens on the foreign operations of domestically-based companies. Our objective must be to ensure that the U.S. tax system maintains the competitiveness of U.S. businesses. Why? Because we care about U.S. jobs.

We have identified several specific areas in which action is needed. We believe that addressing the income minimization opportunities conferred by an inversion will remove the juice from the current inversion activity, eliminating the immediate benefits of and, therefore, the impetus for, such transactions.

It would be a mistake to focus such changes solely on inverted companies, however, since an inversion is only one route to accomplishing the same type of reduction in taxes. A U.S.-based start-up venture that contemplates both U.S. and foreign operations may incorporate overseas at the outset, thus positioning itself to achieve the same type of tax reduction. Similarly, an existing U.S. group may be the subject of a takeover by a foreign-based company. The resulting structure may provide similar tax savings opportunities to those provided by an inversion transaction.

A policy response targeted solely at the inversion phenomenon may inadvertently result in a tax code favoring other types of foreign ownership structures at the expense of domestically-managed companies. In turn, other decisions affecting location of new investment, choice of suppliers, and jobs may be adversely affected. While the openness of the U.S. economy has always made and will continue to make the United States one of the most attractive and hospitable locations for foreign investment in the world, there is no merit in policies biased against domestic control and domestic management of U.S. operations. Consequently, the policy response to the recent corporate inversion activity should be broad enough to address the underlying differences in the U.S. tax treatment of U.S.-based companies and foreign-based companies without regard to how foreign-based status is achieved.

There are four specific areas in which action should be taken: Related party debt, related party asset transfers, treaties, and information reporting.

First, related party debt. The statutory rules regarding the deductibility of interest payments to related parties must be tightened to prevent the inappropriate use of related party debt to generate deductions against income from U.S. operations that otherwise would be subject to U.S. tax. Accordingly, we propose statutory changes to tighten the related party interest disallowance rules of section 163(j). Specifically, we propose replacing the current debt-equity ratio safe harbor with a test that would deny a deduction for related party interest to the extent the U.S. company's indebtedness exceeds its worldwide level of indebtedness. There is no compelling policy justification for allowing interest deductions for related party debt where the U.S. company is more highly leveraged than the worldwide operations.

We propose scaling back the 50 percent of income limitation on interest deductions by revising the definition of income to focus the test on net interest expense as a percentage of income rather than cash flow.

Finally, we propose curtailing the rules that allow companies to carry over to subsequent years interest deductions subject to the limits.

Second, we are undertaking a comprehensive review of related party asset transfers, which can be used to shift income from the United States. We believe that substantial improvements can be made in this area through regulatory changes and focused enforcement. To the extent that we identify problems during our review requiring statutory changes, we will promptly advise the Committee.

Third, we will undertake a comprehensive review of our income tax treaties to ensure that they do not provide inappropriate opportunities to reduce U.S. taxes or to shift income from the United States. Our review will ensure that all our treaties serve the goal of eliminating double taxation, not taxation altogether, or they will be modified to do so.

Fourth, we will require Form 1099 reporting to ensure that inverted companies' shareholders pay the tax they owe on gain recognized in the inversion transaction.

We are continuing to study other areas, including the corporate organization and reorganization rules and the income shifting issues that arise in the context of inversion transactions involving insurance and reinsurance companies.

Finally, we must address the tax disadvantages faced by U.S.-based companies that do business abroad relative to their counterparts in our major trading partners. The burden imposed by our international tax rules on U.S.-based companies with foreign operations is disproportionate to the tax burden imposed by our trading partners on their companies' foreign operations. The recent inversion activity and the increased foreign acquisitions of U.S. multinationals evidence that fact and the significant consequences that may have for U.S. businesses and the U.S. economy. The U.S. rules for the taxation of foreign source income are unique in their breadth and complexity. It is time to revisit them. Our rules should not disadvantage U.S.-based companies competing in the global marketplace.

Our overarching goal is maintaining the U.S. position as the most desirable location in the world for incorporation, headquartering, foreign investment, and business operations. In short, that means keeping jobs in the United States, creating jobs in the United States, and bringing jobs to the United States.

Thank you for your attention. I would be pleased to answer any questions.

[The prepared statement of Ms. Olson follows:]

Statement of Pamela F. Olson, Acting Assistant Secretary for Tax Policy, U.S. Department of the Treasury

Mr. Chairman, Congressman Rangel, and distinguished Members of the Committee, we appreciate the opportunity to appear today at this hearing on corporate inversion transactions.

In recent months, several high-profile U.S. companies have announced plans to reincorporate outside the United States. The documents prepared for shareholder approval and filed with the Securities and Exchange Commission cite substantial reductions in overall corporate taxes as a key reason for the transactions. While these so-called corporate inversion transactions are not new, there has been a marked increase recently in the frequency, size, and profile of the transactions.

On February 28, 2002, the Treasury Department announced that it was studying the issues arising in connection with these corporate inversion transactions and the implications of these transactions for the U.S. tax system and the U.S. economy. On May 17, 2002, the Treasury Department released its preliminary report on the tax policy implications of corporate inversion transactions. (A copy of the Treasury preliminary report is attached.) The Treasury preliminary report describes the mechanics of the transactions, the current tax treatment of the transactions, the current tax treatment of the companies post-inversion, the features of our tax laws that facilitate the transactions or that may be exploited through such transactions, and the features of our tax laws that drive companies to consider these transactions.

Inversion transactions implicate fundamental issues of tax policy. The U.S. tax system can operate to provide a cost advantage to foreign-based multinational companies over U.S.-based multinational companies. The Treasury report identifies two distinct classes of tax reduction that are available to foreign-based companies and that can be achieved through an inversion transaction. First, an inversion transaction may be used by a U.S.-based company to achieve a reduction in the U.S. corporate-level tax on income from U.S. operations. In addition, through an inversion transaction, a U.S.-based multinational group can substantially reduce or eliminate the U.S. corporate-level tax on income from its foreign operations.

The Treasury preliminary report discusses the need for an immediate response to address the U.S. tax advantages that arise from the ability to reduce U.S. corporate-level tax on income from U.S. operations. My testimony today will focus on several specific actions that we believe are urgently needed to eliminate these opportunities to reduce inappropriately the U.S. tax on U.S. operations and thereby to ensure continued confidence in the U.S. tax system. We believe that addressing these opportunities will have an immediate effect on the corporate inversion activity that is now occurring by eliminating the substantial upfront tax reductions that can be achieved through these transactions. This approach also addresses the similar tax reduction opportunities that are available to companies that form offshore from the outset and to foreign companies that acquire U.S. businesses, and therefore avoids advantaging companies that begin as non-U.S. companies over those that begin here in the United States.

The Treasury preliminary report also discusses the need to address the U.S. tax disadvantages that are caused for U.S.-based companies because of the U.S. tax treatment of their foreign operations. We must evaluate our tax system, particularly our international tax rules, relative to those of our major trading partners, to ensure that the U.S. tax system is competitive.

An inversion is a transaction through which the corporate structure of a U.S.-based multinational group is altered so that a new foreign corporation, typically located in a low- or no-tax country, replaces the existing U.S. parent corporation as the parent of the corporate group. In order to provide context for consideration of the policy issues that arise, the Treasury preliminary report includes a technical description of the forms of the inversion transaction and the potential tax treatment of the various elements of the transaction under current law. The transactional forms through which the basic reincorporation outside the United States can be accomplished vary as a technical matter, but all involve little or no immediate operational change and all are transactions in which either the shareholders of the company or the company itself are subject to tax. This reincorporation step may be accompanied by other restructuring steps designed to shift the ownership of the group's foreign operations outside the United States. The restructuring steps involving movement of foreign subsidiaries are complex and varied, but, like the reincorporation itself, are transactions that are subject to tax. When all the transactions are complete, the foreign operations of the company will be outside of the U.S. taxing jurisdiction and the corporate structure also may provide opportunities to reduce the U.S. tax on U.S. operations.

Market conditions have been a factor in the recent increase in inversion activity. Although the reincorporation step triggers potential tax at the shareholder level or the corporate level, depending on the transactional form, that tax liability may be less significant because of current economic and market factors. The company's shareholders may have little or no gain inherent in their stock and the company may have net operating losses that reduce any gain at the company level. While these market conditions may help facilitate the transactions, they are not, however, what motivates a company to undertake an inversion. U.S.-based companies and their shareholders are making the decision to reincorporate outside the United States largely because of the tax savings available. It is that underlying motivation that we must address.

The ability to achieve a substantial reduction in taxes through a transaction that is complicated technically but virtually transparent operationally is a cause for concern as a policy matter. As we formulate a response, however, we must not lose sight of the fact that an inversion is not the only route to accomplishing the same type of reduction in taxes. A U.S.-based start-up venture that contemplates both U.S. and foreign operations may incorporate overseas at the outset. An existing U.S. group may be the subject of a takeover, either friendly or hostile, by a foreign-based company. In either case, the structure that results provides tax-savings opportunities similar to those provided by an inversion transaction. A narrow policy response to the inversion phenomenon may inadvertently result in a tax code favoring the acquisition of U.S. operations by foreign corporations and the expansion of foreign controlled operations in the United States at the expense of domestically managed corporations. In turn, other decisions affecting the location of new investment, choice of suppliers, and employment opportunities may be adversely affected. While the openness of the U.S. economy has always made—and will continue to make—the United States one of the most attractive and hospitable locations for foreign investment in the world, there is no merit in policies biased *against* domestic control and domestic management of U.S. operations.

The policy response to the recent corporate inversion activity should be broad enough to address the underlying differences in the U.S. tax treatment of U.S.-based companies and foreign-based companies, without regard to how foreign-based status is achieved. Measures designed simply to halt inversion activity may address these transactions in the short run, but there is a serious risk that measures targeted too narrowly would have the unintended effect of encouraging a shift to other forms of transactions and structures to the detriment of the U.S. economy in the long run.

An immediate response is needed to address the U.S. tax advantages that are available to foreign-based companies through the ability to reduce the U.S. corporate-level tax on income from U.S. operations. Inappropriate shifting of income from the U.S. companies in the corporate group to the foreign parent or its foreign subsidiaries represents an erosion of the U.S. corporate tax base. It provides a competitive advantage to companies that have undergone an inversion or otherwise operate in a foreign-based group. It creates a corresponding disadvantage for their U.S. competitors that operate in a U.S.-based group. Moreover, exploitation of inappropriate income-shifting opportunities erodes confidence in the fairness of the tax system.

In the case of inversion transactions, the ability to reduce overall taxes on U.S. operations through these income-shifting techniques provides an immediate and quantifiable benefit. Because of the cost and complexity of these transactions, the immediate and quantifiable benefit from reducing U.S. tax on U.S. operations is a key component of the cost-benefit analysis with respect to the transaction. In other words, the decision to consummate the inversion often is dependent upon the immediate expected reduction in U.S. tax on income from U.S. operations. Accordingly, eliminating the opportunities to reduce inappropriately the U.S. tax on income from U.S. operations will eliminate the upfront tax reductions that are fueling the inversion transaction activity.

We believe there are several specific areas in which changes are urgently needed. The statutory rules regarding the deductibility of interest payments to related parties must be tightened to prevent the inappropriate use of related-party debt to generate deductions against income from U.S. operations that otherwise would be subject to U.S. tax. We must undertake a comprehensive review of the rules governing the transfer of assets among related parties and establish a revitalized compliance program to ensure adherence with the arm's-length standard for related party transfers. We must undertake a comprehensive review of our income tax treaties and make the modifications to particular treaties necessary to ensure that they do not provide inappropriate opportunities to reduce U.S. taxes. We must promulgate reporting requirements to provide the IRS with information to ensure that shareholders are paying the tax owed on the gain recognized in an inversion transaction. We also are working on other areas where further study is needed.

In addition, we must continue to work to address the U.S. tax disadvantages faced by U.S.-based companies that do business abroad relative to their counterparts in our major trading partners. We look forward to working closely with the Committee on this important issue.

Interest on Related Party Debt. One of the simplest ways for a foreign-based company to reduce the U.S. tax on income from U.S. operations is through deductions for interest payments on intercompany debt. The U.S. subsidiary can be loaded up with a disproportionate amount of debt for purposes of generating interest deductions through the mere issuance of an intercompany note, without any real movement of assets or change in business operations. Interest paid by a U.S. subsidiary to its foreign parent or a foreign affiliate thereof gives rise to a U.S. tax deduction but the interest income may be subject to little or no tax in the home country of the foreign related party recipient. It is important to recognize that a U.S.-based company could not achieve such a result. Indeed, the rules governing the allocation of interest expense to which U.S.-based companies are subject can operate effectively to deny a U.S. company deductions for interest expense incurred in the United States and paid to an unrelated third party.

The potential to use foreign related-party debt to generate deductions that reduce taxable income in the United States is not unique to inversion transactions, and concern about this technique is not new. Section 163(j) of the Internal Revenue Code was enacted in 1989 to address these concerns by denying U.S. tax deductions for certain interest expense paid by a corporation to a related party. Section 163(j) as it currently exists applies only where (1) the corporation's debt-equity ratio exceeds 1.5 to 1, and (2) its net interest expense exceeds 50 percent of its adjusted taxable income (computed by adding back net interest expense, depreciation, amortization and depletion, and any net operating loss deduction). If the corporation exceeds these thresholds, no deduction is allowed for interest in excess of the 50-percent limit that is paid to a related party and that is not subject to U.S. tax. Any interest that is disallowed in a given year is carried forward indefinitely and may be deductible in a subsequent taxable year. Section 163(j) also provides a four-year carryforward for any excess limitation (*i.e.,* the amount by which interest expense for a given year falls short of the 50 percent of adjusted tax income threshold).

A revision of these rules is needed immediately to eliminate what is referred to as the real "juice" in an inversion transaction. The prevalent and increasing use of foreign related-party debt in inversion transactions demonstrates the importance to these transactions of the tax reductions achieved through interest deductions and the need to act now to eliminate this benefit. Accordingly, we propose statutory changes to tighten the interest disallowance rules of section 163(j) in several respects. Moreover, the opportunities for generating interest deductions that reduce U.S. taxable income are not limited to inversion transactions. These U.S. taxable income minimization strategies, which are not available to U.S.-based companies, are possible as well in cases where a U.S. business is structured from the outset with a foreign parent and in cases where a foreign corporation acquires a U.S. operating group. Therefore, we believe these revisions to section 163(j) should not be limited to companies that have inverted but should apply across the board. There is no reason to allow companies to reduce income that would otherwise be subject to U.S. tax through deductions generated simply by putting in place debt owed to related parties.

The fixed debt-equity test of current law effectively operates as a safe harbor for corporations with debt-equity ratios of 1.5 to 1 or lower. We propose replacing the safe harbor protection currently available under the fixed 1.5 to 1 debt-equity test with a test that would deny a deduction for related party interest to the extent that the corporate group's level of indebtedness in the United States exceeds its worldwide level of indebtedness. This worldwide test would compare (i) the ratio of indebtedness incurred by the U.S. members of the corporate group to their assets, with (ii) the ratio of the entire corporate group's worldwide indebtedness (excluding related party debt) to its worldwide assets. Interest that is paid to related parties and that is not subject to U.S. tax would be denied deductibility to the extent it is attributable to indebtedness in excess of the worldwide ratio.

With this approach, the 50-percent of adjusted taxable income test would operate as a second, alternative test applicable in cases where the U.S. debt-to-assets ratio does not exceed the worldwide ratio. We propose modifying the 50-percent test by revising the definition of adjusted taxable income to eliminate the addback of depreciation, amortization and depletion. This would have the effect of appropriately focusing the test on net interest expense as a percentage of income rather than cash flow.

We also propose curtailing the carry over rules applicable under section 163(j). Although the current carryforwards appropriately provide relief to those taxpayers whose interest-to-income ratio may be subject to unanticipated fluctuations due to business fluctuations, an indefinite carryforward has the effect of dampening the impact of the deduction denial. This consequence is further exacerbated by the ability under current law to carry forward excess limitation to shelter additional interest deductions in future years. Accordingly, we propose eliminating the carryforward of excess limitation and limiting the carryforward period for disallowed deductions to 5 years.

Income Shifting and Transfers of Intangibles. Another way for a foreign-based company to reduce the U.S. tax on income from U.S. operations is through related-party transactions for other than arm's length consideration. Many inversion transactions involve the movement of foreign subsidiaries out of the U.S. group so that they are held directly by the new foreign parent. Some inversion transactions involve transfers of intangible or other assets, or business opportunities, to the new foreign parent or its foreign subsidiaries. This type of movement of foreign subsidiaries, assets, and opportunities is not unique to inversion transactions. The same sort of restructuring transactions are common whenever a multinational group is acquired or makes an acquisition. Cross-border transfers of subsidiaries and assets can give rise to significant valuation issues, and the ongoing transactions between the various entities can give rise to significant income allocation issues.

The outbound transfer of subsidiaries and assets to a related person in a taxable transaction is subject to the transfer pricing rules of section 482 and the regulations thereunder, which provide that the standard to be applied is that of unrelated persons dealing at arm's length. In the case of transfers of intangible assets, section 482 further provides that the income with respect to the transaction must be commensurate with the income attributable to the intangible assets transferred. The magnitude of the potential tax savings at stake in substantial outbound transfers of assets, especially intangible assets, puts significant pressure on the enforcement and application of the arm's length and commensurate with income standards. Where the arm's length standard is not properly applied or enforced, the inappropriate income shifting that results can significantly erode the U.S. tax base.

Treasury will undertake a comprehensive study focusing on the tools needed to ensure that cross-border transfers and other related party transactions, particularly transfers of intangible assets, cannot be used to shift income out of the United States. This will include a review and appropriate revisions of the contemporaneous documentation and penalty rules and of the substantive rules relating to transfers of intangible property and services and cost sharing arrangements. It also will include an administrative compliance initiative. While there is much that can and will be accomplished in this area through regulatory guidance and enhanced enforcement efforts, Treasury will report to the Congress on any need for statutory changes or additions.

Treasury and the IRS will undertake an initiative to review current practices related to the examination of transfer pricing issues and the imposition of transfer pricing penalties, with a particular emphasis on transactions in which intangibles are transferred. The volume and complexity of cross-border related party transactions have grown significantly in recent years, and a number of U.S. trading partners have undertaken broad compliance initiatives relative to transfer pricing. The purposes of this comprehensive review will include ensuring that contemporaneous documentation from taxpayers is utilized effectively by the IRS and that transfer pricing penalties are imposed where warranted on a fair and consistent basis. This focused review also will help identify potential improvements to existing rules, including the provisions regarding penalties, reporting, and documentation, that would enhance transfer pricing compliance.

We will revise the current section 482 cost sharing regulations with a view to ensuring that cost-sharing arrangements cannot be used to facilitate a disguised transfer of intangible assets outside the United States in a manner inconsistent with the arm's length standard, as reinforced by the commensurate with income standard. The purpose of the cost sharing regulations is to facilitate the allocation among related taxpayers of future income attributable to future intangible property in a manner that reasonably reflects the actual economic activity undertaken by each related taxpayer to develop that property. This work will focus initially on the effectiveness of the current rules intended to apply the arm's length standard to taxpayers that contribute to the cost sharing arrangement the right to use existing intangible property, such as know-how or core technology, which often constitutes the most important and valuable input into the development of future intangible property.

We also will review the section 482 regulations applicable to transfers of intangible assets to ensure they do not operate to facilitate the transfer of intangible property outside the United States for less than arm's length consideration. These regulations relating to the transfer of intangible assets implement the arm's length and commensurate with income standards by allowing periodic adjustments to transfer prices in limited circumstances based on objective standards. While these objective standards have provided certainty and minimized disputes in this otherwise contentious area, focus is needed on ensuring the proper operation of the periodic adjustments provisions.

Finally, as part of an ongoing project to update the 482 regulations applicable to services, we will work to mitigate the extent to which the structuring or characterization of a transfer of intangible assets as the provision of services can lead to inappropriate transfer pricing results. The differences between the section 482 regulations relating to the provision of services and those relating to the transfer of intangible property could be exploited through the characterization of a transfer of intangible property as a provision of services. While a transfer of intangibles through a license in return for royalty payments and the provision of technical services utilizing the intangibles in return for a service fee, for example, may be similar from an economic perspective, the transfer pricing results may differ depending on whether the transfer pricing regulations related to services or intangible property are applicable. The transfer pricing rules should reach similar results in the case of economically similar transactions regardless of the characterization or structuring of such transactions.

Because the potential to use related party transactions to reduce the U.S. tax on income from U.S. operations is not unique to inversion transactions, our proposals in this area are not limited in scope to corporations that have inverted.

Income Tax Treaties. The United States imposes a withholding tax at a rate of 30 percent on payments of interest and royalties (as well as dividends) from a U.S. corporation to a foreign affiliate. This withholding tax may be reduced or eliminated in certain circumstances under an applicable income tax treaty. The cost advantage achieved by shifting income by means of deductible payments to foreign related parties is most effective when the payments are to a foreign related party that is eligible for benefits under a comprehensive U.S. income tax treaty and, in addition, is not subject to significant local tax on the income.

Most inversion transactions have involved a reincorporation into a foreign jurisdiction either that does not have a tax treaty with the United States or whose treaty with the United States does not generally reduce U.S. withholding tax rates. However, many of the newly created foreign parent corporations may be considered resident for treaty purposes in a country that has a comprehensive tax treaty with the United States and that does not subject certain payments received by its corporations to significant local income tax. Through such a structure, the cost advantage achieved by shifting income can be maximized. Similar results may be obtained through the use of finance subsidiaries located in certain treaty jurisdictions.

We must review and evaluate our tax treaties to identify any inappropriate reductions in U.S. withholding tax that provide opportunities for shifting income out of the United States. U.S. income tax treaties are intended to prevent the double taxation by the United States and its treaty partner of income earned by residents of one country from sources within the other. Thus, the United States does not enter into income tax treaties that lower the rates of U.S. withholding tax on U.S.-source income (*e.g.*, U.S.-source interest and royalties) with jurisdictions that do not have a comprehensive income tax system. In such a case, there is no need to reduce the U.S. withholding tax because there is no risk of double taxation. We must make certain that the operation of our treaties is consistent with the expectation of the United States and its treaty partners that treaties should reduce or eliminate double taxation of income, not eliminate all taxation of income. If a current or prospective treaty partner does not tax a particular category of U.S.-source income earned by its residents, either because of a general tax exemption or a special tax regime, reduction of U.S. withholding tax on that category of income may not be appropriate.

We also must consider whether anti-abuse mechanisms already within our treaties are operating properly. Because U.S. tax treaties are intended to benefit only residents of either the United States or the treaty partner, U.S. income tax treaties include detailed limitation on benefits provisions, to prevent the misuse of treaties by residents of third countries. Those limitation on benefits provisions are important for ensuring that a resident of a third country cannot benefit inappropriately from a reduction in U.S. withholding tax by structuring a transaction, including a transaction designed to generate deductible payments, through a treaty country. One of Treasury's key tax policy goals in modernizing our network of existing tax treaties is to bring the limitations on benefits provisions in all our treaties up to current model standards so as to remove the opportunity for such misuse.

Reporting Requirements. In many inversion transactions the company's shareholders are required to recognize gain. Current Treasury regulations generally require Form 1099 reporting to the IRS of the gross proceeds from any sale for cash effected by a broker in the ordinary course of its business. However, there are no similar reporting obligations in the case of an inversion where a shareholder exchanges stock of one corporation for stock in another corporation. We intend to establish a Form 1099 reporting requirement for stock transfers in inversions and other taxable reorganization transactions. Requiring reporting of these transactions will increase the IRS's access to information about the transactions. It also will serve to remind shareholders of the tax consequences to them from the company's transaction and of their obligation to report any gain.

Other Areas of Further Study. There are two other areas where we believe that further study is needed and we have begun careful consideration of these areas.

A comprehensive review of the corporate organization and reorganization rules is needed in light of the increasing pressure put on these rules through the larger and more complicated international restructuring transactions that are becoming commonplace. The corporate organization and reorganization rules, as well as the other related rules affecting corporations and their stock and option holders, were written largely for purely domestic transactions. Section 367, and the lengthy regulations there under, modify those rules for application in the case of cross-border transactions. With the increasing globalization of both U.S. companies and foreign companies, these rules are being applied more frequently and to larger and more complicated cross-border transactions. It is critical that the rules governing cross-border reorganizations keep up with these developments. The current cross-border reorganization rules are something of a patchwork, developed and revised over the last twenty years. One focus in this reconsideration of the current-law rules will be on achieving greater consistency in treatment across similar transactions, in order to avoid both traps for the unwary and opportunities for taxpayers to exploit the rules to reach results that are not intended. Moreover, clearer rules will help provide greater certainty to taxpayers and the government in this complex area.

A careful review also is needed of the income-shifting issues that arise in the context of the several inversion transactions that have involved insurance and reinsurance companies. The initial reincorporation outside the United States typically has been accompanied by a shift of some portion of the existing U.S. insurance business through reinsurance with a related foreign affiliate. An evaluation must be made as to whether the use of related party reinsurance permits inappropriate shifting of income from the U.S. members of a corporate group to the new foreign parent and its foreign affiliates, and whether existing mechanisms for dealing with such related party transactions are sufficient to address these opportunities. In this regard, further analysis is appropriate to consider and evaluate the approaches used by our trading partners in taxing insurance companies, including, for example, the use by some countries of a premium-based tax that captures within the country's tax base all business written on risks within the country.

Finally, we must continue our work to address the U.S. tax disadvantages for U.S.-based companies that do business abroad relative to their counterparts in our major trading partners. The U.S. international tax rules can operate to impose a burden on U.S.-based companies with foreign operations that is disproportionate to the tax burden imposed by our trading partners on the foreign operations of their companies. The U.S. rules for the taxation of foreign-source income are unique in their breadth of reach and degree of complexity. Both the recent inversion activity and the increase in foreign acquisitions of U.S. multinationals are evidence that the competitive disadvantage caused by our international tax rules is a serious issue with significant consequences for U.S. businesses and the U.S. economy. A comprehensive reexamination of the U.S. international tax rules and the economic assumptions underlying them is needed. As we consider appropriate reformulation of these rules we should not underestimate the benefits to be gained from reducing the complexity of the current rules. Our system of international tax rules should not disadvantage U.S.-based companies competing in the global marketplace.

As we work to address these important issues, we must keep our focus on the overarching goal of maintaining the attractiveness of the United States as the most desirable location in the world for incorporation, headquartering, foreign investment, business operations, and employment opportunities, in order to achieve an ever higher standard of living for all Americans.

[The attachment is being retained in the Committee files.]

Chairman THOMAS. Thank you very much, Ms. Olson. As I said in my opening remarks, one, for the fact that you issued a study which may or may not have been serendipitous in terms of its timing, but it was still, nevertheless, very useful. Second, your testimony is very specific, and again, that is refreshing, because you have offered some very specific remedies to a specific problem.

You also state in your testimony on page two, the first full paragraph there, that the Treasury preliminary report also discusses the need to address the U.S. tax disadvantages that are caused for U.S.-based companies because of U.S. tax treatment of their foreign operations. We must evaluate our tax system, particularly our international tax rules, relative to those of our major trading partners to ensure that the U.S. tax system is competitive. That sounds like a fairly broad statement about the need to examine far more fundamentally our tax code than the specifics that you provided in your testimony focused on inversions.

As you know, we have embarked on trying to put together a tax package to respond to, because we are required to respond to the

WTO decision on the fact that our foreign sales structure is considered a subsidy. Could you give us some specifics of what you meant by that paragraph in terms of what it is that we should be focusing on, and are there other areas in which, for want of a better term, inversions have occurred or might occur that would not necessarily be captured by the specifics that you have provided, or that since we are looking at the way in which we deal with corporations that are involved internationally, other tax aspects that perhaps we should at least begin to lay on the table?

I know that is a very broad question, and obviously, the Chair will appreciate whatever verbal response you can give, but I am anticipating that this may involve a more extensive written response to the question, which you will provide us with over the next few days.

Ms. OLSON. All right. Thank you. First of all, of course, the U.S. operates a worldwide system of income tax, which means that U.S. companies with foreign operations are subject to tax in the United States on the income from those foreign operations. The double tax that can result from that is addressed by our foreign tax credit system, but the foreign tax credit system is extremely complicated. It has a number of limitations and many companies find that they are not able to make full use of the foreign tax credits to offset the double taxation.

In addition, we have subpart F of the tax code, under which we impose current U.S. tax on a number of foreign activities of U.S. companies with foreign subsidiaries without regard to whether or not that income is actually distributed to the U.S. parent. That is another area of the Tax Code that requires a look, because in that realm in particular, a number of our major trading partners do not tax that income at all, let alone tax it currently.

In addition, we need to look at our interest allocation rules, which function almost opposite of the way that the interest rules function with respect to foreign-owned companies, and they sharply limit U.S. companies' ability to use foreign tax credits.

Chairman THOMAS. That means, then, that obviously, if we are looking at this one particular example which has come to the attention, for want of a better term, of the popular press, it is more or less on the cliché of the tip of the iceberg of things that we need to look at, which then takes me to the bottom of page two in terms of your testimony in which you say a narrow policy response to the inversion phenomenon may inadvertently result in a tax code favoring the acquisition of U.S. operations by foreign corporations and the expansion of foreign-controlled operations in the United States at the expense of domestically managed corporations.

Would it not be ironic if we are attempting to resolve the problem of U.S. companies going foreign to remain U.S. companies if we created a change in the law which made it more advantageous for foreign corporations to acquire U.S. corporations. What did you mean specifically and to what reference is this a narrow policy response directive?

Ms. OLSON. Well, if we passed legislation, for example, that only imposed sharper rules, stricter rules on companies that had inverted, then that would mean that companies that started, for example, in Bermuda or Luxembourg or some other foreign country or currently foreign-owned companies would have tax advantages over U.S. companies that might seek to invert. So if we just focus on the inverted companies, we may create some real discontinuities in the tax code that would advantage foreign-owned companies and we want to avoid that.

I want to mention one other thing on the question that you asked previously. You asked about inversion transactions that might be occurring that might not be caught by the proposals that we have laid out today and one of those is the insurance transactions, which have been occurring for some time, involving inversion transactions into Bermuda. Those would not be captured by the rules that we have talked about here because that is not a problem associated with mis-pricing. At least so far as we know, the transactions have been priced at arms' length market prices. What we try to capture within the U.S. tax base is income, and so we try to appropriately measure income in making sure that we have got arms' length prices.

So long as those transactions, which include a move to Bermuda followed by reinsurance of U.S. risks into Bermuda, are appropriately priced, they would not be captured by the current rules in the tax code, and so for that we need to perhaps take a more fundamental look at the direction of the tax code and whether or not it makes sense in that area to continue to try to tax on the basis of income or whether we should be looking at something more along the lines of what some of our trading partners do, which is to focus a tax on premiums.

Chairman THOMAS. If I understand what you are saying, as companies involve themselves internationally or international companies involve themselves in the United States, if you base your tax system on the income, you are going to be chasing these corporations all over the world and examining the structures that they offer amid different taxing structures around the world to try to figure out how we would extract what would be an appropriate tax on the income, and maybe that is probably not the best way to go in terms of trying to produce revenue in an appropriate amount and that we should look at a different way of dealing with companies that are dealing with insurance.

Would this be unique to insurance or would it have relevance to other corporations as well? That is, that pursuing the income of the corporations may not be the most meaningful way to raise appropriate revenue on U.S. activities?

Ms. OLSON. In many ways, our study and the Internal Revenue Code, in general, the complexity of it reflects our continuing dissatisfaction with our attempts to define income. We keep slapping new rules on to chase this, that, or the other thing and it makes it extremely complicated, and in the end, somebody always finds a way around it and then we come back to try once again to define income so that we feel that we have satisfactorily captured within the U.S. base the amount that we want captured.

Chairman THOMAS. At least in terms of the example that you raised, insurance companies, just give me a brief review again of what might be suggested. I do not believe you are offering this as a policy today, but you are using it as an example of the difficulty of trying to tax income. What could be an option that would replace the corporate income tax on insurance companies would be what?

Ms. OLSON. It would be a tax on the premiums written by the insurance companies, which is the way that some of our trading partners tax the insurance business.

Chairman THOMAS. Premiums in the United States?

Ms. OLSON. Premiums written within the United States, and that way, what you would capture within the tax base is all of the risks written in the United States.

Chairman THOMAS. Your concern about too narrow a response obviously means we would lead perhaps to some unanticipated consequences because of the ongoing drive to be the lowest-price competitor, and where the tax code comes into place, we had better be careful of making a change in one area because it may have repercussions in other areas that we have not anticipated, and that, of course, requires, then, a broader look to make sure that if we do make a move, we understand what are the relevant ancillary consequences of decisions that we make, which means we have a bit of a dilemma because we have a relatively immediate problem in dealing with these corporate inversions as we have begun to understand them, especially with the Treasury Department study, and the need, as you indicate, to look at a number of other areas that taxes might be changed, which clearly would not be a short-term response to the immediate problem, and that is part of the dilemma, I think. How do you deal with the immediate problem while you are looking at the larger concerns that may require a more in-depth and a more broadly-based tax modification?

Thank you very much for your testimony. Does the gentleman from New York wish to inquire?

Mr. RANGEL. Thank you, Mr. Chairman.

I regret, as much as you would have wanted to avoid the conflict that we have today between the full Committee hearing testimony on what is a complex tax issue and what is a real important tax issue on the Floor. Through no fault of your own, the Members of this Committee find ourselves before this panel, recognizing that a lot of U.S. companies have announced that in order to avoid U.S. income taxes during a time of war, that they will leave the United States and seek a tax haven elsewhere. So there has to be long- and short-term consequences, and we had thought this matter was going to be in front of the subcommittee. The Chair has decided it is important enough to be in front of the full Committee.

We also thought that since at least two Members of the Congress had information that they could bring to us to say what impact this would have, both of them being from Connecticut, Mrs. Johnson and Mr. Maloney, that they would be able to share some light on this subject matter, and we have learned that notwithstanding the request made by Congressman Maloney, that has been denied and he will not be allowed to testify in front of the full Committee.

I have been here 32 years. I have never heard of a Member, a sitting Member of this body's request to testify being turned down. It is an election year and it is probably a good reason, but we will find out what it is about.

Second, we have a bill on the Floor to make permanent the estate tax repeal, which I have been advised in the next 10 years, if you include debt service, is going to cost us $1 trillion. We all are trying to find ways to preserve Social Security, Medicare, prescription drugs, but in this political year, make no mistake about it, to Members of this Committee, it is a very, very important issue because we have jurisdiction.

So we really think—we beg you to reconsider, because of the witnesses, because of the audiences, and because this is not going to work, that just because we are in the minority that you expect us to be two places at one time. I am supposed to manage the bill on the estate tax repeal at the same time. I feel some sense of responsibility as the senior Member to see which way the testimony is going on this complex issue before us.

Now, I know you do not want it to have this conflict, and I do not either, but I will ask you to consider postponing this meeting until after we complete our work on the Floor, and before I put it into a motion, I will ask you to respond whether you would consider it.

Chairman THOMAS. I appreciate the gentleman's presentation. I do want to make sure that all of us understand what the facts are and what the time line is.

The Chair intended to have a full Committee hearing on this subject just as we had a full Committee hearing on FSC, to set the tone so that we could then examine the more specific aspects of areas, as we are now doing on the foreign sales corporation. We had an initial hearing. There was no Member panel at that particular hearing, and we moved forward, notwithstanding the fact there is legislation in dealing with foreign sales corporation tax changes. There was no appeal by the minority at that time about how unfair it was that Members were not allowed to testify.

The letter from Members requesting testimony arrived at the majority office after the minority staff was notified that, as was the case in the foreign sales corporation hearing, there would be no Member panel. I want to emphasize that. The hearing requesting testimony was received after we notified the minority staff that there would be no Member panel, and the assumption clearly is, once we decided that was not going to be the case, then you tried to get a letter in, which you now just used as justification for the requirement that the Members be heard.

The Chair said in his opening statement that we are obviously going to have a series of hearings on this. I am quite sure if I turn to the Chairman of the Select Revenue Subcommittee that he would respond in a positive way to the desire to have Members in front of the Subcommittee because we are not denying anyone who wants to be heard.

In addition to that, this hearing is similar to every other hearing that we have had in which the Committee call for the hearing indicates written testimony can be received from any individual, entity, Member, or otherwise, and it will be made a part of the record, so that the record would never be less than complete unless, of course, individuals wished not to submit the written testimony.

We are holding this initial hearing in exactly the same format as we held the foreign sales corporation full Committee hearing. We have the same structure that we had at that time and then we will move forward examining the specifics just exactly the same way that we are doing with the foreign sales corporation.

Mr. RANGEL. Mr. Chairman, I ask unanimous consent that this Committee allow Congressman Maloney to testify.

[Objections were voiced.]

Chairman THOMAS. Objections are heard.

Mr. RANGEL. Mr. Chairman, I move that this Committee allow Congressman Maloney to testify.

Chairman THOMAS. There is no such thing as a motion.

Mr. RANGEL. Mr. Chairman, I——

Chairman THOMAS. There is a unanimous consent of the Committee rules being in order, but there is not a motion that is in order at a hearing.

Mr. RANGEL. I ask unanimous consent that the Committee recess until such time as the conflict that we have with the business on the Floor and the business before this hearing is resolved.

[Objections were voiced.]

Chairman THOMAS. Hearing objection, and the Chair would note that there is no conflict. The measure that is the jurisdiction of this Committee is not now in front of the Floor and that it is entirely appropriate for this Committee to continue to meet. The Ranking Member's concern about Members managing their time would probably be more appropriate when, in fact, the measure is before us on the Floor. It is not before us on the Floor, and we could be moving forward with the hearing rather than continuing this discussion.

Mr. KLECZKA. Will the Chairman yield on that point?

Mr. RANGEL. Mr. Chairman, as we talked, the rule which sets the guidelines in which this important Committee on Ways and Means tax issue before the Floor is being debated, as you know, you and I participate in testifying before the Rules Committee, so that is of concern to us. In addition to that, we really think that notwithstanding the request, when it was made, that allowing a Member 5 minutes to testify, whether it is a man or woman, Republican or Democrat, is just a courtesy. If we are not going to get any consideration at all, then I have to be forced to move to adjourn formally this hearing.

Chairman THOMAS. The gentleman has moved to adjourn. There is no debate on the motion to adjourn but there is a vote. All those in favor, say aye.

Those opposed?

In the opinion of the Chair, the noes have it. The noes have it——

Mr. RANGEL. I ask for a roll call vote.

Chairman THOMAS. The Clerk will call the roll.

The CLERK. Mr. Crane?

Mr. CRANE. No.

The CLERK. Mr. Crane votes no.

Mr. Shaw?

Mr. SHAW. No.

The CLERK. Mr. Shaw votes no.

Mrs. Johnson?

Mrs. JOHNSON OF CONNECTICUT. No.

The CLERK. Mrs. Johnson votes no.

Mr. Houghton?
[No response.]
The CLERK. Mr. Herger?
[No response.]
The CLERK. Mr. McCrery?
Mr. MCCRERY. No.
The CLERK. Mr. McCrery votes no.
Mr. Camp?
Mr. CAMP. No.
The CLERK. Mr. Camp votes no.
Mr. Ramstad?
[No response.]
The CLERK. Mr. Nussle?
[No response.]
The CLERK. Mr. Johnson?
[No response.]
The CLERK. Ms. Dunn?
[No response.]
The CLERK. Mr. Collins?
Mr. COLLINS. No.
The CLERK. Mr. Collins votes no.
Mr. Portman?
Mr. PORTMAN. No.
The CLERK. Mr. Portman votes no.
Mr. English?
Mr. ENGLISH. No.
The CLERK. Mr. English votes no.
Mr. Watkins?
Mr. WATKINS. Pass.
The CLERK. Mr. Watkins passes.
Mr. Hayworth?
Mr. HAYWORTH. No.
The CLERK. Mr. Hayworth votes no.
Mr. Weller?
[No response.]
The CLERK. Mr. Hulshof?
Mr. HULSHOF. No.
The CLERK. Mr. Hulshof votes no.
Mr. McInnis?
Mr. MCINNIS. No.
The CLERK. Mr. McInnis votes no.
Mr. Lewis?
Mr. LEWIS OF KENTUCKY. No.
The CLERK. Mr. Lewis votes no.
Mr. Foley?
Mr. FOLEY. No.
The CLERK. Mr. Foley votes no.
Mr. Brady?
[No response.]
The CLERK. Mr. Ryan?
Mr. RYAN. No.
The CLERK. Mr. Ryan votes no.
Mr. Rangel?
Mr. RANGEL. Aye.

The CLERK. Mr. Rangel votes aye.
Mr. Stark?
Mr. STARK. Pass.
The CLERK. Mr. Stark passes.
Mr. Matsui?
Mr. MATSUI. Aye.
The CLERK. Mr. Matsui votes aye.
Mr. Coyne?
[No response.]
The CLERK. Mr. Levin?
Mr. LEVIN. Aye.
The CLERK. Mr. Levin votes aye.
Mr. Cardin?
Mr. CARDIN. Aye.
The CLERK. Mr. Cardin votes aye.
Mr. McDermott?
[No response.]
The CLERK. Mr. Kleczka?
Mr. KLECZKA. Aye.
The CLERK. Mr. Kleczka votes aye.
Mr. Lewis from Georgia?
[No response.]
The CLERK. Mr. Neal?
Mr. NEAL. Aye.
The CLERK. Mr. Neal votes aye.
Mr. McNulty?
Mr. MCNULTY. Aye.
The CLERK. Mr. McNulty votes aye.
Mr. Jefferson?
[No response.]
The CLERK. Mr. Tanner?
Mr. TANNER. Aye.
The CLERK. Mr. Tanner votes aye.
Mr. Becerra?
Mr. BECERRA. Aye.
The CLERK. Mr. Becerra votes aye.
Mrs. Thurman?
Mrs. THURMAN. Aye.
The CLERK. Mrs. Thurman votes aye.
Mr. Doggett?
Mr. DOGGETT. Aye.
The CLERK. Mr. Doggett votes aye.
Mr. Pomeroy?
[No response.]
The CLERK. Mr. Houghton?
[No response.]
The CLERK. Mr. Herger?
[No response.]
The CLERK. Mr. Ramstad?
[No response.]
The CLERK. Mr. Nussle?
[No response.]
The CLERK. Mr. Johnson?
[No response.]

The CLERK. Ms. Dunn?
[No response.]
The CLERK. Mr. Weller?
[No response.]
The CLERK. Mr. Brady?
[No response.]
The CLERK. Mr. Coyne?
[No response.]
The CLERK. I'm sorry, Mr. Watkins passed.
Mr. WATKINS. No.
The CLERK. Mr. Watkins changes his vote from pass to no.
Mr. McDermott?
[No response.]
The CLERK. Mr. Lewis from Georgia?
[No response.]
The CLERK. Mr. Jefferson?
[No response.]
The CLERK. Mr. Pomeroy?
[No response.]
The CLERK. Mr. Chairman?
Mr. STARK. Clerk?
The CLERK. Yes?
Mr. STARK. How am I registered?
The CLERK. Mr. Stark is recorded as pass.
Mr. STARK. Off pass, please, onto aye.
The CLERK. Mr. Stark changes from pass to aye.
Mr. Chairman?
Chairman THOMAS. No.
The CLERK. Mr. Chairman votes no.
Chairman THOMAS. The Clerk will announce the vote.
The CLERK. Sixteen noes, twelve ayes.
Chairman THOMAS. There being 16 noes, 12 ayes, the motion is not agreed to.
Mr. KLECZKA. Mr. Chairman?
Chairman THOMAS. The gentleman from Wisconsin?
Mr. KLECZKA. Inquiry of the Chair. You indicated to Ranking Member Rangel that the bill to repeal the estate tax was not currently on the Floor, and the Chairman is correct. We are debating the rule which precedes the bill. Is it the Chairman's intention that once the bill proper comes up, the Committee will recess so we can participate in the debate on this legislation?
Chairman THOMAS. I would tell the gentleman that any Member who wishes to participate in a debate or go somewhere else is not required to attend this hearing.
Mr. KLECZKA. Well, but Mr. Chairman, this——
Chairman THOMAS. This hearing will go forward.
Mr. KLECZKA. This hearing is important enough that the Members should be here, also. I am at a loss as to why the Chairman would schedule this hearing and send the bill to the Floor at the same time. I am somewhat suspect that maybe this hearing should overshadow what we are doing on the Floor so the public does not know we are providing a big giveaway to the wealthy of the wealthy on the House Floor. That is my suspicion——
Chairman THOMAS. I tell——

Mr. KLECZKA. Nevertheless, Mr. Chairman——

Chairman THOMAS. I tell the gentleman——

Mr. KLECZKA. We might think we are powerful on this Committee, but we still——

Chairman THOMAS. Get your point out.

Mr. KLECZKA. Despite that, cannot be in two places at once.

Chairman THOMAS. I understand that. This is a very difficult job——

Mr. KLECZKA. This is a pretty big Committee, but we have not mustered that trick.

Chairman THOMAS. It is a complex job and oftentimes we are forced to make decisions on a priority basis, and——

Mr. KLECZKA. Priority schmiority, Mr. Chairman. We could have had this hearing yesterday.

Chairman THOMAS. I understand——

Mr. KLECZKA. We could have had it tomorrow. We could have had it Tuesday.

Chairman THOMAS. I will respond to the gentleman that this hearing has been scheduled for some time. The Chair is not in control of the scheduling of the Floor.

Mr. KLECZKA. Oh, do not give us that. You knew damn well when that bill was coming up.

Chairman THOMAS. I understand the gentleman's difficulty in dealing with the complex world.

[Laughter.]

Mr. KLECZKA. No, the problem is being in two places at once, okay? Now, maybe Mr. Thomas can do that and walk on water at the same time, but I think the bulk of this Committee has not been able to do that.

Chairman THOMAS. If the gentleman has finished——

Mr. KLECZKA. The truth does hurt, sir, and I——

Chairman THOMAS. If the gentleman is finished with his parliamentary inquiry, which it was not, and the Chair would——

Mr. KLECZKA. It was only an inquiry of the Chair. It was not parliamentary.

Chairman THOMAS. Fine. The Chair has responded to the inquiry.

Now, does anyone wish to ask questions of the Treasury Department based upon what the Chair considers some of the finest testimony that has been offered under any Administration as a specific guide to assist this Committee in dealing with the very difficult problem in front of us?

The gentleman from Illinois?

Mr. CRANE. Thank you, Mr. Chairman.

Ms. Olson, has the Treasury Department surveyed any of the companies that have inverted or been acquired by a foreign company and asked them what changes to our tax laws would have kept them a domestic company?

Ms. OLSON. Yes, Mr. Crane, we have spoken with a number of companies over the course of our study of the inversion transactions to learn what was motivating the transactions and have identified some of the things that I discussed in response to my question from Mr. Thomas regarding the subpart F rules, the complexity of the foreign tax credit rules, the interest allocation rules.

Those are things that particularly complicate and make it expensive for U.S. companies to compete against their foreign competitors in the same lines of business.

Mr. CRANE. Would you not agree that current tax law, like the 30 percent withholding tax on the dividend income received by offshore investors in U.S. mutual funds has the effect of a punitive export tax, and does this force U.S. mutual funds offshore in order to be competitive against foreign investment funds?

Ms. OLSON. That is an issue that we are looking at and we will continue to look at that and I appreciate you raising the question.

Mr. CRANE. I understand that some of the highest average worker wages are paid by the investment management industry here in the United States. As a matter of national public policy, would we not prefer as a Nation to employ those workers in financial services firms here in the United States rather than shipping high-quality jobs offshore? By keeping this economic activity in the United States, would we not enhance the collection of U.S. tax revenues? Instead of exporting products, we are exporting high-paying jobs. What kind of national public policy is that?

Ms. OLSON. It sounds to me like one we should change quickly. [Laughter.]

Mr. CRANE. Finally, in light of the economic devastation from September 11 that hit the financial services industry particularly hard, would not correcting this flaw in U.S. tax policy assist in putting some of the victims back into quality jobs?

Ms. OLSON. That is certainly something we can take a look at.

Mr. CRANE. Thank you.

Chairman THOMAS. Does the gentleman from California, Mr. Stark, wish to inquire?

Mr. STARK. Thank you, Mr. Chairman.

Ms. Olson, if the Chair had allowed Congressman Maloney to testify, you would have learned that the Boston Globe, in referring to Congresswoman Johnson, suggested that her proposal for a moratorium was so sneaky and pernicious that no one could argue that it was anything but a phony way to avoid taxes and could not argue that it was good for the United States or anybody except the executive officers of companies who do it, or like the Stanley Works, plan to do it. So why should we have a temporary basis when a flat-out ban was needed?

Then, of course, Mr. Maloney speaks to the workers and the common people in his district, unlike Mrs. Johnson, who only talks to the executives and stockholders, of which she is one of the Stanley Works. In talking to one of the retirees, Congressman Maloney determined that this retiree at the Stanley Works would be facing a tax bill of $17,000. As any retiree could tell you, that is a huge amount to pay, and particularly in the face of Mrs. Johnson supporting the privatization of Social Security and the privatization of Medicare. That would leave this Stanley Works machinist with precious little.

Now, again, as I say, because you did not have the opportunity to hear from Congressman Maloney, who is concerned, vitally concerned about the people in his new district, could you tell me why we would allow the Stanley Works machinist to wait with this hanging over his head like the Sword of Damocles while the Republicans privatize Social Security and Medicare and then subject him to a tax bill which for him is substantial, while the executives at Stanley would be getting $30 and $40 million in extra compensation? Can you explain why the Boston Globe would have called Mrs. Johnson's moratorium sneaky and pernicious?

Ms. OLSON. First, I would say that I think that trying to put up a Berlin Wall in response to these transactions is something that is unlikely to work and likely to have harmful effects on the U.S. economy. If we were unable to craft a response to the inversion transactions that would take the juice out of the transactions, remove the reasons for doing them quickly, then it would seem to me that approaching it from the standpoint of a moratorium, a temporary move in that direction might be appropriate.

What we have put forward today is what we think is a set of proposals that will go a long ways toward eliminating the impetus for the inversion transactions and so we think that is a preferable route to a moratorium. A moratorium would be preferable to putting up a complete block on these kinds of transactions because they are just not going to work, and they are going to have other effects that are going to be harmful for the economy.

Mr. STARK. What is not going to work, Ms. Olson?

Ms. OLSON. I am sorry?

Mr. STARK. What will not work?

Ms. OLSON. An approach such as saying companies just cannot move. Number one, people will find ways to get around it, and number two, if you target something solely at inversion transactions, what you are then ignoring is the fact that companies can start offshore, that foreign companies can acquire U.S. companies and achieve the same results, and that is not good for the economy.

Mr. STARK. Is it better for the economy to have them invert?

Ms. OLSON. No. We definitely do not want them inverting. That is why we have tried to come up with a——

Mr. STARK. So we could stop that. We could eliminate that permanently, could we not?

Ms. OLSON. That is definitely what we would like to see happen.

Mr. STARK. So if we followed Congressman Maloney's approach, and the approach that most of us feel would be much more certain to prevent the harm coming to these workers in Connecticut than we would under some moratorium which might last for 16 or 18 months. Then we would be right back in the soup, would we not?

Ms. OLSON. No, I do not think we would be back in the soup because the reason to do a moratorium is to have time to consider fully what you ought to do to——

Mr. STARK. Nothing gets considered in this Congress, Ms. Olson——

Ms. OLSON. I am afraid there is, Mr. Stark——

Mr. STARK. You are seeing that. They will not even allow Members of Congress who are experts in this field, who have a concern for the workers in Connecticut, like Congressman Maloney, to testify, only to protect the inadequacy of the representation that is given to them by Congresswoman Johnson. That is the problem we have in this Congress.

Chairman THOMAS. The gentleman has the right to say whatever he chooses to say.

Mr. STARK. Thank you, Mr. Chairman. I wish that that were extended to all Members of Congress.

[Laughter.]

Chairman THOMAS. The gentleman can get on the Committee. If the gentleman is willing to give up his seat to allow the other Member on the Committee, he can express himself right now.

Mr. STARK. We could operate with a certain amount of courtesy and decency and get rid of the fascist——

Chairman THOMAS. The gentleman's time has expired. Does anyone else wish to respond? That comment does not need to have a response.

The gentleman from Florida?

Mr. SHAW. Ms. Olson, I would join the Chairman in complimenting you on a very clear and precise description of the problem. I think Mr. Stark was getting into it. Clearly stated, does the legislation filed by Mr. Maloney, H.R. 3922, solve the problem that we are trying to solve?

Ms. OLSON. No, we do not believe it does solve the problem we are trying to solve. We think it would miss a lot of things. It would have other effects, and those other effects could be very harmful for the economy.

Mr. SHAW. Thank you. I think, Mr. Chairman, some of the comments that have been made from the other side of the aisle, I think fully explain why we should not turn these hearings into political contests between someone on the Committee and someone not on the Committee. It would absolutely, I think, be a tragedy if hearings of this Congress were to stoop to that level so that we ended up having these type of spats every other year during election years. I think that is very unfortunately. I would, frankly, compliment the Chairman for holding firm on that.

I have a question regarding the stock transactions. This is the trading of American incorporated stock for foreign incorporated stock. As I recall from your comments, that is a taxable gain, is that not correct?

Ms. OLSON. Yes, it is. There is tax on the shareholders when they exchange the stock in the U.S. company for stock in a Bermuda company.

Mr. SHAW. Would it result in a stock loss, also, if the stock was below what the stockholder paid for it?

Ms. OLSON. No. The loss is not recognized.

Mr. SHAW. The loss is not recognized. How about stock options held by corporate employees? Is that taxable if the exchange is made for an option on a foreign stock?

Ms. OLSON. Assuming it is an option covered by section 83, no, it is not treated as property, so it would not be treated as a taxable exchange.

Mr. SHAW. We could clearly make it taxable?

Ms. OLSON. Yes, we could.

Mr. SHAW. Thank you. Thank you, Mr. Chairman.

Chairman THOMAS. I thank the gentleman. Does the gentleman from California, Mr. Matsui, wish to inquire?

Mr. MATSUI. Thank you, Mr. Chairman.

Ms. Olson, one of the concerns that I have regarding the testimony you just gave—first of all, let me just say this. Mr. Neal and Mr. Maloney's bill basically, and correct me if I am wrong, but just the bare essentials would be that if a company reincorporates offshore but maintains essentially its shareholders and there is no change or very little change in shareholders, that company then will be treated for tax purposes as a U.S. company? It seems to me that that is pretty straightforward. It does not add a lot of complications in it, which seems to make a lot of sense, given the kind of offshore reincorporation that is being anticipated now. I say that and perhaps when you answer some of my questions, you might want to respond to that.

The concern I have is that in Mr. O'Neill's comments in the press release when the Treasury Department's preliminary report was issued, I will just quote. "When we have a Tax Code that allows companies to cut their taxes on their U.S. business by nominally moving their headquarters offshore, then we need to do something to fix the Tax Code." It sounds like we either move to a value-added tax or a national sales tax or perhaps lower U.S. corporate taxes as a way to do this, and, of course, that would do it. We can eliminate U.S. corporate taxes and there is no question in that situation that you would probably not see inversion.

On the other hand, I could see a lot of corporations 6 months later saying our environmental laws are just too stringent and it might be better just to take companies offshore and have them open up there because we can save hundreds of millions of dollars over the next decade by doing that, or labor standards, or any other standards. Maybe our antitrust laws are too stringent, so we will just move some of the businesses offshore for that purpose.

I guess that is a consequence of globalization, and we all recognize that is happening. We cannot change that. We do not want to change it. It obviously lifts all boats.

I think the answer you are giving basically will allow corporations to make that case of lower taxes for almost every other U.S. regulation or U.S. law that we have to maintain U.S. standards in terms of our country and what we stand for, national character. We are playing, to some extent by making this argument, right into the hands of those people that I disagree with that demonstrated in Seattle, Washington.

I would hope that, somehow, you can try to come up with something that might have a little bit more weight to it, because I am afraid that that argument will be used by everybody. I mean, it is a very dangerous position, I think, if you extend it beyond where we are.

I would like some of your thoughts on this, because I think there is a value in discussing the larger issue of the impact of globalization on U.S. regulations and U.S. laws. There is no question that at the National Oceanic and Atmospheric Administration discussions, this will be a major issue. We are going to get into competition policies, obviously with the GE-Honeywell deal, with the recent European Union complexity in terms of how they view antitrust laws and how we do with respect to Microsoft.

I think we are going to have to discuss these things, and somehow, the Congress and the American public is going to have to be well aware of the direction we are going. I think this is just the tip of the iceberg that we are seeing, and to suggest that we just eliminate U.S. corporate taxes or we lower U.S. taxes is not the answer because we can make that case for almost everything in terms of what we stand for as a Nation.

Ms. OLSON. Thank you, Mr. Matsui. You are absolutely right. I want to first address the Neal and Maloney bill. We are not enthusiastic about any kind of a bill that would just kind of erect a blockade against companies going because we think that it would produce other ways of doing the same thing.

This bill—you have heard said before, I am sure, that tax lawyers are among the most creative people alive and if you erect some kind of a rule, they will find their way around it. The Neal-Maloney bill, I think, is one that people would fairly quickly find their way around, and because of that and because of the other ways of achieving the same effects that the inverted companies are achieving, we do not think that is the right direction to go. So we think it is better to focus on the underlying problems and try to fix the underlying problems.

With respect to the questions about our tax system in general, I am sure you have read the press about the Secretary directing us to begin thinking about tax reform, and that is something that we have underway. One of the things that is clear when you spend a lot of time looking at the tax code is that basing our tax system on income is something that is inherently very difficult to do. It is a very complicated process to figure out how you appropriately measure income.

What I know the Secretary wants us to do is not to think about anything that reduces revenues, but rather to find the most efficient way of collecting for the government the revenues that it needs to operate. So one of the things that we may want to explore is whether there are alternatives to an income tax on business tax that might more efficiently collect the revenues that we need from that sector of the economy to fund government, and when we do that, I think it is critically important that we look at what is going on in our major trading partners.

I think that the quality of life that we have here in the United States is surpassed nowhere and that is a natural magnet for business to the United States. I think the concern about quality of life also means that the countries that we have to be most concerned about are our major trading partners and whether our rules are in step with our major trading partners.

Professor Michael Graetz in a book that he wrote a few years ago observed that in looking at our tax system and in particular international tax reform, we could no longer merely contemplate our own navel, and I think that is exactly right. We have to think more broadly, as you have suggested, about how other countries tax things, what their other rules are like on the antitrust side, the environmental side, et cetera. I think our focus will be mainly on our major trading partners whose systems are, in many respects, similar to ours, but in important respects differ from ours.

Mr. MATSUI. Thank you.

Chairman THOMAS. The gentleman's time has expired.

Mr. MATSUI. Mr. Chairman, reluctantly, given what Chairman Rangel has said earlier, or Ranking Member——

Chairman THOMAS. The gentleman's time has expired.

Mr. MATSUI. I want to make a preferential motion.

Chairman THOMAS. Does the gentlewoman from Connecticut wish to inquire?

Mr. MATSUI. Mr. Chairman, I make a preferential motion. Mr. Chairman, I would like to make a preferential motion, a privileged motion at this time, in that——

Chairman THOMAS. All you have to do is move.

Mrs. JOHNSON OF CONNECTICUT. Thank you, Mr. Chairman.

Mr. MATSUI. I move to adjourn, Mr. Chairman.

Chairman THOMAS. The gentleman from California moves to adjourn. All those in favor, say aye.

Those opposed.

In the opinion of the Chair, the ayes have it. The Committee is adjourned.

[Whereupon, at 12:26 p.m., the hearing was adjourned.]

[Questions submitted from Mr. Neal to Ms. Olson, and her responses follow:]

U.S. Department of the Treasury
Washington, DC 20220

1. Henry Paulson, the chief executive officer of Goldman Sachs, this week lamented the fact that faith among U.S. investors in corporate executives is at an all-time low, and that this lack of confidence was forestalling a recovery in our U.S. financial markets. Paulson said, "I cannot think of a time when business over all has been held in less repute." However, his concerns are not necessarily shared by other corporate executives. John Trani, the chief executive officer of Stanley Tools also said this week of his decision to move Stanley to Bermuda, "If you are taking your stewardship seriously, I think you have to do what I did." And he added if he had it to do over again, he would have done it earlier.

Does the Treasury Department share the concerns of Mr. Paulson? Does the Treasury Department believe that corporations fleeing for offshore tax havens will harm the image of corporate America? Further, does Treasury believe that any such perceptions of greed or disloyalty will lead to a lack of investor confidence hurting our U.S. financial markets?

The Treasury Department is very concerned about U.S.-based multinational companies moving their place of incorporation to outside the United States in order to reduce their U.S. income taxes. These so-called inversion transactions provide a substantial reduction in taxes through a transaction that is complicated technically but virtually transparent operationally. Our tax law should not operate to permit that to occur. As Secretary O'Neill has said, "When we have a tax code that allows companies to cut their taxes on their U.S. business by nominally moving their headquarters offshore, then we need to do something to fix the tax code."

An immediate response is needed to eliminate the juice from these inversion transactions. We must eliminate the ability to engineer ways to inappropriately reduce the U.S. tax on income earned in the United States. The response to these transactions should be broad enough to address the underlying differences in the U.S. tax treatment of U.S.-based companies and foreign-based companies, including the ability to reduce the U.S. corporate-level tax on income from U.S. operations. Inappropriate shifting of income from the U.S. companies in the corporate group to the foreign parent or its foreign subsidiaries represents an erosion of the U.S. corporate tax base. It provides a competitive advantage to companies that have undergone an inversion or otherwise operate in a foreign-based group. Moreover, exploitation of inappropriate income-shifting opportunities erodes confidence in the fairness of the tax system.

2. This week's major newspapers feature the scandal enveloping Tyco, a former U.S. company now headquartered in Bermuda. Back in 1999, Tyco argued before the

SEC that it should not be bound by SEC rules with regard to shareholder proposals because it was not incorporated in the U.S. More recently, a Stanley public statement warns, "It may be difficult for you to enforce judgments obtained against Stanley Bermuda in the U.S. courts.

Does the Treasury Department have a concern that U.S. investor rights, including those of state pension funds and employee organizations, may be diminished by the exodus of former U.S. corporations to tax havens?

Because this question regarding investor protections involves matters outside of my area of expertise, I would refer you to the Securities and Exchange Commission.

3. The SEC filing of Stanley states, "It is intended that Stanley Bermuda's business will be centrally managed and controlled in Barbados." However, Stanley has stated that the move to Bermuda is to lower U.S. taxes on U.S.-source income.

Does Treasury have a concern that the use of Barbados in this situation will be in order to exploit treaty provisions which might allow a company to avoid U.S. taxes on U.S.-source income as well? Does Treasury have the same concern with the use of Luxembourg by Accenture and PWC, in addition to being based in Bermuda?

The Treasury Department is concerned about the possible use of income tax treaties to inappropriately reduce U.S. taxes on U.S. source income. To address this concern, we are reviewing and evaluating our tax treaties to identify any inappropriate reductions in U.S. withholding tax that provide opportunities for shifting income out of the United States. We must ensure that our treaties serve the intended purpose of reducing or eliminating double taxation of income, not eliminating all taxation of income. Treaties that do not operate consistently with this goal will be modified to do so. We also must examine whether anti-abuse mechanisms already within our treaties are operating properly. Because U.S. tax treaties are intended to benefit only residents of either the United States or the treaty partner, U.S. income tax treaties include detailed provisions to prevent the misuse of treaties by residents of third countries. One of Treasury's key tax policy goals in modernizing our network of existing tax treaties is to bring the limitations on benefits provisions in all our treaties up to current standards so as to remove the opportunity for such misuse.

4. The reinsurance transaction to tax haven parent corporations is designed specifically to avoid U.S. tax on U.S.-source income. This is true regardless of whether there has been an inversion by the insurance companies involved. This is distinguishable from other cases where companies are primarily avoiding U.S. tax on foreign-source income. So in the case of reinsurance, there is no broader tax policy question of whether our tax code should permit foreign-based reinsurers to avoid U.S. tax on U.S.-source income.

Does the Treasury Department share the concern that insurance companies are using related-party reinsurance transactions to avoid U.S. tax on U.S.-source income, a clear an egregious tax avoidance situation? Do you agree that a general fix on inversions will not solve the problems of tax avoidance by reinsurance? And, after 3 years of study and evaluation of this specific issue, what specifically do you recommend to eliminate the reinsurance abuse if you do not support the provisions of the Johnson-Neal bill, H.R. 1755?

The Treasury Department is concerned about the use of related party reinsurance to avoid U.S. tax on U.S.-source income. In particular, the use of related party insurance may permit the shifting of income from U.S. members of a corporate group to a foreign affiliate. Existing mechanisms for dealing with insurance transaction are not sufficient to address this situation. In this regard, further analysis may be appropriate to consider and evaluate approaches to address the problems presented by related party reinsurance. Such analysis should include an examination of methods used by our trading partners in taxing insurance companies, including, for example, the use of some countries of a premium-based tax that captures with the country tax base all business written on risks within the country.

[Submissions for the record follow:]

Statement of the AFL–CIO

The AFL–CIO is pleased to have the opportunity to express our concerns about American companies reincorporating to tax havens such as Bermuda. We commend

Chairman Thomas and Ranking Member Rangel for holding these important hearings.

A growing number of companies are seeking to "reincorporate" from the U.S. to tax haven countries to avoid paying taxes on non-U.S. income. In general, the disadvantages of these reincorporations outweigh the advantages for shareholders because these reincorporations reduce the legal protections given to shareholders and also reduce shareholders' ability to hold companies, their officers and directors accountable in the event of wrongdoing.

In light of highly-publicized recent events at other publicly traded companies such as Enron and Tyco International, worker pension funds have become more sensitive to issues of corporate accountability. We want to be sure we are able to seek appropriate legal remedies on behalf of our worker beneficiaries in the event of any corporate wrongdoing—when companies elect to incorporate in Bermuda our ability to do so is limited.

We believe this trend represents a significant threat to shareholders and the pension funds of working people. These reincorporations can diminish shareholders' rights, and set in motion a "race to the bottom" that generally lowers the standards of corporate accountability.

On June 14th, Nabors Industries is seeking shareholder approval to reincorporate to Bermuda. A coalition of institutional investors—the Amalgamated Bank, the AFL–CIO, the Central Laborers' Pension Fund and the Laborers' International Union of North America—are opposing the move based on concerns about its adverse impact on shareholder rights and doubts over the economic benefits of the reincorporation. The principle reason Nabors gives for reincorporating is lower tax bills, although Nabors does not quantify the savings. In our effort to preserve shareholder rights and corporate accountability at Nabors, we have gained the support of several influential public pension funds, and investment management community is becoming increasingly concerned about the effects of these reincorporations on shareholder rights.

Delaware is the state of incorporation for 60% of Fortune 500 companies, according to the Delaware Division of Corporations. We believe that so many companies choose to incorporate in Delaware because it has an advanced and flexible corporate law, expert specialized courts dealing with corporate-law issues, a responsive state legislature and a highly-developed body of case law that allows corporations and shareholders to understand the consequences of their actions and plan accordingly. Bermuda, by contrast, does not even have published reports of legal cases, making it difficult to determine how the courts have ruled on corporate law issues. It is also difficult to obtain access to books on Bermuda law, since public law library resources are almost non-existent. We believe the stability, transparency and predictability of Delaware's corporate-law framework are superior to Bermuda's and provide advantages to shareholders.

While many investors have concerns about aspects of corporate law statutes and the interpretation of those statutes in Delaware, and shareholder activists have long worried that incorporation in Delaware represented a race to the bottom, Delaware law is clearly superior to Bermuda law from a shareholder perspective.

Reincorporation in Bermuda substantively reduces shareholder rights and corporate accountability. In those areas of the law under which shareholders continue to enjoy the same rights—for example federal securities law—shareholder's substantive rights may not be effected by the reincorporation, but their procedural ability to enforce those rights is weakened.

By incorporating in Bermuda companies may make it more difficult for shareholders to hold companies, officers and directors legally accountable in the event of wrongdoing. It is crucial that shareholders have ability to pursue legal remedies to deter wrongdoing. If a company reincorporates to Bermuda, it may be more time consuming and expensive to hold that company or its officers and directors accountable in U.S. courts for several reasons.

A judgment for money damages based on civil liability rendered by a U.S. court is not automatically enforceable in Bermuda. The U.S. and Bermuda do not have a treaty providing for reciprocal enforcement of judgments in civil matters. A Bermuda court may not recognize a judgment of a U.S. court if it is deemed contrary to Bermuda public policy, and Bermuda public policy may differ significantly from U.S. public policy.

Unlike Delaware, Bermuda does not generally permit shareholders to sue corporate officers and directors derivatively—on behalf of the corporation—to redress actions by those persons that harm the corporation. Shareholder derivative suits recognize that a corporation is unlikely to pursue claims against the same officers and directors who control it and provide, we believe, a critical mechanism for remedying breaches of fiduciary duty, especially breaches of the duty of loyalty. Derivative litigation also, in our opinion, serves to protect the market for corporate control and thus promotes efficiency and accountability.

Bermuda law differs from Delaware law in ways that may limit shareholders' ability to ensure accountability and participate in corporate governance. Bermuda law requires unanimous written consent of shareholders to act without a shareholders' meeting. Delaware law contains no such prohibition, although it allows companies' charters to limit the right. In the event a Delaware company does elect to include such a provision in its charter, shareholders can request that the board initiate a charter amendment to remove it.

Unlike Delaware law, Bermuda law does not require shareholder approval for a corporation to sell, lease or exchange all or substantially all of the corporation's assets. Thus, a Bermuda company can significantly change its business without seeking shareholder approval.

At Bermuda companies like Tyco and Global Crossing, shareholders appear to have been unable to assert the kinds of legal claims for breach of fiduciary duty one would expect to see given what has occurred at those companies.

In addition, when worker funds have attempted to exercise basic shareholder rights under federal securities laws, Tyco has taken the position that those laws did not apply to Tyco in the same way they applied to U.S. incorporated companies.

It concerns us that many of these transactions have been structured in a way that executives receive large payments in connection with the reincorporations. The combination of these structures and reduced accountability suggest that management may have other reasons to reincorporate besides tax benefits.

We understand there is bi-partisan support for a legislative response to this problem, and we encourage Congress to take swift action. The AFL–CIO is in full support of the legislation introduced by Rep. Neal (H.R. 3884).

Beyond our shareholder concerns, we believe that it is unpatriotic for corporations to place a larger burden on other taxpayers while still benefiting from the stability and privileges this country provides. America's working families pay their taxes, and expect that American corporations will do the same. Simply put, reincorporation is a poor decision and should be reevaluated by all who promote good corporate citizenship and governance.

The AFL–CIO urges this Committee and this Congress to support legislation that puts a stop to these corporate inversions. The AFL–CIO looks forward to working with you in the coming days on this important task.

Coalition for Tax Competition
Alexandria, VA 22310–9998
April 24, 2002

The Honorable William Thomas
Chairman
Committee on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Chairman Thomas:

American-based companies must pay tax to the IRS on income earned in other nations. This "worldwide" system of taxing corporate income is very anti-competitive, causing many companies to give up their U.S. charters and instead become foreign-based companies. These "expatriations" are legal, but have become controversial. Lawmakers likely will choose from two options in deciding how best to respond to this development.

One option is tax reform. Lawmakers could take a number of steps to make the internal revenue code more competitive. The U.S. corporate income tax rate, for instance, is the fourth highest in the developed world. Lower tax rates would make America more attractive. Policy makers also could eliminate the corporate alternative minimum tax. Another option is to reduce the tax bias against investment by shifting from "depreciation" to "expensing." Last but not least, Congress could junk "worldwide" taxation and instead shift to a "territorial" system that would tax companies only on their U.S. income.

The other option is to preserve "worldwide" taxation and instead impose restrictions on the ability of companies to re-charter in other jurisdictions.

The first option—tax reform—is the correct answer. If bad tax law is driving companies to re-charter in other jurisdictions, the obvious solution is to improve U.S. tax law. This market-based approach will make America more competitive. Fiscal protectionism, by contrast, is bad policy. We all understand that high-tax California should not be allowed to stop companies from moving to low-tax Nevada. We also should understand that the federal government should not be able to stop companies from escaping bad U.S. tax law.

This issue already has been clouded by demagoguery. Some assert that companies choosing to re-charter in other jurisdictions will evade or avoid U.S. tax. This is not true. All corporations, regardless of where they are based, pay tax to the IRS on all profits they earn in the United States. Some also claim that "expatriation" is unpatriotic and hurts America. This is nonsense. Re-chartering helps U.S. workers and U.S. shareholders since the newly formed company still maintains its U.S. operations, but now is able to more effectively compete with businesses that operate overseas.

Corporate relocation is yet another reason why lawmakers should fix the internal revenue code. Companies are relocating because excessive tax burdens and worldwide taxation make it very difficult for U.S.-chartered firms to compete. Instead of making a bad system even worse by imposing more burdens on U.S.-based companies, lawmakers should reform the tax system. Lower tax rates and territorial taxation are just two of many options that would improve the internal revenue code.

Sincerely,

Andrew F. Quinlan, *President,* Center for Freedom and Prosperity
Daniel Mitchell, *Senior Fellow,* Heritage Foundation
Veronique de Rugy, *Fiscal Policy Analyst,* Cato Institute
Paul Beckner, *President,* Citizens for a Sound Economy
David R. Burton, *Senior Fellow,* Prosperity Institute
James Cox, *Executive Director,* Association of Concerned Taxpayers
Stephen J. Entin, *President,* Institute for Research on the Economics of Taxation
Tom Giovanetti, *President,* Institute for Policy Innovation
Kevin Hassett, *Resident Scholar,* American Enterprise Institute
Lawrence Hunter, *Chief Economist,* Empower America
Charles W. Jarvis, *Chairman,* United Seniors Association
Karen Kerrigan, *Chairman,* Small Business Survival Committee
James L. Martin, *President,* 60 Plus Association
Edwin Moore, *President,* James Madison Institute
Steve Moore, *President,* Club for Growth
Grover Glenn Norquist, *President,* Americans for Tax Reform
John Pugsley, *Chairman,* Sovereign Society
Richard Rahn, *Senior Fellow,* Discovery Institute
Gary and Aldona Robbins, Fiscal Associates, Inc.
Tom Schatz, *President,* Council for Citizens Against Government Waste
Eric Schlecht, *Director of Congressional Relations,* National Taxpayers Union
Fred L. Smith, *President,* Competitive Enterprise Institute
Lewis K. Uhler, *President,* National Tax Limitation Committee
Paul M. Weyrich, *National Chairman,* Coalitions for America
Christopher Whalen, Whalen Consulting Group

* Organizational affiliations are included for identification purposes only.

cc. Senate Majority Leader Trent Lott
Senator Max Baucus
Senator Charles Grassley
House Majority Leader Richard Armey
Representative William Thomas
Secretary Paul O'Neill
Dr. Glenn Hubbard
Dr. Larry Lindsey

[Identical letter was sent to Ranking Member Rangel.]

Statement of the Hon. Richard Blumenthal, Connecticut Attorney General, Hartford, Connecticut

I appreciate the opportunity to speak on the issue of corporate inversions, a hyper-technical term for corporations exploiting tax law loopholes and corporate directors and management profiting and protecting themselves from proper accountability.

I urge your support for legislation such as H.R. 3884, the Corporate Patriot Enforcement Act that would permanently close a loophole in our laws that permits corporations to abandon America and abrogate their moral responsibility to this country.

Long-time American corporations with operations in other countries can avoid paying tens of millions of dollars in federal taxes by the device of reincorporating in another country, thereby becoming a "foreign company" under our tax laws that does not pay taxes on profits from its foreign operations. How do they become a "foreign company"? They simply file incorporation papers in a country with friendly tax laws, open a post-office box and hold an annual meeting there. They need have no employees in that country or investments in that country—in short, no financial stake there at all. It is a sham, a "virtual" foreign corporation—and our tax laws not only allow this ridiculous charade, they encourage it. This is a tax law that has run amok. It is a tax loophole that must be slammed shut.

Bermuda may seem close geographically and familiar in language and customs, but it might as well be the moon in terms of legal rights and protections for shareholders. In pitching reincorporation, management has repeatedly misled shareholders—failing to reveal the real long term costs, and concealing even the short term financial effects.

Apologists for this loophole say that the corporation must do this to "compete" on a global scale with foreign-based corporations whose countries do not assess the same level of corporate taxes as American companies. What they ignore is the fact that those countries do not provide the kinds of governmental services and legal protections as the United States does. So these corporations become "foreign" companies in name only to reduce their federal taxes, yet keep their businesses in the United States to benefit from the very services and protections those taxes pay for.

These "foreign competition" arguments are the same ones used to weaken our tough air and water pollution standards and worker protections and benefits. The bottom line: America should not compromise its standards just so corporations can earn higher profits, and certainly America should not have tax laws that encourage corporations to move a few filing cabinets to other countries and call them a corporate headquarters.

Connecticut has learned this lesson the hard way from Stanley Works, the most recent—and potentially the most notorious—corporation to attempt to avoid taxes through this corporate shell game. Stanley Works is a proud American company that is based in the industrial town of New Britain, Connecticut. For more than 150 years, it has been a manufacturer of some of the best-known American-made tools.

Over the past 20 years, however, it has moved a lot of its manufacturing overseas where cheaper labor means more profits. In fact, it has moved so much of its operations that it was in danger of losing its ability to claim that its products were made in America, a major selling point. Several years ago, there was an attempt to weaken the standards for claiming products are "made in the USA". This proposed rule would have allowed corporations to use the "made in the USA" label on products that were mostly made in other countries, with only the finishing touches applied here. It was nothing less than an attempt to create the "veneer" of American craftsmanship. I, along with many others, strongly opposed this weakened standard and it was eventually withdrawn.

It is no surprise then that this same company would attempt to sell its American citizenship for $20–30 million pieces of silver. By reincorporating in Bermuda, hundreds of millions of dollars in profits from its foreign divisions would be tax-exempt in the United States. Stanley Works, of course, is not the only company to use this tax law loophole. Cooper Industries, Seagate Technologies, Ingersoll-Rand and PricewaterhouseCoopers Consulting, to name but a few others, have also become pseudo-foreign corporations for the sole purpose of saving tax dollars.

While profits may increase as a result of this foreign reincorporation gimmick, there are some significant disadvantages to shareholders that may not be readily apparent to them. Shareholders must exchange their stock in the corporation for new foreign corporation shares—generating capital gains tax liability. So while the corporation saves taxes, employees and retirees who hold shares are now unexpectedly facing significant capital gains tax bills. Some must sell many of the new shares in order to pay the capital gains tax—reducing the dividend income they were counting on for their retirements.

At the same time, corporate executives and other holders of thousands of shares of the corporation will receive huge windfalls in stock options as the stock price rises because of increased profits. Stanley Works estimates that its stock may rise by 11.5% after re-incorporation in Bermuda. That increase results in a $17.5 million gain in CEO John Trani's stock option value while shareholders are facing $150 million in capital gains taxes. Smaller shareholders, of course, do not have huge stock option gains that they can use to pay the capital gains tax.

Incorporating in another country may also restrict shareholder rights because that country's laws may not be as protective of shareholders as the United States. This issue is not apparent to many shareholders because they may look at re-incorporation as a merely technical move with only corporate tax implications. The company's headquarters remains in the United States so shareholders may think that American laws will still apply. Management has been in no rush to clarify the weakening, even eviscerating of shareholder rights to hold management accountable.

Taking advantage of corporate tax loopholes, corporations, including Stanley Works, typically reincorporate in Bermuda. Bermuda law differs from the corporate law of most states in several very important respects.

First, there is the simple problem of the opacity of Bermuda law. Even sophisticated shareholders may have extreme difficulty in obtaining information about Bermuda law and evaluating the impairment of their rights under Bermuda law. Bermuda does not even maintain an official reporter of its court decisions. We have learned from the Enron scandal the danger for shareholders, employees and regulators of shielding important corporate information from public scrutiny. The movement of corporations to a place where the legal rights of shareholders are severely constrained and confused—indeed at best unclear—is a matter of grave concern.

Corporations proposing to move their place of incorporation from the United States to Bermuda, such as Stanley, often tell shareholders that there is no material difference in the law. But from what we have been able to learn about Bermuda law—and divining Bermuda law is no easy task—this claim is certainly not accurate. There are several important aspects of Bermuda law that greatly diminish shareholder rights.

For example, Bermuda law lacks any meaningful limitations on insider transactions. Connecticut law, like the law of most states, imposes significant restrictions on corporate dealings with interested directors of the corporation—the kind of restrictions that appear to have been violated in the Enron debacle. Those protections appear to be absent under Bermuda law.

Bermuda law also fails to provide shareholders with any decision-making authority on fundamental changes in the corporation. Connecticut law, like statutes of most states, requires that shareholder approval be obtained before the corporation may sell or dispose of a substantial portion of the assets of the corporation. Bermuda law contains no such requirement.

Similarly, Bermuda law permits shareholder derivative lawsuits in only very limited circumstances. Derivative lawsuits are an essential protection for shareholders. In the United States, shareholders may bring actions on behalf of the corporation against officers and directors seeking to harm the corporation. The availability of derivative lawsuits is a profoundly important tool to protect shareholders from the malfeasance and self-interest of officers and directors. It is a central tenet of American corporate governance. This form of protection is apparently all but unavailable under Bermuda law. In addition, there are serious questions about the enforceability of U.S. judgments in Bermuda. There is presently no treaty with Bermuda that ensures the reciprocity of judgments. Thus, a person who has successfully prosecuted a federal securities claim or products liability lawsuit in the United States against the corporation, for example, may be unable to enforce that judgment against the corporation in Bermuda. Bermuda courts have the right to decline to enforce an American judgment if they believe it is inconsistent with Bermuda law or policy. Bermuda may be not just a tax haven, but also a judgment haven.

Finally, a Bermuda incorporation will greatly impede my office or any state Attorney General in protecting the public interest and safeguarding shareholder rights including the state's—stopping a shareholder vote, for example, if shareholders are provided with misleading information. Earlier this year in Connecticut, Stanley Works had issued conflicting statements to 401k shareholders. The first statement said that failure to vote would be counted as a "no" vote. The second one said that failure to vote would allow the 401k administrator to cast a ballot consistent with the 401k plan. My office, representing the state of Connecticut as a shareholder, filed an action in state court that halted the vote because of the tremendous confusion caused. Whether I could have taken a similar action had Stanley Works been incorporated in Bermuda is at best unclear.

The misstatements made by Stanley Works management were so misleading and potentially deceptive, that I have requested a full investigation by the Securities and Exchange Commission (SEC) and an order delaying any revote until such an investigation is complete. I am awaiting a response from the SEC.

Some corporation proxy statements may seek to assure shareholders that the new corporation bylaws will restore some of these lost shareholder rights. This substitute is simply inadequate. If corporate bylaws were sufficient to protect shareholder rights, we would not need federal and state securities laws.

In sum, reincorporation in another country like Bermuda is not in the best interests of American shareholders. Corporate CEOs, whose compensation is typically tied to short-term gains in stock price or cash flow, often gain millions in additional pay stemming directly from the tax savings obtained by these moves and will be better able to engage in insider transactions. They are less exposed to shareholder derivative lawsuits and federal securities action. They are shielded from shareholders seeking to hold them accountable for misjudgments or malfeasance. The incentive for corporate officers to make the move to Bermuda is obvious. But it is patently detrimental to the interests of ordinary shareholders, and to the United States, to leave this loophole available for exploitation.

I urge the Committee to first approve legislation that will permanently close this loophole and then determine whether our tax laws need to be changed to address inequity concerns that have been raised. The Treasury Department's preliminary report listed several areas for review, including rules limiting deduction for interest paid on foreign related debt, rules on valuations on transfers of assets to foreign related parties and cross-border reorganizations. I do not endorse any specific proposal for tax law change, or even necessarily general change itself. What I endorse strongly and unequivocally is the need for closing this destructive loophole, as HR 3884 would do. The status quo is unacceptable.

DIMON Incorporated
Danville, Virginia 24543–0681
June 4, 2002

Via e-mail
hearingclerks.waysandmeans@mail.house.gov

Congressman Bill Thomas
Chairman of the Committee on Ways and Means
c/o Committee on Ways and Means
1100 Longworth House Office Building
Washington D.C.

Gentlemen:

[1] I am writing you concerning your review of corporate inversions and U.S. international competition.

[2] I am Vice President of Taxes for DIMON Incorporated ("DIMON"). DIMON is a NYSE multinational tobacco leaf dealer (symbol "DMN"). We source, process and trade in tobaccos from more than 40 countries all over the world. I am a CPA and lawyer and have an LLM in Taxation from Georgetown Law Center. Prior to joining DIMON, six years ago, I was a Senior Manager in the Washington National Tax Practice of PricewaterhouseCoopers LLP in Washington DC for ten years.

[3] I have been following the recent corporate inversions with some interest because I am aware of how our U.S. corporate tax system punishes U.S. based multinational companies. Every day DIMON competes with non-U.S. tobacco traders who have the ability to move funds and structure transactions more efficiently than DIMON can because DIMON is a U.S. corporation and they are not. This punishment arises from Congressional fiat. Specifically, the source of the trouble can be found in three places in the Internal Revenue Code (Title 26): (1) Subpart F (Sections 951 through 972), (2) Foreign Tax Credit rules (Sections 901 through 908) and (3) Corporate Alternative Minimum Tax rules (Sections 55 through 59). The collective force of these provisions have driven U.S. companies, such as McDermott, Helen of Troy, Tyco, White Mountain, and Stanley Works to consider reincorporating outside the U.S.A.

[4] What concerns me especially is the hysterical reaction by members of Congress regarding these corporate inversions. Some members of Congress have referred to corporate inversions as "unpatriotic". Other members refer to inversions as a "tax loophole". In a press release accompanying the announcement of proposed remedial legislation, Senator Charles E. Grassley said "These expatriations aren't illegal, but they're sure immoral. During a war on terrorism, coming out of a recession, everyone ought to be pulling together. If companies don't have their hearts in America, they ought to get out." Representative Richard E. Neal's anti-inversion Bill, introduced on March 6, 2002, was proposed to be effective immediately for those corporations that expatriate after an effective date clearly chosen for political reasons—September 11, 2001. Similarly, a recently proposed Bill to combat inversions was introduced as the "Uncle Sam Wants You Act of 2002." The controversy over inversions may also become an issue in upcoming Congressional elections.

[5] What as been ignored in these comments is that corporate inversions are fully taxable events under I.R.C. Section 367(a). White Mountain, for example, estimated that their inversion into Bermuda would generate a current tax expense of approximately $40m. Stanley Works estimated it would cost its shareholders approximately

$120m. These significant short-term costs are generally justified as necessary to allow the inverting company to position themselves to compete better in the international arena. Specifically, the long-term benefit is that an inversion allows the inverted company to reinvest every dollar of profit earned in growing their business outside the U.S.A., instead of paying 35 cents to the U.S. Treasury and only having 65 cents to invest in growth. This is because the existing rules under Subpart F are overreaching.

[6] Most people who are not tax professionals are surprised to discover that if a subsidiary of a U.S. based company sells a product manufactured in Brazil to a customer in Poland, for example, the profit on that sale is fully and currently taxable in the U.S., even if U.S. management had no involvement in the transaction and if the funds are permanently reinvested outside the U.S.A. This strange outcome results from the Subpart F rules concerning Foreign Base Company Sales Income, which can be found in I.R.C. Section 954(a)(2). If the U.S. multinational corporation wants to reinvest those profits in growing their markets outside the U.S.A., it must do so after paying 35% in taxes to the U.S Treasury. The U.S. taxpayer's non-U.S. competitor does not have that added cost. Therefore, due to the U.S. tax rules the cost of capital for a U.S. company is 35% greater than their competitor. In order to invest $1 the U.S. company must earn $1.54, while its foreign competitor only needs to earn $1.

[7] If the U.S. taxpayer corporation wants to repatriate the profits from abroad to provide for growth in the U.S. in theory foreign tax credits are available to offset any U.S. taxation on the repatriation of dividends. The problem is that under corporation alternative minimum tax rules (I.R.C. Section 59) the foreign tax credits can only offset 90% of the alternative minimum tax. Therefore the corporation will always have to pay tax if it repatriates profits, even if those profits are being taxed under the nondeferral rules of Subpart F (in other words, the money is not in the U.S. to pay the tax). This also sounds strange and unusually complex to a non-tax professional, and it should. Additionally, the basketing rules under Section 904 create many traps whereby there can be U.S. taxation if the timing of the dividend is not carefully planned.

[8] Why punish U.S. based multinational corporations? What is the policy behind laws that encourage companies to leave the U.S? Why encourage great American companies like IBM and Coca Cola to move out of the United States? Members of both the House of Representatives and the Senate thus far have introduced six separate Bills to combat the perceived abuses related to inversion transactions. All of the Bills rely primarily on the technique of treating the new foreign corporate parent as a domestic corporation for United States federal tax purposes, although one of the most recent Bills also uses other measures to combat "limited" inversion transactions. All of the Bills focus on a hypothetical transaction where (1) a foreign corporation acquires stock or substantially all of the property of a domestic corporation or partnership, and (2) more than 50% or 80% of the stock of the foreign corporation, determined by vote or value, is held by former shareholders of the domestic corporation or partnership. Several of these bills provide an exception if substantial business operations also leave the United States. Four of the Bills were introduced by House Members and two of the Bills were introduced by Senators. They are as follows:

H.R. 3857, introduced by Representative McInnis on March 6, 2002, effective for transactions after December 31, 2001.

H.R. 3884, introduced by Representative Neal and others on March 6, 2002, effective for transactions completed after September 11, 2001, and would also apply after 2003 to transactions completed on or before September 11, 2001. This Bill is known as the "Corporate Patriot Enforcement Act of 2002."

H.R. 3922, introduced by Representative Maloney on March 11, 2002, effective for transactions completed after September 11, 2001 (and certain pre-September 11, 2001, transactions).

H.R. 4756, introduced by Representative Johnson on May 16, 2002, effective for transactions completed after September 11, 2001 and not to apply to transactions beginning after December 31, 2003. This Bill is known as the "Uncle Sam Wants You Act of 2002."

S. 2050, introduced by Senator Wellstone and others on March 21, 2002, effective for taxable years of any "inverted domestic corporation" beginning after December 31, 2002, without regard to whether the corporation became an inverted domestic corporation before, on, or after such date.

S. 2119, introduced by Senators Baucus and Grassley and others on April 11, 2002, effective for transactions occurring on or after March 21, 2002 (and the pre-approval process would be effective for certain transactions occurring before

March 21, 2002). This Bill is known as the "Reversing the Expatriation of Profits Offshore Act " (the "REPO Bill").

[9] The House Bills and the Bill introduced by Senator Wellstone are essentially the same, in that they all seek to prevent a transaction whereby a domestic corporation or partnership expatriates in order to avoid U.S. income tax. Each of these Bills provides that a foreign corporation will be treated as a domestic corporation if (1) a foreign corporation acquires directly or indirectly substantially all of the properties held directly or indirectly by the domestic corporation, and (2) former shareholders of the domestic corporation receive more than 80% of the foreign corporation's stock. The 80% threshold is reduced to 50% if the foreign corporation has no substantial business activities in the country of its organization and is publicly traded and the principal market for the public trading is in the United States. The way to avoid the lower threshold is to move assets and jobs to a foreign location and re-list the Corporation on the London Stock Exchange. This, of course, promotes an even more radical exodus from America. The Bills also cover transactions in which a foreign corporation acquires directly or indirectly substantially all of the properties constituting a trade or business of a domestic partnership and the foregoing requirements are otherwise satisfied.

[10] The REPO Bill introduced by Senators Baucus and Grassley is more comprehensive and appears to build on the concepts used by the others. This Bill targets two types of transactions—"pure" inversion transactions and "limited" inversion transactions. In a "pure" inversion transaction, (1) a foreign incorporated entity acquires, directly or indirectly, substantially all of the properties of a domestic corporation (or a domestic partnership) in a transaction completed after March 20, 2002; (2) after the acquisition, the former shareholders (or partners) of the domestic corporation (or partnership) hold 80% or more of the vote or value of the stock of the foreign corporation; and (3) the foreign corporation, including its "expanded affiliated group," does not have substantial business activities in its country of incorporation. Under the REPO Bill, in a "pure" inversion transaction, the new foreign parent corporation would be deemed a domestic corporation for U.S. tax purposes. The solution is to move "substantial business activities" out of the United States into the country of incorporation.

[11] A "limited" inversion transaction is similar to a "pure" inversion transaction except that the shareholders of the domestic corporation obtain more than 50% and less than 80% of the vote or value of the stock of the foreign corporation. "Limited" inversion transactions also include a "pure" or "limited" inversion transaction completed on or before March 20, 2002. Under the REPO Bill, in a "limited" inversion transaction, the foreign corporation will not be treated as a domestic corporation, but there are a number of other consequences: (1) no offsets such as NOLs or other credits could be applied to reduce tax on gain realized by a domestic corporation on the inversion transaction or on subsequent transfers of stock or property to related foreign persons; (2) for 10 years after the date of the inversion transaction (or, if later, January 1, 2002) the domestic corporation and its U.S. affiliates would be required, at such time as may be specified by the IRS, to enter into annual pre—approval agreements as specified by the IRS to ensure the integrity of the earnings stripping, gain and loss and intercompany pricing rules of Sections 163(j), 267(a)(3), 482, and 845 for each taxable year within that 10-year period; and (3) the earnings stripping rules would be revised in order to eliminate the 1.5 to 1 debt-to-equity threshold and reduce the taxable income offset from 50% to 25%. The REPO Bill would also amend Section 845 to expand the reallocation authority of the IRS over related party reinsurance agreements to include adjustments necessary to reflect the proper "amount," as well as "source and character," of taxable income of each of the parties. The Section 845 amendment would apply whether or not an inversion transaction has occurred, effective for risks reinsured in transactions after April 11, 2002.

[12] These bills promote bad policy. They would not only encourage American companies to reincorporate outside the U.S.A., they would also encourage the headquarters and jobs to leave with the corporation. The reason they would encourage American companies to reincorporate abroad is because none of these bills address the problem. Companies are not inverting to non-U.S.A. locations because their management is unpatriotic and immoral. They are inverting because the U.S. tax code is punishing them. None of these bills address the overreaching effect of Subpart F and the costs of corporate alternative minimum tax.

[13] The solution is not to further tax fully taxable transactions. It is to make the U.S. corporate income tax regime less punitive to multinational corporations. The way to do this is as follows:

- Repeal corporate alternative minimum tax,

- Repeal or significantly reduce the reach of Subpart F
- Greatly simplify the basket rules under the foreign tax credit provisions Section 904, or change the rules to exclude foreign income from taxation, similar to the "participation exemption" most European countries use.

[14] These changes could be funded, at least partially, from the windfall from repealing the ETI regime, which has been deemed to violate GATT.

* * * * *

[15] I hope these comments are helpful in your efforts to stem corporate inversions and enhance U.S. international competition. Please do not hesitate to contact me at (434) 791–6734, or via e-mail at gbryant@dimon.com, to discuss this matter further.

Respectfully submitted,

Greg Bryant
Vice President of Taxes

Statement of Gary Hufbauer, Reginald Jones Senior Fellow, Institute for International Economics

Chairman Thomas and members of the Committee, thank you for inviting me to comment on "corporate inversions". An inversion occurs when a U.S. parent corporation with foreign subsidiaries (controlled foreign corporations, or CFCs) reorganizes itself in the following manner. First it creates a new foreign parent corporation (FP), based in a low-tax country such as Bermuda. The U.S. operations then become a subsidiary corporation to FP. The former foreign subsidiaries (CFCs) of the U.S. parent corporation also become subsidiaries of FP. Ingersoll Rand, Noble Corporation and Stanley Works are among recent corporate inversions.

Inversions are motivated both by the U.S. parent corporation's desire to reduce the burden of U.S. taxation on the activities of its foreign subsidiaries and by its desire to partake in the delights of earnings stripping. The core issue is *not* U.S. taxation of income from business activity transacted *entirely within* the United States; rather the core issues are U.S. taxation of income from business activity *entirely outside* the United States (the extraterritorial income problem) and the U.S. deduction for interest paid by U.S. corporations to foreign parent corporations (the earnings stripping problem).

Back in 1975, when I was Director of the International Tax Staff in the U.S. Treasury Department, J.L. Kramer and I co-authored an article titled "Higher U.S. Taxation Could Prompt Changes in Multinational Corporate Structure".[1] Congress was then debating severe limits on the foreign tax credit for oil and gas income, and elimination of deferral. We argued that such changes might prompt corporate expatriation (now called corporate inversion) on a large scale—thus defeating the purpose of the proposed tax laws. The proposals died in the Congress, and corporate expatriation drifted from the public policy debate. But it did not drift from the minds of clever tax attorneys. Every time tax regimes change in the United States or abroad, tax advisors take a fresh look at corporate structures to see whether reorganizations could save a pot of money.

Sure enough, over the last three decades, the United States has created a tax atmosphere that encourages inversions, but not in the way we feared back in the 1970s. Instead, other legislative changes in the 1980s and 1990s gradually made the United States less desirable as a location for parent corporations (the extraterritorial income problem). Meanwhile, foreign corporations with U.S. corporate subsidiaries discovered that the best way to gather income from their U.S. operations was through interest payments, not dividends (the earnings stripping problem). Lately, some U.S. corporations have decided that they, too, would like to take advantage of earnings stripping.

In the Reagan era, the United States sharply lowered its corporate tax rate, initially making the United States a very attractive place to do business. But other industrial countries soon got smart, and lowered their corporate tax rates as well. Today, the United States is the fourth highest corporate tax rate country in the OECD (counting both federal and sub-federal taxes), exceeded only by Japan, Bel-

[1] *International Tax Journal*, Summer 1975.

gium and Italy.[2] If all OECD countries had the same system for taxing foreign subsidiaries, this fact alone would make the United States an undesirable location for parent corporations. If the same parent corporation were located not in the United States, but in another industrial country such as Canada, the United Kingdom, or the Netherlands, the parent country tax burden on foreign subsidiary income would be lower.

Other tax facts reinforce this basic point. Most importantly, the norm among industrial countries is *de jure* or *de facto* exemption systems for dividends received by parent corporations from most of their foreign subsidiaries (those that are actively engaged in business, not just off-shore pocketbooks). By contrast, the U.S. worldwide tax system taxes the dividends received from foreign subsidiaries, but allows a foreign tax credit. This is a lot more complicated, and often results in additional tax paid by the parent corporation.

Peculiar features of the U.S. foreign tax credit limit also make the United States a less desirable location for parent corporations. The United States has an absurd method for allocating parent company interest expense to foreign source income, and the net result is to reduce the parent corporation's allowable foreign tax credit. Unlike other countries, the United States attributes a substantial portion of R&E expense to foreign source income, and this too reduces the allowable foreign tax credit.

Continuing the list of disadvantages, the United States disallows deferral for so-called "base company income"—income earned by a foreign subsidiary for handling export transactions between members of a corporate family. In other words, base company income is taxed currently under Subpart F of the Internal Revenue Code. Other industrial countries, for the most part, either exempt base company income from home country taxation, or permit deferral.

Meanwhile, the WTO has ruled against the Foreign Sales Corporation and Extraterritorial Income Exclusion Act. If these provisions are simply repealed, that will be another negative score for the United States.

Finally, there's the competitive tax disadvantage to the U.S. parent corporation that competes, in the U.S. domestic market, with a foreign parent corporation that conducts its business through a U.S. subsidiary. The foreign parent can "strip" the earnings of its U.S. subsidiary by using a capital structure high in debt and low in equity. Interest paid to the foreign parent is a deductible expense for the U.S. subsidiary; and after interest is paid, hardly any earnings may be left for the U.S. corporate tax. The U.S. parent can't play the same game, because it files a consolidated return with its U.S. subsidiaries, and interest payments within the corporate family simply net out. But if the U.S. parent inverts, the newly created foreign parent can strip the earnings of its U.S. subsidiaries.

With all these tax disadvantages, it's not surprising that some U.S. parent corporations are jumping ship. Inversions are just the tip of the iceberg. Less noticeable, but more important, foreign multinationals are acquiring U.S. companies at a much faster clip than the other way around. Taxes are not the only reason, but they are a contributing force. So long as the U.S. tax system is unfriendly to parent corporations, and friendly to foreign parent corporations, there will be a strong tendency for multinational companies to locate their headquarters elsewhere. This will show up in the way mergers and acquisitions are structured, the balance between debt and equity in U.S. subsidiaries, the headquarter choices made by firms of the future, and in more U.S. corporate inversions. Purely from a tax standpoint, few attorneys today would recommend putting the headquarters of a multinational firm in the United States. Why subject your foreign subsidiaries to the U.S. worldwide tax system? Why deny yourself the advantages of earnings stripping?

Congress can make inversions more difficult by "look-through" provisions, such as those proposed by Senator Baucus and Senator Grassley, or by raising the toll-taxes under Sections 351 and 367. Congress can deter earnings stripping by applying a stricter debt/equity ratio to inverted corporations under Section 163(j). But such remedies do not address the underlying problem—the fact that, from a tax standpoint, the United States is not a good location for headquartering a multinational corporation.

The extraterritorial income dimension of the underlying problem can only be addressed by centering U.S. corporate taxation on business activity within the territorial borders of the United States, and exempting the activities of foreign subsidiaries engaged in trade or business abroad. The earnings stripping dimension can only be addressed by applying the same debt/equity ratio test to all U.S. subsidiaries of foreign parent corporations, whether the foreign parent is an inverted U.S. parent, or a foreign parent home-grown in another country.

[2] Chris Edwards, "New Data Show U.S. Has Fourth Highest Corporate Tax Rate", Cato Institute Tax and Budget Bulletin, April 2002.

In my opinion, it's far more important for the United States to retain its position as the nerve center for multinational corporations than to collect whatever revenue is gathered from the activities of foreign subsidiaries by the cumbersome U.S. system of taxing worldwide income. And it would be foolish for the United States to enact new tax provisions (such as a discriminatory earnings stripping rule) that would give foreign multinationals a leg up when competing in the U.S. market.

Where headquarters are located, key corporate functions of strategy, law, finance, distribution and R&E activity are likely to follow. For the high-skilled, high-tech society of 21st century America, these are critical functions. Corporate inversions are not the fundamental problem; they are simply the wake-up call.

Statement of the Hon. James H. Maloney, a Representative in Congress from the State of Connecticut

Chairman Thomas, Ranking Member Rangel, and members of the Committee, thank you for holding this hearing. It is my sincere hope that the Committee will move quickly to pass H.R. 3884, the "Corporate Patriot Enforcement Act of 2002" (commonly referred to as the Neal-Maloney bill), bring it to the floor of the House, and end the outrageous corporate expatriation tax dodge, both immediately and permanently.

So called "corporate expatriates" are former US companies who set up paper headquarters in tax havens in order to avoid US taxes. For little more than the cost of a post office box in an offshore tax haven like Bermuda, US companies are trying to avoid millions of dollars in federal income taxes. Some of these expatriates are even using third countries, with which the US government has tax treaties, in order to avoid paying virtually ALL of their tax obligations.

These companies continue to reside in the United States, take advantage of our infrastructure, our education system, our water systems, federal, state, and local services such as police, fire, and public schools, and, of course, they still rely on the protection of our courageous Armed Services, here at home, and around the world. The only difference is: they now get it all for free, while US citizens and loyal US companies are paying the bill. Some of America's largest corporations have engaged in such transactions, including Tyco, Ingersoll-Rand, and Global Crossings. Ironically, some of these same companies have large contracts to provide goods and services to the Federal Government. Now they are saying they don't want to pay their fair share of US taxes. This is outrageous, and must be permanently stopped.

These Bermuda tax avoidance schemes are especially unpatriotic in light of our current economic and national security situation. We are now seeing a major, growing budget deficit. The Wall Street Journal reported on June 4, 2002 that the federal deficit could total as much as $200 billion next year. The huge federal surplus we had only a year ago has been wiped-out. Corporate expatriates contribute to the growing, long-term budget deficit problem. Critical programs like Social Security and Medicare are in serious jeopardy just as the largest generation in the history of this country is getting ready to retire. In addition, as our country continues its war on terrorism, and makes efforts to improve homeland security, all or our citizens, elected officials, and corporations should remain united and committed to defending our homeland and eliminating terrorism. Corporate expatriates are saying that profit gained from tax avoidance is more important than the security and well-being of our country.

As I am sure you have heard, this tax scheme outrage is happening in my home state of Connecticut. In September 2001, Stanley Works announced that it was closing its last hardware manufacturing facility in New Britain and moving it to China. In February, Stanley Works followed-up with an announcement that its board had approved a plan to re-incorporate in Bermuda.

More and more companies are contemplating such moves as aggressive consultants and legal firms try to sell their clients this unpatriotic tax dodge. In an effort to stem the tide, Congressman Richard Neal of Massachusetts and I introduced legislation on March 6, 2002, to close the expatriate tax loophole. Our legislation is quite simple. It states that if you are, in fact, a domestic US corporation, you are subject to US corporate income tax, wherever you locate your nominal headquarters. Importantly, our legislation, with an effective date of September 11, 2001, will end this unfair tax dodge permanently.

A second important provision of our legislation would restore the tax obligations of those companies that expatriated before 9/11. Our legislation would give such companies until 2004 to come into compliance. This provision, in turn, ensures that all US corporations play by the same rules, with no one having a tax advantage.

The US Treasury Department, while recognizing the problem, has argued that we need to study the issue. Others have proposed a tempoary measure that would only extend through the end of 2003.

We must not wait. Certainly, the tax system needs to be reformed. But there is no reason that fixing the immediate problem needs to be contingent upon reforming the entire system. If your house, which may be in need of remodeling, also has a fire in the attic, you don't do the remodeling first. Instead, you put out the fire immediately, and then move on to the longer range tasks. This is precisely the case here: we need to put out the raging fire of this expatriate tax abuse—and then move on to remodel our tax code. The calls for delay or a study are nothing but sham excuses for failing to take the action so obviously and urgently required.

So also in regard to any temporary measure: a nationally-syndicated Boston Globe columnist recently wrote, ". . . the proposal for a moratorium is so sneaky and pernicious. . . . No one can argue why phony expatriation to avoid taxes is good for the US or good for anybody except the executive officers of companies who do it. So why have a moratorium when a flat-out ban is what's needed?" (May 28, 2002). I strongly agree. These tax schemes are a cancer on the American tax code. They need to be eliminated now. Every day we wait, the situation only gets worse. And you certainly would not start treatment for cancer and then abruptly stop after 12 months. You work to get rid of the problem once and for all! Of course, a temporary measure may seek to serve as an election year gimmick—but it does not solve the problem. A temporary measure is a clear breach of our responsibility to act effectively in the interest of the American people.

In addition, the proposed temporary legislation would not apply to those companies that expatriated before September 11, 2001. Why would we allow those who expatriated before September 11, 2001, to continue to escape their tax obligations? We certainly should not allow expatriated companies to maintain indefinitely a tax advantage over American companies that are loyal to our country. In contrast to the temporary measure, the Neal-Maloney bill fixes the problem permanently, and restores all US corporations to a uniform, level tax policy.

It should be stressed that these expatriate tax schemes are seriously detrimental to many of the companies' own shareholders. Corporations are supposed to act in the interests of their shareholders; here they are not. Under these expatriation schemes, individual shareholders will have to recognize capital gains taxes on the value of their shares at the time of reincorporation, and make immediate payment of those taxes to the IRS. For example, Stanley Works has admitted that if they were to reincorporate in Bermuda it would cost their shareholders $150 million in immediate capital gains taxes. Thus, Stanley is merely shifting its tax burden to individual shareholders. The New York Times recently reported on the scope of this slight-of-hand, stating, "[e]ven if their shares rose 11.5%, they [the Stanley shareholders] will barely break even after taxes" (May 20, 2002).

For the smaller investors, retirees, and those nearing retirement, this will be an especially onerous burden—one they cannot afford. One retired Stanley Works machinist shared with me that he would face an estimated tax bill of $17,000. As any retiree will tell you, having to pay a bill of that magnitude threatens their financial security when they need it most. For those facing these payments, where will they get the resources to pay the tax? They will be forced to borrow the money from a bank, take out a second mortgage, dip into their 401Ks (thereby incurring additional taxes and penalties), or take other detrimental action This tax shift from corporations to individuals is patently unfair and must be stopped now and permanently.

Finally, the New York Times recently reported that the Stanley Works CEO ". . . stands to pocket an amount equal to 58 cents of each dollar the company would save in corporate income taxes in the first year." (May 20, 2002) That is $17.4 million of an estimated $30 million in 'savings' out of the US Treasury, and into the CEO's personal checking account. In the same story, the NY Times reported that the Stanley CEO is also eligible for additional stock options under the current plan, and that he could gain another $385 million by exercising those options.

Let's close this loophole and stop this unfair shift of taxes from corporations to individuals. The Neal-Maloney bill is the solution to the problem. The legislation is straight-forward: if you are, in fact, a domestic US corporation, you are subject to US corporate income tax, wherever you locate your nominal headquarters. Secondly, our legislation would recapture those companies that have already expatriated by giving them until 2004 to come into compliance. This provision ensures that all US corporations are playing by the same rules, and that no one has a tax advantage.

Our legislation will end this unpatriotic tax dodge once and for all. I urge immediate action on H.R. 3884, the Neal-Maloney bill.

Statement of Steven C. Salch, Partner, Fulbright & Jaworski, L.L.P., Houston, Texas

Mr. Chairman and Members of the Committee:

My name is Steven C. Salch. I sincerely appreciate the invitation to appear before you today and discuss with you the subject of corporate inversions. The statements and views I will express today are my own personal views and do not represent the views of the law firm, its clients, or any association or professional organization of which I am a member.

Later this month, I will celebrate my 34th anniversary as a lawyer with the Houston, Texas office of Fulbright & Jaworski L.L.P. Prior to joining that firm, I was a tax accountant for a major energy company then located in Dallas, Texas. I am a former Chair of the Section of Taxation of the American Bar Association and am currently the Fifth Circuit Regent of the American College of Tax Counsel. I have been involved with international commercial, regulatory, and tax issues since I entered into the private practice of law in 1968. As you might expect from a Texas lawyer, a good deal of my practice has focused on the energy industry and financial and service sectors relating to that industry. However, over the years I have represented both domestic and foreign clients in the agriculture, construction, manufacturing, distribution, financial, and service sectors regarding their operations in this country and abroad. My testimony today is predicated on that experience and background.

This Committee and its Subcommittee on Select Revenue Measures have undertaken a formidable task: rationalizing the U.S. income tax system's treatment of foreign operations in an era of globalization of business and financial resources and the enhanced competition that creates for contracts, sales, financial services, and jobs.

Looking back today, it is hard to imagine that the United States once imposed restrictions of direct foreign investments by U.S. businesses and an interest equalization tax on foreign borrowings. Forty years ago, the Congress, at the urging of the Kennedy administration, enacted Subpart F of the Code,[1] which in its original form essentially eliminated deferral for U.S. businesses that utilized certain foreign business structures to reduce their foreign tax liability while simultaneously deferring the lower-taxed foreign income from current U.S. income tax. Starting a decade later in 1971, the Congress and the Executive Branch have endeavored to level the playing field between U.S. businesses and their foreign competitors within the constraints presented by our income tax system, multilateral international agreements, and bilateral treaties, while concurrently endeavoring to preserve the U.S. income tax base, through a variety of statutory mechanisms.

As we all know, the export incentive elements of those efforts have consistently been found to be contrary to GATT or WTO, in large measure because of the different manner in which those trade agreements regard the application of territorial tax systems employed by most other countries, as contrasted to the worldwide tax system the United States employs to tax the income of resident business taxpayers. Consequently, a U.S.-based business with multinational operations today generally faces a higher rate of worldwide income taxation of its net income than does a foreign-based competitor with the same operations, business locations, and employee locations. The reason for this difference generally is that the foreign competitor will not be subject to U.S. federal income tax on its income from sources without the United States that is not effectively connected with a U.S. trade or business or attributable to a U.S. permanent establishment and also will not be subject to income taxation in its base country on foreign business income (income from business operations outside its foreign base company).

Under a pure territorial tax system the business revenues derived from outside the foreign residence country of the foreign business do not sustain taxation by its country of residence. More significantly, perhaps, many foreign countries do not share the same concern about external structures that permit their resident businesses to minimize their business income tax burden in other countries in or with

[1] Unless otherwise noted, references to the "Code" are references to the Internal Revenue Code, 26 USC, then in effect, and references to "section" are to sections of the Code.

which they do business.[2] Over two decades ago, one of my foreign friends from what was then a fairly popular base country characterized his country's exemption of income from direct foreign business investments as "pragmatic" and intended to "facilitate the expansion of both the base country revenue and employment by attracting base companies and at the same time permit resident companies to be extremely competitive in foreign markets."

For over 34 years, I have worked with U.S. businesses seeking to minimize their cost of capital and maximize their net after-tax earnings by managing the combined U.S. and foreign effective tax rate on their business income. During that same period, I have worked with foreign businesses seeking to achieve the same goals by minimizing the U.S. income taxation of their U.S. operations or foreign taxation of their third-country business operations. On one hand, the latter group of clients is generally easier to serve since in many instances their U.S. and foreign business revenues were not taxed in their home countries, while on the other it is somewhat more challenging to explain that the U.S. will tax foreign operating revenues of their U.S. subsidiaries or foreign subsidiaries of those subsidiaries. It doesn't take foreign clients a long time to appreciate that, as a general rule, they should not have operating foreign subsidiaries below their U.S. subsidiaries or conduct non-U.S. operations through U.S. subsidiaries.

At the same time, it has always been trying to explain to a U.S. businessperson or entrepreneur that they will be competing with foreign businesses that enjoy the benefits of VAT rebates on exports and what are explicitly or effectively territorial systems with largely unrestricted opportunities to minimize foreign taxation of their business income. As economies become more intertwined and competition increases around the globe, these experiences have become more trying.

Here is an example of a typical situation and concerns that the Code's approach to income taxation of foreign business operations produces.

Company X and its subsidiaries, domestic and foreign, are in a service industry. Over the years, their customers' activities have become increasingly focused on foreign business opportunities. As a result, the percentage of the gross revenue and income that Company X and its subsidiaries derive from performing services outside the United States has grown. It now is more than 50% of their gross revenue from operations and generally is projected to either remain at that level or increase over the foreseeable future. Company X competes with other U.S. firms and with foreign-based companies. Within the last six months, Company X was unable to achieve an acquisition of substantially all the assets of Company A, a domestic company whose business would complement Company X's operations with over 60% of its operating income from foreign operations, because foreign Company Z offered a cash price that was substantially more than the price Company X thought was feasible based on its targeted goals for return on capital and concerns about maintaining share value in an equity marketplace environment that is becoming increasingly discriminating. Company X's Board asks its management to analyze the situation and report back on the failed bid.

Company X's analysis indicates that Company Z has a lower tax rate on operations than Company X, or indeed any of Company X's U.S. competitors. One of the reasons is that Company Z does not pay tax in its home country on income from foreign operations or foreign subsidiaries. Another reason is that Company Z's home country's exemption of Company Z's foreign operational income from tax permits Company Z to conduct its foreign operations in the manner that minimizes taxation by other countries. While other factors, such as higher employment taxes and office rental, partially offset the tax savings, Company Z has a higher rate of return on invested capital than Company X, largely because of the tax differential.

When Company X's personnel applied Company Z's after-tax rate of return from operations to Company A, the result was a price that was actually higher than the price Company Z paid for Company A. Thus, if Company Z is able to achieve its pre-acquisition rate of return with respect to Company A's business, the acquisition should actually increase the value of Company Z since the acquisition price, though higher than Company X could pay, was based on a lower rate of return than Company Z actually achieves. Company X's analysis showed that under Company Z's ownership the only portion of the operations of Company A that would continue to pay U.S. corporate income tax were those that served the U.S. market exclusively.

In that regard, since Company Z had purchased Company A's assets, all the intellectual property of Company A was now owned by a foreign corporation that would charge and receive an arm's length royalty from Company A's U.S. operations (determined pursuant to the section 482 regulations) that would be deductible for fed-

[2] That low level of concern about business taxation does not extend to individual taxation or passive investment income taxation, however.

eral income tax purposes and be exempt from U.S. withholding tax by virtue of a bilateral income tax treaty. The income derived from the foreign operations of Company A would no longer by subject to U.S. federal income tax or state income tax.

Company X's CEO reported to the Board that Company Z was in the process of downsizing Company A's U.S. workforce by terminating personnel in the research, engineering and design, procurement, and administrative areas because those tasks would be performed by existing staff of Company Z in foreign locations for a fee paid by the U.S. operations. Manufacturing jobs in Company A would remain in the U.S. as needed to serve the U.S. plants. What was not known was how long those plants would all remain active to provide goods for foreign markets, as well as the domestic U.S. market. The CEO commented that it was likely Company X would see a decline in sales to what was Company A as Company Z's foreign engineers and procurement specialists began specifying foreign supplier's components, including those of Company Z and its affiliates, whenever customers did not specifically request open sourcing or Company X components.

Company X's Board quickly grasped the concept that Company X's rate of return on invested capital, and presumably its share price, would increase if Company X could restructure so that it's income from foreign operations was not subject to U.S. corporate income taxation. The question was whether that could be achieved. That's when the outside tax and investment banking experts were brought into the picture.

They suggested to Company X's Board that it should effectively reincorporate itself as a Bermudian company and utilize a domestic holding company to own its U.S. operations. The transaction would involve the U.S. shareholders exchanging Company X shares for shares of a Bermuda company ("BCo"). That exchange would trigger realization of any built-in gain in the Company X shares, but not loss. While precise data were not obtainable, in view of the decline in the stock prices over the past several years, the investment bankers advised that it was probable that there were a great many shareholders who had losses and the amount of gain for stockholders who had held Company X shares for more than three years would be relatively low.

Company X's foreign subsidiaries would be held by a foreign subsidiary of BCo. The existing intercompany pricing policies of Company X and its affiliates would continue to be observed by BCo and its foreign subsidiaries and the U.S. holding company. The U.S. holding company would continue to operate the U.S. fixed facilities. With proper attention to the Code provisions regarding effectively connected income, the income produced by BCo and the foreign subsidiaries should not be subject to U.S. corporate income tax, other than withholding on dividends distributed by the U.S. holding company. The savings achieved by eliminating U.S. corporate income taxation on BCo and its foreign subsidiaries significantly enhance BCo's return on capital and hopefully, its share price. It also makes BCo more competitive with Company Z and other foreign firms.

This example is what I refer to as the classic or straight inversion. It was employed for the first time approximately 70 years ago. Approximately 30 years ago I obtained from the IRS a private letter ruling that dealt with inversion issues. For various non-tax reasons that transaction did not go forward. Subsequently McDermott did invert and Congress tightened the Code to assure that there was an exit fee for similar transactions. Subsequent inversions have likewise generated legislative amendments designed to prevent others from pursuing a similar transaction without additional cost.

The recent increase in proposed inversion transactions and corresponding publicity have caught the attention of the Treasury Department and both the House and the Senate. One result is that a number of members and senators have proposed legislation to address or suppress inversions in several different ways.

I respectfully submit that one of the problems with several of the pending anti-inversion legislative proposals is that they have effective dates that would extend to transactions that were done decades ago. Not all inversion transactions in the past were undertaken solely or perhaps even principally for U.S. tax reasons. To go back into the past and attempt to determine which "old and cold" inversions that were entirely legal when they were implemented, should now be penalized, strikes me as unfair, unsound, and overkill.

I also submit to you that the classic or straight inversion is not a "tax shelter," "abusive transaction," "job loser," or "unpatriotic." As the foregoing example illustrates, the classic inversion generally is motivated by systemic features of the Code and a discontinuity between those features of our law and comparable features of the tax laws of other countries. The classic inversion does not reduce U.S. tax on U.S. source business revenue, except insofar as section 482 dictates that there be an arm's length charge for intercompany transactions in which the foreign affiliate is a provider to a U.S. business.

The example also shows that in the simplest terms, the classic inversion is all about numbers that investors and investment bankers translate into stock prices or purchase prices of businesses. In that context, preserving U.S. ownership of business, a classic inversion can also directly and indirectly save U.S. jobs and business that would be lost if the same business came under foreign ownership.

I realize that Congress needs time to study and develop solutions to the systemic issues, including the export issue and the WTO. However, I am concerned that unless Congress can also enact a moratorium on foreign purchases or acquisitions of U.S. businesses, a moratorium on inversions that precludes U.S. businesses with substantial foreign operations from engaging in the classic inversion will merely provide foreign purchasers an opportunity to extend their present competitive advantage in purchasing and operations during the moratorium period. No matter what your views may be on inversions, I hope you can all agree that result would not be desirable.

If classic or straight inversions were the only type of inversion transaction that we are seeing, I'm not sure we would all be here today for this purpose. We are also seeing transactions that are derivative of the classic inversion in some respects but go beyond it. One such derivative generally involves companies that do not have or reasonably anticipate substantial business income from foreign sources. A simple inversion does not produce a tax benefit for those companies because the systemic issue is not present in the absence of foreign source income. Thus, any tax savings that are achieved are a result of something else and are achieved with respect to U.S. source income. Transactions that fit that description are the transactions I believe the Committee and the Treasury Department should scrutinize carefully. However, any solutions should apply equally to both domestically and foreign owned U.S. businesses, in order to avoid the inadvertent creation of an additional competitive advantage for foreign owned businesses.

Some inversion transactions implicate bilateral income tax conventions to which the United States is a party. If in scrutinizing those transactions, the Congress determines that there are issues that require action, I hope the Congress will provide the Treasury Department with an opportunity to address those issues in negotiations with the other countries that are parties to the treaties in question, rather than unilaterally overriding those treaties. Treaties work for U.S. businesses and are beneficial to international business and financial transactions. Thus, it is in everyone's best interest to permit the normal treaty negotiation or renegotiation process to occur in an orderly fashion, rather than jeopardize an entire treaty over any single issue or transaction.

It is a part of our American culture that we will compete on a level playing field with anyone, anytime, and anyplace. Once the playing field was local. Then it became regional, and later it became national. Today the playing field is international, and our rules are not the only rules in play. Thus, we need to be vigilant that others do not adopt rules that unfairly penalize our businesses seeking to operate abroad. We also need to be vigilant that our rules neither penalize U.S. businesses operating abroad nor grant an unfair advantage to foreign businesses operating here.

Mr. Chairman, classic inversions are not "the problem." They are symptoms that indicate a systemic problem exists. I urge the Committee and the Congress to seek a solution that cures those systemic problems as the best means of alleviating the symptoms. At the same time, Congress and the Treasury should also address variations of classic inversions that achieve savings by reducing taxation of U.S. source business income and assure that any remedial measures apply equally to domestic and foreign investors.

Mr. Chairman, thank you again for the opportunity to appear today. I will be pleased to respond to any questions.

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