CORPORATE INVERSIONS

HEARING

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED SEVENTH CONGRESS

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CORPORATE INVERSIONS

TUESDAY, JUNE 25, 2002

House of Representatives,
Committee on Ways and Means,
Subcommittee on Select Revenue Measures,
Washington, DC.

The Subcommittee met, pursuant to notice, at 3:23 p.m., in room 1100 Longworth House Office Building, Hon. Jim McCrery (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON SELECT REVENUE MEASURES

FOR IMMEDIATE RELEASE
June 18, 2002
No. SRM–8

CONTACT: (202) 225–7601

McCrery Announces Hearing on Corporate Inversions

Congressman Jim McCrery (R–LA), Chairman, Subcommittee on Select Revenue Measures of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing on Corporate Inversions. **The hearing will take place on Tuesday, June 25, 2002, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 3:00 p.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. However, 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:

As noted in announcing the full Committee hearing of June 6, 2002, in 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 report 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 McCrery stated, "Some say inversions are a problem which must be stopped. Others say they are a symptom of a greater problem with our international tax rules. The Subcommittee hearing will give Members an opportunity to learn more about this complex problem and the consequences of proposed remedies."

FOCUS OF THE HEARING:

The focus of this hearing is to build upon the full Committee hearing and further examine the mechanics of inversion transactions and examine policy options that will deter inversions and enhance U.S. international competition.

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, Tuesday, July 9, 2002. Those filing written statements that wish to have their statements distributed to the press and interested public at the hearing should deliver their 200 copies to the Subcommittee on Select Revenue Measures in room 1135 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.

Chairman MCCRERY. The hearing will come to order. Our guests will take their seats.

Good afternoon, everyone. Today the Select Revenue Measures Subcommittee continues its examination of the impact of the Tax Code on the competitiveness of American businesses. The first three hearings looked at possible responses to the World Trade Organization's decision in the Foreign Sales Corporation/Extraterritorial Income Exclusion Act (FSC/ETI) dispute. This hearing will examine the practice known as inversions, whereby some companies move their legal residence from the United States to another country, usually a low-tax or no-tax jurisdiction.

Let me begin by making clear what I said to Mr. Neal and others during House debate last week. I agree inversions are a problem. I agree there is something wrong with a Tax Code which allows American companies to reduce their taxes by moving their nominal residence to another country, and I agree that legislation to address this problem is something this Congress should, and I believe will, take up.

Let me also make clear that my support for legislation to tackle the issue of inversions is not an endorsement of any of the bills which have been introduced to this point. This hearing will give us a chance to evaluate the strengths and weaknesses of current proposals and examine whether other more comprehensive approaches are necessary.

Inversions are not a new phenomenon. In fact, the first inversion to attract significant attention involved a Louisiana company back in 1983. Preventive legislation was enacted in response to that.

A decade later, Helen of Troy inverted in a differently structured transaction. The Internal Revenue Service responded swiftly with new regulations.

Now, two decades after inversions first gained public attention, they are back in the spotlight. The outcry from the press and the public has prompted legislators to introduce a slew of proposals to put a finger in the inversion dike.

Inversions are motivated by two types of tax savings. First, the inverted company generally structures its affairs so as to avoid U.S. tax on its global income, thereby getting around our worldwide tax system. This has sometimes been referred to as "self-help territoriality."

Second, and perhaps even more concerning, inverted companies have engaged in a practice known as interest stripping to reduce U.S. taxes on U.S. income. This occurs when the parent loans money to the U.S. subsidiary. The interest payments made to the parent or other foreign affiliate are deducted from a subsidiary's income, thereby reducing taxable U.S. income. The payments received by the parent are either not considered taxable income or are subject to a very low rate of taxation.

Combined, these incentives provide significant tax savings to inverting companies but erode our U.S. tax base. They also point out the danger of narrow legislative solutions. Just as water will find another way through or over the dike, legislation which leaves in place these incentives but only places them further out of reach encourages clever tax professionals to respond by redesigning and repackaging these inversion transactions.

So long as we are focused on the headline-grabbing inversions and not the underlying factors which prompt these moves, I am concerned we will continue to play catchup with enterprising companies and their tax planners who find ways around the statutes.

The fundamental problem, as identified by the U.S. Department of the Treasury, is the "juice" which makes inversions such an attractive option for many companies. Existing barriers such as toll charges on the shareholders of inverting companies under section 367 are inadequate in some cases. With stock prices depressed and many institutional shareholders indifferent to this tax, this check on inversions is not as formidable as it was once thought.

These challenges suggest the need to think broadly and address not only the narrow issue of inversions but also the broader flaws in our Tax Code which make it attractive for long-established U.S. companies to invert.

I look forward to examining these issues with the witnesses today and to working with my colleagues in the days and weeks to come to craft legislation which responsibly removes the incentive for American companies to send their headquarters overseas.

It is now my pleasure to yield to my good friend from New York, the Ranking Member of the Subcommittee, Mr. McNulty.

[The opening statement of Chairman McCrery follows:]

Opening Statement of the Hon. Jim McCrery, a Representative in Congress from the State of Louisiana

The hearing will come to order. I ask our guests to please take their seats.

Good afternoon.

Today, the Select Revenue Subcommittee continues its examination of the impact of the Tax Code on the competitiveness of American businesses. The first three hearings looked at possible responses to the World Trade Organization's decision in the FSC/ETI dispute.

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I look forward to examining these issues with the witnesses today and to working with my colleagues in the days and weeks to come to craft legislation which responsibly removes the incentive for American companies to send their headquarters overseas.

It is now my pleasure to yield to my friend from New York, Mr. McNulty.

Mr. MCNULTY. Thank you, Mr. Chairman, and before I make my opening statement, I ask unanimous consent to submit the statement of Congressman Doggett concerning his bill, H.R. 4993.

Chairman MCCRERY. Without objection.

[The statement of Mr. Doggett follows:]

Statement of the Hon. Lloyd Doggett, a Representative in Congress from the State of Texas

The parade of corporations changing their charter and buying a foreign mailbox as their home address is only the most blatant example of abusive corporate tax shelters that increasingly plague our country. Effectively resolving this particular form of abuse is urgent, but the broader issue must also receive prompt attention. Regretfully, just as the Committee has shown no recent interest in exploring tax ripoffs by Enron, it has given no attention to the *Abusive Tax Shelter Shutdown Act* (H.R. 2520), or related recommendations by the Joint Tax Committee [1] or the Department of the Treasury [2] since a hearing on November 10, 1999.

When corporations renounce their U.S. citizenship, they take much of their U.S. income with them. Of the $30 million that Stanley Works expects to avoid each year in U.S. taxes under its reincorporation plan, well over two-thirds is apparently a result of moving abroad income earned on operations here in the U.S. Once a company has inverted, several accounting tricks allow it to artificially shift American income to no- or low-tax jurisdictions without first paying its fair share of taxes due in the U.S.

One common means of shifting income is by having a U.S. affiliate borrow heavily from a related foreign company; taxable income generated here can be converted into interest deductions and sent abroad. Even the Treasury Department has recognized that the "U.S. subsidiary can be loaded up with a disproportionate amount of debt for earnings stripping purposes through the mere issuance of an intercompany note. Thus, the desired earnings stripping, and the U.S. tax reduction, can be accomplished without any real movement of assets or change in operations." [3]

The Treasury has failed, however, to grasp the seriousness and scope of the problem. Rather than the zero tolerance attitude that is required, the Administration provides the Congress with many suggestions on how to maintain this loophole: through safe harbors based on the company's ability to leverage itself on a worldwide basis; by removing accelerated depreciation values from the formula; and by giving a free-ride 100% deduction on all interest stripping up to a "to-be-determined" threshold.

The use of intercompany debt to siphon American income abroad is only one piece of the puzzle. If you have wondered why some corporations have chosen to celebrate their new foreign address by discarding not only their citizenship but also by swapping a valuable and well-known trade name for something new, one answer is in the royalties. Probably a large consulting firm could only be convinced to name itself after a day of the week if there were significant moneys to be made in the process. By generating new intellectual property abroad, and then renting it at unreasonable prices to the U.S. subsidiary, more artificial shifting of American income can occur. A decade ago, the Ways & Means Committee recognized that foreign companies could use royalty payments to evade U.S. taxes in the same way that debt and interest payments are used,[4] but the Tax Code offers even fewer protections against such royalty abuse. This is not new, but it has been ignored during the current debate.

While both pleased that the Senate Finance Committee has provided a bipartisan response through S. 2119 and fully supportive of the approach adopted by Representatives Neal and Maloney in H.R. 3884 of which I am a cosponsor, the broad extent of tax evasion requires a multi-faceted response. It should also be noted that those corporations that were first out of the gate with abusive moves would not be immediately affected by these proposals. Among those corporations which appear to have reincorporated before September 11, 2001 are: Helen of Troy; Triton Energy Corporation; ADT Ltd.; Global Crossing; Tyco International; Fruit of the Loom, Inc.; Xoma Corporation; Transocean Offshore, Inc.; PXRE Corporation; Everest Reinsurance Group; Foster Wheeler Corporation; and Accenture, Ltd. In addition to these, Ingersoll-Rand and Global SantaFe appear to have reincorporated prior to March 20, 2002, the effective date of S. 2119. There is a need to reach those companies that have already expressed an interest in circumventing H.R. 3884 and S. 2119.

I believe the root of the problem lies in extending the valuable benefits of our tax treaties to tax evading corporations, which lack a legitimate claim to use them. Tax treaties quite properly are meant to avoid double taxation but should not be a means for avoiding *any* taxation.

Most of our more modern income tax treaties recognize that there can be opportunities for abuse in cross-border payments between related parties, through "treaty shopping." Some of our treaty partners may even promote such activity by estab-

[1] "Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act 1998 (Including Provisions Relating to Corporate Tax Shelters)," Joint Committee on Taxation, July 22, 1999.

[2] "The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals," Department of the Treasury, July 1999.

[3] "Corporate Inversion Transactions: Tax Policy Implications," Office of Tax Policy, Department of the Treasury, May 2002, at page 21.

[4] *See, for example*, Hearing Before the Subcommittee on Oversight of the Committee of the Ways and Means on the Department of the Treasury's Report on Issues Related to the Compliance with U.S. Tax Laws by Foreign Firms Operating in the United States. (Pages 2–4.) April 9, 1992.

lishing very low "residency" requirements for purposes of accessing tax treaty benefits. Many treaties contain "limitation on benefits" provisions to limit access to significant (often total) reductions on the withholding taxes levied on interest and royalty payments. Such provisions contains a series of tests meant to ensure that treaty benefits go only to true residents of the tax treaty partner. The Treasury Department has stated, in its technical explanation to the 1996 model income tax convention, that "[t]he assumption underlying each of these tests is that a taxpayer that satisfies the requirements . . . probably has a real business purpose . . . or has a sufficiently strong nexus to the other Contracting State (*e.g.,* a resident individual) to warrant benefits even in the absence of a business connection. . . ." Unfortunately one of these tests reflects an outdated assumption about residency that renders the limitation on benefits provision of little value where it is most needed.

The limitation on benefits provision, as included in over thirty of our tax treaties, provides that any corporation that satisfies the domestic residency rules of a tax treaty partner and trades its shares primarily on a recognized stock exchange (generally including "any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange under the U.S. Securities Exchange Act 1934") will be granted full access to the benefits of the tax treaty. In this age of globalized securities markets, a listing on the NASDAQ has no more relevancy in determining whether a company is a resident of a foreign partner to a tax treaty than does an annual beach-side board meeting, but it can nevertheless translate into tens of millions of dollars in taxes evaded for a corporation that chooses to reincorporate abroad and become a "resident" of the right tax haven.

H.R. 4993, the *No Tax Breaks for Corporations Renouncing America Act of 2002*, would close this loophole. This legislation would require that corporate beneficiaries have true ties to the treaty partner, either through ownership or through a public stock market listing and substantial activities. It is similar in approach to prior congressional action to close tax treaty loopholes that were providing unanticipated and unbargained-for benefits to third parties.[5]

What American businesses need immediately is a return to a level playing field. When Stanley Works can unilaterally cut its taxes by $30 million overnight, its competitors are disadvantaged and American families are unfairly required to pay an increased share of the costs for meeting our security and other needs.

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

Mr. MCNULTY. I also ask unanimous consent to present for the record the statement of Professor Samuel Thompson of the University of Miami concerning his views in general on corporate inversions.

Chairman MCCRERY. Without objection.

[The statement of Mr. Thompson follows:]

Statement of Samuel C. Thompson, Jr., Professor and Director, Center for the Study of Mergers and Acquisitions, University of Miami School of Law

I. BACKGROUND

My name is Samuel C. Thompson, Jr., and I am a Professor of Law and the Director of the Center for the Study of Mergers and Acquisitions at the University of Miami School of Law. I am submitting these comments because I have an academic and scholarly interest in the topic of inversions, which involve various transactions in which a publicly held U.S. corporation becomes a subsidiary of a publicly held foreign holding company. I do not represent any client that has an interest in inversions, and all of the views expressed on this subject are my own and have not been approved by any other person or organization.

As a young lawyer, I worked in the Treasury's Office of International Tax Policy, and as a practicing lawyer for many years, I counseled clients on various issues relating to the Federal income taxation of international transactions. As a law professor, I have taught International Taxation for many years, and I have published a casebook on the topic: *U.S. Taxation of International Transactions* (West Publishing 1994). I first became interested in inversions and similar transactions in 1998 in connection with a lecture I gave at the University of Cincinnati Law School on section 367 of the Code. The lecture was published in the University of Cin-

[5] *See*, *for example*, section 884(e) of the Internal Revenue Code, responding to treaty shopping by foreign corporations to avoid branch profits taxation.

cinnati Law Review: *The Impact of Code Section 367 and the European Union's 1990 Council Directive on Tax-Free Cross-Border Mergers and Acquisitions*, 66 U. Cin. L. Rev. 1193 (1998). I continued my interest in this subject by publishing in the March 18, 2002 issue of Tax Notes an article entitled: *Section 367: a 'Wimp' For Inversions and a 'Bully' For Real Cross-Border Acquisitions*, 94 Tax Notes 1505 (March 18, 2002) [*Section 367: A Wimp and a Bully*]. This article was the basis of the Polisher Tax Lecture I gave at the Dickinson Law School on April 24, 2002. I also recently published in Tax Notes International the following three articles on this subject: *Analysis of the Non-Wimpy Grassley/Baucus Inversion Bill*, 26 Tax Notes International 741 (May 13, 2002) [*Analysis of Grassley/Baucus Bill*], *Treasury's Inversion Study Misses The Mark: Congress Should Shut Down Inversions Immediately*, 26 Tax Notes International 969 (May 27, 2002) [*Treasury Misses the Mark*], and *U.S. Treasury Official Gives Unconvincing Reason For Not "Blockading" Inversions*, 26 Tax Notes Int'l 1321 (June 17, 2002) [*Treasury's Unconvincing Reason*]. I also made a written submission to the House Ways and Means Committee in connection with its hearing on corporate inversion transactions, which was held on June 6, 2002, and this submission builds on that submission.

II. FOCUS OF THESE REMARKS

Several bills have been introduced to stop these inversion transactions, including bills by Representatives Doggett, Johnson, Neal, McInnis, and Maloney and by Senators Grassley, Baucus, Wellstone and Dayton. I have previously analyzed the bill introduced by Senators Grassley and Baucus. *See Analysis of Grassley/Baucus Bill*. Also, on Friday, May 17, 2002, the U.S. Treasury issued a tentative report on corporate inversion transactions. *See* Office of Tax Policy, Department of the Treasury, *Corporate Inversion Transactions: Tax Policy Implications* (May 2002) [*Treasury Report*], and on June 6, 2002, the Treasury testified on this topic before House Ways and Means Committee. *See Treasury's Unconvincing Reason*. My comments today focus on the Treasury Report, the Treasury's June 6, 2002 testimony, and the policy question of whether the case has been made to bring these transactions to an end. I do not comment here on the technical aspects of the bills that have been introduced, but I think the Grassley/Baucus REPO bill would provide a good starting point for closing down these transactions. This submission does not repeat the sections of the June 6 submission that discuss the background of inversions and summarize the Treasury's Report.

III. SUMMARY OF MAJOR POINTS

- By avoiding the CFC provisions, inversion transactions extend *de facto* territorial taxation to both active foreign income and passive foreign income; not even the most avid proponent of territorial taxation supports such a system for passive income.
- The Treasury Report and the National Foreign Trade Council's (NFTC) Study do not establish that U.S. companies face a competitive problem in conducting business in foreign markets; there may be such a problem, but it has not been established.
- The NFTC's June 11, 2002 position against adopting a territorial system is an acknowledgement that the entire issue needs further study.
- Inversions create a real competitive problem for U.S. firms that cannot, or choose not to, engage in inversions, while their competitors pursue such transactions.
- There is no reason to refuse to act now on inversions because of concern with similar transactions. It is possible to address similar transactions, which is the case with the Grassley/Baucus bill, and there is no evidence that cross border mergers with real companies in OECD countries have been used to accomplish the purposes of inversion transactions.
- The Treasury and Congress should be careful not to overstate the potential simplification advantages of a territorial system. As Ron Pearlman, a former Assistant Secretary of Treasury for Tax Policy in the Reagan Administration said many years ago: "Corporate transactions by their nature are complex and * * * the rules governing those transactions will be complex."
- Without respect to one's views on the desirability of a territorial system, it is difficult to comprehend on tax policy grounds why the Congress would not act immediately to close down inversions.
- After shutting down inversions, Congress and Treasury should then turn their attention to the real issue: a thorough, effective, careful, and honest study of the merits of both (1) a move to a territorial system, and (2), in the words of the NFTC's June 11 Report, the "reform of our current deferral and foreign tax credit system."

IV. CRITIQUE OF THE TREASURY REPORT

A. Relationship of Inversions to Possible Move to a Territorial System

The Treasury Report correctly points out that it is appropriate for Congress to consider the possibility of moving to a territorial regime for active income. Senators Grassley and Baucus [1] made the same point in introducing their anti-inversion bill. So there is no real debate on whether Congress should consider moving to a territorial system, and the treatment of inversions should have nothing at all to do with that coming debate.

A move in the direction of a territorial system has been one of the principal goals of the National Foreign Trade Council, Inc. (NFTC), an industry sponsored organization, which has argued for such a change in its book: *International Tax Policy for the 21st Century*.[2] The NFTC has been careful only to make the case for a territorial system for active foreign income, and there are principled arguments that can be made for adopting such a regime.[3] However, with respect to the treatment of foreign passive income, the NFTC has said: "[W]e * * * have * * * recommended no change relating to the basic operation of the foreign personal holding company income rules of subpart F." [4] Thus, the NFTC does not argue against the current CFC treatment of passive income, which generally imputes such income to controlling U.S. shareholders.

By avoiding the CFC provisions, the inversion transactions extend *de facto* territorial taxation to both active foreign income and passive foreign income. The Treasury Report only addresses the avoidance of tax on foreign source passive income in a footnote, and in that footnote the Treasury says: "Further study must be given to this issue." [5] Thus, the Treasury must think that there could be some argument in favor of extending a territorial regime to foreign passive income. I submit that no principled argument can be made for such a position. For example, all of our significant trading partners with territorial systems only extend territorial treatment to active foreign income. Even though the Treasury seems to support a territorial system, it should have recommended immediate action to end inversions on the grounds that these transactions extend the territorial principles beyond the breaking point.

Further, the NFTC has recently backed away from its support for a move toward a territorial system; in a June 11, 2002 Report, it states that its (apparently recently formed) Territorial Study Group "concludes that, on balance, legislative efforts to improve current international tax rules are better spent on reform of our current deferral and foreign tax credit system and on finding a WTO compliant replacement for FSC/ETI than on adopting a territorial system." *Id*. Executive Summary at 3. Thus, since the principal proponent of a move in the direction of a territorial system has abandoned that position and recommended more study, it would be irresponsible for Congress to decide not to immediately shut down inversions. This recent action of the NFTC emphasizes the need for Congress and the Treasury to carefully study this issue.

B. The Competitiveness Argument

Although the Treasury Report asserts that U.S. corporations face a competitive disadvantage, the Report does not adequately document such a disadvantage. Thus, I believe that there is absolutely no foundation for the following statement in the Treasury Report: "The impact of this competitive disadvantage is seen most starkly with the recent inversion activity * * *." [6] There is nothing in the Treasury Report to support the assertion that inversions are undertaken to address a competitiveness problem these companies face overseas. Certainly inversions reduce the overall tax liability, but there is no evidence that the tax liability these companies are facing is greater than the tax liabilities their competitors face. Although the Treasury says that it reviewed the proxy statements of many companies engaging in inversion transactions, the Treasury Report does not cite to any statements in those proxy statements to the effect that the transactions are being undertaken to allow the companies to address competitiveness problems they face.

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[1] *Analysis of Grassley/Baucus Bill, supra.*

[2] National Foreign Trade Council, Inc., *International Tax Policy for the 21st Century* (December 15, 2001) [*NFTC Report*].

[3] I do not believe the case for a territorial system has been adequately made in the NFTC Report or otherwise, but I believe the move to a territorial system for real active foreign income is something Congress should consider.

[4] *NFTC Report*, *supra* note 17 at 26–27.

[5] *Treasury Report*, *supra* at 29, footnote 50.

[6] *Treasury Report*, *supra* at 28.

In fact, it would appear that our current deferral system for active income, in large measure, addresses the basic competitiveness issue. For example, assume that a U.S. corporation (USC) operates an active business through a foreign subsidiary located in foreign country (X). Also, a foreign competitor (FC) that is organized in a country with a territorial system operates a competing active business through a foreign subsidiary in X. In this case, the foreign subsidiaries of USC and FC face the same foreign tax in X, which is, say, at a 30% rate. The CFC provisions do not require the imputation to USC of the income of its sub, because the income is active income earned in X. Therefore, at the time the business operations are conducted or earnings are reinvested, there is a level playing field for USC and FC in X from an income tax perspective.

At the time the earnings of the subs are repatriated, USC is subject to tax on the repatriated amounts, but USC is, subject to certain limitations, allowed a foreign tax credit for the 30% taxes the sub has paid to X. Where the tax paid to X is less than the U.S. tax liability, the full amount of the foreign tax is generally allowed as a credit. Thus, in such case, the net additional tax due to the U.S. would be the 5% difference between the 30% rate in X and the 35% corporate rate in the U.S. On the other hand, under the territorial system that applies to FC, it can repatriate the income from its sub tax-free. Thus, in this case, the competitive disadvantage faced by USC with respect to its current operations is the present value of the 5-percentage point difference in tax rates between the U.S. and X, which is to be incurred at some point in the future when the income is repatriated. A careful analysis of this type of situation could lead to the conclusion that this difference is insignificant from a competitiveness standpoint.

Let me be clear, I am not asserting that there is no competitiveness problem. I am merely stating that (1) the Treasury Report has not presented evidence of a competitiveness problem, and (2) the issue needs to be carefully studied. There are many elements to this competitiveness issue. For example, consider the impact the following facts have on competitiveness: (1) the U.S. has the lowest tax to GDP ratio of any of its major trading partners except Japan,[7] and (2) in Japan, the corporate tax is 13% of total tax revenues, whereas in the U.S. the corporate tax is only 9% of total tax revenues, which is the average for the OECD.[8] The competitiveness issue is too complex and too important for any one to "jump the gun."

C. The Reverse Competitiveness Argument with a De facto Territorial System

While the Treasury Report focuses on the competitiveness problem between U.S. companies and their foreign competitors, the inversion transaction creates a competitiveness problem between competing U.S. firms. For example, assume that the major U.S. competitor of Coopers Industries, which is considering an inversion, also competes with Coopers in foreign markets. Also, assume that the competitor's shareholders vote no on a proposed inversion transaction because the tax cost to the shareholders under the section 367 regulations is too high. However, Coopers Industries goes forward with its inversion transaction, because the tax cost to its shareholders is not a barrier to the transaction. In such case, it would appear that Coopers Industries has attained a real competitive advantage over its U.S. competitor. Also, the lower tax rate might give Coopers an advantage in attracting capital. It would appear that this is a much more serious competitiveness problem than the potential and unproven competitiveness problem Coopers Industries may face with its foreign competitors.

D. Treatment of Similar Transactions

The Treasury Report argues for moving slowly on inversions because there are other transactions that can have a similar effect, such as initial incorporations in tax havens in going public transactions and acquisitions by substantial foreign acquiring corporations of U.S. targets. It appears that the Grassley/Baucus anti-inversion bill would apply to many foreign, going public incorporations, and in any event, the bill should be amended to clarify and broaden its application to these transactions.[9]

With respect to real cross border transactions, there seems to be no evidence that these transactions are motivated for the purpose of avoiding the U.S.'s CFC provisions. Indeed, most such transactions involve acquiring corporations that are located in countries that have CFC provisions, such as the U.K., Germany, and France. But if the purpose of any such transactions is the avoidance of the U.S.'s CFC regime, the IRS should be given the tools to challenge those transactions along the lines of

[7] OECD Economic Outlook, 171 (June 2001).
[8] *Id*. at 174.
[9] *Analysis of Grassley/Baucus Bill, supra.*

the prior approval provisions of the Grassley/Baucus bill.[10] There is no need to wait on addressing inversions, because these similar transactions can be also addressed.

E. Concern with Congressional "Deal Chasing"

If creative lawyers and accountants come up with new inversion schemes not covered by the legislation, which is certainly a possibility, Congress should act to shut down such transactions. Indeed, this has been the pattern with legislation dealing with tax shelters. For example, during the Ford Administration in 1976, Congress enacted the "at risk" rules under section 465 to address real estate tax shelters. These rules proved ineffective, and as a response during the Reagan Administration in 1986 Congress enacted the very effective passive loss rules under section 469. Also, during the Reagan Administration, in 1981 Congress enacted the disallowance of loss rules under section 1092 and the mark to market rules under section 1256 to eliminate tax sheltering in futures straddles transactions, and in 1983 Congress extended those rules to stock option straddles transactions, which had become a new market for such sheltering. These are examples of what some may refer to as "deal chasing" by Congress. I believe that in view of the very creative tax bar we have in this country, it is necessary for Congress to be prepared to "chase deals." Otherwise, tax planners will find ways to undermine the tax system.

F. Assumption that a Territorial System would be Less Complex than the Current System

Although the Treasury Report criticizes the complexity with our current system of taxation of foreign income, it fails to acknowledge that there will be similar complexities in structuring a territorial system for active income. For example, there would have to be rules distinguishing between the active income that qualifies for such treatment and the passive income that does not. It would be a mistake to think that in an interconnected global world of business, it is possible to write simple rules that taxpayers will not be able to abuse.

The Treasury would be wise to listen to the words of Ron Pearlman, a very effective former Assistant Secretary of the Treasury for Tax Policy in the Reagan Administration and a former Chief of Staff of the Joint Committee on Taxation. In commenting at a 1988 conference on efforts to simplify the corporate tax provisions of the Code, Assistant Secretary Pearlman said:

> We think it a bit dangerous * * * to sell these [corporate reform proposals] as simplification. Corporate transactions by their nature are complex and they will continue to remain complex, we suspect. We would guess that, ultimately, the rules governing those transactions will be complex.[11]

Since the time Mr. Pearlman wrote those words 14 years ago, as he predicted, corporate transactions have become more complex, and this is particularly true of international corporate transactions. The lesson the Treasury should learn from Mr. Pearlman is that it would be a "bit dangerous" to sell a territorial regime as simplification.

Also, if simplification is the principal goal in structuring an international tax regime, it might be advisable to move in the opposite direction of a territorial system and eliminate all deferral by simply imputing all of the income of controlled foreign corporations to their U.S. shareholders. This would eliminate the need to determine subpart F income and could dramatically simplify the foreign tax credit rules. Indeed, there would be complexity with such a move, but on balance, it could be less complex than either the current system or a territorial system.

G. Decoupling the Territorial Issue From the Inversion Issue

There is no sound basis for coupling the examination of the potential move to a territorial system with the inversion problem. They are different problems and should be treated as such. Without respect to one's views on the desirability of a territorial system, it is difficult to comprehend, on tax policy grounds, why Congress would not act immediately to close down inversions, because these transactions produce territorial taxation for passive income, which is not even supported by the NFTC. Indeed, the ability of an inverted company to park passive income offshore tax-free will act as a giant magnet sucking capital out of the U.S.

H. Potential Additional Approach to Interest Stripping

Both the Treasury Study and the Grasssley/Baucus bill address interest stripping with potential amendments to section 163(j). A potential additional approach to in-

[10] *Id*.

[11] Pearlman, *The Political Environment of Corporate Tax Reform*, A Report of the Invitational Conference on Subchapter C 34 (1988).

terest stripping might be an amendment to the Code, along the lines of Congressman Doggett's bill, that overrides any treaty, such as the Barbados treaty, insofar as the treaty is employed in an inversion or similar transaction for purposes of interest stripping or other transactions having a similar effect. This would merely be a statutory extension of the Treasury's anti-treaty shopping provisions of the Model Treaty. The inadequacy of those provisions makes interest stripping possible.

V. TREASURY JUNE 6, 2002 TESTIMONY

A. Summary of Treasury Testimony

On Thursday June 6, 2002, Pamela Olson, the Treasury's Acting Assistant Secretary for Tax Policy, testified at a hearing before the House Ways and Means Committee on Corporate Tax Inversions. Her testimony basically followed the arguments made in the Treasury's May 17, 2002 Interim Report on Inversions. She also recommended "removing the juice" from inversions by curtailing earnings stripping. She said, however, that Treasury does not favor action directly attacking inversions, because a "blockade" against inversions may make other transactions that can have a similar effect "more beneficial." Specifically, she referred to start-up incorporations in tax haven jurisdictions and to foreign acquisitions of U.S. companies. In response to Chairman Thomas's question concerning the wisdom of a "narrow approach" to inversions, she said something to the effect that "foreign companies will have an advantage if we only address inversions." At a later point she said that putting up a "Berlin Wall" against inversions or "blockading" them would be harmful to the U.S.

B. Critique of Treasury's Testimony

This explanation for not immediately "blockading" inversions is unconvincing. First, foreign corporations can acquire U.S. corporations whether or not U.S. corporations can engage in inversions. Second, the Treasury has cited no evidence that acquisitions by substantial foreign companies located in non-tax haven jurisdictions, such as Germany and France, have been acquiring U.S. companies for tax motivated reasons. Third, any acquisition of a U.S. company by a foreign company located in a tax haven jurisdiction, such as the prior acquisition by a Bermuda based company of Tyco in a reverse acquisition, likely would be treated as a pure inversion under the Grassley/Baucus REPO bill, and as a consequence, the foreign acquiror would be treated as a U.S. corporation. In any event, there seems to be no evidence that foreign acquirors with active business operations in tax havens are acquiring U.S. corporations. Fourth, the Grassley/Baucus REPO would address in part many start-up foreign incorporations, and the bill should be amended to pick-up these transactions more completely.

The Treasury's approach would in essence retain the status quo with inversions, except for modification of the earnings stripping provisions, tightening the transfer pricing rules, renegotiating treaties, and enhancing reporting requirements for gain under the section 367 regulations. With the exception of the reporting issue, all of these changes are focused on the base erosion aspects, such as interest stripping, of these transactions, and the Grassley/Baucus bill would address these issues more directly and with less complexity by treating the foreign holding companies in pure inversion transactions as domestic corporations.

To summarize, the Treasury's no "blockade" approach would give companies engaging in inversion transactions *de facto* territorial taxation for all types of foreign income, including: (1) active foreign income that would be foreign base company sales income and, therefore, subject to imputation under the Controlled Foreign Company (CFC) provisions in the absence of an inversion, and (2) passive foreign income that also would be subject to imputation under the CFC provisions in absence of an inversion. Thus, as indicated above, the Treasury's acceptance of a *de facto* territorial approach would even go further than the approach initially proposed by the NFTC.

VI. CONCLUSION

The Treasury has missed the mark by a wide margin in both its Interim Report and in its Testimony. Under the Treasury's suggestion for further study of a move to a territorial system, in the interim, companies would be able to engage in inversions and similar transactions that produce a *de facto* territorial system for both active and passive foreign income. This is an indefensible tax policy position, and Congress should move quickly to bring a prompt end to inversions and similar transactions by adopting the Grassley/Baucus anti-inversion bill or some similar provision. After shutting down these transactions, Congress and Treasury should then turn their attention to the real issue: a thorough, effective, careful, and honest study of the merits of both (1) a move to a territorial system, and (2), in the words of the

NFTC's June 11 Report, the "reform of our current deferral and foreign tax credit system."

Mr. MCNULTY. And, as usual, I ask unanimous consent that all Members of the Subcommittee have the opportunity to submit written statements.

Chairman MCCRERY. Without objection.

Mr. MCNULTY. Thank you, Mr. Chairman. I am very pleased that you have scheduled today's hearing of our Subcommittee on this very important subject. Since the estate tax sunset bill was being considered before the House of Representatives at the same time the Committee was receiving the June 6 testimony on this most important issue, it was appropriate that we postpone the full Committee hearing and resume today before this Subcommittee.

I welcome all of our colleagues from the Congress who are appearing before this Subcommittee today to discuss the legislation they have introduced to stop corporate inversion transactions.

We must act on this legislation with great speed. The problem is clear, and the solution is simple. I have no sympathy for the argument that these Benedict Arnold companies are justified in their actions, literally turning their back on this country because of problems they claim with our tax laws. No one should justify tax avoidance at a time of war by complaining about the laws. We have at least two concrete proposals to address this issue.

First, Congressman Neal has authored H.R. 3884, the "Corporate Patriot Enforcement Act," which is coauthored by Congressman Maloney, and merits our particular attention. Their bill would address a real and growing problem of U.S. corporations avoiding taxes through paper reincorporation overseas. The bill would raise $4 billion over 10 years and eliminates any tax benefits for companies that expatriated after September 11, 2001. Companies that expatriated before that date would be brought back into the U.S. tax system in 2 years.

Second, Congressman Doggett has authored H.R. 4993, which also merits our serious attention. His bill would provide a backstop to the Neal bill by eliminating the ability of corporations to use U.S. tax treaties to strip earnings out of the United States for the purpose of eliminating tax. In such circumstances, the bill would limit the availability of tax benefits to treaty-country residents.

Corporate executives may decide that patriotism needs to take a back seat to profits. I believe that Congress will take a different view. At a time when we are asking our Armed Forces to risk their lives in the war against terrorism, I find it contemptible that corporations would renounce their allegiance to this country in order to evade taxes. It is especially troubling that some of these expatriating corporations have profitable contracts with the Federal Government.

The public expects us to act and to act now. Every dollar of tax evaded by corporations fleeing our borders must be paid by someone else.

I want to thank you, Mr. Chairman, for holding this important hearing and providing especially our Members and other interested parties with the opportunity to be heard. Thank you.

[The opening statement of Mr. McNulty follows:]

Opening Statement of the Hon. Michael McNulty, a Representative in Congress from the State of New York

I am very pleased that the Select Revenue Measures Subcommittee is holding today's hearing. Since the estate tax sunset bill was being considered before the House of Representatives at the same time as the Committee was receiving the June 6th testimony on this most important issue, it was appropriate that we postponed the full Committee hearing and resume today before this Subcommittee.

I welcome all of the Members of Congress appearing before the Subcommittee to discuss the legislation they have introduced to stop corporate inversion transactions. We must act on this legislation with great speed. The problem is clear and the solution is simple.

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The public expects us to act and to act now. Every dollar of tax evaded by corporations fleeing our borders must be paid by somebody else.

I want to thank you Mr. Chairman for holding this hearing and providing Members and interested parties with the opportunity to be heard. Thank you.

Chairman MCCRERY. Thank you, Mr. McNulty.

Our first panel today is a distinguished one, to say the least: four Members who have been leaders in the effort to get the Congress to take a look at this issue. Mrs. Johnson, I remember, was taking a leading role in this issue, kind of a side issue on insurance companies; 3 or 4 years ago, she pulled me aside and said we have got to be concerned about this. Then Scott McInnis, I think, was the first one this year to introduce legislation on this subject. Mr. Neal and Mr. Maloney, of course, have the bill that was the subject of Mr. McNulty's opening remarks and have been leaders in trying to get the Congress to shed some light on this issue.

So we indeed have a distinguished panel before us of our colleagues today, and we are very thankful for you all agreeing to come and share with the Subcommittee your ideas, your thoughts, on this very important topic.

So with your permission, gentlemen, I will begin with the lady amongst you, Mrs. Johnson. Mrs. Johnson, and all of you, your written remarks will be entered into the record in full, but as you know, we would like for you to try to summarize those in about 5 minutes. Mrs. Johnson.

STATEMENT OF THE HON. NANCY L. JOHNSON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CONNECTICUT

Mrs. JOHNSON OF CONNECTICUT. Thank you, Mr. Chairman, Mr. McNulty, and Subcommittee Members. I appreciate your convening this hearing on a very important topic: the troubling practice of American companies reincorporating overseas to avoid paying taxes. I am strongly opposed to these moves, including the ones most recently proposed by Stanley Works in Connecticut.

I have introduced legislation to impose an immediate moratorium to stop Stanley Works and other companies from reincorporating in tax havens like Bermuda, while giving the Congress the time to enact broader legislation aimed at keeping jobs and companies in America. My bill, H.R. 4756, would extend through December 31, 2003.

My legislation will stop the destructive practice of American companies renouncing their American identity to avoid the taxes that provide the very services they benefit from. American companies should act like American companies and pay their fair share to keep our country strong.

The Treasury Department's recent report on corporate inversions confirmed that more American companies will exploit this tax loophole if action is not taken to address the cause of the problem.

On June 6, 2002, in testimony before the full Committee, the Treasury Department made clear that a ban, without taking further steps to reform our Tax Code to keep jobs and companies in America, is unlikely to work and could be very harmful to our economy.

The Treasury Department points out that just plugging the Bermuda loophole without solving the larger problem sets U.S. companies up for foreign takeovers because foreign owners would escape the very taxes a U.S. company dodges by moving to a tax haven. Unfortunately, a foreign owner not only escapes taxes but has less incentive to keep jobs in America.

The Treasury Department prefers my moratorium proposal because we need a thorough understanding of all aspects of the fundamental problem to ensure that the solution we adopt does not make matters worse; in fact, does address the problem. The problem is much greater than companies reincorporating overseas to avoid paying taxes, and companies must make sure that we don't plug one hole only to leave others open or create even bigger ones.

The underlying problem is that our Tax Code is driving U.S. companies offshore. The signs have been clear. For example, I have been lobbying for a bill I introduced with Mr. Neal 2 years ago, and again this Congress, to stop reinsurance companies from taking advantage of a similar Bermuda tax loophole.

Insurers originally incorporated in Bermuda that acquired U.S. companies are able to siphon U.S. profits offshore to a tax haven out of the reach of our Treasury Department by reinsuring their U.S.-owned subsidiary's reserves to Bermuda.

Congress should address both the inversion and reinsurance loopholes, as well as any other loophole that exists if we are going to permanently resolve the alarming exodus of U.S. interests to offshore tax havens to avoid paying their fair share of taxes.

And the now near total loss of the reinsurance industry to Bermuda isn't the only sign the Committee has had of this problem. According to testimony heard by the full Committee on Ways and Means 2 years ago, DaimlerChrysler is German-owned because of the U.S. Tax Code. So current downsizing decisions are being made in Germany, not in America.

Prompt passage of my moratorium is essential. It will give Congress the time to develop a more comprehensive solution to keep jobs and companies in America. Without a permanent and all-inclusive approach, loopholes will remain, and tax lawyers will simply circumvent the legislative proposals before the Subcommittee, inviting foreign takeovers of U.S. companies and putting decision-making about U.S. jobs and research and development (R&D) in the hands of foreign executives.

Our goal is simple: Keep companies in America; keep jobs in America. Any proposal that does less is unacceptable. The Treasury Department has recommended specific steps that Congress should take to remove the tax incentives that are driving companies to re-incorporate overseas. I support taking action on these urgent changes, but this may take time. Unfortunately, in this politically charged climate, it is often difficult to get the House and Senate to work in a bipartisan way on even the simplest of legislative initiatives to save American jobs.

Given the complexity of this corporate inversion issue and the short amount of time remaining in this congressional session, I urge the Subcommittee to act immediately on my moratorium legislation to stop companies from reincorporating overseas. There is nearly universal agreement that we must take action to stop companies from reincorporating in tax havens.

Given this breadth of support, let us pass a moratorium to stop them in their tracks and send a powerful message, to others who may be looking at other possible tax loopholes, that Congress is watching, and we will be acting as quickly as possible to prevent the dodging of U.S. taxes in a comprehensive way.

A moratorium will ensure that no company slips through the cracks while Congress develops a permanent solution to keep U.S. companies in America, keep them competitive, and protect American jobs. We cannot afford to wait.

Thank you, Mr. Chairman.

[The prepared statement of Mrs. Johnson follows:]

Statement of the Hon. Nancy L. Johnson, a Representative in Congress from the State of Connecticut

Mr. Chairman and Members of the Subcommittee:

Thank you for convening this important hearing concerning the troubling practice of American companies reincorporating overseas to avoid paying taxes. I am strongly opposed to these moves, including the one most recently proposed by Stanley Works in Connecticut.

I have introduced legislation to impose an immediate moratorium to stop Stanley Works, and other companies, from reincorporating in tax haven countries like Bermuda, while giving Congress time to enact broader legislation aimed at keeping jobs and companies in America. My bill, H.R. 4756, would extend through December 31, 2003.

My legislation will stop the destructive practice of American companies renouncing their American identity to avoid the taxes that provide the very services they benefit from. American companies should act like American companies and pay their fair share to keep our country strong.

The Treasury Department's recent report on corporate inversions confirmed that more American companies will exploit this tax loophole if action is not taken to address the cause of the problem. On June 6, 2002, in testimony before the full Committee, the Treasury Department made clear that a ban, without taking the further step of reforming our Tax Code to keep jobs and companies in America, is unlikely to work and could be very harmful to the economy. Treasury points out that just plugging the Bermuda loophole without solving the larger problem, sets U.S. companies up for foreign takeovers, because foreign owners would escape the very taxes a U.S. company dodges by moving to a tax haven. Unfortunately, a foreign owner not only escapes taxes, but has less incentive to keep jobs in the U.S.

The Treasury Department prefers my moratorium proposal because we need a thorough understanding of all aspects of the fundamental problem to ensure that the solution we adopt does not make matters worse. This problem is much greater than companies reincorporating overseas to avoid paying taxes and Congress must make sure that we don't plug one hole, only to leave others open, or create even bigger ones.

The underlying problem is that our Tax Code is now driving U.S. companies offshore. The signs have been clear. For example, I have been lobbying for a bill I introduced with Mr. Neal two years ago and again this Congress to stop reinsurance companies from taking advantage of a similar Bermuda tax loophole. Insurers originally incorporated in Bermuda that acquire U.S. companies are able to siphon U.S. profits offshore to a tax haven, out of the reach of our Treasury, by reinsuring their U.S.-owned subsidiaries' reserves to Bermuda. Congress should address both the inversion and reinsurance loopholes, as well as any other loopholes that exist, if we are going to permanently resolve the alarming exodus of U.S. interests to offshore tax havens to avoid paying their fair share of taxes.

And the now near total loss of the reinsurance industry to Bermuda isn't the only sign the Committee has had of this problem. Daimler-Chrysler is German-owned because of the U.S. Tax Code, so current downsizing decisions are being made in Germany, not the U.S.

Prompt passage of my moratorium is essential. It will give Congress the time to develop a more comprehensive solution to keep jobs and companies in America. Without a permanent and all-inclusive approach, loopholes will remain, and tax lawyers will simply circumvent the legislative proposals before the Committee, inviting foreign takeovers of U.S. companies, and put decisionmaking about U.S. jobs in the hands of foreign executives.

Our goal is simple: Keep companies in America. Keep jobs in America. Any proposal that does less is unacceptable!

The Treasury Department has recommended specific steps that Congress should take to remove the tax incentives that are driving companies to reincorporate overseas. I support taking action on these urgent changes, but this may take time. Unfortunately, in this politically charged climate, it is often difficult to get the House and Senate to work in a bipartisan way on even the simplest of legislative initiatives. Given the complexity of this corporate inversion issue, and the short amount of time remaining in this congressional session, I urge the Committee to act immediately on my moratorium legislation to stop companies from reincorporating overseas.

There is nearly universal agreement that we must take action to stop companies from reincorporating in tax haven countries. Given this breadth of support, let's pass a moratorium to stop them in their tracks and send a powerful message to others who may be looking at other possible tax loopholes, that Congress is watching and we will be acting as quickly as possible to prevent the dodging of U.S. taxes in a comprehensive way.

A moratorium will ensure that no company slips through the cracks while Congress develops a permanent solution to keep U.S. companies in America, keep them competitive and protect American jobs. We cannot afford to wait.

Chairman MCCRERY. Thank you, Mrs. Johnson. Mr. Neal.

STATEMENT OF THE HON. RICHARD E. NEAL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MASSACHUSETTS

Mr. NEAL. Thank you, Mr. Chairman. First let me acknowledge that you and Mr. McNulty have been faithful to your word here about keeping this issue before the Subcommittee, and I want to thank you again personally for scheduling this hearing today for our consideration.

The practice of reincorporating in a foreign country to avoid paying U.S. income tax is inconsistent with American corporate citizenship and blatantly unfair to those individuals and businesses who pay their fair share in taxes.

Since I first wrote to my colleagues in early February about this issue, and indeed 2 years ago with Mrs. Johnson about the reinsurance issue, the stream of corporations signing up to flee the United States has continued unabated. Despite patriotic sentiments expressed around this great Nation in the wake of the attacks of September 11, even public rebukes in newspapers have had little impact, including today's from Allan Sloan in the Washington Post condemning this practice as, quote, "the worst abuse of all, moving corporate headquarters to places like Bermuda to duck U.S. taxes on U.S. income."

To address the problem of corporate inversions, or corporate expatriation, Mr. Maloney and I have introduced H.R. 3884, the "Corporate Patriot Enforcement Act." This bill, supported by both Republicans and Democrats, simply says that companies that reincorporate overseas must pay U.S. income tax when the new company has substantially the same assets and more than 80 percent of the same shareholders of the former U.S. company.

A tougher test is applied to corporate expatriates that have no substantial U.S. business activity in a foreign country and if its stock is principally traded in the United States.

The Neal bill currently has 104 bipartisan cosponsors. That is almost one quarter of this body which has put their name to this legislation. It would save $4 billion in Federal taxpayer money, which would otherwise be siphoned off by expatriate companies.

Earlier this month, Goldman Sachs Chief Executive Officer, Henry Paulson, said he knew of no time before that, quote, "business overall has been held in less repute." Restoring the integrity in our corporations," he said, was crucial for getting the economy back on track. With companies resorting to expatriation schemes that have no legitimate business purpose, it is easy to see why investors have doubts about corporate integrity.

Preventing corporate expatriates from cheating the Federal Treasury while their honest competitors and hardworking Americans pay their fair share is a responsibility this Subcommittee must assume. The solution is common sense. Stop the corporate traitors by shutting down the corporate loophole now and permanently.

We are fortunate today to have experts before us to testify about this issue. We are also fortunate that several Members have been actively engaged on this issue and all have similar approaches to dealing with the problem.

Mr. Chairman, in addition to my written statement, I would also request that the record include a report detailing the more than $2 billion in government contracts won by corporate expatriates and a preliminary list of 25 corporate expatriates and their former U.S. headquarters.

I want to emphasize that my interest in this issue was generated, obviously, based upon the reinsurance question. But at the same time, it was not the American Federation of Labor-Congress of Industrial Organizations, it was not the consumer groups, it was not the green party and Ralph Nader who brought this issue about. It was the business community in America who approached me and said, "We stay. We like America. We like doing business here. We want an American address, and we hope we are not to be penalized for the good work that we undertake."

I want to close on the note that I opened with, Mr. Chairman. Thanks to you and Mr. McNulty, you all have attempted to hear what we all have said on this very, very important question. Thank you.

[The prepared statement of Mr. Neal follows:]

Statement of the Hon. Richard E. Neal, a Representative in Congress from the State of Massachusetts

Mr. Chairman and Mr. McNulty, thank you for bringing this important issue before the Committee today for consideration. The practice of reincorporating in a foreign country to avoid paying U.S. income tax is inconsistent with American corporate citizenship and unfair to those individuals and businesses who pay their fair share in taxes. Since I first wrote to colleagues in early February about this issue, the stream of corporations signing up to flee the U.S. has continued unabated, despite patriotic sentiments expressed around this great Nation in the wake of the attacks of September 11th. My colleague, Mr. Maloney, was the first to raise this issue in our Democratic caucus meetings, as many workers and retirees in his district are currently struggling with Stanley Tools' decision to leave for Bermuda.

To address the problem of corporate inversions (or corporate expatriation), Mr. Maloney and I have introduced H.R. 3884, The Corporate Patriot Enforcement Act. This bill, supported by both Republicans and Democrats, simply says that companies that reincorporate overseas must pay U.S. income tax when the new company has substantially the same assets and more than 80% of the same shareholders of the former U.S. company. A tougher test is applied to corporate expatriates that have no substantial business activity in a foreign country and if its stock is principally traded in the U.S.

The Neal-Maloney bill currently has more than 100 cosponsors, would save $4 billion in Federal taxpayer money otherwise siphoned off by expatriate companies, and narrowly lost on the House floor last week as an amendment to another tax bill (Roll Call 247, 186 For, 192 Against).

Investor/Shareholder Issues

Earlier this month, Goldman Sachs CEO Henry Paulson said he knew of no time before that "business overall has been held in less repute." Restoring integrity in our corporations, he said, was crucial for getting the economy back on track. With companies resorting to expatriation schemes that have no legitimate business purpose, it is easy to see why investors have doubts about corporate integrity. As one aggressive tax practitioner was quoted a mere two months after September 11th regarding corporate expatriation, "maybe the patriotism issue needs to take a back seat" to improved corporate earnings.

One corporate expatriate even chose Flag Day as the day shareholders voted to renounce U.S. corporate citizenship. With U.S. corporations contemplating expatriating on patriotic holidays, it is no wonder a new poll found that 57% of Americans do not trust corporate executives to give them honest information and one-third of Americans believe what happened at Enron is typical of behavior at most companies. (Wall Street Journal/NBC News Poll, *Wall Street Journal*, June 13, 2002, A4.)

Furthermore, investors and shareholders of expatriating companies should be forewarned that this move could negatively impact their rights. One expatriating company warned in an SEC filing, "Our shareholders may have more difficulty protecting their interests in Bermuda than would shareholders" in the U.S. These warnings are beginning to resonate among some public investors. Consider these comments by public officials and pension trustees, many who have now cast votes against corporations seeking to leave the United States for tax havens:

> H. Carl McCall, the Comptroller of the State of New York and sole trustee of the state's Common Retirement Fund, "We are concerned that Nabors' re-

incorporation would compromise the accountability of the company's officers and directors, and threaten the long-term interests of shareholders."

Brad Pacheco, spokesman for the California Public Employees' Retirement Fund (CalPERS), one of the largest Stanley shareholders, "We voted against the plan. It sets a bad precedent and could create of flood of companies moving to Bermuda."

Denise L. Nappier, Treasurer of the State of Connecticut and principal fiduciary of the Connecticut Retirement Plans and Trust Funds, "While in some instances Connecticut and Bermuda law regarding shareholder rights may be similar, the overall weight of the differences results in a substantial reduction in the rights of shareholders. Basic shareholder rights that we take for granted in the United States are either non-existent or vague in a number of critical areas."

The State of Wisconsin Investment Board Executive Director Pat Lipton, "offshore reincorporations add risks for shareholders, since we know it could be more difficult to enforce our legal rights there and we're not sure how protective the Bermuda legislature and courts will be of shareholders."

The five New York City Pension Funds Comptroller William C. Thompson, "These companies have offered no compelling business reasons for reincorporating in Bermuda other than the notion that it would reduce U.S. taxes. We are concerned about the effect such a move would have on shareholders. I believe, on balance, that the interests of shareholders are not served by such a move."

In light of the difficulties shareholders, investors, and creditors of Enron are experiencing, this Committee should ensure that our laws do not encourage or reward expatriates who flee to tax havens or "judgment havens." I expect we will hear some expert testimony on this today from Connecticut Attorney General Blumenthal.

Ideological Divide

Some have characterized corporate expatriation as "rational business decisions" or "sensible corporate activity." I find these rationalizations absurd. The same outrage Americans feel about the excesses of Enron and Tyco is also being expressed towards these expatriating companies, one which rented a box in Bermuda to avoid $40 million in U.S. taxes.

Many of these defenders quote Judge Learned Hand, stating that no taxpayer has a patriotic duty to increase their taxes. We would all agree with that statement. Oddly enough in that case, Judge Hand ruled against the taxpayer finding her transaction to be a tax shelter lacking business purpose. The essence of Judge Hand's opinion, and what should be emphasized here, is that while you need not *increase* your taxes to be a good citizen, you also should not unfairly evade taxes either. Our system of voluntary compliance depends on corporations and citizens alike abiding by the rules and not unfairly shifting the tax burden to others.

Taxpayers are rightly outraged when they hear of such flimsy tax avoidance scams. I have been encouraged in my efforts by the support of newspapers around the country, including these selected excerpts from editorials:

"The simple answer to corporate flight is the one advocated by congressional Democrats: Refuse to change the tax treatment of companies that move their legal base abroad without changing where their real operations are located." *The Washington Post*, 6/9/02.

"Tax policy of this sort is outrageously offensive, if not masochistic. It penalizes businesses that behave ethically and responsibly and rewards those that do not. . . . Americans should be outraged, and so should Congress, which should move quickly to pass pending legislation outlawing the dodge." *Peoria Journal Star editorial, May 12*.

"Businesses that want to enjoy the benefits and protections provided by this country should pay their fair share of taxes. Guess who will wind up picking up the tab as a result of Stanley's tax avoidance? Other American taxpayers, of course." *Hartford Courant editorial, May 14*.

"Even in the best of times, it is outrageous for companies to engage in offshore shenanigans to avoid paying their fair share of taxes. Doing so after the Enron scandal, in dire fiscal times and when the Nation is at war is unconscionable." *New York Times editorial, May 13*.

"American companies that have no headquarters, no employees or operations in foreign tax havens should not be able to lower their taxes by, in essence, acquiring an island post office box. Basic fairness to American companies that remain incorporated in the United States is at stake." *Houston Chronicle editorial, May 9*.

"When a U.S.-based corporation decides to reincorporate, basing its operations in, say, the Cayman Islands when the company has little more than a mailbox there, it can legally avoid millions of dollars in taxes. . . . There will come no better moment than this one to right that wrong. We look forward to the floor vote." *Springfield Union News editorial, May 7*.

The Administration and others would prefer a "go slow" approach on corporate inversions, preferring instead to study the intractable issue of fundamental tax reform. Recently, the CEO of corporate expatriate Stanley Tools endorsed this approach, stating that he "favors recommendations" by Treasury to overhaul the Tax Code, as opposed to specific legislation to close the loophole. It is my sincere hope that this Committee does not follow his advice.

Conclusion

Preventing corporate expatriates from cheating the Federal treasury while their honest competitors and hard working Americans pay their fair share is a responsibility this Committee must assume. The solution is common sense—stop these corporate traitors by shutting down the loophole now, and permanently. While we continue to fight for tax simplification ensuring that U.S. businesses remain competitive globally, we all acknowledge that this effort will take some time. Still, it will *never* be right for companies to buy a file cabinet in a tax haven to avoid paying millions in U.S. taxes, whether we keep our current corporate tax system or switch to another. A plug to this loophole is needed today, tomorrow, and forever.

We are fortunate today to have experts before us to testify about this issue. We are fortunate also that several Members have been actively engaged on this issue and all have similar approaches to dealing with this problem. Again, I look forward to the testimony and prompt action to shut down this offensive practice.

Chairman MCCRERY. Thank you, Mr. Neal. And, without objection, the report to which you refer will be admitted to the record. Mr. McInnis.

[The information follows:]

Corporate Expatriates and U.S. Federal Government Contracts

This information was compiled by the Office of Rep. Richard Neal and is based on a sample of former U.S. companies from public information sources, and is not intended to be exhausive.

Accenture
Consulting business, formerly part of Arthur Andersen.
Inversion to Bermuda completed in July, 2001.
Total Federal Contracts in excess of $1 billion.

- December 13, 2001: Two Federal contracts awarded from the U.S. Department of Education/Office of Financial Assistance for system redevelopment and operation. Total cost **$234.6 million**.
(www.washtech.com/news/govtit/14177-I.html)
- October, 2001: Company earnings statement released, showing Net Revenue for government contracts topping **$1 billion** in fiscal year 2001.
(www.informationweek.com/story/IWK20011011 50008)
- September 17, 2001: Accenture rates among the Top 10 GSA schedule holders based on sales to the Federal Government between July 1, 2000 and June 30, 2001, including management consulting projects for the U.S. State Department and Defense Department. Estimated revenues **$183.7 million**.
(www.fcw.com/supplements/fedList/200I/fed-acc-09-17-01.asp)
- July 30, 2001: Internal Revenue Service awards 5-year contract to redesign IRS website (the Digital Daily). Total costs expected to reach **$46 million**.
- Additionally, Accenture holds numerous contracts with state government agencies for consulting work, including as welfare and social services contracts, among other professional services (see e.g., Nebraska, Ohio, Texas).

PricewaterhouseCoopers Consulting (PwCC)
Accounting firm spun-off consulting firm, which completed inversion to Bermuda in March, 2002. Total Federal Contracts in excess of $760 million.

- May 6, 2002: PwC is listed as number 46 on the Washington Technology 2002 list of Top 100 prime contractors in the Federal IT market. Contracts totaled **$128,328,000**.
(www.wtonline.com/news/17–3/features/I 82141.html)
- March 25, 2002: PricewaterhouseCoopers wins a **$4.5 million** contract from the Defense Supply Center for management support services.
(www.washingtonpost.com)
- December 15, 2001: The U.S. Army granted a **$453 million** contract to PwC to implement its new distant-learning initiative.
(www.govexec.com)
- August 1, 2001: Listed as one of the top 200 Government Contractors (No. 125) for the fiscal year 2000. Total Government Contracting award for 2000 was **$171,752,000**, with **$69,865,000** in Department of Defense contracts and **$101,887,000** in Civilian contracts.
(www.eagleeyeinc.com/pressroom/GovExecTop200-2000-2.htm)
- 2000: The Federal Reserve paid PricewaterhouseCoopers **$1.4 million** to audit the individual and combined financial statements of the Reserve Banks and an additional **$200,000** to audit the Fed's pension and thrift savings plan.
(www.fmcenter.orp-,/pdf/fedauditindep.l)df)

Tyco International
Conglomerate. Inversion to Bermuda completed in March, 1997. Total Federal Contracts in excess of $1 billion.

- February, 2001: Listed as one of the top 10 Federal contractors for Architecture/Engineering Services for the U.S. Department of Defense. Total Federal Contracting award for 2000 was **$60,976,000**.
(www.fpdc.gov/fpdc/fpr.htm, Section l of the Federal Procurement Report)

—ADT Securities (subsidiary):

- August 14, 2000: ADT security systems awarded contract from the United States Navy for alarm, signal, and security detection systems. Total cost equaled **$283,804**.
(www.washingtonpost.com/wp-srv/WPlate/200008/14/1221081400-idx.html)
- December 20, 1999: ADT announces contract to install aviation security technology (Qcontrol) at Miami International Airport. **Contract price not revealed.**

—Tyco Electronics Corporation (subsidiary):

- October 15, 2001: M/A–Com, a unit of Tyco Electronics, awarded a 10-year contract for technology, equipment, and services to U.S. Federal agencies for the Base Radio System, managed by United States Army. Total award up to **$1 billion**. Additionally, awarded contract for HYDRA land mobile radio systems for Space and Naval Warfare Systems Center. Award not to exceed **$46 million**.
(www.macom.com/about-macom/press.asp?ID=85)
- July 30, 2001: Elo Touchsystems, Inc., a unit of Tyco Electronics Corporation, was added to the GSA schedule, allowing Federal agencies to purchase their touchscreen technology, used by military and civilian agencies. **Unable to estimate.**
(www.fcw.com/few/articles/2001/0720/web-market–07–30–01.asp)

—Earth Tech (subsidiary):

- March 13, 2002: Five-year contract awarded to provide emergency response services for the U.S. Environmental Protection Agency (EPA) for several southwestern U.S. states and the Mexico border, including responding to terrorist activities as they pertain to environmental cleanup. Total contract award **$100 million**.
(www.prnewswire.com/cgi-bin/stories.pl?ACCT=105&STORY=/www/story/ 03–12–2002)

—AMP Incorporated (subsidiary):

- April 15, 1999: Placed on GSA schedule contract. Under schedule 70, Federal agencies may purchase AMP's cable and wiring products for up to **$500,000** without seeking additional bids.

Foster Wheeler
Engineering, Environmental, &
Construction Company.
Inversion to Bermuda completed
on May 25, 2001.
Total Federal Contracts in excess
of $600 Million.

- One of the top 10 Federal Contractors for Civilian government agencies in 2000: Total 2000 award **$52,713,000**.

—Foster Wheeler Environmental Corporation (subsidiary):

- February 5, 2002: Contract awarded by the U.S. Navy, to perform environmental cleanups at contaminated Navy and Marine Corps installations. This was the third consecutive award for this subsidiary. Award not to exceed **$100 million**.
(www.corporateir.net/ireye/ir__site.zhtml?ticker=fwc&script=414&layout=7&item__id=255272)
- November 30, 1999: Contract awarded for 5-year project by the U.S. Army Corps of Engineers to perform environmental cleanup of ordnance and explosives at the former U.S. Army Training and Doctrine Command Facility at Fort McClellan, Alabama. Total award **$50 million**.
(www.fwc.com/news/rel-I 999/1991210b.cfm)
- November 11, 1999: Contract awarded to build and operate a dry spent nuclear fuel storage facility for the U.S. Department on Energy, guaranteed through 2009, with the option to handle other spent nuclear fuel. Facility to be owned privately by Foster Wheeler and licensed by the NRC. Total award **$217 million**.
(http://newsdesk.inel/gov/contextnews.cfm?ID=51)
- September 27, 1999: Five-year contract awarded, with renewal option, by the Federal Supply service of the U.S. General Services Administration to provide environmental advisory services to Federal agencies. Total award (with renewal) **$50 million**.
(www.fwc.com/news/rel__1999/19990927.cfm)
- August 20, 1998: Ten-year contract awarded by the U.S. Department of Energy to handle, treat, and repackage low-level radioactive waste at Oak Ridge National Laboratory. Total award **$212 million**.
(www.em.doe.gov/em30/pvortwt.html)

Ingersoll-Rand
Industrial Equipment,
Construction, and Security.
Inversion to Bermuda completed
on December 31, 2001.
Total Federal Contracts Worth:
$3.8 million.

- March 26, 2002: Company website lists variety of products available for government agency purchase, including forklifts and golf carts to the military and light towers to the civilian agencies. Multi-year contract; award amount not available.
(www.irco.com/corpinfo/government__01.html)
- August 8, 2001: Contract awarded by the U.S. Department of Energy for research and development to provide a refrigeration system for a new cooling, heating, and power system as part of the Bush Administration's National Energy Plan. Total award **$2,305,469**.

(www.energy.gov/HQPress/releases01/augpr/pr01138__v.htm)

—**Northern Research and Engineering Corporation, Ingersoll-Rand Energy Systems (subsidiary)**

- July 25, 2000: Contract awarded by the U.S. Department of Energy for industrial combined heating, cooling, and power products. Total contract award **$1,457,863**. (www.energy.gov/HWPress/releases00/julpr/pr00201.htm)

STATEMENT OF THE HON. SCOTT MCINNIS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF COLORADO

Mr. MCINNIS. Thank you, Mr. Chairman. I too appreciate, as has been earlier communicated to you and the Ranking Member, your interest in this. As previously stated, we should point out again that even at this table as we now speak, we have two Republicans and two Democrats.

This is a bipartisan issue. Our focus should not be a political focus in an election year, our focus should be on what is going on out there. The analogy, the best analogy I can see, is that it is like out at the ranch when you have got a bucket; you know you need a new bucket because the bucket has got some holes in it. But before we get the replacement bucket up to the ranch, we have got to use the one we have, and the first thing you do is plug the holes.

When I talked with Congresswoman Johnson, her moratorium does exactly that. And I think there are good things in all of these bills. I am not locked in on one method. I, like the others here, am locked in on the fact that it isn't right. That is how you can simply put it. No matter how complicated these tax accountants like to make it, no matter what the Chairman of Stanley Works talks about, how it is justified to preserve jobs and and so forth, and so forth, the fact is it doesn't feel right, it doesn't look right, and frankly, it is not right.

I introduced the first bill on this, and my focus really on this issue was not just on the reincorporation that we have seen going on in Bermuda and so on. My focus was also broader than that, and that is what is going on with intellectual property, for example, or the earnings which the Chairman and Ranking Member have both noted.

I will give you an example. When we talk about intellectual property, you could have Stanley Works reincorporate in Bermuda, and then Bermuda takes possession of the name, the trade name Stanley Works; then license it to the American operations. The American operations pay for the rights to use the intellectual property or trademarked name of Stanley Works; it gets to deduct that as a business expense, and the earnings then go to Bermuda.

I mean, this is going on across the country, and I am absolutely convinced that the amount of money that is leaving the borders of this country without bearing the appropriate share of the burden is grossly underestimated. I think there is a lot of money that is going because of corporate greed outside the borders of this country, and it is not just on reincorporations.

So my hope today is that the panel looks at the issue—and I know you have, obviously, from the statements of the Chairman and the Ranking Member—but that we broaden this and take a look at the earnings stripping, and we take a look at the intellectual property and what is occurring out there.

I would like to compliment Congresswoman Johnson. I have got some of these corporations, I am sure, in Colorado, but I was not driven to this by a particular corporation. I was reading an analysis on it. In fact, when I was overseas at a North Atlantic Treaty Organization (NATO) meeting, I was so upset by this that I actually called my staff from the NATO meeting and told them to look into it, and find out who in our body is kind of an in-house expert on it, and the first name that came up was Congresswoman Johnson. I have had numerous conversations with her. I have had conversations with Mr. Neal. I think we are prepared to do it if we can just come in with the right way to plug the holes in that bucket. Some of the holes are bigger than the other holes, and some of them may take a different type of fix, but, boy, we are leaking a lot of water.

I would also point out the motivation behind a lot of this, despite what they say is the noble reason they are doing this, i.e., they want to save jobs or the tax system is unfair—I think probably the more realistic reason was stated by an accountant, and was earlier commented by the Ranking Member, the Ernst & Young tax partner that said, really the earnings are so powerful by doing this that patriotism has to take the back seat.

I can tell you, Mr. Chairman, that when the Chairman of Stanley Works came to my office, which was a surprise to me that he would come to my office, but he did come to my office, I gave him a little wallet-sized list of the soldiers, both men and women, that we had lost to date in Afghanistan, and I asked him to put it in his wallet. So every time he talks about this, pull it out and give it consideration. What kind of obligation do these corporations have in this country?

So, Mr. Chairman, in conclusion, we can get into the merits of each of our bills. They are very similar. They are obviously aimed at the same target. We are in agreement, and we have got to do something.

So, Mr. Chairman, I appreciate the fact that you and the Ranking Member have given us this time in this hearing, and also want to publicly reacknowledge, as I have done a couple times in this statement, your particular conversations with me and your focus on plugging those holes, because where you come from and where I come from, we don't want that water going out of the bucket.

Thank you, Mr. Chairman.

[The prepared statement of Mr. McInnis follows:]

Statement of the Hon. Scott McInnis, a Representative in Congress from the State of Colorado

Mr. Chairman, Members of the Subcommittee, thank you for holding this hearing on inversions, transactions where companies reincorporate offshore to avoid U.S. taxation. I had hoped to be able to offer some questions at the hearing in the full Ways and Means Committee on June 6, but unfortunately was unable to do so. I look forward to today's opportunity to discuss the issues. I especially look forward to working with the Treasury Department and the Committee to address the plague of inversions that has visited itself on our country.

Near the beginning of this year, I first became aware of inversion transactions, and frankly became incensed. On March 6, I introduced H.R. 3857, the first legislative proposal designed to target inversion transactions. My proposal would treat inverted companies as U.S. companies, ignoring the paper-thin transaction designed to avoid taxes. This bill has bipartisan support, including support from a number of Members of this Ways and Means Committee, including Rep. Nancy Johnson (CT). I also cosponsored H.R. 4756, Representative Nancy Johnson's bill that she introduced to impose a moratorium on these inversion transactions. It is clear from those facts that this is not a partisan issue or a political issue—and people should get over trying to make it one. Rather this is an issue of policy, and I am pleased that the Subcommittee will have the opportunity to discuss the policy issues here today.

My bill is similar in design to several of the bills introduced afterwards, applying a two-level test to the transaction. The first is a clear bright line test based on a high level of stock ownership by the same owners following the inversion. The second, involves a lower level of ownership following the inversion, and sets out a three part test to distinguish transactions with little substance. The effective date on this legislation includes transactions completed on or after January 1, 2002. That date was not designed to include or exclude any particular company, but rather reflected fair warning to every company contemplating these tax avoidance techniques.

As I have told anyone that asks me, my overriding goal is to end these inversions, the exact means of how that happens is less important to me than the result. I am absolutely willing to work on better ways to go about achieving that overriding goal. I am aiming a missile at inversions—but if that missile won't get the job done, then get me one that will—because that's the one I want to use. My goal in this case is about the end result, the end result that prevents these inversions from occurring, not about how we get there and not about who gets the credit along the way.

When I was drafting my legislation, I sat down with my staff and sought out advice from recognized experts about how to address the issue. My legislation reflects some of that advice, but I am the first to admit that we have learned quite a bit about these transactions since February and early March of this year. I have become convinced that the most significant aspect driving these inversions is the ability to strip out U.S. earnings, via payments to the foreign parent for interest, dividends and the use or licensing of intangibles. On April 11 of this year, I announced that it was my intention to work to tighten the earnings stripping rules, so I have been on record for several months as recognizing the need to address earnings stripping.

That earnings stripping was such a significant part of these transactions was not well understood in February. If we can take the financial incentive out of the transactions, then I am convinced that companies inverting to avoid taxes will cease. Moreover, as I have learned more about these transactions, it has become clear that if an inverted company can strip earnings to achieve a lower tax rate, so can an existing foreign company that owns a U.S. subsidiary. That issue needs to be addressed as well, because it will leave a large hole in any policy response to inversions if we just close one window but ignore the other window next to it that is wide open. I will continue to look into these complex transactions and work to refine and revise my approach as new information yields new facets of these transactions.

A tax partner for a leading accounting firm, Ernst & Young, commenting on the current climate regarding inversions, noted that "we are working through a lot of companies who feel that it is, that just the improvement on earnings is powerful enough that maybe the patriotism issue needs to take a back seat to that." I cannot disagree with this sentiment strongly enough. I cannot help but view this issue as a patriotic issue; this country provides tremendous liberties and protections to the employees of the companies that invert and the individuals who run these companies. We have a right to expect that everyone shoulders a fair share of the burden. Avoiding taxes just shifts the burden from these companies to every other American. Focus for a moment on the young men and women who are now fighting the War on Terrorism in Afghanistan and elsewhere. I would like to think that if these soldiers can shoulder their burden, we can expect our companies to shoulder their own fair share. Of course these companies should preserve American jobs, but tax avoidance is not the way.

To give you some perspective from the common man, as I have traveled Colorado discussing this issue, I have had small business owners ask me how they can reduce their effective tax rates by 10%, like the inverted companies do. You're out of luck, I tell them. I have supported legislation that gives these small businesses lower tax rates. I am all for reducing the taxpayers' burden, but for everyone, not just the select few companies that have little concern for the sacrifices made by many to allow us the freedoms we hold dear.

We should consider the competitiveness issue from the perspective of a small or midsize business that is trying to compete with an organization that avoids U.S. taxation by stripping out any U.S. earnings. How is a small or midsize business to compete against that kind of 10% margin advantage? We on the Ways and Means

Committee should stop the politics and get down to the tough business of figuring out how to help the people who work for and own those small and mid-size business—because the real competitiveness issue is how they can compete to sell their products and services against some other company with a 10% advantage.

Many have noted that inversions are a symptom of the U.S. Tax Code's flaws, especially our international tax provisions, which I agree are tremendously complex and burdensome. Many of the companies which have chosen to turn their back on this country argue that the Tax Code drove them to take the action. One response has been that the U.S. international tax system should be reformed to address the complexity and fairness of the Internal Revenue Code and address the problem.

The way I view this issue is best illustrated by considering a person who has a bucket that has sprung leaks. The first thing you do is plug the leaks, then you work on how to get a new bucket and make decisions about what kind of bucket to get. I propose to plug the leaks in our international tax system that are inversions, and I agree we can and should work on fixing the larger and more complicated problem of how the Tax Code's complexity could lead to inequities and make the U.S. tax system less competitive.

I would also like to highlight an oversight or unclear provision regarding the requirement that shareholders pay capital gains upon a company inverting. That is the current law, but many shareholders may have no idea, and that is because there is absolutely no clear requirement that individual shareholders receive a Form 1099 that tells them there has been some event that might trigger capital gains tax. I have a strong suspicion that many innocent shareholders don't even realize that the company they own some shares in has inverted. That information reporting requirement needs to be fixed.

I would also take issue on a related point made by some companies which claim that the U.S. taxpayer is not losing out in these inversions. Some companies have claimed that the capital gains received on the transaction will make up for years of reduced taxes the company will pay—implying the U.S. taxpayer won't see any loss for years. Fact is, this argument ignores that a large percentage of the shareholders of these companies are held by either tax exempt or tax deferred vehicles, like pension plans, 401(k) plans or IRAs. Those shares won't be paying any capital gains, and in one inversion case I know of, just over 50% of the shares were held in accounts that do not pay capital gains on the transaction. I also would note that it is a lot easier to get the necessary shareholder vote if such a large percentage of shareholders aren't paying any toll charge, another reason I have doubts about the significance of the votes that authorize these transactions.

Finally, I am very pleased that the Treasury Department was able to produce its report in such a short time period. The Bush Administration has taken these transactions seriously, and worked to produce a meaningful look at the transactions and the causes and possible cures. In that report, the Treasury Department noted that earnings stripping and the transfer of intangibles are both significant components of these transactions; I don't think our current limitations on earnings stripping are working well, otherwise, why would these companies take these steps to take advantage of the transaction. I would like to work with the experts who know the Tax Code inside and out, like the Treasury Department, to fix this problem.

In conclusion, I very much appreciate Chairman McCrery scheduling today's hearing on inversions. This is an important issue for the Ways and Means Committee to consider. This is not a partisan issue, it is an issue of how to ensure our tax laws are applied in a fair and consistent manner—to everyone. I look forward to the other testimony and to working with the Committee, the Department of Treasury and others to address this problem.

Chairman MCCRERY. Thank you, Mr. McInnis. Mr. Maloney.

STATEMENT OF THE HON. JAMES H. MALONEY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CONNECTICUT

Mr. MALONEY. Thank you, Chairman McCrery, Ranking Member McNulty, and Members of the Subcommittee, and thank you for holding this hearing.

It is my sincere hope that this Subcommittee will move quickly to pass H.R. 3884, the "Corporate Patriot Enforcement Act of 2002," referred to as the Neal-Maloney legislation.

As I am sure the Subcommittee is aware, on June 18, the Senate Committee on Finance passed the Grassley-Bachus bill. Clearly, this issue has bipartisan support and deserves quick action in the House. In fact, the Neal-Maloney bill, which is very similar to the Grassley-Bachus bill, already—as Mr. Neal indicated—has over 100 bipartisan cosponsors, and we continue to add more virtually every day.

So-called corporate expatriates are former U.S. companies who set up paper headquarters in tax havens to avoid U.S. taxes. Some of these expatriates are even using third countries, such as Barbados, with which the U.S. Government has tax treaties, in order to avoid paying virtually all of their tax obligations. These companies continue in fact to reside in the United States, take advantage of our 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 U.S. citizens and loyal U.S. companies are paying the bill.

This is outrageous and must be permanently stopped. These Bermuda tax avoidance schemes are especially unpatriotic in light of our recent and current and economic national security situation. The Wall Street Journal reported on June 4 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. Critical programs like Social Security and Medicare are in serious jeopardy just as the largest generation in our history is getting ready to retire. In addition, as our country continues its war on terrorism, all of 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, and they could not be more wrong.

The Treasury Department, while recognizing the problem, has argued that we need to study the issue. Others have proposed a temporary stop-gap measure that would only extend through the end of next year.

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 changing 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 study are nothing more but sham excuses for failing to take the action so obviously and urgently required.

So, also in regard to any stop-gap measure, a nationally syndicated Boston Globe columnist recently wrote, quote: "... the proposal for a moratorium is so sneaky and pernicious ... no one can argue why phony expatriation to avoid taxes is good for the United States or for anyone except the executive officers of the companies who do it. So why have a moratorium when a flat-out ban is what is needed?"

I strongly agree. In addition, a stop-gap bill will not ensure that all U.S. corporations are playing by the same rules. Indeed, a stop-gap approach actually allows the situation to get worse. It maintains the disparity in tax treatment, while sending the wrong message—that the Congress is not really serious about this problem, but is merely trying to let the issues slide until after the election.

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. 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, the stop-gap may seek to serve as an election year gimmick, but it does not solve the problem. A stop-gap measure is a clear breach of our responsibility to act effectively in the interest of the American people.

In addition, the proposed stop-gap legislation would not apply to those companies who expatriated before September 11. Why would we allow those who expatriated before September 11 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 stop-gap proposal, the Neal-Maloney bill fixes the problem permanently and restores all U.S. corporations to a uniform, level tax policy.

The Neal-Maloney bill will end this unpatriotic tax dodge once and for all, and I urge immediate action on the bill. Thank you very much.

[The prepared statement of Mr. Maloney follows:]

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

Chairman McCrery, Ranking Member McNulty, and Members of the Subcommittee, thank you for holding this hearing, and thank you for allowing me the opportunity to appear before you today.

It is my sincere hope that the Subcommittee, and in turn the full 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.

As I am sure the Subcommittee is aware, on June 18, 2002, the Senate Finance Committee passed The Grassley-Baucus bill, the *Reversing the Expatriation of Profits Offshore* Act, S. 2119 (REPO). Clearly, this issue has bipartisan support and deserves quick action in the House. In fact, the Neal-Maloney bill, which is very similar to the Grassley-Baucus bill, already has over 100 bipartisan cosponsors, and we continue adding more.

So called "corporate expatriates" are former U.S. companies who set up paper headquarters in tax havens in order to avoid U.S. taxes. For little more than the cost of a post office box in an offshore tax haven like Bermuda, U.S. companies are trying to avoid millions of dollars in Federal income taxes. Some of these expatriates are even using third countries, with which the U.S. 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 U.S. citizens and loyal U.S. 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 U.S. 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.

More and more companies are contemplating such abusive tax dodges, as aggressive consultants and legal firms try to sell their clients this unpatriotic scheme. 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 U.S. corporation, you are subject to U.S. 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 U.S. corporations play by the same rules, with no one having a tax advantage.

The U.S. Treasury Department, while recognizing the problem, has argued that we need to study the issue. Others have proposed a temporary, stop-gap measure that would only extend through the end of next year.

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 stop-gap 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 U.S. 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. In addition, a stop-gap bill will not ensure that all U.S. corporations are playing by the same rules. Indeed, a stop-gap approach actually allows the situation to get worse. It maintains the disparity in tax treatment, while sending the wrong message—that the Congress is not really serious about this problem, but is merely trying to let the issue slide until after the election.

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 stop-gap may seek to serve as an election year gimmick—but it does not solve the problem. A stop-gap measure is a clear breach of our responsibility to act effectively in the interest of the American people.

In addition, the proposed stop-gap 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 stop-gap proposal, the Neal-Maloney bill fixes the problem permanently, and restores all U.S. 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 U.S. 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 U.S. corporation, you are subject to U.S. 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 U.S. 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.

Chairman MCCRERY. Thank you, Mr. Maloney, and thank all of you for your testimony.

As is tradition in these hearings when we have Members testify, I am not going to ask you any tough questions. I am going to save those for the experts that will follow, but I do have a couple of thoughts, though, as I listen to you all. You all may not know it, but since you have highlighted this issue, I have taken an interest in it and done some studying, listened to a lot of tax experts, economists, and others who have looked at this situation. I have to tell you that in examining all of the legislation that you all have introduced, including the moratorium, I find flaws with each approach, and I hope that you all will listen to the questions that I and others will ask of the experts who follow you in the next panel, because I am going to try to bring out some of the flaws that I see in your legislation, not because I want to denigrate your efforts or stop the effort to do something about the problem. As I have said repeatedly, I think it is a problem, we ought to do something about it, but I don't want us, the Congress, to do something about it in a way that would have consequences that we may not foresee without more careful examination. That is not to say, Mr. Maloney, that I want to delay. I want to do this as expeditiously as possible, and I want to do it this year. But I don't know that it is necessary for us to just do it right now before we have really fully examined all of the consequences that may follow our actions.

For example, if we were to enact the moratorium, it would, as Mr. Maloney said, kind of freeze in place the advantages that some companies have gained by expatriation. On the other hand, if we go with the Neal-Maloney bill, it seems to me that there may be greater incentive for foreign takeover of American corporations, which is not what we want, I don't think. That in many respects is worse than expatriation or inversion, because generally speaking, when foreign companies take over American companies, we lose jobs as a result of that, and good, high-paying jobs. We lose research and development. We lose executives.

So I think those are the things that we all need to talk about and examine before we come up with a solution. Again, I want to congratulate all of you for getting out there and putting something forward to draw attention to the problem. I do think we ought to just go a little slow for at least a few days and think about this as a group before we go forward.

Mr. McNulty.

Mr. MCNULTY. Thank you, Mr. Chairman. And unlike the Chairman, I think that my opening statement reveals my bias and support on a couple of these approaches. I just wanted to highlight something that I heard Mr. Neal say at the end of his prepared statement, and I want to make sure that we have this in the record. Congressman Neal, did you say that you have identified over $2 billion in government contracts by some of these corporations?

Mr. NEAL. That is correct.

Mr. MCNULTY. How many corporations were involved in that list you compiled, approximately?

Mr. NEAL. They are not numbered here, but I have them. We have five on a contracting basis.

Mr. MCNULTY. Okay, fine. I just think it is ironic that these corporate expatriates are relying so heavily on government funds. Did we get unanimous consent, Mr. Chairman, to put that in the record?

Chairman MCCRERY. Yes.

Mr. MCNULTY. So make sure that list is in the record. Thank you. I thank all of the Members for their testimony.

Chairman MCCRERY. Mr. Foley.

Mr. FOLEY. Thank you very much, Mr. Chairman. I would like to see if any of the panelists would answer the following question. Eighty percent of the transactions valued over $300 million involve foreign companies buying U.S. firms. Do any of your bills deal with foreign companies buying U.S. firms?

Mr. NEAL. Can I give you a little bit longer answer to that, Mr. Foley?

Mr. FOLEY. Not too long. We obviously only have 5 minutes.

Mr. NEAL. Right. Look, the argument that I have in this instance with the question of what is wrong with the corporate Tax Code is based upon what I heard back in 1994 from the election season. When I came to the Committee at that time, after having been out of it for 2 years, all we heard here was what we were going to do about the corporate Tax Code. We had leaders of this Committee saying we were going to pull the Tax Code up by its roots. We had others saying we were going to drive a stake through the heart of the Tax Code. We were going to a long funeral procession for the Tax Code.

I understand there may well be problems with the corporate Tax Code. But for those of us who are watching this train pull out of the station, where President Bush has correctly said we are in a state of war and war calls for a national purpose, we all sacrifice and pull that train together, what troubles me is that it becomes simply an excuse to study it for a while longer.

I am happy to get into a full-scale debate about the corporate Tax Code, but I don't see any evidence, based upon the last 8 years, or the time that I was on this Committee before that, that we were really about to disturb the Tax Code in any major way to address this issue.

Mr. FOLEY. Did anybody on the panel, did you—you are a Member of the Committee—offer legislation to change the Tax Code from its high 35 percent——

Mr. NEAL. Mark, I stick to the position of progressivity and have in tax debates, and I will say that we heard from the Committee Chairman at the time, that we were going to move to a consumption tax. The Majority Leader said we were going to move to a flat tax. This room was packed with people who wanted to hear where we were heading. And the truth is—I think we all would agree on this, at least quietly, we may not be able to agree on it publicly but we would agree on it quietly—we are no closer today to make any structural changes in the Tax Code than we were then.

Mr. FOLEY. Well, I think we have a significant obligation. I would like to find out, though, if we are going to publish lists of corporations that are apparently unpatriotic, should we be, in the Federal Government, buying Chryslers?

Mr. NEAL. Mark, can I ask you something on that? What are you suggesting by "apparently unpatriotic"? Do you think they are unpatriotic?

Mr. FOLEY. Well, I think we have allowed, through the Tax Code, opportunities to minimize their taxable obligations.

Mr. NEAL. Do you think they are unpatriotic?

Mr. FOLEY. I don't like them leaving our shores, no question.

Mr. NEAL. I think they are unpatriotic.

Mr. FOLEY. We can also make the claim that a citizen leaving Connecticut to move to Florida, because we have no income tax, is unpatriotic to its home State of Connecticut.

Mrs. JOHNSON OF CONNECTICUT. Mr. Foley, I would like to just comment on your question. As a Member of the Committee, I want the record to note that the Chairman of the Committee convened a series of four quite extensive seminars in which all Members of the Committee had an opportunity to review the seriousness of the problems facing our country in the international arena. It is a problem so serious, that we are as close to a trade war with Europe as I have ever seen.

I would remind this body that when Reagan was President and Rostenkowski was Chairman of this Committee, we did pass a tax bill that dropped corporate taxes in such a way that our companies were insulated from foreign takeovers, and, in fact, foreign capital poured into America in a positive way.

So it is perfectly possible for us to do what has to be done to defend American jobs, but what came out of that seminar that was very concerning to a lot of us. I asked each panelist at each meeting about the issue of permanently closing this loophole and the moratorium, and all of them agreed that we had to at least do the moratorium. There was tremendous disagreement about whether we should close one loophole without doing the others. The gist of the matter was an absolutely startling chart that one of the people who presented at those seminars showed us about the increased rate at which corporations in America are being bought by foreign companies, as opposed to American companies buying foreign companies, and we are up to something like 80 percent of those mergers being foreign-owned.

Now, DaimlerChrysler is foreign-owned because of our Tax Code. They sat right here 2 years ago and told us that. And now when DaimlerChrysler is in trouble, who is making the decisions about what jobs are going to be cut, what R&D is going to be eliminated? It is the Germans, not the Americans. So this is a very big issue, and that is why I suggested a moratorium.

I don't want companies to reincorporate in Bermuda. It is not right. They need to pay their fair share of American taxes. We may need to be sure that we stop them in a way that doesn't expose our companies to foreign takeovers, because foreign companies who buy American companies don't have to pay those taxes. This is a big and important issue. This is about American jobs. It is about the strength of our economy, and I don't—I hope that this Subcommittee will move on all fronts, and that is why I introduced the moratorium. Thank you.

Chairman MCCRERY. Before I move to Mr. Brady, let me make clear to my good friend, Mr. Neal, this Chairman of this Subcommittee is not proposing, as much as I would like to, a massive overhaul of our tax system. I agree with you. It is not going to happen any time soon. I think it should, but I am not going to waste a lot of time urging it. That is not what I am talking about when I say we need to examine together opportunities to change the Tax Code that will not only discourage or stop the inversions, the corporate inversions, but also guard against foreign companies taking over American companies and not only taking tax revenue out of this country but jobs out of this country. We can do that, I think, without a massive overhaul of the Tax Code. So let us get together and try to agree on some commonsense, smaller changes than the ones you referred to, and then I think we can make some progress.

Mr. Brady.

Mr. BRADY. Thank you, Mr. Chairman. I appreciate this important hearing, and the testimony of all four Members of Congress, who are here for the right reasons.

A number of companies headquartered in our region, the Houston region, most of them oil and gas service businesses, have announced or completed corporate moves to be incorporated overseas. I may not like it, but the hard truth is that Houston companies have incorporated overseas in order to compete fairly and to endure. As a result, a lot of good manufacturing and research jobs in the Houston region have been preserved and created as a result of corporate inversion.

Let me say that again. Corporate inversions have saved good jobs in Houston and will create more of them. That doesn't make me like it any more. In fact, I think we need to address this. The fact of the matter is that they have been driven overseas but have kept the jobs here.

It seems to me the Congress has a choice. We can ignore the root cause, which is Washington's backward Tax Code, and we could leave very solid American companies vulnerable to foreign firms, or we can create a smarter, fair way to tax these companies that keeps American jobs in towns here.

Mr. Maloney, I know you talked and used a good analogy about it is time to put the fire out, but the fact of the matter is this is about the tenth fire in the kitchen, and while we are putting it out, we probably ought to look at what is causing these fires. That is what this Subcommittee is intent to do: both address the short term, but use common sense and think through the long-term reason for this.

This is a lot like, unfortunately, our seniors who have to go overseas—to Mexico or Canada—to buy prescription drugs they can afford. I don't like the fact they have to go there, but I know there is a reason for it. I know there is a reason these companies are reincorporating overseas.

I am real impressed that this Subcommittee is taking a good, thoughtful approach in looking at this, because I think in the end, like most of our tax issues that deal with America versus other countries and that competition, Republicans, Democrats, we are going to have to put our best heads together to work this out.

With that, I would yield back the balance of my time.

Mr. MALONEY. Mr. Chairman, if I could just respond to Mr. Brady's comment on the issue of the need for fundamental change and fundamental reform, I could not agree with you more. Absolutely, I agree with you. I hope and trust that the Subcommittee proceeds in that direction.

I thought the Chairman's comments were very appropriate in terms of addressing some of the other issues that arise because of these corporate expatriations. My point is simply that we cannot put off doing that work. We cannot put off looking at foreign takeovers, and we cannot put off looking at structural reforms of the Tax Code. We can't use the corporate inversion situation as an excuse to put it off.

We have to still address the corporate inversion, the corporate expatriation problem. That has to be addressed. If we address the other issues simultaneously, that is fine, but doing one shouldn't be an excuse for failing to do the other.

Mr. BRADY. I agree. And what is important, too, that we not rush into a bill. For example, I look at your bill and I think it has got some good parts to it, but it has got real flaws. I think we hand a huge advantage to foreign companies under this bill. but I think if we work together to think through and pick out the best parts of the different approaches, we might have a chance at really putting this fire out, once and for all.

Thank you, Mr. Chairman.

Chairman MCCRERY. Thank you, Mr. Brady. Mr. Ryan.

Mr. RYAN. Thank you, Mr. Chairman. I think it is important that we do look at these structural problems.

You know, Nancy, when you talked about the Rostenkowski-Reagan tax bill, what they did then was lower our corporate tax rates so that our companies were more competitive, and then we kept jobs. What has happened since then is that our competing nations have since lowered their tax rates, so U.S. tax rates are higher than our competitor's now. So this thing has come around full circle.

The concern I have with each of these bills—not as much with the moratorium, but with each of these bills—is you are going to go out and you are going to ban one form or one kind of inversion. That may be a headline grabber, but the problem is you can always get an intelligent tax lawyer to find a way around the ban you just drafted.

And the other problem is, rather than trying to try and stop inversions at the consequence end and at the result end, you are going to simply set up more foreign takeovers. It has already been mentioned a few times, but if we try and put up barriers to inversions, penalize inversions, you are simply going to make it easy for our companies to be purchased and acquired by foreign countries, foreign competitors.

The other problem that I see is we need to address the "juice," we need to address the source of these things. So that does not mean fundamental tax reform, as much as many of us would like to engage in that, that means writing intelligent legislation that can be done this year, that can really address the source of these inversions, so that you don't have to go around chasing the consequence, the end result. That is, I think, the more intelligent approach that I hope all of us can come together.

I think the four of you have done a great service in bringing the issue to fruition. I think that your bills are intelligently written, in some ways. However, I am concerned that there are a lot of unintended consequences that will result from this, but I would invite comments.

Sure. I think Mr. Neal, first, wanted to. Then, Scott.

Mr. NEAL. Thanks, Paul. Just briefly, I am glad Mrs. Johnson highlighted Reagan and Rostenkowski. Is there anybody sitting up there today that believes in this atmosphere that a Reagan-Rostenkowski bipartisan deal could be done? That was a different era in the Congress. That was an entirely different era.

One of the things that Rostenkowski did here—and I had dinner with him the other night, he is as proud of that tax act as anything that ever happened on his watch here. Rostenkowski had a lot of Republicans that voted with him. He could regularly get Republicans on this Committee to vote with him. I haven't seen many Democrats that are even asked on this Committee to vote with them, or even allowed once in a while to have a victory on this Committee.

Mr. RYAN. You know, Richie, to allow a Democrat to vote for a Republican tax bill, it just means the Democrat has to vote for a Republican tax bill. It just means that you want to participate in reforming the Tax Code. So I think this Subcommittee—and I am the new guy on the Subcommittee—has become so much more partisan, but I think that the partisanship, not just in this Committee but in the Congress, has been absolutely opposed to fundamental tax reform.

So, yes, while you have heard the Majority speak about fundamental tax reform, tried to act on it, you have had every door closed by the Minority on that issue, and, therefore, we haven't reached much progress on this.

Mr. McInnis.

Mr. MCINNIS. Thank you, Mr. Ryan.

I would like to point out to Mr. Neal, there has been a politically driven attack against Representative Johnson's moratorium and that is coming from one side of the aisle. Frankly, we heard in our opening comments from the gentleman that sits to my left, who does not sit on the Committee on Ways and Means, has not come to the intense briefings that we have had on this, and I think it is an unfortunate reflection. So you are right. You bring up one side, I will bring you the other one.

I think this moratorium has some sense to it, because this issue is extremely complicated. The more I got into it, the more I found more ways that they could go around the very mission that we were trying to accomplish, and, you know, whether it is corporate takeovers, I think the foundation here is our earnings stripping. I think that is where the biggest issue is.

So I just want to comment on your statement, does a Democrat ever get to do this? I mean, the whole assault on the moratorium is coming from one side of the aisle. Not from you, Mr. Neal; you and I have been able to work together. But I think it is going to require some bipartisan—from some people who deal with it on a daily basis, a bipartisan effort. We can do it, and we can move fairly quickly on it.

Mr. RYAN. I yield.

Chairman MCCRERY. Before I recognize Mr. McNulty for another round of questions, let me repeat, we are not going to do a 1986 Tax Act. So forget about it. You can put your mind at ease. We are not going to undertake that. Mr. Neal is right. We couldn't do it right now, but we do need to fix this problem. So let us just cool it and start talking about some things that we can do, rather than things that we can't do, and maybe we will get something accomplished together.

Mr. McNulty.

Mr. MCNULTY. Thank you, Mr. Chairman. Before I ask just one more question, I think there is another thing we ought to cool it on, and that is questioning the motives of Members who testify before this Subcommittee, whether they are Members of the Committee or not. I note, Mr. Chairman, that under your watch, that has never occurred before. In my opinion, all four of these Members came before this Subcommittee today with very sincere and strongly held views, and expressed them quite admirably. I will defend their right to do that, whether they are a Member of the Committee or not.

I just had one other question for Mr. Neal. The question was brought up about possible foreign takeovers. Mr. Neal, in your opinion, were any of the companies that were cited on your list in danger of being taken over by a foreign company?

Mr. NEAL. No. I think it is kind of interesting that in the press release—I think the four of us, by the way, agree about Stanley Works. I think the four of us are in total agreement about Stanley

Works. I want to say that I think that what strikes me about Stanley Works is the press release. They said they were leaving because of corporate taxes. They weren't leaving because they were in danger of being taken over.

The second thing I was party to last week, as I did a TV interview with Bloomberg News on this, Stanley Works went out and hired a PR firm to explain this and to parade the leadership of that company around this town to the radio and TV stations, and then tried to back away when they found out the questioning was so hostile to what they were attempting to do.

So I am not aware of anybody that was endangered on this, and I think that for a press release to say, hey, we are leaving because of corporate taxes or we are leaving because of our tax burden, that was the suggestion that was clearly put in front of all of us. I have got to tell you, that press release really got me worked up, as you can tell.

Mr. MCNULTY. Thank you, Mr. Neal. Thank you, Mr. Chairman.

Chairman MCCRERY. Mr. Weller.

Mr. WELLER. Thank you, Mr. Chairman, and thank you for conducting this hearing. You have held a very worthwhile series of hearings this year on looking at international aspects as well as things we should be doing to make the corporate Tax Code more user-friendly and helping make the United States a better place to do business; to grow and prosper and create and produce, as well as a place to work. I commend you for this series of hearings, and I recognize this is just one more in a series of hearings on issues that we on the Subcommittee are here to address.

I also want to thank my colleagues on the panel today for participating. Three of you I serve with on this Committee are all very thoughtful and hardworking Members and represent your point of view and work very hard. The other gentlemen I don't know quite as well, but I appreciate your participating as well as in this hearing.

The concern I have got is as we look at this issue, I think that the whole issue of inversions really illustrates a problem we have. Why is it that the United States is no longer an attractive place to do business or to headquarter your company? I think that is a fair question to ask. If it is really to your advantage to go somewhere else, something is wrong. I think we have millions of loyal Americans who are entrepreneurs and create new businesses and are proud to build their business and hope to pass on the family business to their kids, and we certainly want to create the kind of climate that gives everyone an opportunity to achieve that.

But the question is: What is it about our Tax Code that actually drives business decisionmakers to want to relocate their headquarters elsewhere? Some clearly have made a decision we don't like, which is the issue that is before us today, and legislation has been introduced in response to that. Of course, it is an election year. I think we have to be very careful as we look at this issue that we choose not to make a political response to the issue, but we very thoughtfully and very carefully come forward with good policy that, frankly, makes the United States a more attractive place to do business. We want to do business here.

Mr. Maloney, you indicated in response to one of my other colleague's questions that you are a supporter of overhauling the corporate Tax Code, and since you are not a Member of the Committee, I thought I would give you an opportunity. If we look at overhauling the Tax Code to make the United States more competitive, what is the first thing you would do to our Tax Code to make the United States a more competitive place to do business?

Mr. MALONEY. Mr. Chairman, am I required to use all 5 minutes to answer that question?

Mr. WELLER. No, just 1 minute.

Mr. MALONEY. What I would say to you is, you may or may not be aware of this, I have joined with the Republicans in supporting the notion that in order to force this debate—this is a debate that is highly conflicted, it has pressures from every divergent point of view and every special interest, and the debate needs in fact to be forced—I have supported the Republican efforts to sunset the tax cut. I have been a sponsor of this legislation, and I have voted for it on many, many occasions, precisely because we do need to grapple with this issue. We need to take it on.

So I would say to you, the very first thing I would do is bring that legislation forward and try to get it passed, and perhaps you could get it passed in the House and in the Senate.

Mr. WELLER. Reclaiming my time, you would sunset the Tax Code. I personally believe we either need to scrap how we depreciate assets and move to full expensing, or eliminating the corporate alternative minimum tax I believe would help quite a bit.

Let me direct my next question to Mrs. Johnson.

You have talked about your proposal which would provide a moratorium, essentially put up a wall, stop it for a period of time, while we very thoughtfully put forward a proposal that does solve the problem. What do you feel is the basic reason a moratorium would work better than some of the alternative legislation that is before the Subcommittee today?

Mrs. JOHNSON OF CONNECTICUT. I think the advantage of the moratorium is that it could be done fast. You can get that through. You can send that signal very clearly in law but you can't do this, and during the year that you have them you can get together the bill that will address the causes of why companies want to do that.

Now, it may be that we can get together a bill that will address the causes and then we just need a moratorium to prevent this from happening until those bills go into effect, or those tax changes goes into effect. The community, the business community in America understands that they are going to be back on a level playing field. So I think the moratorium has some very real advantages.

Second, the moratorium, which is structured very much like the Neal bill, is also circumventable. It is just that for a moratorium it will work. As a permanent fix it won't; because as a moratorium it isn't worth the companies going to the expense of trying to circumvent it. If it is permanent law, there are lots of reasons why then they would just figure out how to circumvent it.

So the moratorium, I would remind you, does have, and I am well aware, has the same weaknesses that the Neal bill has, but on a short-term basis there wouldn't be the motivation to pay tax lawyers to find the way around. A moratorium combined with the bill that addresses the causes is what this Nation needs to keep American jobs here and to keep American taxes in America to support the vital services on which we all depend.

Mr. WELLER. May I have—just do a quick follow-up, Mrs. Johnson. As a quick follow-up, the Treasury Department when they testified 2 weeks ago on that abbreviated hearing that we had that day raised concerns about Mr. Neal's legislation, and you know their concern was that it would actually cause greater opportunity for foreign takeover by foreign corporations taking over American companies, and with the moratorium would we run that same risk?

Mrs. JOHNSON OF CONNECTICUT. They did mention that they would support the moratorium as an immediate and short-term solution, and in those seminars I alluded to, both sides, people who had all spectrums of the concerns about the American Tax Code in terms of the position that it leaves American business in and the competitive world, all of those people, whether they were for or against the Neal bill—and many of them were for it. Some of them were against it, but all of them agreed that we needed to stop that action. All of them also agreed that this whole approach of inversion is being shopped in board rooms; that there are groups of lawyers who are making this a specialty, who are making it their business to sell this alternative to companies. So this could turn into a torrent.

In the other areas that we have faced this possibility, both with the reinsurance when we did the reinsurance bill 3 years ago, nobody believed us, and it was being shopped but in a very limited portion of the business community. This has clearly now taken on a life of its own and has the potential to be a real deluge of activity which would have a very harsh impact on revenues as well as on our economy.

Mr. WELLER. Thank you.

Mr. NEAL. Mr. Chairman, could I just close on one note? Just 2 seconds.

Chairman MCCRERY. Yes.

Mr. NEAL. In general reference to Mr. Weller's comments, you and I worked on subpart (F) together and section 809. Mr. Weller and I did that expensing bill. Mr. Foley and I have a Hospital Preservation Act, which in the end is going to be what the hospital fix is. So I think I have demonstrated every effort to try to find common ground on these issues and that is what I want to do in this instance as well. But I need a little help from the other side.

Thank you.

Chairman MCCRERY. Thank you, Mr. Neal, Mrs. Johnson, Mr. McInnis, and Mr. Maloney. I will say one thing I think has already been accomplished by Mrs. Johnson's moratorium bill, the Neal-Maloney-Bill-McInnis bill, and that is we put corporations on notice that something is afoot here, and I think you have seen some corporations delay their plans to expatriate because of the bills that all of you have introduced and the hearings that we have held. So you are to be congratulated for being leaders on this.

Now with that, I will excuse the first panel and invite our second panel to come forward. On the second panel we have Mr. Steven C. Salch, Partner in Fulbright & Jaworski, and the Honorable

Richard Blumenthal, Attorney General of the State of Connecticut. Welcome, gentlemen.

We are told we are going to have a vote in about 10 minutes on the Floor, so we will attempt to get your testimony in and then we may have to recess and come back for questions, if that is okay with you all.

Our first witness on the last panel of the day is Mr. Steven C. Salch, who is a Partner with Fulbright & Jaworski in Houston, Texas, and Mr. Salch has worked on international tax issues for a number of years. He has worked with the American Bar Association and other organizations in trying to figure out and bring some sense to our international tax laws, and so he indeed is an expert on these matters and we look forward, Mr. Salch, to hearing your testimony. Your entire testimony will be admitted into the record, and we would like for you to summarize that in about 5 minutes and you may begin.

STATEMENT OF STEVEN C. SALCH, PARTNER, FULBRIGHT & JAWORSKI, L.L.P., HOUSTON, TEXAS

Mr. SALCH. Thank you, Mr. Chairman. My name is Steven Salch. I am an attorney, and I am appearing before you today in my individual capacity. The views I express are my own.

I appreciate the opportunity to appear and testify regarding corporate inversions. In my written statement, I have tried to provide you with one example of the tax factors that can cause a U.S. business with substantial foreign business operations to conclude that an inversion transaction will be beneficial for its business and those who invest in it. I hope that if you understand that basic model you can better understand the policy issues that underlie the inversion decision, the systemic factors that create those issues, and then some of the recent embellishments.

Let me make it clear, my testimony today does not relate to U.S. operations of foreign businesses. My testimony does address the situation of a U.S. business with U.S. shareholders that has significant business operations and revenues from outside the United States.

It is a very competitive world, and U.S. businesses need to be able to compete effectively in that world. Differences in the tax environment in which a business and its competitors operate can make a difference in the ability of the business to compete. That is why it is important for the Congress and the Treasury Department to consider the competitive impact of tax legislative policy alternatives as they make policy decisions.

It is also important to understand that if there are winners and losers when tax policy judgments are made, the losers may feel compelled to explore a different environment in which to operate. To some extent, I think the case can be made the competitive pressures arising from prior tax policy judgments may have led companies to consider the possibility of engaging in what I call classic inversions. Other industrialized countries of the world have taken a different approach than the United States for the taxation of the foreign business operations of their companies.

The example in my written statement is an effort to illustrate some ways in which a territorial or exemption system differs from the worldwide system of taxation of business operations utilized by the United States. That example also tries to illustrate some of the ways in which those differences can translate into economic consequences. While I have tried to keep the example simple, these are not simple issues and they have no simple solutions. They are issues that are interwoven with other tax issues, including the taxing export income issue that this Subcommittee has been studying this year. They implicate treaties to which the United States is a party and which we ought not to unilaterally override.

In the classic form, inversions do not reduce the U.S. tax on U.S.-sourced business revenue, except insofar as section 482 of the Internal Revenue Code effectively requires an arm's-length charge for inter-company transactions in which the foreign affiliate is a provider to the U.S. business. I am aware that some inversions go beyond the classic example and have embellishments that do reduce the U.S. tax on U.S.-sourced business revenue. In those transactions not all the benefit achieved is attributable to elimination of the systemic problems. Benefits flow for other reasons. Those situations are clearly matters that warrant legislative and administrative consideration. In that regard, while I may have some reservations about certain aspects of the Treasury Department's proposals announced on June 6, I believe those proposals are a good place to begin addressing the non-classic inversions.

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

[The prepared statement of Mr. Salch follows:]

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 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

[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.

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

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 Federal 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.

Chairman MCCRERY. Thank you, Mr. Salch. Our next witness is the Attorney General of the State of Connecticut, Mr. Richard Blumenthal. Thank you very much for coming, and now we will hear your testimony.

STATEMENT OF THE HON. RICHARD BLUMENTHAL, ATTORNEY GENERAL, CONNECTICUT ATTORNEY GENERAL'S OFFICE

Mr. BLUMENTHAL. Thank you very much, Mr. Chairman. I am honored to be before this Subcommittee, and I thank you and other Members of the Subcommittee for demonstrating the interest and the diligence to pursue this very, very critically important topic. I agree with some of the other speakers who have appeared already, and I would request permission to enter my full statement in the record and to summarize it very briefly.

Chairman MCCRERY. Without objection.

Mr. BLUMENTHAL. Extemporaneously if I may.

I agree with a number of the other speakers that this loophole is unfair, unpatriotic and really does great harm to the credibility of our Tax Code. I believe also it does great harm to the credibility and trust of the American public in corporate management because it operates as a kind of a stealth weapon used by management to evade corporate accountability. I have focused my remarks on the issue of corporate governance and the way that reincorporation to Bermuda seriously weakens and dilutes the rights of shareholders to hold management accountable in the event of self-dealing or malfeasance.

The impacts on corporate accountability are not technical or hypothetical or speculative. They are real and immediate. They are demonstrated, for example, by some of the corporations that have already moved to Bermuda, such as Tyco and Global Crossing, which are using these obstacles to corporate accountability to evade responsibility for management self-dealings and malfeasance.

I appear before you as the chief law enforcement officer of a State who has gone to court to stop a reincorporation that would have been done in a way that was severely misleading to many of its shareholders, the 401(k) shareholders in our State, and as one who is responsible for protecting the public interest and the rights of shareholders in our State, including the rights of the State as a shareholder. So I have a very direct and immediate interest in a topic that is real and urgent.

Corporations often portray the impact on corporate accountability as nonexistent or inconsequential. In fact, these effects go to the core of the body of law we have built to protect shareholder rights, and I would simply offer as an example the reversal that has been done by Stanley Works in its revised statement to the Securities and Exchange Commission (SEC) where it was compelled by pressure from my office, by the threat that we would ask for a SEC investigation, to acknowledge, and I would quote from the revised proxy statement that was submitted only last Friday and came to my office only this morning, and the quote is in the revised proxy statement: "Your rights as a shareholder may be adversely changed as a result of the reorganization because of differences between Bermuda law and Connecticut law and differences in Stanley Bermuda's and Stanley Connecticut's organizational documents."

We still have problems with that statement because it, along with other representations in the revised proxy statement, minimizes the effects which may be more for reacting. They are real, and they are in areas where Bermuda law is extraordinarily opaque. Their legal opinions are not published or officially reported, very difficult to access. In the books and records of Bermuda corporations there is a lack of meaningful limits on the insider transactions, the very kind of self-dealing that we have seen in Enron and many other corporations which have recently come to light. There are no requirements for shareholder approval of substantial sales or exchanges of the corporate assets such as there are in most States, including Connecticut. There are severe limits on derivative actions brought in the name of the corporation, one of the central tools of enforcing accountability, the right of a shareholder to protect the corporation, all of the shareholders, not just his or her own interests. There are serious questions about the enforceability of U.S. judgments against a corporation that reincorporates in Bermuda. As you well know, there is no treaty of reciprocity. There are very severe burdens in time and cost, not to mention the possible burden of a defense raised that a judgment is inconsistent with Bermuda policy, whatever that may be in specific instances. So the rights of creditors, as well as shareholders, may be adversely impacted.

Let me just summarize, if I may, Mr. Chairman, by saying that I am always interested in hearing from corporations, from all of us. I think have used the term that we want a level playing field, and certainly a level playing field is greatly to be desired and sought. I simply urge that these corporations be on our side of the field and that we seek and achieve a result that enforces stability, transparency, and predictability in the requirements that apply to these corporations.

Thank you very much.

[The prepared statement of Mr. Blumenthal follows:]

Statement of the Hon. Richard Blumenthal, Attorney General, Connecticut Attorney General's Office

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.

When I was first scheduled to speak on June 6, 2002, I intended to quote at length from a speech delivered only the day before by Henry Paulson, chairman of Goldman, Sachs, who expressed alarm that American business has never been held in lower repute. Now, even more clearly, we know that one major reason for such low repute is this type of tax avoidance loophole.

Long-time American corporations with operations in other countries can dodge tens of millions of dollars in Federal taxes by the device of reincorporating in another country. How do they become a "foreign company" and avoid taxes on foreign operations? 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 loophole is a special exception 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.

Connecticut has learned this lesson the hard way from Stanley Works—the most recent and potentially 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 manufactured some of the best-known American-made tools.

Over the past 20 years, sadly, it has moved much 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, it supported an attempt to weaken the standards for claiming products are "made in the U.S.A." This proposed rule would have allowed corporations to use the "made in the U.S.A." 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. Along with others, I strongly opposed this weakened standard and it was eventually withdrawn.

Now, this same company is seeking to sell its American citizenship for $20–30 million pieces of silver. Reincorporating in Bermuda would render hundreds of millions of dollars in profits from foreign divisions 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, 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 from stock options as the stock price rises because of increased profits. Stanley Works estimates that its stock may rise by 11.5% after reincorporation in Bermuda. That increase produces 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 and protections because foreign laws are far weaker than ours. This issue is not apparent to many shareholders because they may look at reincorporation 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 hardly rushed to clarify the weakening, even eviscerating of shareholder rights.

Taking advantage of corporate tax loopholes, corporations like 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 reincorporate to Bermuda, such as Stanley, often tell shareholders that there is no material difference in the law. But what we have learned about Bermuda law—and divining Bermuda law is no easy task—shows 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. Like most states, Connecticut 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 decisionmaking 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-dealing by 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 financial interests—stopping a shareholder vote, for example, if shareholders are provided with misleading information. Earlier this year in Connecticut, Stanley Works 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 requested a full investigation by the Securities and Exchange Commission (SEC) and an order delaying any revote until such an investigation is complete. I further requested that the SEC review the May 28, 2002 Stanley Works proxy statement to determine whether Stanley Works has accurately explained the impact of the Bermuda move on shareholder rights. The SEC expressed interest in reviewing the proxy statement.

As a result of my complaint and SEC interest in this matter, Stanley Works issued a revised proxy statement on June 21, 2002 which was just made available to me this morning. The revised statement contains—for the first time—a clear concession by Stanley Works that a Bermuda reincorporation will restrict shareholders' rights. The revised proxy statement states: "Your Rights as a Shareholder May be Adversely Changed as a Result of the Reorganization Because of Differences between Bermuda Law and Connecticut Law and Differences in Stanley Bermuda's and Stanley Connecticut's Organizational Documents."

I am hopeful that continued SEC pressure—along with legal challenges to the adequacy of similar proxy statements by other corporations proposing a reincorporation in Bermuda—will compel clearer and more truthful descriptions in proxy statements concerning the severe weakening of shareholder ability to hold management accountable under Bermuda law.

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 undermines the interests and rights 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 are 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 the interests of ordinary shareholders and the United States are gravely disserved.

If American corporations seek a more level playing field—fairer tax burdens so they can better compete globally—they at least ought to stay on our side of the field. They ought to pay their fair share of the financial cost of American services and benefits that also aid them. And they should be required to show a specific need or disadvantage compared to some foreign competitor that threatens American jobs or economic interests.

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 unequivocably is the need for closing this destructive loophole, as H.R. 3884 would do. The measure should be permanent so as to assure credibility and certainty. The status quo is unacceptable.

Chairman MCCRERY. Thank you, Mr. Blumenthal. So, Mr. Blumenthal, your primary concern, at least judging by your oral remarks, is the diminution of shareholder power by virtue of a corporation leaving our shores and reincorporating offshore. Then I take it that you would favor anything, any legislative solution to that. You are not tied to Mr. Neal's bill, although you endorse that, I think, in your written testimony. Is that an accurate statement? I mean, are you tied to Mr. Neal's bill or would you be willing to look at other things that would accomplish the same thing?

Mr. BLUMENTHAL. Mr. Chairman, I appreciate that question because it fills a gap that unfortunately I left out in the summary that I presented. I very strongly support Congressman Neal's bill; that is, H.R. 3884. I believe that closing this loophole should be done permanently because of the certainty that it provides. First, as to shareholders, they have a right to know what the future means in terms of the tax laws that apply to their corporations, and management has an interest in that certainty as well. To provide for a moratorium in 1 year I think undercuts the interests of the corporation in terms of certainty and also the credibility of the Tax Code itself.

Chairman MCCRERY. I am not talking about a moratorium. I am talking about a different approach to solve the problem. You are not adverse to hearing other approaches to solving the problem legislatively, setting aside the moratorium?

Mr. BLUMENTHAL. If the problem is to make sure that there is in fact a level playing field and there are other reforms that the Committee, the Committee on Ways and Means, wishes to consider, I certainly wouldn't foreclose them. I have focused here on the corporate governance issue because I believe, with all due respect, that it has been largely ignored or disregarded by many of the public comments, well intentioned and correct as they have been, in concentrating on the fiscal impact, on the equities involved. I am seeking simply to draw on my own personal experience in enforcing these laws.

Chairman MCCRERY. I appreciate that. I think it is a very important point, and I am glad that you emphasized that during your remarks. Since you have endorsed the Neal bill, I assume you have looked at it, you have studied it, and I want to ask you a few questions about it and get your response.

If a company with manufacturing operations in Ireland, for example, decided to invert to Ireland, would H.R. 3884, the Neal bill, prevent that transaction?

Mr. BLUMENTHAL. Would it prevent reincorporation in Ireland?

Chairman MCCRERY. Right.

Mr. BLUMENTHAL. Well, I don't know that any of the measures that close the tax loophole would bar reincorporation per se. What the impact would be on tax treatment of foreign earnings would depend on how the bill were adopted and what specific form. Of course, I say all this with deference and respect to the author of the bill, who happens to be on this panel, and would yield to him if he has an answer that contradicts mine.

Mr. NEAL. A friend of Ireland as well.

Chairman MCCRERY. Well, the answer is if that company, the resulting company, based in Ireland, had less than 80 percent of the shareholders who were the same as the American company that preceded the Irish company, then the Neal bill would have no impact on that inversion because there are substantial operations in Ireland.

Mr. BLUMENTHAL. I am aware of the limits so far as shareholder—numbers of shareholders are concerned. Incidentally, although I have endorsed the Neal-Maloney bill, if there are improvements that can be made by this panel or the full Committee or the Congress, I certainly am not wedded to these specific provisions. The basic point is that shareholders need to be protected.

Chairman MCCRERY. Well, that is the answer I am looking for, that you are not wedded to the Neal bill. You are willing to explore other approaches. I think it is appropriate that we point out some flaws in the Neal bill, and I hope that when we get through examining it we can agree that we need to look further and improve upon the Neal approach.

For example, if a company issued an initial public offering (IPO), they issued IPO stock as part of the inversion transaction, the Neal bill wouldn't stop that if the result of that were to dilute the shares of stock of the previous shareholders below 80 percent, which could easily be done. If the new parent, for example, issued stock to the U.S. subsidiary, a so-called hook stock transaction, as done by Ingersoll-Rand, again the Neal bill wouldn't affect that because the probable result would be that the U.S. subsidiary would own more than 20 percent of the new shares.

So those are just a few examples of how a company intent on inversion could easily circumvent the provisions in the Neal bill.

Mr. Salch, can you—you talked in your written testimony about some of the provisions in our Tax Code that make U.S. companies less competitive in the global marketplace. Can you list some of those for us, just tick some off that are particularly egregious to American companies with foreign operations?

Mr. SALCH. Mr. Chairman, it is going to vary depending from company to company.

Chairman MCCRERY. Is your mike on?

Mr. SALCH. It is going to vary based on company to company, but in broad general terms we start out with the fact that we have two competing systems of income taxation. Ours is worldwide. Many of our major trading partners and competitors are territorial or use a participation or an exemption system to get there with respect to business profits.

Now, let's be sure we are talking about business profits rather than so-called passive income. You have to worry about what that is. From a business profit perspective, if a Dutch company operates in a particular jurisdiction and has an active business in that jurisdiction, it doesn't pay tax on the profits of that operation, whether they are held by a subsidiary or by the Dutch company. That is different.

Initially, it also gives that parent company the opportunity to take profit from this business to another business and reinvest it without having to pay tax on it, which lowers its cost of capital and gives it an opportunity to leverage its business better. If we had a U.S. company that had two foreign subsidiaries, you get the profit from one subsidiary and invested it in the other subsidiary, you would have to pay tax coming through the United States as a dividend.

So, it is that type of a situation that begins to bring this into focus. Some aspects of subpart (F), if you have a Dutch company that has a Swiss subsidiary and a subsidiary in Latin America that grows commodities, agricultural commodities, and the Latin America subsidiary sells those to the Swiss company which then markets them worldwide, the Dutch company doesn't pay tax on any of those profits. Well, our U.S. company might not pay tax on the profits of the producing country, but it will pay tax on the profits of the Swiss company because that is foreign base company sales income. It is active business income. There are 35 people in that office in Switzerland that are actively marketing those commodities and actively arranging the shipment and everything else. It is not passive. But it is subpart (F) foreign base company sales income.

Chairman MCCRERY. Thank you for that short recitation of a few provisions in the Tax Code that make our companies less competitive in the international marketplace.

Now, are these companies that are inverting, that are expatriating, moving offshore, does that make life better for them from a tax standpoint? Do they suddenly step into the shoes of that Swiss company you were talking about and not have to pay taxes on some of those transactions?

Mr. SALCH. Actually, in my example, Mr. Chairman, the Swiss company would pay 5-percent tax in Switzerland on its profits. The companies that are inverting to Bermuda are inverting to a country which imposes no tax, no income tax, period. So they automatically go into a tax-free environment that is totally independent of the participation type exemption or territorial tax system. They also, however, by acquiring foreign status, avoid subpart (F). Subpart (F) no longer applies to their foreign subsidiaries if the foreign subsidiaries go out in the inversion and that is the hook stock that you were talking about. Typically that is used to purchase the stock or the assets of the foreign subsidiaries of the existing U.S. operation and then move that underneath the new inverted foreign parent.

Chairman MCCRERY. Likewise, they would not be subject to the foreign base sales and service requirement.

Mr. SALCH. That is correct. That is correct.

Chairman MCCRERY. Thank you, Mr. Salch. Before I go to Mr. McNulty, let me just say, Mr. Blumenthal, again I appreciate your highlighting the issue of shareholder rights.

One thing you didn't mention which I think maybe the Members of this Subcommittee ought to talk about before we finish our examination of this subject is the question of executive pay, stock options, and so forth, and how they might be treated differently from shareholders' stock when these inversions are made.

Mr. BLUMENTHAL. If I may, Mr. Chairman, I made that point in my written testimony, that very often there are not so hidden or disguised rewards in terms of executive compensation. I agree that that is an area that may deserve further scrutiny.

Chairman MCCRERY. Thank you. Mr. McNulty.

Mr. MCNULTY. Thank you, Mr. Chairman. I thank both of our distinguished witnesses for their testimony, and I yield to Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman, and thank you, Mr. McNulty.

Mr. Salch, do you think that Stanley Works did the right thing?

Mr. SALCH. In what respect do you ask that question, Mr. Neal? I should say I am not as familiar with Stanley Works as you are, but I will try and answer your question. What do you mean, did the right thing? In what respect?

Mr. NEAL. Do you think in this atmosphere where President Bush has asked for $48 billion more for our national defense, where he has asked for $38 billion more for the establishment of a Homeland Security Department, do you think Stanley Works is doing the right thing by shedding their responsibility?

Mr. SALCH. What responsibility have they shed?

Mr. NEAL. To contribute to the payment of the request that the President has made for the common defense. He has stated that the national purpose here is war.

Mr. SALCH. Well, they haven't moved anywhere yet, Mr. Neal.

Mr. NEAL. They certainly are trying very hard.

Mr. SALCH. My understanding is that they would continue to pay U.S. tax on their U.S. business operations and their U.S. business income.

Mr. NEAL. Let me ask you, do you think that their decision to move their corporate address to Bermuda is the right thing?

Mr. SALCH. Mr. Neal, that goes to a matter of corporate governance, which is beyond the purview of a poor old tax lawyer like me.

Mr. NEAL. Mr. Blumenthal, do you think that Stanley Works is doing the right thing?

Mr. BLUMENTHAL. No, I don't, Mr. Neal. I believe very strongly that they are doing the wrong thing, beyond the issue of patriotism or allegiance to country. I happen to think that this move has proved to be a disaster to Stanley Works' image.

You know, my first experience with Stanley Works as Attorney General was to defend this corporation against a hostile takeover. We literally, and I personally, went to court when a major national corporation in effect wanted to pursue it, and we stood shoulder to shoulder. We believe in Stanley Works as a company. It is a well-established American corporation, and I think this entire experience has given it an enormous black eye, certainly costing it way beyond the $30 million that it would have gained in tax savings, and I believe very strongly, with the fundamental point that you have made, that it has enjoyed and benefited from services that are provided by this country. It should be required to pay its fair share of those services and that is one of the fundamental reasons I think this loophole should be closed.

Mr. NEAL. Mr. Blumenthal, are you knowledgeable about why Barbados was included with the inversion decision of Stanley Works?

Mr. BLUMENTHAL. Barbados is the means by which additional tax savings are achieved if foreign income in effect is funneled through the Barbados. My understanding is that there are additional savings to the corporation. In fact that may be one of the pivotal means by which the savings are achieved following the re-incorporation to Bermuda.

Mr. NEAL. Mr. Salch, would that be your understanding as well?

Mr. SALCH. My understanding is that Barbados was used because of the Barbados-U.S. treaty.

Mr. NEAL. For the purpose of sheltering vs. income?

Mr. SALCH. Also a reduced withholding rate on interest.

Mr. NEAL. Okay, thank you.

Mr. Blumenthal, given the number of lawsuits that have been filed against Enron, what conceivably could be done in this instance by a company taking on a new corporate address in Bermuda to shareholder rights?

Mr. BLUMENTHAL. I think many of the shareholder lawsuits that have been brought against Enron could not be brought under Bermuda law or would encounter much greater obstacles in cost and time if Enron were a Bermuda corporation instead of a company incorporated in this country, and judgements obtained against Enron in this country would face very severe hurdles in enforceability in another country. All of the kinds of self-dealing, malfeasance, violation of shareholder interests and rights I think would be much more difficult to pursue, if they could be pursued at all, if Enron were a Bermuda corporation.

Mr. NEAL. Well, based upon your good work and the work of other Attorneys General across the country, where some would argue that it was perhaps the responsibility of boards of directors and others to have taken a harder look at some of these decisions, do you think that it is legitimate that individuals like yourself who hold these offices should be having to make these decisions about pursuing those who have neglected their responsibilities as boards of directors, as members of boards of directors?

Mr. BLUMENTHAL. I think in representing our pension funds as well as a parens patriae action defending our citizens' interests, we have a right and responsibility to be in court pursuing wrongdoing when it occurs among boards of directors or officers. So I think it is an obligation, as well as an opportunity to use laws of our States and to seek to make those laws as transparent and enforceable as possible. I think it is part of the job of being in law enforcement.

Mr. NEAL. Thank you. I think my time has expired, Mr. Chairman.

Chairman MCCRERY. You can have another round.

Mr. NEAL. Okay.

Chairman MCCRERY. Mr. Brady.

Mr. BRADY. Thank you. First of all, I want to make it clear no one on this panel that I know of is defending corporate inversions. On the other hand, we recognize there is no more dangerous combination than an election year, a lot of political rhetoric, and U.S. jobs at stake. What we are trying to find here are solutions to this problem, a problem, by the way, that rather than pointing fingers at companies we probably ought to be pointing fingers at ourselves. They are following U.S. tax law created by Congress and hopefully solved and addressed by Congress.

Mr. Salch, the introduced inversion bills disregard a company's inversion and continues to treat the company as a domestic U.S. corporation. From your experience, and you have a lot, does this approach make U.S. companies even bigger targets of foreign takeovers or smaller targets of foreign takeovers?

Mr. SALCH. It is always difficult to tell looking down your crystal ball, but I think if I had to be an odds maker, I would say that the odds are more likely than not that it would make them bigger targets rather than smaller targets. It just takes some people out of the marketplace.

Mr. BRADY. Sure. From a policy standpoint and a job standpoint, isn't making—isn't foreign acquisition, foreign takeovers of all U.S. companies a potentially large threat to U.S. jobs? I mean, when these takeovers occur decisions are made elsewhere. Sometimes they can be a benefit to us when the situation is right, but isn't that also a real live threat to U.S. jobs?

Mr. SALCH. Mr. Brady, that is stretching my tax lawyering a little bit, too. Let me just say that from some experience dealing with U.S. and foreign firms, there may be a tendency to think if you are a U.S. firm and you are in your own hometown, if that is where your business and your people are, you may think long and hard about dismissing those people, whereas if your business is someplace else it might be an easier decision to make. I mean that is just human nature.

Mr. BRADY. Sure, and I think the point of all of this is as we look for solutions, very thoughtfully, as we put our best heads together on this, we need to look at those consequences. I am not interested in making U.S. companies more attractive to be taken over by foreign firms. I want them to keep U.S. jobs and their U.S. headquarters here and do it in a good thoughtful way.

I yield back the balance of my time.

Chairman MCCRERY. Thank you, Mr. Brady. Let me just follow up very quickly, Mr. Salch, to try to give you an example along the lines Mr. Brady was talking about.

Let's assume that there were two companies interested in acquiring a U.S. company. One of those companies was a U.S. company. The other company is a foreign company. Now, both of those corporations look at the transaction, and at least on a tax basis which one would have the clear advantage, assuming that that U.S. corporation that they are wanting to acquire has foreign operations, foreign income.

Mr. SALCH. That last assumption, that the U.S. corporation has foreign operations and foreign income, I think illustrates the point I have tried to make in my written statement. If that foreign company is based in a country which has a territorial system, whether it is exemption or participation or whatever, they have an advantage in terms of rates of return, in economic theory, that would allow them to price that acquisition differently than the domestic corporation looking at the same transaction from its perspective, and I think that is one of the concerns that is illustrated in the example in my written statement.

Chairman MCCRERY. Thank you. Mr. Ryan.

Mr. RYAN. Thank you, Mr. Chairman. Gentlemen, thank you for coming here today because this is really a fairly new issue for our Subcommittee.

We have had, I think, on record 25 inversions over the last 25 years, or something to that effect, and about 8 of those occurred in the last 2 years. So it is a relatively new issue that Congress and the country are considering. As I see this thing unfold, there are basically two ways to look at it. An inversion is a unique isolated problem that needs to be banned or abolished in tax law, or an inversion is a symptom of a larger problem, which is our tax structure is much, much less competitive relative to our competing nations. I think that that broader view captures the whole picture much more accurately, so we need to hear more from experts like yourself, Mr. Salch, as we look at how we fix and address these changes. I wanted to ask you a couple of quick questions.

Have you reviewed the Treasury Department's corporate inversion study?

Mr. SALCH. Yes.

Mr. RYAN. I had a couple of concerns about that. Again, as we react quickly, which I think we are going to do in this Congress, we want to make sure we don't involve some unintended consequences, make someone pay more taxes than they otherwise were paying for no reason. My questions are in these two areas. One, if we go from a 1.5 to 1 ratio, safe harbor debt to equity ratio, safe harbor regime to a worldwide debt to equity ratio, where we compare a domestic holding company or domestic subsidiary's debt to equity to the worldwide debt to equity ratio, do you think we are going to get some people we shouldn't be getting? Meaning, aren't there a lot of businesses like a manufacturing business that may have in the U.S. operation a credit, high capital intensive or financial services business, but because of their structure has higher debt in the United States than they otherwise would on the worldwide basis, and aren't we going to in effect capture those people with safe harbor rules that will in effect raise their taxes for no good reason?

Mr. SALCH. It gets to be a very complicated question to answer because you have to decide what your view of money is, is it fungible and can it flow? If money is fungible and it can flow, then the next question is, is the decision on financing made on a businesswide, expanded, affiliated group basis? If it is, then the Treasury Department's position on 163(j), which is what you are talking about, doesn't seem to me to be a bad policy decision with which to begin, because what it says to the business is you can make your decision where you want to deploy your resources and in what relationship you do that. We are going to sort of level that playing field around the world wherever you operate as far as we are concerned, and then the issue is will our trading partners follow suit, and most of them probably would, in my judgment.

Mr. RYAN. So, you think if we tighten up 163(j) along the lines of the Treasury Department that there will be residual actions by our foreign competitors?

Mr. SALCH. To some extent there already are. They are already there. This is not a new and novel technique necessarily. To the extent that they are not already there, if you want to say that from a global sense everyone is concerned about preserving what they believe to be their tax base, which is their domestic base outside, even in the so-called territorial regimes you are looking at their own domestic tax base, then they will be interested in measures which eliminate stripping of that tax base or eroding that tax base.

Mr. RYAN. Well, again on 163(j), do you think that there are legitimate business reasons why a foreign owned company group may choose to place more debt in a U.S. subsidiary because of more readily access to our U.S. capital markets? I mean, our capital markets in the United States are very efficient. Money is cheaper in the United States. To me that is a good thing for our economy. We want our capital markets to be accessed. We want people to borrow more money in our capital markets than in, say, foreign capital markets. Are there or are there not legitimate reasons why a company that is held foreign but has a large U.S. subsidiary would want to increase their debt load in the United States because of cheaper capital markets or access to these capital markets?

Mr. SALCH. Well, understand, Mr. Ryan, that 163(j) doesn't have to do with bank debt or capital market debt. It has to do with related party debt.

Mr. RYAN. If it is intercompany debt or if it is indebtedness guaranteed by the foreign parent, doesn't that include whether or not they are going to have more access or less access to the U.S. capital markets? If we follow through with this, this idea that we need to tighten this up on 163(j).

Mr. SALCH. Again, if you believe that money is fungible and that there are markets within which a multinational can borrow around the world, then I don't think that a global base that the Treasury Department proposed is going to necessarily prejudice access to U.S. markets for that business to borrow as it would any foreign market. The business may borrow wherever it is cheapest and able to borrow and then deploy it wherever it wishes to do so. All this does is say for in terms of preserving our tax base on U.S.

revenues with interest payments that are moving outside, here is where we draw the line, and it is a line that is drawn worldwide without regard to where you borrow.

Mr. RYAN. Okay. So as we draw that line, would it be safe to conclude that in seeking to, you know, stop the juice on inversions we will also cut back on the ability for a company to access U.S. capital markets and raise its indebtedness by intercompany debt or guaranteed debt in their U.S. subsidiary relative to where they are today?

Mr. SALCH. No. It is not reasonable because 163(j) has nothing to do with capital market access. It has nothing to do with where you borrow or at what rate you borrow or where you deploy the borrowed funds.

Mr. RYAN. Won't it raise—don't you believe it will raise the cost of borrowing if their taxes are increased?

Mr. SALCH. No. Well, it raises the cost of borrowing in the sense that you are not going to necessarily be able to deduct interest if your rate of borrowing is above your worldwide rate of borrowing.

Mr. RYAN. That is right. That is what I am trying to get.

Mr. SALCH. So to that extent it becomes more expensive for you to leverage in the United States than it does to use equity in the United States.

Mr. RYAN. Thank you. It took me a while to get there, but that is what I was trying to get at. Appreciate it.

Chairman MCCRERY. I think Mr. Ryan raises some interesting points and ones that we ought to consider. I am not sure that the conclusion he reaches is one that we ought to embrace right now without further examination. I think Mr. Salch's remarks were right on point, that there are a lot of different motivations for accessing capital markets, both here and abroad, and we ought not conclude that just because a guarantee by the foreign parent would bring that under 163(j) and preclude them from deducting that interest would necessarily preclude them from accessing our capital markets.

Mr. RYAN. If the Chairman would yield.

Chairman MCCRERY. Sure.

Mr. RYAN. I am not drawing a conclusion. I am trying to get some answers, and this is thick stuff and I think it is important that we dig as far as we can to see if there are some unintended consequences that might result from passing these recommendations, and that is really where I am trying to go.

Chairman MCCRERY. Well, I agree. I think we ought to examine this very carefully to try to make sure that there are not unintended consequences that would be deleterious to job creation here in the United States, and that was the whole point I tried to make in the opening in our discussion with Mr. Neal and the other panelists.

Mr. Weller.

Mr. WELLER. Thank you, Mr. Chairman, and again I want to express gratitude to our distinguished panel here, our second panel, two experts in important areas. In building on some of the points that were made by colleagues, particularly Mr. Brady and Mr. Ryan, the flaw that I hear the greatest concern about, the Treasury Department illustrated it a few weeks ago and I hear it from others, regarding Mr. Neal's proposal regarding the issue of inversions is that it would make American owned and headquartered companies more attractive for foreign takeover. I was wondering, Mr. Blumenthal, does that concern you about the proposal? Are you concerned about that as well?

Mr. BLUMENTHAL. It would concern me certainly, if I thought that this kind of proposal would have a dramatic or a material effect on foreign takeovers of American companies. I think there are a variety of factors that affect these kinds of takeovers. I am not a mergers and acquisitions lawyer, but the reasons for foreign takeovers involve a great many complex and sometimes changing financial issues just as access to foreign or domestic capital markets is more complex than perhaps we can summarize.

Mr. WELLER. Mr. Blumenthal, you had indicated your primary premise is you are here as an advocate of shareholder rights in the presentation that you made. If a company is taken over by a foreign company, an American company is taken over by a company that is headquartered in a foreign nation, does that concern you on the impact of shareholder rights and how it impacts the rights of American shareholders of that company?

Mr. BLUMENTHAL. Very much so.

Mr. WELLER. As we discuss this, I think, you know, as Mr. Ryan pointed out, that inversion really is—a growing course of inversions really illustrate a symptom of our complicated Tax Code and now that we are in a global economy and, of course, we want to be more competitive in a global economy, our Tax Code is one of the issues out there and the inversions clearly are illustrating that we have a problem. I asked Mr. Maloney, what would be the first step he would take to make our Tax Code more competitive, and he suggested sunsetting the Tax Code. Do you agree?

Mr. BLUMENTHAL. I do agree.

Mr. WELLER. So you feel that that—and what would you do from that point of sunsetting the Tax Code, what would you do from that point once you end it?

Mr. BLUMENTHAL. Well, I am not prepared, with all due respect, to talk in detail about what I would do on the Tax Code. I agree that there ought to be real reform. I take from the Chairman's remarks that far-reaching reform is probably not going to happen in the remainder of this year or in this session of the Congress, that it will be the subject of further study. I do think that for the sake of the credibility of the American business as well as our Tax Code, this measure makes sense now.

Mr. WELLER. Mr. Salch, now, the concern that Mr. Neal's proposal would actually encourage or leave American corporations vulnerable for foreign takeover, how would you change his proposal to address that issue? Have you put any thought into that?

Mr. SALCH. I guess I have to start out by saying I don't think his proposal will work. There are ways to deal with this proposal and that is why people like me make a living. If I told him how I could fix his proposal then I probably would really get fixed. I am not really sure because, as I said in my testimony, the concern I have is that we have a level playing field and Mr. Neal's bill, well thought, takes a slice and in that one little slice it says you can't do these things. Then there is everything else that is left un touched. I am not so sure—as a matter of fact, I am reasonably sure that we can develop methodologies to deal with the other things and still keep them moving forward for these people who are within the slice.

Mr. WELLER. Mr. Salch, the feeling is we need to put a stop to inversions. We need to put a stop right now. Would a moratorium be more effective in quickly bringing a halt to any future inversions that are being considered right now in corporate America?

Mr. SALCH. Not the way the bill is written, no. It takes Mr. Neal's definitions, and quite honestly, there are a lot smarter people than I am and I am sure who can drive a bigger truck than I could build through it.

Mr. WELLER. So there is a lot of—this is something that is going to take a tremendous amount of thought; we can't rush into is what you are saying?

Mr. SALCH. Mr. Weller, as I sit here I am reminded that then Treasury Secretary George Shultz told this Committee in 1969, when the Committee was considering limitations on artificial losses and the Chairman asked Mr. Shultz if he could guarantee that if the Committee enacted that measure it would stop all the abuses then perceived. Mr. Shultz thought about it and said, Mr. Chairman, it is the best mousetrap we can build right now but there are 10,000 lawyers and certified public accounts (CPAs) out there trying to build a better mouse while we are talking about it, and now there are probably about 30,000 lawyers and CPAs in this country and then another 50,000 outside. I think that is, I guess, the nature of the beast that we have to deal with. I am not sure there is a perfect way to stop inversions without stopping all business dead in its tracks, and that is certainly not desirable.

Then I think we have all learned over the years that whatever lines are drawn there is always a two-edged sword and somebody will find some way to work the other side of the line. That is the problem with section 482 and earnings stripping. It works great when you are trying to get income flowing into the United States with respect to services and goods that are exported, but it doesn't work so well sometimes when the flow is coming this way.

Mr. WELLER. I have run out of time. Thank you, Mr. Chairman.

Chairman MCCRERY. Thank you. Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman. Mr. Salch, do you favor inversion?

Mr. SALCH. Mr. Neal, I don't favor or disfavor inversions. I don't like the embellishments that I see to some of the more recent inversions, which are based strictly on transactions. I have serious policy reservations about that, but what I call a classic inversion I don't think is unpatriotic.

Mr. NEAL. You don't think it is unpatriotic?

Mr. SALCH. No, sir.

Mr. NEAL. Do you do any inversion work?

Mr. SALCH. Pardon.

Mr. NEAL. Do you do any inversion work?

Mr. SALCH. I have done inversion work. I don't have any currently in process, now, sir.

Mr. NEAL. I have a list here of 25 companies, and I don't think that any one of these companies was threatened with takeover as they went to Bermuda. Could I send these companies along to you because the suggestion has been made here by some Members of the Committee that the reason that these companies might be leaving is because of American taxes that conceivably also threaten them with merger or takeover or—but I have got 25 companies here, and I am not aware of any of them that were being threatened with takeover.

[The information follows:]

Corporate Expatriate List[1]

Company Name	Date of Inversion	U.S. Headquarters
Accenture (ACN)	July 2001	Chicago, IL
Amerist Insurance	1999	
APW (APWLF)		Waukesha, WI
Cooper Industries (CBE)	May 21, 2002	Houston, TX
Everest Re (RE)	2000	Liberty Corner, NJ
Foster Wheeler Ltd. (FWC)	May 25, 2001	Clinton, NJ
Fruit of the Loom (FTLAQ)	March 4, 1999	Bowling Green, KY
Gold Reserve (GLDR under the OTC)	1999	Spokane, WA
Helen of Troy (HELE)	February 16, 1994	El Paso, TX
Ingersoll Rand (IR)	December 31, 2001	Woodcliff Lake, NJ
Leucadia National Corp. (LUK)	Yes vote May 15 (move postponed)	New York, NY
McDermott International (MDR)	1983	New Orleans, LA
Nabors Industries (NBR)	June 14 vote	Houston, TX
Noble Drilling (NE)	May 1, 2002	Sugar Land, TX
Playstar (PLAYF)	1998	
PriceWaterhouseCoopers (PWCC)	May 2, 2002	New York, NY
PXRE Group Ltd. (PXT)	1999	Edison, NJ
Seagate Technology	2002	Scotts Valley, CA
Stanley Works (SWK)	pending	New Britain, CT
Transocean Inc. (RIG)	May 1999	Houston, TX
Triton Energy	1996	Dallas, TX
Tyco (TYC)	March 1997	Exeter, NH
Veritas DGC (VTS)		Houston, TX
Weatherford International Inc. (WFT)	June vote	Houston, TX
White Mountain Insurance Company (WTM)	1999	White River Junction, Vermont
XOMA (XOMA)	1999	Berkeley, CA

[1] *Information compiled from various news sources, by the Office of Representative Richard Neal.*

Mr. SALCH. I don't have the benefit of your list, sir, so I can't comment.

Mr. NEAL. I am going to send it along to you.

Mr. SALCH. Okay, that is fine. That is good.

Mr. NEAL. Maybe you can take a look at it and if you could get some evidence for us here.

Mr. SALCH. Sure.

Mr. NEAL. Okay. I would appreciate that.

[The information follows:]

Fulbright & Jaworski, L.L.P.
Galveston, Texas 77551–5719
July 9, 2002

Hon. Jim McCrery
Chairman
Subcommittee on Select Revenue Measures
Committee on Ways and Means
House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Chairman McCrery:

During the Subcommittee Hearing on June 25, 2002, Representative Neal stated he would forward to me a list with the names of 25 businesses and asked if I would indicate whether I knew any of them were takeover candidates at the times stated in the list. I have received that list. Most of the businesses named on the list are clients or former clients.

The Texas Disciplinary Rules of Professional Conduct, the ethics rules mandated by the Texas Supreme Court for attorneys licensed in Texas, preclude me from unauthorized disclosure of confidences of clients or former clients. Because of those ethical constraints, it would not be ethically appropriate for me to comment in response to Mr. Neal's request.

I apologize for any inconvenience this may occasion for the Subcommittee.

Very truly yours,

Steven C. Salch
Partner

Mr. NEAL. Mr. Blumenthal, do you think that the shareholders were aware of the fact that Stanley Works' Chief Executive Office John Trani conceivably would have received 58 cents on every dollar, I guess up $30 million or so, based upon their decision to relocate?

Mr. BLUMENTHAL. They certainly weren't told about it. If they knew they had information that the majority of them, in fact the vast majority of them, didn't have and weren't told that kind of information really should have been given to them along with the fact that many of them would have to pay capital gains taxes. They weren't told, for example, that $150 million in capital gains taxes would have to be paid by shareholders.

Mr. NEAL. Many of these employees are retired.

Mr. BLUMENTHAL. Are retired and many are in 401(k) plans.

Mr. NEAL. 401(k) plans.

Mr. Chairman, could we have a copy, if Mr. Blumenthal would provide it for us, of the newest proxy statement included in the record?

Chairman MCCRERY. Without objection.

[The information follows:]

RISK FACTORS

Certain Stanley Connecticut Shareholders Will Recognize a Taxable Gain as a Result of Exchanging their Stanley Connecticut Common Stock for Stanley Bermuda Common Shares in the Reorganization

Our tax advisor, Ernst & Young LLP, has advised us that generally for U.S. Federal income tax purposes shareholders who are U.S. holders will recognize gain, if any, but not loss, on the receipt of Stanley Bermuda common shares in exchange for Stanley Connecticut common stock pursuant to the reorganization. Such a holder will generally recognize gain equal to the excess, if any, of the trading price of the Stanley Bermuda common shares received in exchange for Stanley Connecticut common stock in the reorganization over the holder's adjusted tax basis in the shares of Stanley Connecticut common stock exchanged therefore. Generally, any such gain will be capital gain. Shareholders will not be permitted to recognize any loss realized on the exchange of their share of Stanley Connecticut common stock in the reorganization. In such case, the aggregate adjusted tax basis in the Stanley Bermuda common shares received would equal the aggregate adjusted tax basis of their shares of Stanley Connecticut common stock. Thus, subject to any subsequent increases in the trading price of Stanley Bermuda common shares, any loss would be preserved. The holding period for any Stanley Bermuda common shares received by a U.S. holder recognizing gain with respect to the reorganization should begin the day after the effective date of the reorganization. The holding period for any Stanley Bermuda common share received by U.S. holders with a loss on their Stanley Connecticut common stock will include the holding period of the Stanley Connecticut common stock exchanged for those shares.

WE URGE YOU TO CONSULT YOUR TAX ADVISORS REGARDING YOUR PARTICULAR TAX CONSEQUENCES OF THE REORGANIZATION.

The Benefits of the Reorganization Could be Reduced or Eliminated if There Are Unfavorable Changes in or Interpretations of Tax Laws

Several Members of the U.S. Congress have introduced legislation that, if enacted, would have the effect of eliminating the anticipated tax benefits of the transaction. On March 6, 2002, Representative Richard E. Neal (along with 18 cosponsors) introduced legislation (H.R. 3884) that, for U.S. Federal tax purposes, would treat a foreign corporation, such as Stanley Bermuda, that undertakes a corporate expatriation transaction such as the reorganization as a domestic corporation and, thus, such foreign corporation would be subject to U.S. Federal income tax. The Neal Legislation is proposed to be effective for corporate expatriation transactions completed after September 11, 2001. Representative James H. Maloney has also introduced legislation that is substantially similar to the Neal Legislation, including a September 11, 2001 effective date (H.R. 3922). Representative Scott McInnis has also introduced legislation that is substantially similar to the Neal Legislation, except that it is proposed to apply to transactions completed after December 31, 2001 (H.R. 3857). Representative Nancy Johnson has also introduced legislation that is substantially similar to the Neal Legislation, except that it is proposed to apply to transactions completed after September 11, 2001 and beginning before December 31, 2003 (H.R. 4756). Furthermore, Senator Charles Grassley, the Ranking Minority Member of the Senate Finance Committee, along with Senator Max Baucus, the Chairman of the Senate Finance Committee, also introduced legis1ation, which was approved by the Senate Finance Committee on June 18, 2002, that is substantially similar to the Neal Legislation, except that it is proposed to apply to transactions completed after March 20, 2002 (S. 2119). If any of the Neal Legislation, the Maloney Legislation, the McInnis Legislation, the Johnson Legislation or the Grassley Legislation were enacted with their proposed effective dates, the anticipated tax savings from the reorganization would not be realized. Senator Paul Wellstone has also introduced legislation that is substantially similar to the Neal Legislation, except that it is proposed to apply to tax years beginning after December 31, 2002 without regard to when such transactions were completed (S. 2050). If the Wellstone Legislation were enacted with its proposed effective date, the anticipated tax savings from the reorganization would be substantially eliminated.

Several other Members of the U.S. Congress and the Treasury Department are currently investigating transactions such as the reorganization. On May 17, 2002, the Office of Tax Policy of the Department of the Treasury issued their preliminary report on off-shore reincorporation transactions which concluded:

> "We must work to ensure that our tax system does not operate to place U.S.-based companies at a competitive disadvantage in the global marketplace. The tax policy issues raised by the recent inversion activity are serious issues. Fur-

ther work is needed to develop and implement an appropriate and effective long-term response. As an immediate matter, careful attention should be focused on ensuring that an inversion transaction, or any other transaction resulting in a new foreign parent, cannot be used to reduce inappropriately the U.S. tax on income from U.S. operations. A comprehensive review of the U.S. tax system, particularly the international tax rules, is both appropriate and timely. Our overreaching goal must be to maintain the position of the United States as the most desirable location in the world for place of incorporation, location of headquarters, and transaction of business."

As a result of the increased scrutiny of such transactions, changes in the tax laws, tax treaties or tax regulations may occur, with prospective or retroactive effect, which would eliminate or substantially reduce the anticipated tax benefits of the reorganization or subject the company to material tax liability as a result of the reorganization. If in response to any such changes the reorganized company or its subsidiaries undertake a corporate restructuring, such restructuring could result in additional material tax liability to the company or its shareholders.

In addition, the IRS or other taxing authority could disagree with our assessment of the effects or interpretation of existing laws, regulations and treaties (including Stanley Bermuda's treatment as a tax resident of Barbados), which could subject the company to material tax liability as a result of the reorganization or subject the future operations of the reorganized company and its subsidiaries to material tax liability.

The Benefits of the Reorganization Could be Reduced or Eliminated if the IRS Successfully Challenges the Tax Treatment of the Reorganization

We believe that Stanley Connecticut should not incur a material amount of U.S. Federal income or withholding tax as a result of the reorganization. It should be noted, however, that the IRS may not agree with this conclusion. If the IRS were to challenge successfully the tax treatment of the reorganization, this could result in the company being liable for a material amount of taxes. Liability for a material amount of taxes could reduce or eliminate the expected tax benefits of the reorganization and could also have an adverse impact on the company's liquidity and capital resources.

Stanley Bermuda May Become Subject to a Material Amount of U.S. Corporate Income Tax, Which Would Reduce Stanley Bermuda's Net Income

Stanley Connecticut currently is subject to U.S. corporate income tax on its worldwide income. After the reorganization, Stanley Connecticut and its subsidiaries will continue to be subject to U.S. corporate income tax on their operations. Stanley Bermuda anticipates that its non-U.S. operations will not be subject to U.S. corporate income tax other than withholding taxes imposed on U.S. source dividend and interest income.

Stanley Bermuda and other non-U.S. Stanley affiliates intend to conduct their operations in a manner that will cause them not to be engaged in the conduct of a trade or business in the U.S. Stanley Bermuda intends to comply with guidelines developed by its tax advisors designed to ensure that Stanley Bermuda and its non-U.S. affiliates do not engage in the conduct of a U.S. trade or business, and thus, Stanley Bermuda and its non-U.S. affiliates believe that they should not be required to pay U.S. corporate income tax, other than withholding tax on U.S. source dividend and interest income. However, if the IRS successfully contends that Stanley Bermuda or any of its non-U.S. affiliates are engaged in a trade or business in the U.S., Stanley Bermuda or that non-U.S. affiliate would be required to pay U.S. corporate income tax on income that is subject to the taxing jurisdiction of the U.S., and possibly the U.S. branch profits tax. Any such tax payments would reduce Stanley Bermuda's net income.

The Enforcement of Judgments in Shareholder Suits Against Stanley Bermuda May Be More Difficult Because Stanley Bermuda is Incorporated in Bermuda

Stanley Bermuda is a Bermuda company. As a result, it may be difficult for you to effect service of process within the United States or to enforce judgments obtained against Stanley Bermuda in United States courts. However, Stanley Bermuda will irrevocably agree that it may be served with process with respect to actions based on offers and sales of securities made in the United States by having Stanley Connecticut, located at 1000 Stanley Drive, New Britain, Connecticut 06053, be its United States agent appointed for that purpose.

Stanley Bermuda has been advised by its Bermuda counsel, Appleby, Spurling & Kempe, that a judgment for the payment of money rendered by a court in the United States based on civil liability would not be automatically enforceable in Bermuda because there is no Bermuda law or treaty between the U.S. and Bermuda providing for the enforcement in Bermuda of a monetary judgment entered by a U.S. court. Stanley Bermuda has also been advised by Appleby, Spurling & Kempe that a final and conclusive judgment obtained in a court of competent jurisdiction in the United States under which a sum of money is payable as compensatory damages may be the subject of an action in the Supreme Court of Bermuda under the common law doctrine of obligation, by action on the debt evidenced by the court's judgment. Such an action should be successful upon proof that the sum of money is due and payable, and without having to prove the facts supporting the underlying judgment, as long as:

- the court that gave the judgment was competent to hear the action in accordance with private international law principles as applied by the courts in Bermuda; and
- the judgment is not contrary to public policy in Bermuda, was not obtained by fraud or in proceedings contrary to natural justice of Bermuda and is not based on an error in Bermuda law.

A Bermuda court may impose civil liability on Stanley Bermuda or its directors or officers in a suit brought in the Supreme Court of Bermuda against Stanley Bermuda or such persons with respect to facts that constitute a violation of U.S. Federal securities laws, provided that the facts surrounding such violation would constitute or give rise to a cause of action under Bermuda law.

Anti-takeover Provisions in Stanley Bermuda's Bye-laws and its Shareholders Rights Plan Will Maintain Certain Existing Anti-takeover Provisions of Stanley Connecticut

Similar to the current authority of Stanley Connecticut's board of directors, the board of directors of Stanley Bermuda may issue preferred shares and determine their rights and qualifications. The issuance of preferred shares may delay, defer or prevent a merger, amalgamation, tender offer or proxy contest involving Stanley Bermuda. This may cause the market price of Stanley Bermuda's shares to decrease significantly.

In addition, provisions in Stanley Bermuda's bye-laws and shareholders rights plan, which replicate certain provisions of Stanley Connecticut's restated certificate of incorporation, bylaws and its shareholders rights plan, could discourage unsolicited takeover bids from third parties or the removal of incumbent management. These provisions include a classified board of directors and the possible dilution of a potential acquiror's interest in Stanley Bermuda as a result of the operation of its shareholders rights plan.

Your Rights as a Shareholder May be Adversely Changed as a Result of the Reorganization Because of Differences between Bermuda Law and Connecticut Law and Differences in Stanley Bermuda's and Stanley Connecticut's Organizational Documents

Because of differences in Bermuda law and Connecticut law and differences in the governing documents of Stanley Bermuda and Stanley Connecticut, your rights as a shareholder may be adversely changed if the reorganization is completed. For a description of these differences, see "Summary—Rights of Shareholders" on page 11 and "Comparison of Rights of Shareholders" beginning on page 40.

Mr. NEAL. Would that be okay? I want to thank you both for your testimony, and I don't have an opponent at the moment, so for the suggestion to be made, as it has been made, that some of this is about politics is wrong. I started on this with reinsurance 2 years ago largely driven by corporate considerations. One of the great things about an election is that the election does crystallize the issue for the great judge in the end, the American people, to decide, and I am hopeful that this debate is going to continue. I am hopeful that we will have good witnesses like you two to continue this debate back home.

Most importantly, I am hoping that average taxpayers who understand that if we are spending $48 billion more for defense, $38 billion more for homeland security, and these companies are leaving, I hope the average taxpayer understands they are going to pick up the difference.

Thank you, Mr. Chairman.

Chairman MCCRERY. Thank you.

Mr. Salch, do you happen to know the trend in the last few years in terms of foreign companies taking over American companies or American companies taking over foreign companies?

Mr. SALCH. I believe that the Associated Press (AP) reported earlier this month that there was a study that starting in 1998 there had been a steady increase in the amount of merger activity or acquisition activity and investment activity with foreign owners in the United States. So, to that extent from 1998 forward the AP, for whatever that is worth, reports that the trend is an up trend.

Chairman MCCRERY. In fact, I believe in that same story it said that 80 percent of the large transactions since 1998 have been foreign takeovers of American companies. Is that—do you recall seeing that number?

Mr. SALCH. I believe that is right, sir.

Chairman MCCRERY. So even though you can't say they were takeover targets, the fact is over the last few years the vast majority of mergers between foreign companies and U.S. companies have involved foreign takeovers of American companies. There must be some reasons for that, and I would submit that the testimony that we have heard here today illustrates clearly that one of the reasons is the underlying tax provisions that are the subject of this hearing.

Mr. BLUMENTHAL. Mr. Chairman, may I respond briefly to that point, because I think it is a very insightful and thoughtful one. I think all of us, at least on both sides of this panel, have very, very grave concerns about foreign takeovers of American companies, and I certainly share that concern with you. I am not here to advocate one reform or another, whether sunsetting or any particular measure of fundamental reform. I think the concern about takeovers has to be seen separately from this measure, with all due respect, and may relate to more fundamental issues regarding our Tax Code. I think it perhaps conceptually and practically can be separated from the reason that we are here today.

Chairman MCCRERY. Well, I appreciate your remarks but I disagree with you, respectfully. I think they are intertwined, because if we take away from an American company a tool to avoid or to reduce the U.S. taxes and avoid being such an attractive takeover target, then they have nowhere else to go but to be taken over if they are a right target.

So I do think that the issues are intertwined and we ought to address, to the extent that we can, both issues in a single piece of legislation. That just seems to me to make a lot of sense. I believe this Committee and this Congress has a duty to try to balance our—all of our desire to make sure that corporations in America pay their fair share of taxes with our desire to make sure that our economy is one that is suitable for the creation and preservation of good jobs. There is no question that a foreign takeover of an

American corporation has a more harmful effect on jobs in America than an inversion. So, I do think they are related, and if we don't look at both, I think we are not doing our duty to the taxpayers and to our constituents.

Mr. BRADY. If the Chairman will yield just a moment, I want to point out what Mr. Salch just said, not 10 minutes ago, that the bill as it currently is written would make U.S. companies more likely to be taken over by foreign companies. So we cannot separate the issue of foreign takeovers of U.S. companies from corporate inversion—again, known as defending these actions—but we also don't want to create another very unpatriotic effect of chasing and driving U.S. companies overseas and those jobs with them.

Mr. NEAL. Mr. Chairman, would you be so kind as to give me the last word?

Chairman MCCRERY. Sure.

Mr. NEAL. In a report here from the U.S. Department of Commerce in June 2002, by Tom Anderson, he says: "In 2001 outlays by foreign direct investors to acquire or establish U.S. businesses decreased substantially."

Chairman MCCRERY. With all due respect——

Mr. NEAL. You said you would give me the last word, Mr. Chairman.

Chairman MCCRERY. I know, but since you are reading from the report, and I just happen to have a report on the report here, you should know that even though that is true, what you said——

Mr. NEAL. It is basically always true, Mr. Chairman.

Chairman MCCRERY. Even though what you said is true—let me see—even with the big drop last year, the overall spending was still higher than for any year prior to 1998, the overall spending on foreign acquisition of American companies.

Thank you, gentlemen, very much. Excellent testimony.

Mr. BLUMENTHAL. Thank you, Mr. Chairman.

Mr. SALCH. Thank you, Mr. Chairman.

[Whereupon, at 5:50 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

American Institute of Certified Public Accountants
Washington, DC 20004–1081
June 28, 2002

The Honorable Jim McCrery
Chair, Subcommittee on Select Revenue Measures
House Ways and Means Committee
1110 Longworth House Office Building
Washington, D.C. 20515

Re: Comments for the Record of the June 25, 2002 House Ways and Means Committee Select Revenue Measures Subcommittee Hearing on Corporate Inversions

Dear Chairman McCrery:

The American Institute of Certified Public Accountants (AICPA) is pleased to provide our comments for the record of the June 25, 2002 House Ways and Means Committee Select Revenue Measures Subcommittee hearing with respect to the issue of corporate inversion transactions. The AICPA is the national, professional organization of certified public accountants comprised of more than 350,000 members. Our members advise clients on Federal, state, and international tax matters, and prepare income and other tax returns for millions of Americans. They provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

Several high-profile U.S. corporations have recently inverted or announced plans to invert.[1] In general, an inversion transaction is one in which a U.S.-based company becomes a foreign-based company, where the new foreign parent company is typically located in a low-tax country. Although corporate inversions are not new, these recent activities and plans have prompted both Congress and the Treasury Department to focus on inversions and the resulting effect on the U.S. tax base. In addition to the inversion transactions themselves, both Congress and the Treasury Department have been examining earnings stripping plans (e.g., through U.S. tax deductions for interest payments by a U.S. subsidiary to its foreign parent on "loaded up" intercompany debt) that are often a part of an inversion plan. In response, several bills have been introduced[2] and the Treasury Department issued a preliminary report reviewing corporate inversion transactions on May 17, 2002 (the "Treasury Report").[3] On June 18, 2002, the Senate Finance Committee marked-up a proposal that would address the inversion issue in a somewhat targeted manner. Accordingly, the AICPA believes it is appropriate to submit comments at this time.

The AICPA appreciates the political and policy issues that have been expressed as part of the inversion debate. We strongly believe, however, that an appropriate response should not focus solely on the act of inverting, but rather on the incentives for U.S.-based multinational corporations to invert. Such a response should include consideration of both U.S. tax disadvantages facing U.S.-based multinationals as well as U.S. tax advantages available to foreign-based multinationals. The response should be broad enough to address these concerns regardless of whether a corporate group chooses to be foreign-based as a result of an inversion, an acquisition, or through initial formation.

We believe the goal of a legislative response should be to ensure that the United States remains an attractive and competitive venue both for basing multinational operations as well as for foreign investment. In particular, we believe that the U.S. tax treatment for multinational groups with a U.S. parent corporation should be at least as favorable as that for multinational groups with a foreign parent. Further, we are concerned that any legislation narrowly focused solely on preventing inversion transactions, or making them less attractive, will fail to address the underlying long-term policy issues, and could have unintended negative effects on the U.S. economy, such as potentially encouraging the takeover of U.S.-based companies by foreign acquirers.

We would like to commend the Members of Congress and the Treasury Department for giving this serious issue such prompt attention. We urge caution, however, because inversions involve very complex and fundamental tax issues that warrant careful consideration. We agree with the Treasury Department's conclusions in the Treasury Report that inversions are symptomatic of underlying differences in U.S. tax law and policy with regard to U.S.-based companies and foreign-based companies with operations in the United States. The AICPA strongly supports the Treasury Department's recommendation that rather than enacting measures designed simply to halt inversion transactions, the broader question of the U.S. taxation of foreign operations should be addressed through a comprehensive review of the causes of these imbalances.

In view of the potential far-reaching effect of any provisions enacted to deal with inversions, we urge the Congress to address the underlying issues discussed below in a reasoned and carefully considered manner. If immediate action is deemed necessary, we would encourage the Congress to adopt a bill that would, for a period not to exceed two years, treat a new foreign corporate parent entity, created via an inversion in which there was no substantial change in operations or ownership, as a domestic corporation for U.S. tax purposes (thereby nullifying the tax benefits of the inversion). Such a measure would provide more time for appropriate consideration of these important and integrated matters.

[1] For example, Ingersoll Rand, Coopers Industries and Global Marine inverted in 2001, while Stanley Works has announced inversion plans for 2002.

[2] H.R. 3857 introduced by Rep. McInnis (R–CO); H.R. 3884, "Corporate Patriot Enforcement Act of 2002" introduced by Rep. Richard Neal (D–MA); H.R. 3922, "Save America's Jobs Act of 2002" introduced by Rep. Maloney (D–NY); H.R. 4756, "Uncle Sam Wants You Act of 2002" introduced by Rep. Nancy Johnson (R–CN); H.R. 4993, "No Tax Breaks for Corporations Renouncing America Act of 2002" introduced by Rep. Lloyd Doggett (D–TX); S. 2050, introduced by Sen. Paul Wellstone (D–MN) and Sen. Dayton (D–MN); and S. 2119, "Reversing the Expatriation of Profits Offshore (REPO) Act" introduced by Sen. Max Baucus (D–MT) and Sen. Charles Grassley (R–Iowa).

[3] U.S. Treasury, Office of Tax Policy, Corporate Inversion Transactions: Tax Policy Implications, Doc. 2002–12218, 2002 TNT 98–49, http://www.treas.gov/press/releases/docs/inversion.pdf.

We believe U.S. tax rules that treat U.S.-based companies differently than foreign-based companies and put U.S.-based companies at a competitive disadvantage include:

- The U.S. anti-deferral regimes (including subpart F) that are dated, complex, overlapping and in many respects, overreaching; and
- The U.S. foreign tax credit regime and the limitations thereon, including basketing rules, and, in particular, interest expense allocation rules that can cause double taxation.

The Treasury Report also highlighted a need to address those situations where the U.S. tax base is excessively eroded by intercompany indebtedness (so-called earnings stripping). We agree that addressing U.S. tax rules that allow foreign-based companies to strip earnings out of the United States would help to equalize the U.S. tax treatment of U.S.-based companies with U.S. operations as compared to foreign-based companies with U.S. operations. Addressing these issues will also remove many of the underlying incentives for inversions, and prevent erosion of the U.S. tax base by foreign-based companies. Earnings stripping itself, however, is also a complex issue and we recognize that there will be many issues that will require consideration as these rules are modified. In this regard we note that the current proposed earnings stripping Treasury regulations have been in proposed form for over a decade.[4] In addition, we urge Congress to be mindful of the possible effect on U.S. taxpayers if other countries adopt mirror images of selected provisions contained in the Treasury Report, such as the debt/equity ratio adjustment proposed for section 163(j).

In sum, we agree with the findings of the Treasury Report that there is a need for a methodical, well-reasoned consideration of a complex set of issues regarding the U.S. tax treatment of U.S.-based companies versus foreign-based companies, regardless of whether the foreign-based company is an inverted U.S. company. In addition, we recommend caution when considering legislation that attempts to address corporate inversions without adequately addressing the current disparate treatment of U.S.-based companies versus foreign-based companies, a treatment that may have long-term adverse consequences for the U.S. economy. As noted in the Treasury Report:

> 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 to the detriment of the U.S. economy in the long run.

Our goal is a healthy economy and U.S. job growth. We encourage legislative changes that enhance U.S. competitiveness in the global market and eliminate the current underlying advantages under U.S. tax law for foreign-based companies.

The AICPA would be happy to offer our further assistance on this legislation. Please contact me at (805) 653–6300 or ppecar@aol.com; Andrew Mattson, Chair of the International Tax Technical Resource Panel, at (408) 369–2566 or Andy@mohlernixon.com; or Eileen Sherr, AICPA Technical Manager at (202) 434–9256 or esherr@aicpa.org.

Sincerely,

Pamela J. Pecarich
Chair, Tax Executive Committee

cc:

Members of House Ways & Means Committee
Members of Senate Finance Committee
Mr. Jon Traub, Legislative Director to Rep. McCrery
Mr. Bob Winters, Special Counsel, House Ways & Means Committee
Ms. Allison Giles, Majority Chief of Staff, House Ways & Means Committee
Mr. John Kelliher, Chief Counsel, House Ways & Means Committee
Mr. James Clark, Chief Tax Counsel, House Ways & Means Committee
Mr. Greg Nickerson, Tax Counsel, House Ways & Means Committee
Ms. Janice Mays, Democratic Chief Counsel, Ways & Means Committee
Mr. John Buckley, Democratic Chief Tax Counsel, Ways & Means Committee
Mr. John Angell, Staff Director, Senate Finance Committee
Mr. Russell Sullivan, Chief Tax Counsel, Senate Finance Committee
Ms. Maria Freese, Tax Counsel, Senate Finance Committee

[4] Prop. Reg. Secs. 1.163(j)-0–1.163(j)-10 (June 13, 1991).

Ms. Anita Horn Rizek, Democratic Tax Professional Staff, Senate Finance Committee
Mr. Kolan Davis, Republican Staff Director and Chief Counsel, Senate Finance Committee
Mr. Mark Prater, Republican Chief Tax Counsel, Senate Finance Committee
Ms. Lindy L. Paull, Chief of Staff, Joint Committee on Taxation
Mr. H. Benjamin Hartley, Senior Legislation Counsel, Joint Committee on Taxation
Mr. E. Ray Beeman, Legislation Counsel, Joint Committee on Taxation
Mr. David G. Noren, Legislation Counsel, Joint Committee on Taxation
Mr. Oren S. Penn, Legislation Counsel, Joint Committee on Taxation
Mr. Thomas A. Barthold, Senior Economist, Joint Committee on Taxation
Ms. Pamela F. Olson, Acting Assistant Secretary for Tax Policy, Treasury Department
Mr. Rob Hanson, Tax Legislative Counsel, Treasury Department
Ms. Barbara M. Angus, International Tax Counsel, Treasury Department

[By Permission of the Chairman]

Statement of Ingersoll-Rand, Hamilton, Bermuda

I. Ingersoll-Rand's Corporate Reorganization Was A Lawful And Appropriate Response To Competition

Ingersoll-Rand ("I–R") is a world-wide manufacturer of a wide variety of brand name industrial products with about sixty percent of its sales in the United States and forty percent in other countries. It is implementing a global growth strategy, with a particular objective to encourage global cross-brand selling. To do so effectively, it is essential that I–R be competitive with its foreign-incorporated competitors.

As one element of this objective, I–R met every Treasury Department requirement for a legal corporate inversion when it reincorporated in Bermuda. The reincorporation was undertaken in full public view in the fall of 2001 and fully reported to the SEC. It received the approval of eighty-nine percent of I–R's voting shareholders. The transaction was completed and closed in 2001. There was no indication from the Congress, from any Member of Congress during this period, or from any official of the Treasury Department or the Securities and Exchange Commission, that the transaction should be subject to question. It was not until March 2002 that Members of Congress raised concerns about inversion transactions. In April 2002, the Treasury Department report on inversions confirmed the complete compliance of this transaction with current law.

Significantly, I–R's transaction was taxable on the date of reincorporation, both to the corporation and its individual shareholders. Shareholder taxes on gain from the exchange of stock are the direct result of action taken by the Treasury in 1994 to insure that these transactions would not escape U.S. taxation. Thousands of I–R's individual shareholders paid millions of dollars of tax on this transaction. In addition, I–R recognized substantial taxable income.

Labeling I–R's transaction as unpatriotic is unjust. The reorganization will not result in the loss of any U.S. jobs or the closure of any U.S. plants. To the contrary, the transaction will increase I–R's ability to maintain U.S. operations and to expand U.S. manufacturing and employment in the future.

Finally, if Congress determines that modifications should be made to the limitation of interest expense deductibility for U.S. companies with foreign parents, such modifications should be applicable to all companies. This approach was adopted by the Treasury Department in its recent proposals to this Committee with respect to foreign reincorporation transactions. The Treasury Department recognized that U.S.-based companies are subject to an archaic and burdensome tax regime that creates serious problems of competitiveness for those companies with foreign-based rivals. Imposing more restrictions on interest expense deductibility only for certain types of U.S. companies with foreign parents would exacerbate those problems by providing a further advantage to other types of U.S. companies with foreign parents.

II. A Ban on Inversions Will Be Ineffective and Will Exacerbate the Problem of Foreign Takeovers

At best, a ban on corporate inversions, whether in the form of a prohibition or a moratorium, applies a "Band-Aid" treatment to a symptom of a fundamental problem: the Code's treatment of foreign source income. These provisions create an unequal playing field between U.S. and foreign global competitors and thereby encourage foreign takeovers of U.S. companies. The vast majority of global mergers in the past decade between a U.S. and non-U.S. company has resulted in the corporate parent choosing the location of the non-U.S. partner as its global headquarters. This is not a coincidence; it is largely the result of our international tax regime. This trend has far more serious implications for U.S. operations and U.S. jobs than corporate inversions, which maintain U.S. management of all global corporate operations.

Any attempt to ban inversions will further encourage foreign takeovers, injuring American firms, their employees and their investors. Even a relatively short-term moratorium will encourage foreign takeovers of U.S. corporations. This is a particular concern at this time because of the sharp reduction in the value of the dollar, making U.S. companies prime targets for takeovers.

By far the most effective way to discourage inversions is to correct the underlying anti-competitive flaws in the U.S. Tax Code that place U.S. global companies at a disadvantage with their foreign competitors. It is essential that Congress address at the earliest possible time the Code's international tax provisions that place U.S. companies at such a severe disadvantage.

III. Legislation That Imposes New Taxes Solely On Companies That Inverted Should Be Prospective Only

If Congress determines that reorganizations such as that implemented by I-R should be prohibited, or that additional taxes should be imposed on such a reorganization, it should do so prospectively. At the very least, such changes to the tax laws should be prospective from the date on which legislation was introduced or announcement of a likely change in the law was made. This, almost without exception, is the way in which Congress changes the tax laws governing specific transactions so as to avoid fundamentally unfair consequences to taxpayers.

Retroactive application of any prohibition or moratorium to transactions that were completed before March 2002 would be punitive rather than preventative, because those transactions were completed under and fully consistent with existing law before any Member of Congress indicated that a change in law would occur. Such a retroactive application would be particularly unfair to I–R's shareholders, who relied on the benefits offered to the company when they voted to incur taxable income from the transaction. Taxes paid by individual I–R shareholders may have totaled $100 million. As a practical matter, there is no way of returning to all these taxpayers the taxes paid on this specific transaction or restoring them to their pre-tax situation. When the Treasury Department issued its new regulations governing the tax treatment for shareholders on inversions in 1994, it did so prospectively. The regulations did not affect completed transactions.

Nullifying I–R's transaction retroactively could also be unfair to the company, which made a decision to act based upon the law as it then existed. If certain of the proposals before this Committee are enacted, companies will have the opportunity to make choices that were not available to I–R in seeking to satisfy the terms of the new legislation. For example, I–R could have reorganized in a country in which it has substantial business activities, a choice that would improve its treatment under certain proposed legislation and which would have had identical tax consequences to the reorganization in Bermuda. This choice may be available to any company that has not yet acted, but it was not available to I–R.

In addition, there are serious due process concerns with legislation such as a prohibition on inversions that retroactively imposes a new tax without any notice to the taxpayer. Only two types of tax legislation are generally subject to retroactive enactment: (1) changes in tax rates and other such adjustments to existing tax laws, which are often enacted retroactive to the beginning of the tax year for administrative simplicity; and (2) technical corrections to laws that have been enacted recently but unintentionally left "loopholes" that Congress seeks to close retroactive to the original date of enactment. The Supreme Court has indicated that U.S. taxpayers are on notice that these types of changes in the tax laws may occur retroactively, because such changes put legislative intent into effect in a reasonable way.

The "anti-inversion" legislative proposals that would operate retroactively are not amendments to existing tax law or technical corrections seeking to close a recently-enacted loophole. Rather, these proposals would retroactively impose wholly new tax burdens, which could raise serious due process concerns. In 1995, the Joint Committee on Taxation released a report analyzing the due process issues of a proposal to modify the tax treatment of individuals that expatriated. When applied prospectively, the proposals did not pose due process concerns, but the Joint Committee stated that the retroactive application of one proposal to a date long before there was any notice would be "an unprecedented retroactive tax law change that would reach back and pull a non-U.S. citizen into the jurisdiction of the U.S. tax system."

The concerns expressed by the Joint Committee on Taxation were heeded by Congress at that time. These concerns apply equally to the retroactive elements of certain legislative proposals under consideration by this Committee.

Statement of Donald V. Moorehead, Partner, and Aubrey A. Rothrock III, Partner, Patton Boggs LLP

This statement is submitted for inclusion in the record of the hearings held by the Subcommittee on Select Revenue Measures on June 13, 2002 concerning possible changes to the Internal Revenue Code of 1986, as amended (the "Code"), in light of the recent decision of the World Trade Organization (the "WTO") with respect to the extraterritorial income provisions of the Code. We understand that, in fashioning a legislative response to the WTO decision, consideration may be given to making numerous changes to the provisions of the Code governing the taxation of income earned by U.S.-based businesses from their international operations. In this statement, we describe two proposals that should be included as part of such a legislative package.

Passive Income Attributable to Assets Held to Match CFC Pension Liabilities

In the United States and many foreign countries, employers may establish pension plans for their employees and fund those plans through annual contributions to a separate trust or its equivalent. Employees and their beneficiaries generally are taxed only when the benefits are paid to them. In some countries such as Germany, however, the use of a trust or similar funding mechanism would result in the imposition of tax on the employees prior to the commencement of distributions to them upon retirement.

Under German law, if an employer creates a pension plan for its employees, it is required by law to establish a reserve on its balance sheet to reflect liabilities under the plan and to make annual additions to the reserve to reflect the discounted present value of its future obligations under the plan. Although the basic benefits provided under the plan are insured, the insurance is payable only if the employer is unable to pay the benefits as they fall due. Employers may not formally fund these plans, through an irrevocable trust or similar arrangement without adverse tax consequences to their employees.

In some instances, both as a matter of financial prudence and to foster good working relationships with their employees, an employer may seek to "match" its pension obligations (and offset its balance sheet liability) through the purchase of investment assets. German law implicitly encourages such practices by providing special tax treatment for certain types of investments.

When the employer is a controlled foreign corporation (a "CFC"), the purchase of assets to match pension obligations can create adverse U.S. tax consequences. Specifically, the passive income generated by such investments will be treated as foreign base company income under the subpart F provisions of the Code and thus, unless it is de minimis in amount, will taxed to the U.S. shareholders of the CFC (e.g., the U.S. parent corporation) in the year earned by the CFC. Moreover, that income will be allocated to the "passive" basket for purposes of computing the foreign tax credit limitation, even though it is incidental to the active business operations of the CFC.

We believe this is an inappropriate result as a matter of policy. The investment of earnings to fund retirement plans has long been recognized as desirable from a public policy standpoint and Congress itself has sought to provide relief in most instances through section 404A of the Code. Where, however, the host country does not permit the use of a trust or other similar arrangement without adverse tax consequences to employees, section 404A provides no relief if assets are acquired to "match" the liability represented by the pension reserve.

We recommend that, in the case of a CFC engaged in the active conduct of a trade or business, income attributable to investment assets purchased to match pension reserves should be placed in the same foreign tax credit "basket" as the income attributable to the CFC's active business operations. We also recommend that such income be excluded from the definition of foreign base company income and thus not taxed to the U.S. shareholders of the CFC unless and until distributed to them as a dividend or invested in U.S. property.

Foreign Tax Credit "Stacking" Rules

Because U.S. businesses are taxed on their worldwide income, the income they earn from international operations is potentially subject to double taxation: once by the foreign country in which it is earned and a second time by the U.S. Depending upon the character of such income and whether it is earned directly by the U.S. business or indirectly through a CFC, the U.S. tax on foreign source income will be payable either in the year it is earned or deferred until the income is distributed as a dividend to the U.S. shareholders or invested in U.S. property.

The foreign tax credit provisions of the Code are intended to reduce the actual incidence of such double taxation and the effectiveness with which this objective is achieved is critical to the competitive position of American businesses in the world's markets. By reason of the operation of certain of these foreign tax credit provisions, a U.S. corporation may in fact be unable to claim credits on a current basis for all of the foreign taxes paid with respect to the foreign source income included in its U.S. tax return. This is true even where the applicable foreign tax rates are less than the U.S. corporate rate of 35 percent.

In such situations, the excess credits may be carried back to the two preceding taxable years and then forward to the succeeding five taxable years. If they cannot be used during this carryover period, they expire. Under current law, however, excess credits that are carried over to another taxable year may in fact be used only after the credits used in that taxable year have been fully utilized. This stacking rule thus increases the likelihood that otherwise valid credits for foreign taxes actually paid on foreign source income that is subject to U.S. tax will not be used and expire.

We believe this is inappropriate as a matter of policy. Credits for foreign taxes actually paid on income that is subject to U.S. tax should in our view be permitted to be used at the earliest possible date and the Code should be structured so that expiration is only a remote possibility. This is particularly true since many U.S. corporations are in "excess credit" positions largely because of provisions of the Code that reduce foreign source income artificially (e.g., the over allocation of interest expense to foreign source income) or otherwise make it difficult to use credits in the first year they are available (e.g., the allocation of types of foreign source income to different "baskets" and the prohibition on the use of credits earned with respect to income in one basket to offset the U.S. tax on income in another basket).

For these reasons, we recommend that section 904(c) of the Code be amended to provide that, with respect to any taxable year, foreign tax credits would be applied in the following order: (1) credits carried *forward* to that year; (2) credits earned in that year; and (3) credits carried *back* to that taxable year. This approach was taken in prior proposed bipartisan international tax simplification legislation and, is we believe, a more direct solution to the problem than that contained in H.R. 4541. The proposed change would enable the foreign tax credit to achieve its objective more effectively and would reduce the incentive now inherent in section 904(c) for taxpayers to engage in transactions principally to enable them to use foreign tax credits that might otherwise expire.

Western Shower Door, Inc.
Fremont, California 94538
July 9, 2002

Honorable James McCrery
House Ways and Means Committee
Chairman, Subcommittee on Select Revenue Measures

Subject: International Taxation/Tax Inversion

Dear Chairman McCrery:

Thank you for holding your Subcommittee's meeting today on tax inversion. It is an important topic for both big as well as small companies, their employees, the long-term competitiveness of the U.S. economy and the ownership of companies throughout our Great Republic.

Western Shower Door, Inc. ("WSD") is a small/medium-size company. We employ approximately 220 workers in California and Nevada.

WSD is an integrated manufacturer/distributor/specialty subcontractor to the builder-direct marketplace. This is a highly competitive business with thin profit margins.

We have been in business for 43 years. We always pay our taxes. We are not looking for any special treatment.

Due to the pressure by the homebuilders and general contractors to keep our prices low, we have had to increasingly import more and more raw materials and finished goods, which we manufacture and sell on an installed basis using U.S.

workers. As a result, a larger percentage of our profit is coming from overseas procurement rather what is actually being produced in the U.S.

However, we do not think it is fair for the U.S. to tax us on the "profit" between the price of domestic and lower-priced international goods. This "profit" is often generated when we have to go further into debt to pay for such goods often before they arrive at U.S. ports.

We live in fear of foreign competitors. Such a competitor could buy its goods overseas through a foreign company and then legitimately transfer the goods at U.S. prices. Hence, it would have no "profit" on this segment of its business. *However, it would have a significant competitive advantage over wholly owned U.S. companies, which are forced to pay U.S. taxes on such "profits".*

We would prefer to remain a wholly owned U.S. company. However, we believe we should be allowed the same tax freedom as any foreign competitor.

Again, we are not asking for any special favors. Just give us a level-playing field against foreign competitors.

If Congress can't do that, then don't prohibit us from acting like our foreign competition. The long-term issue for you and other Members is whether or not you want our sons, daughters and grandchildren working for U.S. companies or foreign companies?

Mr. Jim Easton, who previously worked with Congressman John J. "Jimmy" Duncan as a House Committee Staff Person and also handled Ways and Means Committee issues for Mr. Duncan's father (Congressman John J. Duncan who was at one time the Ranking Republican on the House Ways and Means Committee), will be in touch in your staff on behalf of Western Shower Door, Inc. to share our thoughts and ideas on this critical matter.

I look forward to an opportunity for Jim and I to work with your staff as this issue continues to gain the close attention of the Ways and Means Committee and the Congress.

Sincerely,

Craig McCarty
President