

# CORPORATE INVERSION

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**HEARING**  
BEFORE A  
SUBCOMMITTEE OF THE  
COMMITTEE ON APPROPRIATIONS  
UNITED STATES SENATE  
ONE HUNDRED SEVENTH CONGRESS  
SECOND SESSION

**SPECIAL HEARING**  
OCTOBER 16, 2002—WASHINGTON, DC

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## CORPORATE INVERSION

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WEDNESDAY, OCTOBER 16, 2002

U.S. SENATE,  
SUBCOMMITTEE ON TREASURY AND  
GENERAL GOVERNMENT,  
COMMITTEE ON APPROPRIATIONS,  
*Washington, DC.*

The subcommittee met at 10:08 a.m., in room SD-192, Dirksen Senate Office Building, Hon. Byron L. Dorgan (chairman) presiding.

Present: Senator Dorgan.

OPENING STATEMENT OF SENATOR BYRON L. DORGAN

Senator DORGAN. I am going to call the subcommittee to order and begin the hearing today.

First of all, good morning to all of you. This hearing is to look at the issue of reincorporation into offshore tax havens by American corporations.

In the last decade, about 20 major U.S. corporations have reincorporated or, on paper, set up shop in offshore tax havens like Bermuda or the Cayman Islands. Companies such as Tyco, Fruit of the Loom, and others are among those that have used this tactic.

This tactic is described in many cases as something called “corporate inversion,” and it is happening largely for one reason—because some companies are feeling that if they involve themselves in a “corporate inversion,” they can reduce substantially the share of U.S. taxes that they are paying. In the aftermath of 9/11 last year, who these kinds of practices raise questions of patriotism.

Let me show a couple of clippings of stories that have been written about this in recent years as some large and high-profile companies have used this tactic.

This is a Washington Post story. Alan Sloan wrote a column, “Uncle Sam Gets Shorted by the Bermuda Bye-Bye.” I will not read it, but it talks about companies playing tax games and moving to Bermuda from New Britain, CT—this is Stanley Tools, and they have since changed their mind about that—but it talks about the incentive for that company wanting to move offshore.

One of the paragraphs in this article reads: “One of the problems I have with all of these companies going to Bermuda in a time of war and budget deficits is that it amounts to a selective repeal of the corporate income tax. It is available to Stanley”—in this case, he was talking about Stanley Tools—“but not to the local hardware store that sells Stanley Tools. It is available to Monday”—again, re-

ferring to another corporation—“but not to a computer consultant working out of his or her house.”

Another piece by Jonathan Weisman in the Washington Post raises questions that I think many on Capitol Hill have also given voice to, including myself: “Patriotism Raining on Tax Paradise—Lawmakers Chafing at Firms that Exist Offshore Only on Paper. Is it the right time to be migrating a corporation to an offshore location? Kate Barton said, ‘A lot of companies feel that the improvement on earnings is powerful enough to say that maybe the patriotism issue should take a back seat.’” That was a statement by Ernst and Young partner Kate Barton, and I have a clip of that that I will use in a moment.

All of this raises significant questions, and we will hear today from Pamela Olson, Assistant Secretary of the Treasury for Tax Policy. I will be interested to hear assessment of this issue.

We are interested in this issue especially from the side of tax enforcement—how much money is needed for tax enforcement issues when a corporation engages in an inversion and effectively renounces its U.S. citizenship and becomes a citizen of another country? This poses, I think, some unique tax enforcement issues—income stripping, transfer pricing, and a range of issues that I think are interesting and also complex. And the question is, what kinds of resources are available and/or necessary for both the Internal Revenue Service and the Treasury to deal with these issues?

I think it is probably useful to begin this hearing by showing you the piece of video that I referred to just a moment ago. This is a piece of video that was broadcast on the internet by the accounting and consulting firm Ernst and Young in November of 2001. The broadcast was intended for Ernst and Young’s clients and was posted on their website, available, of course, to everyone.

Let us see that piece of video. It is about a minute and a half.

That is enough for the moment. In case you did not hear the remarks of the partner, she says, “The improvement on earnings is powerful enough to say that maybe the patriotism issue should take a back seat.”

I did ask Ernst and Young to come to this hearing to explain what they meant by that statement, but they declined to do so.

PriceWaterhouseCoopers is another firm that has aggressively touted its expertise with corporate inversions on their website. Until recently, PriceWaterhouseCoopers was planning to invert to Bermuda as well. I also invited them to be present today, and they declined.

I understand that no one enjoys paying taxes in this country. Company managers have a responsibility to their shareholders to make smart business decisions, including decisions on tax strategy.

But I worry that in recent months, the line between intelligent business decisions and corporate self-interest has been crossed in a way that does not consider the broader public interest in this country.

I think President Bush has the same concern. He recently said: “I think we ought to look at the people who are trying to avoid U.S. taxes. I think American companies ought to pay taxes here, be a part, be good citizens.” That is what the President said.

The trend of corporate inversions is part and parcel of a wave of some irresponsibility, not among the majority or the rule of corporations, but among a select few. We have seen in recent months, in the last year and a half, the stories about Enron, Tyco, Worldcom, Qwest, and many others.

Let me just talk for a moment about Tyco, because it has been in the news a great deal. In the clip we saw, the partner of Ernst and Young was talking about how successful the Tyco situation was. Tyco was a company based in New Hampshire. In 1997, Tyco purchased ADT, a manufacturer of electronic systems that was based in Bermuda. The chairman of Tyco, Dennis Kozlowski, structured the deal as a reverse merger, moving Tyco's headquarters on paper to Bermuda, and because of its Bermuda base, Tyco no longer pays U.S. taxes on its growing overseas income, and through a variety of schemes, it also minimizes its taxes on U.S. income.

For example, Tyco set up a Luxembourg-based subsidiary to finance most of its debt. In a process known as "income stripping," the Luxembourg subsidiary makes loans to Tyco units in the U.S. and elsewhere which then deduct the interest payments from their taxable income.

Tyco indicated that becoming a Bermuda company "saved" it about \$400 million in 2001. One knows, of course, where those savings come from. It means that others in our country have to pay taxes to make up the difference.

Bill Allison, a senior editor at the Washington-based Center for Public Integrity, described Kozlowski as "a Benedict Arnold billionaire" for moving offshore.

I think most corporations in this country understand their responsibilities and do well to meet those responsibilities. But there are some that have decided it is "Katie, bar the door," there are no limits, they are going to do whatever they feel like, and that includes deciding to renounce their U.S. citizenship in order to avoid paying U.S. taxes.

These inversions call into question some people's commitment to this country and we will talk a lot about that today.

Also, I want us to try to evaluate what kinds of resources are necessary for the Internal Revenue Service and the Treasury Department to deal with this issue.

An unrelated but similar question is raised by a September 17 article in the Wall Street Journal which I will ask Ms. Olson about, "IRS Seeks Quick Settlements in Pending Tax Shelter Probes." The implication of this article is that we have a lot of aggressive tax shelters, and what we want to do is just try to move these off the dock and get rid of them, with quick settlements.

My feeling is that whether it is aggressive or abusive tax shelters or inversions, I want the Internal Revenue Service and the Treasury to have all the resources they need to combat this abuse in as aggressive a way as is possible.

The American people pay their taxes. People who run businesses on Main Street pay their taxes. And frankly, it disgusts me to see corporations decide in their boardrooms that they would like to renounce their U.S. citizenship so they can avoid paying taxes. My feeling is that if they would like to be citizens of Bermuda, perhaps they should rely on the Bermuda navy to protect their assets of

there is expropriation somewhere. And I believe the total Bermuda armed forces has somewhere around 27 people. So to Mr. Kozlowski and others who think they would like to become citizens of the country of Bermuda, the next time they are threatened somewhere, maybe they could call on the Bermuda army and navy and air force to protect them.

I think a fair number of people are disgusted about all of this. I am, and I would like to have a discussion about it today.

We will begin with Ms. Olson, who is Assistant Secretary for Tax Policy at the Treasury Department.

We will include all of the statements today in the permanent record. We will have people who are here supporting inversions, who think it is just good business—and I will question that, of course—but we will have people who think that it is a terrible abusive practice that calls into question the patriotism of those who make those decisions, and we will have others who give us likely dull and boring and highly detailed tax policy testimony—but I am not suggesting that you are in that category, Ms. Olson.

#### SUBMITTED STATEMENT

Before you begin, the subcommittee has received a statement from Senator Campbell which he asked to be placed in the record [The statement follows:]

#### PREPARED STATEMENT OF SENATOR BEN NIGHTHORSE CAMPBELL

Thank you Mr. Chairman for calling this hearing on an issue that needs very close and careful examination and I want to thank our witnesses for taking the time to come up and discuss this issue with us.

In recent months, several high-profile U.S. companies have announced plans to reincorporate outside of the United States. It is important to understand that it is well within the rights of these companies to operate how and where it is most beneficial to them, and in turn, to the American consumers as long as they remain within the bounds of the law. However, there have been recent attempts in Congress to prevent companies that have reincorporated in foreign countries from obtaining, completing, or even competing for Federal contracts. Some are even questioning their patriotism, despite the fact that these companies employ thousands of American workers.

What we need to be focusing on is not how we keep these companies from incorporating overseas, but why these companies feel the need to reincorporate in a foreign country. Is it that incorporating a company in the U.S. is a disadvantage when competing against foreign interests? If this is the case, and if these Federal contracts are revoked or not renewed, could foreign workers be providing the same services and products and possibly leave the Federal Government at the mercy of foreign corporations and their employees? In a time when our economy has been suffering and our deficits are back in the red, can we truly say that we'd like more business to go offshore and stay there, possibly at the expense of U.S. jobs and economic gains? We need to look at the overall effects of the offshore reincorporation and determine exactly who will be hurt in the long run before making any rash decisions.

I again want to thank the witnesses for coming.

Senator DORGAN. Why don't we begin with you, however. You are the Assistant Secretary for Tax Policy. We appreciate very much you being here, and your statement will be made a part of the record. You may summarize, and we will go from there.

#### STATEMENT OF PAMELA OLSON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Ms. OLSON. Mr. Chairman, thank you. I appreciate the opportunity to be here today, and I will do my best to keep this short

and keep you awake. My testimony probably will fall in the “dull and boring” category.

I commend you for your interest in this important tax policy issue. Over the past year, several high-profile U.S. companies announced plans to reincorporate outside the U.S. The documents filed with the SEC cite substantial reductions in overall corporate taxes as a key reason for the transactions. While these so-called corporate inversion transactions are not new, there has been, as you have noted, a marked increase in the frequency, size, and profile of the transactions.

Earlier this year, the Treasury Department announced that it was studying the issues arising in connection with corporate inversion transactions and the implications of these transactions for the U.S. tax system and the U.S. economy. This study culminated in the release of a Treasury Department report on the tax policy implications of corporate inversion transactions and a package of proposed legislative and regulatory actions.

Inversion transactions implicate fundamental issues of tax policy. The U.S. tax system can operate to provide a cost advantage to foreign-based multinational companies over U.S.-based multinational companies. The Treasury report identifies two distinct classes of tax reduction that are available to foreign-based companies and that can be achieved through an inversion transaction.

First, an inversion transaction may be used by a U.S.-based company to achieve a reduction in the U.S. corporate-level tax on income from U.S. operations. In addition, through an inversion transaction, a U.S.-based multinational group can substantially reduce or eliminate the U.S. corporate-level tax on income from its foreign operations.

An inversion is a transaction through which a new corporation, typically located in a low -or no-tax country, replaces the existing U.S. parent corporation as the parent of the corporate group. The transactional forms vary, but all involve little or not immediate operational change, and all are transactions in which either the shareholders of the company or the company itself are subject to tax.

This reincorporation step may be accompanied by other restructuring steps designed to shift the ownership of the group’s foreign operations outside the United States.

The restructuring steps are complex and varied, but like the reincorporation itself, are transactions that are subject to tax. When the transactions are complete, the foreign operations of the company will be outside the U.S. taxing jurisdiction, and the corporate structure also may provide opportunities to reduce the U.S. tax on U.S. operations.

Market conditions have been a factor in the recent increase in inversion activity because they have reduced the potential tax imposed on the transactions. But market conditions are not what motivates a company to undertake a transaction.

U.S.-based companies and their shareholders are making the decision to reincorporate outside the U.S. largely because of the tax savings available. It is that underlying motivation that the Treasury Department proposals address.

The ability to achieve a substantial reduction in taxes through a transaction that is complicated technically but virtually transparent operationally is a cause for concern as a policy matter. In formulating a response, however, we must bear in mind that an inversion is not the only route to accomplishing the same type of reduction in taxes. The policy response to the recent corporate inversion activity should be broad enough to address the underlying differences in the U.S. tax treatment of U.S.-based companies and foreign-based companies, regardless of how foreign-based status is achieved.

Measures designed simply to halt inversion activity only address these transactions at the surface level and in the short run. Measures narrowly targeted would have the unintended effect of encouraging a shift to other forms of transactions and structures, to the detriment of the U.S. economy in the long run.

Our policies should provide a level playing field. There is no merit in policies biased against domestic control and domestic management of U.S. operations.

The Treasury Department has made specific proposals relating to legislative and regulatory changes that are needed to address these transactions and the opportunities to reduce taxes that are available through such transactions. Both the Senate Finance Committee and the House Ways and Means Committee have held hearings on this subject, and members of both committees have crafted legislation in response to these transactions. We are working closely with the committees to ensure the enactment of appropriate legislation.

In addition to addressing strategies that inappropriately minimize U.S. income, we must address the tax disadvantages imposed by our international tax rules on U.S.-based companies with foreign operations. Relative to the tax systems of our major trading partners, the U.S. tax rules can impose significantly heavier burdens on the foreign operations of domestically-based companies. Our objective must be to ensure that the U.S. tax system maintains the competitiveness of U.S. businesses in the global marketplace.

#### PREPARED STATEMENT

Our overarching goal is maintaining the U.S. position as the most desirable location in the world for incorporation, headquartering, foreign investment, business operations, and employment opportunities. In short, that means keeping and expanding job opportunities here in the U.S.

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

[The statement follows:]

#### PREPARED STATEMENT OF PAMELA OLSON

Mr. Chairman, Senator Campbell, and distinguished Members of the Subcommittee, I appreciate the opportunity to appear today at this hearing relating to corporate inversion transactions.

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

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

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

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

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

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

The policy response to the recent corporate inversion activity should be broad enough to address the underlying differences in the U.S. tax treatment of U.S.-based

companies and foreign-based companies, without regard to how foreign-based status is achieved. Measures designed simply to halt inversion activity only address these transactions at the surface level and in the short run. Measures that are targeted too narrowly would have the unintended effect of encouraging a shift to other forms of transactions and structures to the detriment of the U.S. economy in the long run.

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

The Treasury Department has made specific proposals relating to legislative and regulatory changes that are needed to address these transactions and the opportunities available through such transactions. Both the Senate Finance Committee and the House Ways and Means Committee have held hearings on this subject and members of both committees have crafted legislation in response to these transactions. We are working closely with these committees to ensure the enactment of appropriate legislation.

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

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

Senator DORGAN. Thank you very much, Ms. Olson.

I think the easy way for people to understand inversions it is that corporations effectively renounce their U.S. citizenship. They say, "We do not want to be a U.S. corporation anymore. We want to be a Bermuda corporation," for example.

You indicate that there is an increase in that, and that is a "cause for concern," you say. What kind of an increase—are you seeing and hearing much more of it—and what kind of cause for concern exists at the Treasury?

Ms. OLSON. The number that we have seen is about the same as the number that you mentioned, about 20 companies that have undertaken inversion transactions. At the same time, there have been some companies that have made decisions to commence operations outside the U.S. Although they are U.S.-based companies, they have made the decision to incorporate the parent company outside the U.S.

We do not know what the revenue cost has been to the Treasury outside of what we have seen reported by the companies themselves as either their actual savings or their projected savings.

Senator DORGAN. Give me your assessment of what you heard on that tape. I assume you are hearing a fair amount of that, and as a tax policy person at Treasury, you are wondering what is going on, what kind of tax advice is given by the major advisors. Here, you see a couple of months after 9/11 a partner at one of the major firms saying that patriotism probably ought to take a back seat to the tax issue for corporations. What do you think of that?

Ms. OLSON. Well, I think it is clear that Members of Congress, the public, and the administration think that this is a serious issue and one that has to be addressed. We clearly do not support the notion of companies deciding to leave the U.S. We think the right approach is to stay here in the U.S. and address whatever the problems are.

Senator DORGAN. And you indicated that we have in our tax system some disadvantages relative to other countries and relative to what corporations face in other countries. Is that a uniformly-held view? Are you aware that the GAO and some others would take issue with that?

Ms. OLSON. I am not aware of GAO taking issue with it, no.

Senator DORGAN. What kinds of disadvantages exist, and how would our tax system pose a disadvantage for U.S. corporations vis-a-vis other countries?

Ms. OLSON. Well, for example, we have a worldwide system of taxation. Some of our trading partners do as well, but some of them tax on a territorial basis rather than on a worldwide basis. The worldwide system is made similar to a territorial system through the grant of a foreign tax credit for taxes paid in other countries, but that is not a perfect match, and we have put a number of restrictions on the availability of foreign tax credits to companies here in the U.S., so that can put them at a disadvantage. That is one example.

Senator DORGAN. The so-called territorial system can also be very complex, can it not?

Ms. OLSON. It can be complex, yes.

Senator DORGAN. And the development of a system like that could accomplish what the corporations are intending to accomplish through inversion; is that correct?

Ms. OLSON. Well, the thing that we found in our meetings—and as part of our study, we did meet with a number of the companies that had either inverted or were planning to invert, and we also met with a number of the advisors—what we found in our meetings with them and in our analysis of the materials that were available was that what really drove the transactions was the opportunity to reduce taxes on income earned here in the U.S. So it was the opportunity to, in the vernacular, “strip” income from the U.S. that really made—it was really the juice in the transactions that drove them. So we think that that is the most significant issue that needs to be addressed in the immediate term.

Senator DORGAN. When you say that this entire issue is “cause for concern,” what is the concern—loss of revenue, or essentially the dismantling of a tax system dealing with the corporate tax?

Ms. OLSON. I think it is both. We obviously depend on the corporate tax for a significant amount of revenues for the government, and that system should be upheld.

Senator DORGAN. How much money are we losing as a result of these corporate inversions?

Ms. OLSON. Other than the information that the companies themselves have provided, we do not have an estimate.

Senator DORGAN. But if it is a cause for concern that we are losing money, I ask. Is it a lot; a little? I mean, do you have any sense of the order of magnitude?

Ms. OLSON. It has the potential to be in the billions of dollars, but no, we have not quantified it. What we can see based on the information we have is that there remain a number of opportunities for companies that might like to consider this. I think the attention that has been focused on the issue by the Congress and by the Treasury Department through its study has essentially brought the traffic in these transactions to a halt.

Senator DORGAN. Tyco indicates that it was to save \$400 million, and that is one corporation. So when you say "billions," if one corporation is boasting about \$400 million in savings, "billions" is an appropriate suggestion; right?

Ms. OLSON. That is the amount that is at stake, yes.

Senator DORGAN. Let me ask you this. You develop tax policy at Treasury, and then, we collect taxes through the Internal Revenue Service. And as I indicated when we started, I do not think anybody really enjoys paying taxes. I think everyone would prefer to have all the benefits that now exist with respect to the way we govern ourselves and roads and defense and schools and so on, without having to pay taxes. But of course, we know that that is not the case; you have to pay the costs of these things that we do together in government.

One of those costs, for example, is the military budget. At 12 o'clock today, I believe, we will have a vote on the conference report on DOD, and I think it is roughly \$360 billion for this year. If we spend \$360 billion for our defense in this country and, for example, Great Britain spends \$34 billion, one-tenth of that, France, \$27 billion, Germany, \$23 billion, and policy analysts take a look at all this and say, "Well, gosh, U.S. corporations are at a disadvantage here with respect to the tax system," is it possible that U.S. corporations, like all other taxpayers, are having to pay part of this burden for our Defense Department that is 10 times larger than Japan, England, and France? Is that part of the reason for the burden? If one accepts—and I will get into that in a moment—but if one accepts the proposition that our tax system bears a heavier burden or requires a heavier burden on corporations than do some of our other trading partners in other countries, might it be that these corporations are paying part of this defense bill that is 10 times the other countries?

Ms. OLSON. That is certainly possible.

Senator DORGAN. And if that is the case—and I expect it is—companies that renounce their citizenship, then, from a policy standpoint, while you take a look at it from the standpoint of tax policy, isn't it the case that they are then saying, "We do not want to contribute to this country's defense expenditures"?

Ms. OLSON. I think what they are doing is taking advantage of what they see as opportunities in the Code to reduce their taxes,

and we ought to look at those opportunities and do what we can to close them down.

Senator DORGAN. What if they all have an opportunity to pay no taxes through whatever windows or cracks or crevices exist in the Tax Code? That would be a real serious problem, wouldn't it?

Ms. OLSON. It would, and we absolutely need to address that.

Senator DORGAN. And when you indicate that a response is necessary to inversions, describe what you think the response ought to be. I get the feeling that you think the response ought to be that we should reduce taxes on the corporations who are wanting to renounce their citizenship.

Ms. OLSON. No. Actually, what the Treasury outlined was a four-prong approach to dealing with inversions. The first is a legislative change to reduce the opportunities for removing income from the U.S. tax base through related-party debt, interest deductions on related-party debt. And that is probably the most significant change that we need to make, because that appears to be the source of the greatest cost savings, tax savings.

Senator DORGAN. Is that the income-stripping technique?

Ms. OLSON. Yes, that is the income-stripping.

The second component of our proposal was the require—

Senator DORGAN. Can we stay on that for just a moment?

Ms. OLSON. Certainly.

Senator DORGAN. If corporations renounce their citizenship and decide "I am now a proud citizen of Bermuda," and engage in "income-stripping," as you call it, describe that for us.

Ms. OLSON. What they would do is encumber the U.S. now subsidiary, what used to be parent corporation, with debt to the Bermuda company or to a company located somewhere else in a low tax jurisdiction, and then, the interest paid on that debt would be deducted from U.S. income, and that would reduce U.S. taxes.

Senator DORGAN. And we need a legislative change to fix that?

Ms. OLSON. We do indeed need a legislative change to fix that. There are specific rules in the Code that cover it, and they are very generous.

Senator DORGAN. All right. And you mentioned three other points.

Ms. OLSON. Yes. The second point is a regulatory point. We are looking at the 482 rules, which are the rules that govern transfer pricing, to make sure that those rules function appropriately. We have broad discretion under Section 482 to write changes in the regulations, so we are reviewing those regulations. We are also looking at the IRS' administrative practices. This is a joint effort between Treasury and the IRS to look at what they are doing in the transfer pricing area, to make sure that those rules are administered as well as possible and produce results that are appropriate so that through the transfer pricing rules, companies are not removing income from the U.S. tax base as well.

Senator DORGAN. But how can you—let me ask about 482 for a moment—how can you, using that approach, convince yourself and the rest of the American taxpayers that you are able to enforce the law here? Are you tackling this through some sort of formulary approach, or is this the arm's-length method by which you are trying to attach the ends of two plates of spaghetti?

Ms. OLSON. I am not sure about attaching the ends of two plates of spaghetti, but we are looking at it using the arm's-length standard bolstered by the "commensurate with income" language that was added.

The IRS has a number of tools that were given it over the course of the last couple of decades to enforce the rules in this area, including contemporaneous documentation, extra penalties for mispricing goods and services that are sold between related parties. So there are lots of ways for the IRS to patrol and police this area to make sure that the rules are adhere to.

Senator DORGAN. But corporations have convinced Treasury now for some while that they should continue trying to do something they cannot do, and I think it has been a spectacular failure. I think many in Treasury admit that enforcement of transfer pricing rules has been a failure can you really enforce rules so that you do not have transfer pricing abuses?

There is a wonderful study that a couple of people have done a lot of work on called the Pack-Sadanowicz study down in Florida that gives you a pretty interesting road map of pricing transfers in which tractors are sold for \$7, toothbrushes for \$15, pianos for \$50—and they are running the tax people around the track like that little rabbit does at dog tracks. And you have never caught them and never will using this 18th century method.

Ms. OLSON. I think it is actually a 20th and 21st century method. Treasury did look at this same issue and came up with a fairly—

Senator DORGAN. Well, it is 20th century. I will admit it is a century back.

Ms. OLSON. Treasury looked at the same issue and concluded that the revenue lost through transfer pricing in 1999 was about \$2.8 billion. So they came up with some fairly different conclusions about what was at stake. But what we are trying to do is make sure that—what can happen in an inversion transaction is not just a simple mispricing of something, which is something that the IRS ought to be able to catch. A movement of property outside of the U.S. borders—intangibles, for example, are something that can be very easily moved—and then, if royalties are charged to the U.S. company for use of the intangibles, you can see how you could strip income out of the United States. Those are hie kinds of things that we are particularly focusing on.

Senator DORGAN. The reason I am asking these questions is because inversions, or the renouncing of corporate citizenship, enables schemes such as income-stripping and transfer pricing to just run circles around the tax administrators or the tax collectors, and therefore, substantially decrease their tax burden in this country, which is what the boards of directors apparently wanted when they decided "We no longer want to be American corporations."

And you are saying that although there are some problems here, and there is some cause for concern, we have got a handle on transfer pricing, and we need some changes in some areas to try to deal with income-stripping. Is that what I am hearing?

Ms. OLSON. Yes, that is right. Now, as I said, we are studying this issue, and if we do conclude that there are additional statutory changes that would be beneficial in this area, we will be back to ask Congress for them.

Senator DORGAN. I believe you indicated that you have recommended to the Finance Committee some things that I have seen in terms of policy changes. What kind of time do we have to try to deal with some of these issues? I think a number of the inversions are on hold. Some corporations have been embarrassed to death and have decided that their original urge to renounce their citizenship really needs to be rethought and have announced that they are now not going to do it.

But I assume—and you probably know better than I—that there are people out there, like that partner from the accounting firm who, even today, are having a conference call with some company saying, “You know, patriotism be damned. Here is a way for you to save on taxes and renounce your U.S. citizenship”—or do you think that that is not going on anymore?

Ms. OLSON. The information I have, which is admittedly only anecdotal, is that, no, those kinds of marketing activities have essentially been put on ice. I think that companies recognize that there is so much PR cost to even considering a transaction that it has put a real crimp in any serious thinking about it.

Senator DORGAN. So perhaps public embarrassment rather than a change in the law is having an impact here?

Ms. OLSON. I think the attention that has been focused on it has definitely had an impact, but I still think we need to change the law.

Senator DORGAN. Let me ask about this issue, “IRS Seeks Quick Settlements in Pending Tax Shelter Probes,” because it relates to part of the reason I wanted to have this hearing. How much money do you need to effectively enforce the law so the folks who are living down on the corner and are working in the wage-earner jobs and have to pay a certain tax and do not have flexibility are not sitting there, wondering whether others who have a lot of flexibility are getting by with paying nothing, doing abusive and abusive tax shelters, and being able to settle later for a penny or 50 cents on the dollar?

How much do you need in resources at the IRS in order to combat these issues and give people a sense of fairness? Tell me about this—“IRS Seeks Quick Settlements in Pending Tax Shelter Probes.” It says: “IRS officials said the agency has proposed settlement offers of 80 percent of the tax owed by major corporations that use”—it talks about a series of schemes here, but what does this mean?

Ms. OLSON. First of all, I think that that article is based on some misinformation, and the way it is written up suggests something that is not the case.

Senator DORGAN. Okay.

Ms. OLSON. It leads one to believe that the IRS is conceding 80 percent. In fact, what the IRS had on the table for some time in that particular issue was an offer for a concession by the Government of 20 percent, and what was going on was that the Government was getting ready to withdraw that offer to settle on the basis of a 20 percent concession by the Government, 80 percent concession by the taxpayer.

So the reporter just did not have complete information when he wrote that article. Since that article was written, the IRS has

issued three settlement initiatives, and one of them is a withdrawal of the settlement initiative of the one that is discussed in there related to corporate-owned life insurance.

Senator DORGAN. But later in the article, it says: "Based on a partial review of the recent amnesty disclosures which involved other types of shelters, IRS officials estimated that in May, 600 or so taxpayers had taken at least \$16 billion in improper deductions." That means they could have avoided roughly \$5 billion in tax. They are talking there about the broader range of tax shelters, some very aggressive, perhaps some abusive. And the implication of the article—and I do not know whether it is accurate—but the implication of the article is that there is an interest, an aggressiveness on the part of the Service and also Treasury to settle these and move them out of the way. Is that not the case?

Ms. OLSON. We clearly need to move things through the system more quickly than we are moving them through. We are still dealing with—a lot of those issue go back for a decade and more. So we clearly need to find some ways to move them through the system more quickly than they are currently moving.

The settlement initiatives that the IRS put out a couple of weeks ago do reflect the fact that there are differences among these transactions. Some of them have almost no merit, some of them actually have some credible arguments behind them, and reasonable people can differ about what the results might be, and the settlement offers that the IRS is entertaining reflect that. But there is a lot of work that needs to be done. The settlement initiatives that are out there only cover three of the 20 or so known shelter transactions that have been engaged in. Some of them have been engaged in by hundreds of taxpayers.

When we are dealing with shelters in the corporate context, it is actually easier for us to deal with, because more corporations are examined on a routine basis by the IRS, so it is much more likely that the IRS is going to have an audit team there and already going to be aware of the transaction. But a lot of these transactions have been entered into by individuals, and that makes it a much more difficult thing for the IRS to handle.

Senator DORGAN. In the last several years, there has been a fair amount of public discussion about tax shelters being more sophisticated and more abusive and concern that Treasury and the IRS need more resources, are not staffed or capable of really combatting the aggressiveness of these tax shelters.

Is that still a concern? What are you seeing with respect to aggressive and abuse tax shelters?

Ms. OLSON. We are actually cautiously optimistic that we have turned the corner on the marketing of a lot of the transactions. We think that advisors are being more cautious; we think that taxpayers are being more cautious. Again, this is anecdotal information in large part, but taxpayers at least say that they are having far fewer promoters knocking on their doors, trying to sell them these kinds of transactions.

So we think that a combination of the IRS getting more aggressive in enforcing in this area and beginning audits of the folks promoting tax shelter promotions is beginning to have an impact and that we will be able to turn the corner on this. There is still a lot

of work to be done, because there are thousands of taxpayers who entered into these kinds of transactions during the nineties, and we have still got to clean all of that up.

Senator DORGAN. But when you saw the video today, and you say that you think things are getting better, does it concern you—you are a tax policy person, an Assistant Secretary of the Treasury—does it concern you when you hear people at the top of some very good companies say, “The improvement on earnings is powerful enough to say that maybe patriotism should take a back seat”? Does that anger you?

Ms. OLSON. It certainly concerns me, and I see it as my obligation to make recommendations that will end those kinds of practices.

Senator DORGAN. Well, it angers me, and I think to myself what goes on every day in these kinds of discussions, conference calls, meetings, and the internet, by which some pretty high-profile advisors tell corporations, “Here is a way to reduce your tax obligation, and it is your first responsibility; go find the line, if you will, or find the edge, and renounce your citizenship if necessary. Everything else takes a back seat.” That worries me, and just in terms of what else they are recommending to clients. And I suspect that that is the root of these abusive shelters.

When I read about some of the shelters that have been proposed over the last several years, it reminds me of the hearings that we have held about Enron. You open it up, and it just stinks. It smells; it is rotten inside. The board of directors of Enron did a study and said that what they found inside the corporation itself was “appalling.”

So I worry about these shelters, and I want you to have the resources necessary, and I want the Internal Revenue Service to have the resources necessary to make sure that the bigger economic interests are paying their fair share of taxes. That is the purpose of all of this, and I know that you share the same goal.

Ms. OLSON. Absolutely.

Senator DORGAN. Ms. Olson, we will work with Treasury and with the Internal Revenue Service to make sure that we determine what kinds of resources are necessary for your combatting tax shelters, particularly abusive and aggressive tax shelters, and I hope you will continue your work, especially on the issue of inversions. I think that there are profound policy questions here, and even more than that, questions of business ethics that concern me a great deal. So I hope that Treasury and the Congress can work together to address some of these issues.

I appreciate very much your being here, and we will include your entire statement as a part of the permanent record.

Thank you very much.

Ms. OLSON. Thank you, Mr. Chairman.

Senator DORGAN. Next, we have a panel that will be comprised of Richard Blumenthal, the Attorney General for the State of Connecticut; Reuven Avi-Yonah, professor of law and Director of the International Tax LLM Program at the University of Michigan Law School in Ann Arbor, MI; Martin Regalia, Vice President for Economic Policy and Chief Economist at the U.S. Chamber of Commerce; Robert McIntyre, Director, Citizens for Tax Justice; and

William Gale, Senior Fellow and Deputy Director of Economic Studies at The Brookings Institution.

Mr. Blumenthal, I understand that you are here today as the current Attorney General of Connecticut.

Mr. BLUMENTHAL. I am.

Senator DORGAN. Welcome. Your entire statement will be made a part of the permanent record as well, and you may summarize. Please proceed.

**STATEMENT OF HON. RICHARD BLUMENTHAL, ATTORNEY GENERAL,  
STATE OF CONNECTICUT, HARTFORD, CT**

Mr. BLUMENTHAL. Thank you very much, Senator, and like all the members of this panel, I am very grateful for this opportunity to talk to you about an issue that is very much on the minds of Connecticut's citizens and, I suspect, people around the country for exactly the reasons that you have articulated so powerfully at the outset of this hearing and that are supported by the kind of video that we saw before. I think many Americans, certainly I and many of my constituents, share the anger and outrage that any corporation should put patriotism in the back seat to profits.

And I do not want to repeat here all of the public policy and moral implications of that stand—the loss of revenue to the United States, the absence of payment of fair share for services, and other benefits of protection to those corporations, and other public policy reasons. My reason for being here is really twofold—to emphasize the urgency and immediacy of this issue in light of Stanley Works' decision to do the right thing. For whatever reason, after very substantial criticism from myself and other public officials, and action by me in court, Stanley Works reversed its decision to reincorporate. Certainly, it did so under very heavy legal pressure as well as pressure from public opinion, but it now stands at a very distinct and perhaps disabling disadvantage in relation to two of its major competitors, Cooper and Ingersoll-Rand, and it fails to have the benefit of a level playing field in relation to those competitors simply because they reincorporated before the spotlight of publicity shone on them, and now they have a very strong competitive advantage over Stanley Works simply because that corporation, a Connecticut corporation, did the right thing, and that has implications not only for the employees and shareholders of Stanley Works, but for all of corporate America.

I urge that the Senate act as soon as possible to close this loophole, shut it down, adopt Senate bill 2119 or its equivalent, House bill 3884, that essentially adopt a common sense, reasonable, sensible test for closing this loophole. And obviously, the urgency and immediacy of this move relate to the rewards that now go to corporations that have already moved to Bermuda, and they are being in effect favored because they did the wrong thing.

I want to urge also, Senator, an aspect of this reincorporation that is not much emphasized in these discussions, and that is its impact on shareholder rights. There are very severe and lasting ways that shareholders are deprived of substantial protection when a corporation moves offshore in this way. Their rights to bring derivative actions, to enforce judgments, to protect against insider trading or self-dealing, to simply know what the law of Bermuda

is, because there is no official reporting system for Bermuda law, all are very, very substantially undermined, if not eviscerated, by these kinds of moves.

As a law enforcement official, one responsible for fighting for the rights of my constituents and enforcing laws that protect them against misleading and deceptive statements, these moves to Bermuda are profoundly troubling. They disadvantage State law enforcement in protecting shareholder rights, as well as the investors themselves in protecting their rights.

So there are corporate accountability issues here at a time when, as you very correctly observed, Enron has brought to the fore the enhanced need to protect shareholders against malfeasance, self-dealing, and other kinds of abuses that the Enron debacle so powerfully disclosed.

#### PREPARED STATEMENT

For all of those reasons, I urge that this committee and the United States Congress move as quickly—and I emphasize “quickly”—as possible to close this loophole. I do not minimize the complexity and the far-reaching effects of changes in the Tax Code, but I would be very reluctant to see prolonged and unnecessary study that does continuing damage to the fairness and efficacy of our Tax Code.

Thank you very much, Senator.

Senator DORGAN. Thank you very much, Attorney General Blumenthal.

[The statement follows:]

#### PREPARED STATEMENT OF RICHARD BLUMENTHAL

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.

Closing this egregious loophole is now more urgent and important than ever: corporations that do the right thing and resist the loophole’s lure—Stanley Works is Exhibit A—should not be doubly penalized. A level playing field is a moral imperative as well as a public policy obligation.

Hence, I urge your support for legislation such as S. 2119, Reversing the Expatriation of Profits Offshore Act, and HR 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.

I commend the Senate’s recent action to prohibit the Pentagon from awarding contracts to corporate inversion companies. This first step is excellent, but only a first step. Congress must approve legislation that will permanently level the playing field between corporations that remain American corporations and those that choose to undergo a corporate inversion.

Earlier this year, Stanley Works, a Connecticut based corporation, announced it was going to reincorporate in Bermuda. I will describe in greater detail later in my testimony this reincorporation attempt by Stanley Works, but the ultimate result was that the company reversed its decision. This reversal was the right decision. Now, Stanley Works must compete in the marketplace with two competitors who have taken advantage of the tax loopholes in corporate inversions: Cooper Industries and Ingersoll-Rand Company. To fail to adopt legislation such as S. 2119 or HR 3884, rewards companies that avoid their fair share of taxes and undermine their shareholders’ incorporation rights. Congress must act now.

Whatever my past sharp disagreements or criticism—directed at Stanley Works management—its employees and shareholders are severely at risk because competitors beat the path to Bermuda before the public spotlight revealed the inequity and unfairness of reincorporation.

Henry Paulson, chairman of Goldman, Sachs, has 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.

This same company then sought 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 estimated that its stock would rise by 11.5 percent after re-incorporation in Bermuda. That increase would have produced a \$17.5 million gain in CEO John Trani’s stock option value while shareholders would have faced \$150 million in capital gains taxes. Smaller shareholders, of course, would not have huge stock option gains that they could have used 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 re-incorporation as a merely technical move with only corporate tax implications. The company’s headquarters remains in the United States so shareholders may think that American laws will still apply. Management has hardly rushed to clarify the weakening, even evisceration 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. Ber-

muda 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.

Second, although corporations proposing to reincorporate to Bermuda, such as Stanley, often tell shareholders that there is no material difference in the law. There are several important aspects of Bermuda law that greatly diminish shareholder rights—and divining Bermuda law is no easy task.

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

Similarly, Bermuda law permits shareholder derivative lawsuits in only very limited circumstances. Derivative lawsuits are an essential protection for shareholders. In the United States, shareholders may bring actions on behalf of the corporation against officers and directors seeking to harm the corporation. The availability of derivative lawsuits is a profoundly important tool to protect shareholders from 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 was completed. 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. The revised statement contained—for the first time—a clear concession by Stanley Works that a Bermuda reincorporation would 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.”

While the SEC was reviewing this matter, the Stanley Works Board of Directors, under great public and shareholder pressure, reversed its decision to reincorporate. Stanley Works is now at a disadvantage to other American companies—direct competitors—that chose to reincorporate in Bermuda and reduce their shareholders' rights.

Shareholders should aggressively challenge the adequacy of similar proxy statements by other corporations proposing a reincorporation in Bermuda—compelling

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 reap 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 unequivocally is the need for closing this destructive loophole, as S. 2119 and HR 3884 would do. These measures should be permanent so as to assure credibility and certainty. The status quo is unacceptable.

Senator DORGAN. Next, we will go to Professor Avi-Yonah, who is from the University of Michigan and is an expert in tax policy. We appreciate your being here.

Please proceed.

**STATEMENT OF REUVEN S. AVI-YONAH, PROFESSOR OF LAW AND DIRECTOR, INTERNATIONAL TAX LLM PROGRAM, UNIVERSITY OF MICHIGAN LAW SCHOOL, ANN ARBOR, MI**

Mr. AVI-YONAH. Thank you very much, Mr. Chairman. Thank you for inviting me to testify at this hearing on corporate inversion.

I want to use my remarks to address a couple of the issues raised by Secretary Olson's testimony today. One is the supposed competitive disadvantage of American corporations and whether that is relevant to the inversion risk.

The first thing I should say, as was pointed out in your questions, is that there really is no evidence that there is such a competitive disadvantage. The so-called territorial systems that we are competing against are not really territorial in the sense that they, just like us, tax passive income that multinationals earn overseas; they allow deferral for taxation of active income, and we do exactly the same thing. So there is no evidence that this is in fact a disadvantage or that takeovers are somehow motivated by it. We had large takeovers of American corporations by British corporations who were subject to a worldwide system, had other takeovers by German corporations who were subject to the so-called territorial system, and there is no evidence that, either way, this was motivated by primarily tax considerations.

Now, what is clear is that there is a competitive disadvantage, as Mr. Blumenthal noted, between inverted companies and Amer-

ican companies that stay in the United States and are in the same business. The reason for that is that inverted companies can avoid taxation on all of their overseas income as well as earning-strip out of the United States. So if you have a purely domestic American company that has purely domestic American income, they pay tax on that. If you have an inverted company, they do not pay tax on that American income because they can earn it straight by interest or royalties or transfer pricing. In addition, they have the huge advantage of being able to earn passive income overseas as much as they want without being subject to any of the American tax rules that are against it.

Basically, I think that there are some companies that are too large to invert because of reputation concerns, because of corporate governance concerns, maybe because there is too much of a tax on the shelter base. I do not think that General Motors, for example, will invert any time soon. There are companies that are too small to invert because the transaction costs of inverting are significant; you have to pay Ernst and Young and all of these people to do it for you. And then, there are the middle companies, and among these middle companies, some companies as a matter of patriotism or for other reasons will not invert, and some will, and it is there that we need to level the corporate playing field.

Secretary Olson also mentioned the possibility that in addition to inversions, there would be companies that would set up shop initially in Bermuda and places like that. In my mind, that is exactly the same as an inversion. I mean, there is no significant distinction here. We are talking about companies that have their management here, their operations here, their shareholders here, and so on. They set up shop, nominally. They have a paper company in Bermuda. There is no difference whether that is a new company or whether it used to be an American company and inverts, except for the fact that, of course, if it is a new company, there is no capital gains tax on the shareholders that would deter the inversion, and I think we should address those in exactly the same way as we do the others.

How are we going to address them? Well, it seems to me that the two bills that have been mentioned are a good start. They close the loophole immediately in the sense that they really fine inverting companies and new start-ups as long as the shareholder base is sufficiently American.

My own view is that the focus on the shareholder base may be a little bit misguided in the sense that management cares more about what happens inside the company than whether the shareholders are American or foreigners. So I would focus more on whether the company is managed in the United States and whether its operations are in the United States, rather than the shareholder base. But that is kind of a technical point. I think that for the time being, you should certainly go ahead and enact those two bills that are the strongest bills that we have against inversions, where everybody agrees that basically, inversions are essentially a way of both stripping earnings out of the United States, avoiding tax on American source income that other companies have to pay tax on, and in addition, they are a way of avoiding the series of rules that we have developed over time to make sure that Amer-

ican multinationals do not avoid taxation on passive income that can be put anywhere in the world and earn income tax-free without being subject to any foreign tax.

PREPARED STATEMENT

Thank you very much. I appreciate being invited to come here. Senator DORGAN. Thank you very much, Professor. [The statement follows:]

PREPARED STATEMENT OF REUVEN S. AVI-YONAH<sup>1</sup>

Thank you very much for inviting me to participate in this hearing. In this testimony, I would like to discuss “inversion” transactions, in which a publicly traded U.S. corporation becomes a subsidiary of a newly established tax haven parent corporation. In the last 3 years, an increasing number of these transactions have been taking place, undeterred by the shareholder-level tax imposed by the IRS on them in 1994. My testimony first discusses the reasons for the increasing popularity of the transactions and the tax goals they aim at achieving (primarily avoiding Subpart F and U.S. earnings stripping). My testimony then discusses the tax policy implications of these transactions. In the short run, I suggest that the proper response is a redefinition of the concept of corporate residency by adoption of a modified “managed and controlled” test for all corporations. In the longer run, inversions may lead to abandonment of residence based corporate taxation in favor of source-based taxation. If that is the case, it is imperative to preserve the corporate tax base by developing better methods of determining the source of income (e.g., formulary apportionment), and by putting some limits on tax competition.

INTRODUCTION: A BRIEF HISTORY OF INVERSIONS

“Inversion” transactions are defined in the recent Treasury Report as “a transaction through which the corporate structure of a U.S.-based multinational group is altered so that a new foreign corporation, typically located in a low-or no-tax country, replaces the existing U.S. parent corporation as the parent of the corporate group.”<sup>2</sup>

The first known inversion from the U.S. was McDermott International’s relocation to Panama in 1983, which prompted the enactment of Code section 1248(i).<sup>3</sup> The next inversion, over 10 years later, was Helen of Troy (1994), which prompted the IRS to issue Notice 94-46, making inversions taxable to public shareholders.<sup>4</sup> Nevertheless, inversions continued, with one transaction in each of 1996, 1997 and 1998.<sup>5</sup> But as the Treasury Report notes, “there has been a marked increase recently in the frequency, size, and profile of the transactions.”<sup>6</sup> There were no less than six inversions in 1999,<sup>7</sup> followed by two more in 2000<sup>8</sup> and four in 2001.<sup>9</sup> There was a temporary lull after September 11, but there are currently at least three new inversions that have been announced in 2002.<sup>10</sup> In the post-September 11 climate, these transactions have raised public concerns, and there are currently seven bills pending in Congress to stop inversions.

<sup>1</sup>Irwin I. Cohn Professor of Law and Director, International Tax LLM Program, the University of Michigan.

<sup>2</sup>U.S. Treasury, Office of Tax Policy, Corporate Inversion Transactions: Tax Policy Implications, 2002 TNT 98-49 (May 21, 2002) (the “Treasury Report”). For an excellent overview of inversions see also New York State Association Tax Section, Report on Outbound Inversion Transactions (May 24, 2002) (the “NYSBA Report”).

<sup>3</sup>All “Code” references are to the Internal Revenue Code of 1986, as amended.

<sup>4</sup>1994-1 CB 356 (April 18, 1994), now reflected in the regulations under Code section 367.

<sup>5</sup>Triton Energy, Tyco, Playstar. For a description of all these transactions see the NYSBA Report.

<sup>6</sup>Treasury Report, 2.

<sup>7</sup>Fruit of the Loom, Gold Reserve, White Mountain Insurance, PXRE, Amerist Insurance, Xoma.

<sup>8</sup>Everest Re, Transocean.

<sup>9</sup>Cooper Industries, Foster Wheeler, Ingersoll Rand, Global Marine. In addition, Accenture, formerly Andersen Consulting, was established as a new Bermuda holding company for partnership assets.

<sup>10</sup>Stanley Works, Nabors, Weatherford International. In addition, Seagate Technology has been formed as a new Cayman parent for U.S. operations, and PwC Consulting has been formed in Bermuda to take over Pricewaterhouse Coopers consulting operations. Stanley and PWCC have since been abandoned under pressure.

## WHY INVERSIONS NOW?

The significant increase in the frequency of inversion transactions in the last 3 years raises the question of what accounts for this trend.

As the Treasury Report notes, inversion transactions are primarily tax driven: “U.S.-based companies and their shareholders are making the decision to reincorporate outside the U.S. largely because of the tax savings available.”<sup>11</sup> Moreover, these transactions “involve little or no operational change” in the company’s business.<sup>12</sup>

The tax advantages from inversion transactions are two-fold. First, since the new parent of the group is not a “U.S. shareholder”, the group can establish new foreign operations without being subject to Subpart F. In some cases, the potential tax saving is significant enough so that even foreign operations currently held by the U.S. parent are transferred to the new foreign parent, even though these transfers are generally taxable at the corporate level.<sup>13</sup>

Second, and no less significantly, the existence of a new foreign parent may enable the U.S. group to reduce taxes on U.S. source income by paying the parent deductible interest and/or royalties through a treaty jurisdiction such as Barbados or Luxembourg, and by manipulating transfer pricing.<sup>14</sup> In addition, U.S. risks formerly insured in the U.S. may be reinsured overseas, with deductible premiums and no U.S.-source income to the reinsurer.<sup>15</sup> Existing provisions such as Code sections 163(j) and 482 appear to be inadequate to prevent this erosion of U.S. corporate tax on U.S. source income.

The combination of these post-inversion tax advantages can lead to significant reductions in effective overall tax rates for the group. For example, Cooper Industries and Stanley Works have stated that they expect their inversions to reduce their annual effective tax rate by 12–17 percent (Cooper) and 7–9 percent (Stanley).<sup>16</sup> Such reductions can translate into significant dollar amounts—Tyco International, for example, has been reported to save \$400 million in 2001 by reason of its inversion,<sup>17</sup> and Ingersoll Rand has stated that it expects to increase net earnings after its inversion by \$40 million per year.<sup>18</sup> Thus, the U.S. fisc’s loss of revenues from inversions is likely to be significant, which explains why even the current Treasury (whose head does not believe in the corporate tax) is concerned.

If inversions are so tax effective, why have they not taken off until 1999? The principal reason appears to be not tax-related, but rather involves the increased market acceptance of the transaction. Until Tyco inverted successfully in 1997, investment bankers generally assumed that a U.S. company would pay an unacceptable price in its share value if it reincorporated in Bermuda. This was the case even though U.S. securities law protections continue to apply to any stock traded on a U.S. exchange, and the companies are not delisted from, e.g., the S&P 500. The presumed drop in share value related to corporate governance concerns and to reputational issues. But after Tyco, it became clear that share prices do not drop as a result of reincorporation—on the contrary, recently inverting companies have seen their share prices rise in reaction to the expected tax savings. Thus, despite the recent troubles of Tyco and Global Crossing, there seems to be no market downside to inversions.

In addition, as the Treasury Report notes, after the market declines in 2000–2001, when most taxable shareholders do not have big unrealized gains in their shares and many corporations have net operating losses, neither a shareholder-level tax nor even a corporate-level tax is likely to deter inversion transactions.<sup>19</sup> The present value of the expected recurrent tax savings overwhelms a one-time toll charge.

<sup>11</sup>Treasury Report, 4.

<sup>12</sup>Treasury Report, 3.

<sup>13</sup>Treasury Report, 19–21.

<sup>14</sup>Treasury Report, 38–39; see also NYSBA Report. Limitations on benefits rules, such as those in the Barbados and Luxembourg treaties, do not typically apply to publicly traded entities. This exception should be restricted to public trading in the residence country (i.e., Barbados or Luxembourg), but the current treaties do not restrict it.

<sup>15</sup>Treasury Report, 40.

<sup>16</sup>Cooper Industries Proxy Statement (July 27, 2001); Stanley Works Proxy Statement (April 2, 2002).

<sup>17</sup>David Cay Johnston, U.S. Corporations are Using Bermuda to Slash Tax Bills, NY Times, February 18, 2002.

<sup>18</sup>Ingersoll-Rand Proxy Statement (April 5, 2002).

<sup>19</sup>Treasury Report, 51–52. In addition, many shareholders are tax exempt. The prevalence of inversions involving a corporate level tax shows that taxing inversions at the corporate level is not a sufficient deterrent.

## THE COMPETITIVENESS EXCUSE

The Treasury Report highlights another purported reason for inversions—the supposed competitiveness concerns of U.S. multinationals. According to the Treasury, “[t]he U.S. international tax rules can operate to impose a burden on U.S. based companies with foreign operations that is disproportionate to the tax burden imposed by our trading partners on the foreign operations of their companies. . . . Both the recent inversion activity and the increase in foreign acquisitions of U.S. multinationals are evidence that the competitive disadvantage caused by our international tax rules is a serious issue with significant consequences for U.S. businesses and the U.S. economy.”<sup>20</sup> Thus, the Treasury recruits inversions as an argument in its quest for a territorial tax regime for the U.S., labeling them “self help territoriality,”<sup>21</sup> and calling for a consideration of “fundamental reform of the U.S. international tax rules, including the merits of the exemption-based tax systems of some of our major trading partners.”<sup>22</sup>

There are well-known counterarguments to this line of thinking, including: Is there a direct relationship between the competitiveness of U.S. multinationals and the competitiveness of the U.S. economy? What is a “U.S. multinational”, anyway (inversions seem to raise some questions on this point)? Is there any evidence for the supposed competitive disadvantage, or for the alleged harshness of our rules compared to those of our trading partners?<sup>23</sup> If a subsidy to U.S. multinationals is needed, why limit it to foreign source income, since a subsidy directed at their domestic operations would be just as effective? And finally, what about the competitive disadvantage to U.S. companies with purely U.S. operations, if a subsidy is given only to U.S. multinationals by exempting their foreign source income?<sup>24</sup>

But it is not my intention here to rehash these old arguments. Instead, I would like to emphasize that in the inversion context the competitiveness issue is the reddest of red herrings—a completely irrelevant line of argument. To demonstrate this, try the following thought experiment: Suppose nothing was done to deter inversions, but the U.S. adopted an exemption for foreign source active income (e.g., by exempting dividends from such income from U.S. tax, as some have suggested).<sup>25</sup> Would inversions stop?

The answer is no, for three reasons. First, as the Treasury Report notes, a major reason for inversions is to reduce U.S. tax on U.S. source income, which would not be affected by the adoption of territoriality. Second, inversions enable U.S. multinationals to avoid all of Subpart F, including the taxation of passive income. None of the current proposals for territoriality go that far, since this would be an open invitation to U.S. multinationals to move their investment earnings overseas.<sup>26</sup>

But the major reason why inversions are unrelated to competitiveness is the following: As even the Treasury Report acknowledges in a footnote,<sup>27</sup> all of our major trading partners have regimes in place that tax passive income of their multinationals. Some of these regimes, in fact, are tougher than Subpart F—the French, for example, only require 10 percent ownership of a foreign corporation to apply CFC rules to it, and many countries include some low-tax active foreign income in their regime.<sup>28</sup> Permitting inversions gives inverting U.S. multinationals a significant competitive advantage over foreign multinationals and non-inverting U.S. multinationals that have to pay tax currently on their foreign source passive income, at the expense of the U.S. fisc.

Thus, the whole competitiveness issue is misleading. It is not the reason for inversions, and inversions would continue even if the U.S. adopted territoriality. The competitiveness debate will doubtless go on (as it has for the last 40 years), but it

<sup>20</sup>Treasury Report, 7, 96.

<sup>21</sup>Treasury Report, 97.

<sup>22</sup>Treasury Report, 98.

<sup>23</sup>In fact, the Europeans have recently been complaining about the harshness of their CFC rules—see discussion below.

<sup>24</sup>For these arguments see, e.g., Reuven S. Avi-Yonah, Tax Competition and Multinational Competitiveness: The New Balance of Subpart F, 18 Tax Notes Int'l 1575 (April 19, 1999).

<sup>25</sup>See, e.g., Harry Grubert and John Mutti, Taxing International Business Income: Dividend Exemption versus the Current System. Washington, DC: American Enterprise Institute, 2001.

<sup>26</sup>Even Rep. Thomas's bill continues to apply Subpart F to passive income.

<sup>27</sup>Treasury Report, fn. 50.

<sup>28</sup>See Brian J. Arnold and Patrick Dibout, General Report, in Limits on the Use of Low Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, Cahiers de droit fiscal international LXXXVIb (San Francisco, 2001); see also Federation des Experts Comptables Europeens, FEE Position Paper of Controlled Foreign Company Legislations in the EU (2002) (complaining of harshness of European CFC rules). Even the base company rule has its analogues in the tax law of many of our trading partners. See Arnold and Dibout, *supra*.

should not affect what we do about inversions. No country should allow its tax base to be eroded by transactions that have no business content other than saving taxes.

A SHORT-TERM SOLUTION: REDEFINING CORPORATE RESIDENCE

What makes a corporation American? This question is at the heart of the inversion issue. It stems from a long-lasting debate about whether multinationals have a national identity.

In the 1950s the distinction between a U.S. and a foreign multinational was clear. A U.S. multinational raised most of its capital (both debt and equity) in the U.S., was managed from the U.S., and had most of its operations and biggest market in the U.S. Although there were some operations and sales overseas, the bulk of the income came from the U.S.—and vice versa for a foreign multinational. In that context it was indeed plausible to state that “what is good for GM is good for America.”

Today, the distinction is far more cloudy. As Robert Reich has pointed out, no distinction can be made between U.S. and foreign multinationals on the basis of where their capital is raised (both trade shares and borrow at home and overseas), where their operations are (all over the world), and where their customers are (the most profitable markets for U.S. multinationals are frequently overseas).<sup>29</sup>

Reich would thus argue that there is no meaningful distinction any more between U.S. and foreign multinationals. In the tax area, this would suggest abandoning residence-based taxation in favor of a purely source-based (i.e., territorial) regime.<sup>30</sup>

However, most Americans still believe that there is a meaningful distinction between, say, GM and Toyota, even though there is little significant difference in their capital structure, operations or markets. The difference, as Laura d’Andrea Tyson pointed out in response to Reich, is that GM is run from Detroit, Toyota from Tokyo.<sup>31</sup> There even is a difference between GM and DaimlerChrysler, because the latter (as Chrysler management belatedly found out) is run from Stuttgart.

This would suggest that the immediate answer to inversions is to change the way corporate residence is defined for tax purposes. Instead of defining a U.S. corporation as one incorporated in the U.S. and a foreign corporation as one incorporated overseas, we should adopt the definition used by many of our trading partners—where the corporation is “managed and controlled” from.<sup>32</sup>

The “managed and controlled” test has a long history, some of which is not very distinguished. In particular, many former U.K. colonies have interpreted it in a mechanical way to focus on where the Board meets, which makes the test not less manipulable than the U.S. test. Boards do not mind meeting twice a year in Bermuda. Even the U.K., from which “managed and controlled” originated, has recently supplemented it with a place of incorporation test.

And yet, if properly defined and interpreted, the managed and controlled test offers the most promising current definition of corporate residency—the one most congruent with business realities and therefore least open to abuse.<sup>33</sup> That is because even in this age of teleconferencing, there is a distinct business advantage in locating the principal officers of a corporation in one location where they can meet and run the corporation on a daily basis. Thus, if one defines “managed and controlled” as the place where the principal officers of a corporation (the CEO and those reporting to her) manage the corporation’s business on a daily basis, one gets close to what actually distinguishes GM from Toyota.

The major advantage of this test is that it is difficult to avoid without significant business cost. The principal officers will not relocate to Bermuda for tax reasons, because the personal and business costs of actually living in a tax haven are too high. And it is still very hard to run a corporation at long distance.<sup>34</sup>

<sup>29</sup>Robert Reich, *Who is Us?* 68 *Harv. Bus. Rev.* 53 (1990); Robert Reich, *The Work of Nations* (1993). A similar point is made from a different political perspective in Edward M. Graham and Paul R. Krugman, *Foreign Direct Investment in the United States* (3rd ed. 1995), ch. 3.

<sup>30</sup>See Gary Hufbauer, *Blueprint for International Tax Reform* (1991); Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 *Texas L Rev* 1301 (1996).

<sup>31</sup>Laura d’Andrea Tyson, *They Are Not Us*, *The American Prospect* (Winter 1991).

<sup>32</sup>A corporation incorporated in the U.S. should be presumed to be managed and controlled from the U.S.

<sup>33</sup>Note that there have been few inversions from Europe—not because of territoriality (Europeans tax passive income too), but because the managed and controlled test makes it harder to invert.

<sup>34</sup>In addition, changes in the location of management and control should be a taxable event at the corporate level. That would deter tax-motivated expatriations under the new test.

Several objections can be raised against this proposal.<sup>35</sup> First, the test represents a significant departure from a long-held U.S. tradition.<sup>36</sup> But it is congruent with the test used by many of our trading partners and in tax treaties, and therefore will readily win international acceptance—an important consideration when changing international tax rules unilaterally. Second, the proposed change will affect more than inversion transactions—for example, it would catch corporations newly incorporated overseas, such as Accenture, PwCC and Seagate. But that is actually an advantage, since it is hard to distinguish as a policy matter between these transactions and “pure” inversions. Accenture, PwCC and Seagate, like Tyco and Stanley Works, continue to be managed from the U.S. Third, the test will not catch foreign takeovers of U.S. multinationals (like Daimler/Chrysler or BP/Amoco). But these transactions are motivated by business reasons and should not be deterred.<sup>37</sup>

Finally, the proposed test is less clear-cut than the current, more formal one, and therefore involves some added measure of uncertainty. But it is clear enough, and far more congruent with business realities (and thus less manipulable) than place of incorporation. U.S. taxpayers have been living with less well-defined terms, such as “effectively connected” and “U.S. trade or business”. They can learn to live with “managed and controlled” as well.

#### A LONG-TERM SOLUTION: A MODIFIED SOURCE-BASED REGIME

In the longer term, however, Reich may be right and residence-based corporate taxation may be doomed. With advances in technology, it may one day be possible to efficiently run a multinational enterprise from multiple locations via an intranet, without the need to meet face to face. In that case, the headquarters-based definition of corporate residency offered above would become obsolete. This is not likely to happen, however, in the next couple of decades, even if a “managed and controlled” test is adopted (and there is therefore a tax incentive to disperse top management).

If residence-based corporate taxation becomes impossible (much to the chagrin of economists, who tend to prefer it), the only way to continue to tax multinationals is on the basis of source.<sup>38</sup> In principle, this would not be a terrible outcome, because the current international tax regime assigns the primary right to tax active business income to the source jurisdiction, for good reasons.<sup>39</sup>

However, a pure source-based regime is problematic, for two reasons. First, it fosters tax competition among source jurisdictions, not just for passive but also for active income, leading to distortions in the location of business activity and erosion of the corporate tax base. Second, the current source rules (and their cousin transfer pricing) are notoriously manipulable and, if left unchanged in a purely source-based world, would lead to massive shifting of income to low-tax jurisdictions.<sup>40</sup>

The first problem can be addressed by limiting tax competition, as the OECD is currently trying to do. However, the ability to do this would itself be compromised by a demise of residence-based taxation. Currently, OECD members are the residence jurisdictions for 85 percent of the world’s multinationals. Therefore, a major focus of the OECD effort has been to expand CFC regimes in its member countries, thus eliminating the incentives of source countries to engage in tax competition. But if residence jurisdiction succumbs, then the OECD can only restrict competition by its members and (perhaps) by pressuring the weaker tax havens. It can do little about tax competition by non-members that are not tax havens, but have preferential regimes to attract foreign investors.

If the OECD cannot be relied on to limit tax competition, what can be done? One possibility is to use the WTO, since some preferential regimes (involving export of goods) are export subsidies under WTO rules. But the WTO subsidies code does not currently cover services, and therefore does not address the tax haven problem and financial services (the current focus of the OECD effort). In addition, as the FSC

<sup>35</sup> See the NYSBA Report, which considers and rejects it for the reasons discussed below.

<sup>36</sup> For example, it may make many CFCs incorporated in tax havens into domestic corporations. That is an advantage, since it indicates they do not have a real business presence overseas and thus should not enjoy deferral.

<sup>37</sup> It was not tax considerations that led to Daimler/Chrysler being a German corporation—it was the German government’s determination to protect Daimler and co-determination.

<sup>38</sup> Note, however, that the U.S. Treasury’s E-commerce White Paper (1996) predicted the demise of source-based taxation because of e-commerce, and recommended re-evaluation of corporate residency.

<sup>39</sup> For these reasons see Avi-Yonah, *Structure*, *supra*.

<sup>40</sup> Subpart F was after all enacted in part as a backstop to Code section 482. Note that the tax expenditure budget’s relatively modest estimate of the potential gain from abolishing deferral (\$8 billion) is not the same as the potential loss from adopting a pure territorial system (much more).

litigation shows, combating export subsidies via the WTO is a long and cumbersome process.

A potential solution to both issues (tax competition and sourcing) involves a general shift to formulary apportionment in a way that restricts the ability of multinationals to shift income to jurisdictions in which they have no substantial economic activity (measured, e.g., by payroll, tangible assets or arm's length sales). But even that would leave "production tax havens" (preferential regimes for real activities) in place, unless some kind of throw-back rule that reassigned low-tax income to other jurisdictions was agreed upon.<sup>41</sup> In any case, the adoption of such an agreed upon formula seems at present unlikely, although the recent EU proposals in this direction are a promising start.<sup>42</sup>

The most plausible long-term solution to the problems of source based taxation involves a coordinated effort by the large market jurisdictions (most of whom are OECD members) to tax multinationals on sales into their markets. The key consideration is that market jurisdictions do not typically engage in tax competition to attract imports. Thus, one could impose a withholding tax on sales to consumers in a given market (such as the EU tax on e-commerce sales to consumers). Such a tax can be modeled on a destination-based VAT, but designed to replicate the corporate income tax base. Moreover, a credit or refund can be given for taxes imposed by other source jurisdictions, thus providing an incentive to them to refrain from tax competition.<sup>43</sup>

#### CONCLUSION

The current international tax regime is based on two principles: The single tax principle and the benefits principle.<sup>44</sup> The single tax principle states that cross-border transactions should be subject to a single level of tax-no more but also no less.<sup>45</sup> The benefits principle sets the tax rate by allocating passive income primarily to the residence jurisdiction and active income primarily to the source jurisdiction.

The inversion issue illustrates the potential tension between the two principles: If active income is taxed purely on a source basis (under the benefits principle), there will be zero taxation if income can be sourced to no-tax jurisdictions (a violation of the single tax principle). Residence-based taxation of corporations was designed by T.S. Adams (the inventor of the foreign tax credit) to prevent zero taxation by having the residence country pick up the tax when there is no source-based taxation. That was the reason Adams rejected territoriality.<sup>46</sup>

If residence-based corporate taxation becomes impossible because technological developments have reduced corporate residence to meaninglessness, some other solution needs to be found to preserve the corporate tax base.<sup>47</sup> A source-based tax on sales into market jurisdictions is the most plausible solution. But I am not convinced that as of 2002, corporate residence has lost its meaning as a business concept, if it is redefined as where the corporation is actually run from. That is the immediate solution to the inversions problem.

Senator DORGAN. Next, we will hear from Mr. Robert McIntyre, Director of Citizens for Tax Justice.

<sup>41</sup> Admittedly, whether production tax havens pose a problem is debatable. For an argument that they are, see Reuven S. Avi-Yonah, *Globalization, Tax Competition and the Fiscal Crisis of the Welfare State*, 113 Harv L Rev 1573 (2000).

<sup>42</sup> See EU Commission, *Company Taxation in the Internal Market* (2002), 501-504 ("Despite complications, in practice [formulary apportionment] works").

<sup>43</sup> For a fuller elaboration of the details of this proposal see Reuven S. Avi-Yonah, *International Taxation of Electronic Commerce*, 52 Tax L Rev 507 (1997); Avi-Yonah, *Globalization*, *supra*.

<sup>44</sup> See Avi-Yonah, *Electronic Commerce*, *supra*.

<sup>45</sup> Interestingly, the Treasury Report acknowledges this when it states that the purpose of tax treaties is to "reduce or eliminate double taxation of income, not eliminate all taxation of income." Treasury Report, at 78. This seems incongruent with the Treasury's support of a territorial tax regime that exempts foreign source income regardless of whether it was taxed overseas. Note that the adoption of a territorial regime for the U.S. without changing the source rules (e.g., the title passage rule) would leave us vulnerable to WTO action, since it would be an export subsidy.

<sup>46</sup> See Michael J. Graetz and Michael O'Hear, *The Original Intent of U.S. International Taxation*, 46 Duke L J 1021 (1997).

<sup>47</sup> Of course, this assumes that the corporate tax should be preserved, an issue I hope to address elsewhere.

**STATEMENT OF ROBERT S. McINTYRE, DIRECTOR, CITIZENS FOR TAX JUSTICE, WASHINGTON, DC**

Mr. McINTYRE. Thank you, Senator. I am glad you are having this hearing today. We should have more like it, because our tax system is really facing a crisis these days.

Offshore tax-sheltering by our big companies is reaching epidemic proportions, with the Bermuda loophole just being one example of what has been going on.

I used to think that almost everybody could agree that we need taxes to run this country and that we cannot run the tax system where people can choose to just opt out if they happen to have enough money and enough power.

But I am not sure that we can all agree on that anymore. There has been a complete moral breakdown at the big accounting firms. We singled out Arthur Andersen, but Arthur Andersen is probably the best of them. You saw Ernst and Young earlier today. You saw PriceWaterhouseCooper's consulting almost move to Bermuda before they got scared away. The whole crowd of them just seem to have lost their moral compass, and they have been advising their corporate clients to do anything and everything to avoid paying for their share of supporting this country, and the main route has been to shift profits offshore—call it tax shelters, call it inversions, call it what you will—it is all the same game they think of it as, and it is not a very pretty game, and that is to generate deductions in the United States, to generate income that magically ends up in Liechtenstein or Luxembourg or the Cayman Islands or the Bahamas or Bermuda or some other place that does not tax them.

It is reprehensible behavior, and the Bermuda example is so clear, so ugly, so awful, just renouncing your U.S. citizenship, that you would not think anybody would defend it. Who could? The Treasury Department did last spring, but Pam Olson came in here today and backed away from that. That is good. Of course, that was Ernst and Young working at the Treasury at the time—before, after, and during, apparently.

But there are some who are defending it—the kneejerk anti-tax groups, the Grover Norquists and the Cato Institutes and the Heritage Foundation. They have written letters to you endorsing inversions. The Chamber of Commerce calls it—what do they call it here—“prudent decisionmaking” to not pay any taxes on U.S. profits. Yikes. So there are some people who are in the sort of American mainstream here, which is sad.

My testimony goes into some of the arguments that are made in favor of the Bermuda loophole and why they do not make any sense. I was glad to see the Treasury Department endorse that, because their report last spring went in the other direction.

The funny argument for why we should keep the Bermuda loophole is coming from Accenture and a few of the other companies, who say that they did not go there for tax reasons. Well, in that case, I guess they will not mind if we close the tax loophole, will they?

But most of the lobbyists admit it. They say, “Yes, we went there to avoid paying taxes, but we did it so we would not have to pay taxes and could compete with our foreign competitors who do not have to pay taxes, either.” Well, that is just false. They are trying

to avoid paying taxes on their American profits and, as Professor Avi-Yonah notes, their passive income, and that is all there is to it.

We do not attempt in any way in this country to tax companies on truly foreign profits. We do attempt to make companies, whether they are foreign-or American-owned, to pay taxes on what they make in the United States. And the companies try to restyle their profits as foreign in order to avoid paying taxes here. That is what the fight is about, but it has gotten a lot worse lately.

So my testimony—and I am almost done here—has a lot of suggestions on what we ought to do in terms of improving our Tax Code in this area. I urge you to be worried about what they are thinking about doing in the House of Representatives, which is to open up many of these loopholes far wider—that is the Chairman of the Ways and Means Committee, Bill Thomas', plan. And I urge, as you talked about earlier today, that if you can get a Treasury Department of good will and an IRS of good will, giving them the resources to work on this will help quite a bit.

Prepared statement

So, yes, this is one of the ugliest issues anybody has seen in a while, but remember—it is just the tip of a large mountain of ugliness that is going on in the American business community and the accounting profession today.

Thank you.

Senator DORGAN. Mr. McIntyre, thank you very much.

[The statement follows:]

#### PREPARED STATEMENT OF ROBERT S. MCINTYRE

Today's hearing involves what is rapidly becoming a crisis in the American tax system: the growing use of offshore tax shelters by many of America's largest and most profitable corporations to avoid paying huge amounts of taxes that ought to be due on their U.S. profits. This issue has received considerable public attention this year due to the publicity over well-known companies reincorporating themselves in Bermuda or other tax haven countries.

I assume we can all agree that taxes are essential to the well-being of our nation and that a tax system that punishes honest, straightforward taxpayers while rewarding sharp dealers and tax scofflaws is unacceptable, unfair, immoral and unsustainable.

Unfortunately, in recent years we have seen a sharp rise in tax dodging by large American corporations. In the just completed fiscal year, corporate tax payments fell to only 1.2 percent of the gross domestic product, their lowest level as a share of the economy since the early 1980s and their second lowest level since the 1930s.<sup>1</sup> Of course, part of this decline is due to the lagging economy and part is due to the huge corporate tax cut enacted last January. But a significant factor in the drop in corporate tax payments is the proliferation of aggressive corporate offshore tax shelters. The Bermuda reincorporation scheme is an easy to understand example of this disturbing trend, but it is only the tip of the tax-shelter iceberg.

#### THE SCOPE OF THE CORPORATE TAX SHELTER PROBLEM

This past March, the IRS reported that companies had responded to a mandate to disclose certain kinds of tax-sheltering activities, mostly offshore, by reporting 322 deals involving \$16.1 billion in tax savings. And these disclosures apparently represent only a small part of the action, since only "about 100 companies filed the

<sup>1</sup>According to the Congressional Budget Office, in fiscal 2002, corporate income tax receipts fell to only \$125 billion excluding an artificial shift of \$23 billion from fiscal 2001 to fiscal 2002 last fall. Congressional Budget Office, *Monthly Budget Review*, Oct. 9, 2002. That represented only 1.2 percent of the GDP, slightly higher than in fiscal 1983 (1.1 percent), but below every fiscal year from a least 1940 on.

required information, compared to the thousands of disclosures that were expected.”<sup>2</sup>

In fact, for corporate America, tax sheltering is all the rage these days. Big accounting firms like PricewaterhouseCoopers, investment banks like Merrill Lynch, and a legion of unscrupulous tax advisers are aggressively marketing their services to otherwise “respectable” companies by promising to help them abuse the tax laws with little likelihood of being detected by the IRS. A reasonable estimate is that corporate tax sheltering activity is now costing ordinary taxpayers upwards of \$50 billion a year.

In 1998, PricewaterhouseCoopers bragged to *Forbes* magazine that it was promoting some 30 “mass-market” corporate tax shelters, plus speciality items for big firms willing to pay extra. It also said that it had hired 40 new salespeople to push its corporate shelters.

We began to learn a little about how some of these shelter deals purport to work because a few of the tax abusers, such as UPS, Colgate-Palmolive, Compaq and AlliedSignal, have actually been caught. The courts threw out their tax shelters as “sham” transactions, entered into for no purpose other than to escape taxes. But these cases, although very recently decided, all date back to shelters from the early nineties or earlier. Since then the problem has gotten much worse and the shelters much more brazen.

For example, in early 2000, a flier for “The Eleventh Annual Cross-Border Leasing Conference” came through my fax machine. For \$1,445, it informed me, members of the Structured Finance Institute and their corporate clients could learn new ways to set up international leasing tax shelters, under the guidance of big accounting firms such as PricewaterhouseCoopers, Deloitte & Touche, and Ernst & Young.

“Let [us] help you meet the challenge in providing timely and authoritative information on doing business overseas,” said the promotional material on the referenced website. “This information translates to tax savings for your business.” At the conference, participants could “Discover what opportunities are available for doing a cross-border synthetic lease” and “Find out the latest issues in structuring double dip . . . transactions.” They could “Learn how to avoid abusive tax shelter issues . . . and how to deal with IRS audit activity in the leasing area” aka: how not to get caught at tax cheating. Based on a previous “Cross-Border Leasing Workshop,” the conference probably featured plenty of controversy about the relative advantages of “Service Contracts” versus “QTEs,” or “FSCs” or “Pickles.” But beyond the mumbo jumbo, the big accounting firms clearly think they have the IRS on the run in the multinational tax-shelter leasing area so much so that they are willing to brag about it in public.

Shelters may not explain all of the big shortfall in corporate tax payments in recent years, but by the late nineties, the Treasury reported that “there is no doubt that there has been a striking growth in abusive tax shelters.” Treasury’s concerns were shared by the congressional Joint Committee on Taxation, which said “the problem is becoming widespread and significant,” and by the American Bar Association, which expressed “growing alarm [at] the aggressive use by large corporate taxpayers of tax products that have little or no purpose other than the reduction of Federal income taxes.”

Although corporate tax-shelter arrangements are typically made intentionally complex to try to avoid detection, the gist of most of the deals is pretty simple. A company enters into a paper transaction, often with a foreign subsidiary or a hired non-taxable third party. The idea is to generate deductions against the company’s otherwise taxable U.S. profits, while shifting the resulting income either offshore or

<sup>2</sup> “Tax Shelter Disclosure Fall Short, IRS Says Agency Seeking to Halt Corporate Abuses,” *The Washington Post*, March 1, 2002, p. E01:

Corporations are refusing to cooperate with a high-profile effort by the Internal Revenue Service to prod U.S. companies to disclose tax avoidance schemes, government official said.

Two years after the tax-shelter crackdown was announced, about 100 companies have filed the required information on approximately 325 transactions, compared to the thousands of disclosures that were expected, said David Harris, manager of the IRS’s office of tax shelter analysis. A limited amnesty from penalties for abusive tax shelters, launched two months ago and in effect until April 23, has resulted in 52 more disclosures.

“We believe that many companies should have disclosed that did not disclose,” Harris said. In one case, he said, the agency had obtained from the accounting firm that created one tax shelter a list of 17 companies that used it and found that only five of those companies had revealed their participation to the IRS. . . .

Still, even the limited disclosures obtained by the IRS suggest that tax ramifications from shelters may be large. Harris said the 272 transactions disclosed by 99 companies in 2001 resulted in total tax savings of \$14.9 billion, while the 52 additional disclosures under the amnesty resulted in more than \$1.2 billion in claimed losses or deductions.

into some other tax-exempt form. The deals have no economic purpose other than tax avoidance.

So why can't the IRS crack down on this abusive activity? As the experts describe the problem, it often comes down to this. Companies are finding that they can get big rewards from illicit tax behavior with very low risk.

Because the deals are so well hidden, they are rarely detected by the IRS. And even when the IRS does discover an abusive shelter, the penalty rules are so lax that usually the worst result a company faces is having to give back the money it stole. (A recent exception to this no-penalty rule of thumb involved Compaq, which didn't even bother to get a bogus "opinion of counsel" condoning its tax shelter, and then shredded the key documents to boot.)

#### THE BERMUDA REINCORPORATION LOOPHOLE

This year, the press has been full of stories about how sleazy American companies have reincorporated themselves in Bermuda and other tax-haven countries to avoid paying taxes on their U.S. profits. Insurance companies led the way a few years ago, and when Congress failed to take action, other patriotically challenged corporations followed suit.

The ploy entails little more than some creative paperwork. In late 2000, for example, Silicon Valley computer-hard-drive maker Seagate Technology turned itself into a Cayman Islands "shell company" called "New SAC," whose operations, Seagate notes in its 2000 annual report, "are substantially identical to the operations of Seagate Technology before the transactions."

In fact, these freshly minted offshore companies don't do anything at all in their new "home" countries. The chief financial officer for New Jersey-based Ingersoll-Rand, which expects to cut its U.S. taxes by \$40 million a year by pretending to move to Bermuda, cheerfully admitted to the New York Times that Ingersoll won't even set up an office in Bermuda. "We just pay a service operation" to accept mail, he said.

Stanley Works, the well-known Connecticut toolmaker, hoped to cut its taxes from \$110 million a year to \$80 million by reincorporating in Bermuda although it has since backed out of the deal under public pressure. The notorious New Hampshire-based Tyco International says it saved more than \$400 million last year by moving to Bermuda. Others with existing or planned mail drops in Bermuda include: the infamous Global Crossing; New Jersey manufacturer Foster Wheeler; the Texas oil-well-services giant Nabors Industries; and Cooper Industries of Texas, which anticipates cutting its taxes by 40 percent.<sup>3</sup>

Our country's biggest accounting firms are aggressively promoting the Bermuda tax-avoidance scheme, and in some cases, engaging in it themselves. Accenture, formerly Andersen Consulting, is now a Bermuda holding company. PricewaterhouseCoopers Consulting almost became a Bermuda corporation this summer, but changed its mind at the last minute. In a message to its clients not long after the Sept. 11, 2001 terrorist attacks, an Ernst & Young partner conceded that moving offshore might look unpatriotic, but urged that "the improvement on earnings is powerful enough that maybe the patriotism issue needs to take a back seat."

Why would setting up a mail drop on a sunny island allow an American company to avoid taxes? United States corporate income tax laws do have restrictions against companies using tax havens like Bermuda to avoid taxes on their U.S. profits. But our anti-tax-haven rules generally apply only to companies incorporated in America. As newly-born "foreign corporations," companies claim to be suddenly exempt from the anti-tax-haven rules. They argue they must pay taxes only on whatever profits they deign to characterize as American. Not surprisingly, that's a lot less than what they really earn here.

One might think that it would be hard to find anyone willing to defend the Bermuda tax avoidance scheme. Unfortunately, that thought would be far too optimistic. Proving that some people will do anything for money, Capitol Hill is now besieged with lobbyists, representing an array of ethically and patriotically chal-

<sup>3</sup> Companies that have reincorporated in Bermuda or other tax havens include: Accenture (formerly Andersen Consulting), APW, Cooper Industries, Everest Reinsurance Group, Foster Wheeler, Global Crossing, Global Santa Fe, Gold Reserve, Helen of Troy (Helena Rubenstein), Ingersoll-Rand, Leucadia National (pending), McDermott International (Panama-based), Nabors Industries, New SAC (Seagate), Noble, PXRE, Transocean Offshore, Tyco International, Veritas DGC, Weatherford International, White Mountains Insurance Group and Xoma Corp. Companies that announced planned Bermuda moves, but changed their mind include: Monday Ltd (PricewaterhouseCoopers Consulting) and Stanley Works.

lenged companies, accounting firms and trade associations, who are arguing for retention of the loophole.

The Chamber of Commerce of the United States, for example, wrote to all the members of the Senate on August 30 of this year apparently endorsing “corporate flight from U.S. tax domicile” and stating: “We believe that corporations should be free to incorporate where they choose, without the Federal Government imposing economic penalties upon their free exercise of prudent decision-making.”<sup>4</sup>

Simultaneously, knee-jerk anti-tax groups such as the Heritage Foundation, the Cato Institute, Citizens against Government Waste, Citizens for a Sound Economy, the National Taxpayers Union, Paul Weyrich’s Coalitions for America and Americans for Tax Reform also wrote in support of the Bermuda tax dodge. Preposterously, they claim that even briefly creating “barriers against companies that wish to re-charter” is “misguided” and would “undermine economic growth.”<sup>5</sup>

Perhaps these groups should consider changing their names. How about the Coalition Against America? Or Citizens for an Insane Economy? Or Bermudians for Tax Reform? Or the Cayman Islands Chamber of Commerce?

THE SPECIOUS ARGUMENTS FOR THE BERMUDA LOOPHOLE AND OTHER OFFSHORE SHELTERS

Beyond the blather, what do the proponents of offshore tax shelters, in particular the Bermuda loophole, specifically have to say in defense of the indefensible? Well, the lobbyists offer two contradictory arguments, neither even slightly plausible. Their silliest claim is that tax avoidance wasn’t why the companies moved offshore merely “a minor factor,” as lobbyist and former-Representative Bob Livingston puts it on behalf of Accenture (the former Andersen Consulting, now incorporated in Bermuda). Actually, Livingston asserts, Accenture’s European partners suddenly decided they couldn’t stand being headquartered in the U.S., while the American partners were adamant that they wouldn’t accept European control. “So they picked a nice island, Bermuda,” Livingston told the Washington Post.

Well, gee, if avoiding taxes isn’t a big deal, then why are the companies so upset about proposals to close their tax loophole? And if Accenture really was only seeking “neutral turf,” then why does its SEC filing note that “Accenture Ltd is a Bermuda holding company with no material assets other than . . . shares in . . . Accenture SCA, a Luxembourg partnership?” Last time I checked, Luxembourg was in Europe.

The lobbyists’ second claim concedes the obvious: avoiding taxes is indeed the only reason their clients moved offshore. Sadly, we’re told, they were forced to do so, because otherwise U.S. tax law would unfairly tax them on their foreign earnings under our allegedly “worldwide” corporate tax system. This claim is also a ridiculous falsehood.

In calling our tax system “worldwide,” the lobbyists conveniently fail to mention two rather large exceptions to that supposed rule. First of all, U.S. taxes on foreign profits are deferred indefinitely. And second, in the rare cases in which companies decide to waive deferral, U.S. taxes are almost always completely offset by a credit for taxes paid to foreign governments.

Rather than taxing corporations on their foreign profits, we try, with insufficient success, to tax companies, both American and foreign, solely on what they earn in

<sup>4</sup>August 30, 2002 Letter to Members of the United States Senate from R Bruce Josten, Executive Vice President, Government Affairs, Chamber of Commerce of the United States of America.

<sup>5</sup>August 29, 2002 Letter to House Ways and Means Committee Chairman Bill Thomas, signed by Andrew E Quinlan, President, Center for Freedom and Prosperity; Daniel Mitchell, Senior Fellow, The Heritage Foundation; Veronique de Rugy, Fiscal Policy Analyst, The Cato Institute; Paul Beckner, President, Citizens for a Sound Economy; Robert B. Carleson, Chairman, American Civil Rights Union; Stephen J. Entin, President, Institute for Research on the Economics of Taxation; Tom Giovanetti, President, Institute for Policy Innovation; John C. Goodman, President, National Center for Policy Analysis; John Hood, President, John Locke Foundation; Lawrence Hunter, Chief Economist, Empower America; Charles W Jarvis, Chairman, United Seniors Association; Gordon S. Jones, President, Association of Concerned Taxpayers; David A. Keene, Chairman, American Conservative Union; Karen Kerrigan, Chairman, Small Business Survival Committee; James L. Martin, President, 60 Plus Association; Ed H. Moore, President, The James Madison Institute; Steve Moore, President, The Club for Growth; Grover Glenn Norquist, President, Americans for Tax Reform; Duane Parde, Executive Director, American Legislative Exchange Council; John Pugsley, Chairman, The Sovereign Society; Richard Rahn, Senior Fellow, Discovery Institute; Gary and Aldona Robbins, President and Vice President, Fiscal Associates; Terrence Scanlon, President, Capital Research Center; Tom Schatz, President, Council for Citizens Against Government Waste; Eric V Schlecht, Director of Congressional Relations, National Taxpayers Union; Solveig Singleton, Senior Analyst, Competitive Enterprise Institute; Lewis K. Uhler, President, National Tax Limitation Committee; Paul M. Weyrich, National Chairman, Coalitions for America; Christopher Whalen, President, The Whalen Consulting Group; Neal C. White, President, National Retail Sales Tax Alliance, Inc.

the U.S. For their part, the multinational companies try, with considerable success, to recharacterize their U.S. profits as “foreign” in order to avoid paying taxes on their U.S. earnings. That’s precisely the goal of the Bermuda shelter, as it is for a wide array of other abusive offshore tax machinations.

#### RELENTLESSLY, COMPANIES SEEK EVEN MORE OFFSHORE SHELTERS

Despite the poverty of their arguments, the multinational tax dodgers and their accounting firm allies continue to clamor for even more ways to avoid paying taxes on their U.S. profits. Legislation introduced in August by Ways and Means Chairman Bill Thomas, for example, includes an array of new offshore tax-sheltering loopholes that the companies have long sought.

To be sure, politics forced Thomas to pretend to attack the Bermuda loophole, but his bill does as little as possible. For starters, he sharply watered down proposals to disallow sham Bermuda reincorporations and then insisted that even that limited reform must expire after 3 years! Although the change might at least temporarily stop some companies’ Bermuda plans, it explicitly grandfathered companies like Tyco that set up their mail drops early.

Another of the Thomas’s Bermuda-related measures would limit schemes to shift profits offshore through interest write-offs a good idea but it would not curb similar deductions for the use of patents, trade names and so forth. That seems to have been carefully designed to protect the Bermuda tax sheltering activities of companies like Accenture, which remonikered itself from Andersen Consulting to get around a law forbidding expatriate companies from charging their American operations hefty deductible fees for the use of pre-existing trade names.

In total, these and a few other reforms in Thomas’s bill are estimated to curb tax-shelter abuses by about \$15 billion over the next decade. In sharp contrast, Thomas wants to spend \$83 billion on what they outlandishly calls “simplification” measures. As Wayne State law professor and leading international tax expert Michael J. McIntyre notes in a written analysis of the Thomas bill, these eighteen new “loop-hole provisions . . . would reduce the fairness and efficiency of the tax system and reduce the competitiveness of the U.S. economy . . . Their unifying aspect is that they have been on various goody lists prepared by the big accounting firms over the past several years.”

For example, while Thomas’s Bermuda-related reform curbing improper interest write-offs would raise \$5.5 billion over 10 years, another provision in the bill would increase unjustified interest deductions for multinationals, at a cost of \$23.4 billion. Another Thomas proposal would lose \$37.4 billion by scrapping a long-standing rule that’s made it harder for companies to artificially shift profits into tax havens by manipulating intracompany “transfer pricing.” Other provisions would undo essential prior reforms, expand existing tax-shelter loopholes or create brand new ones.

#### WHAT WE SHOULD DO TO CURB ABUSIVE CORPORATE OFFSHORE TAX SHELTERING

Rather than expanding offshore corporate tax shelters, we should be taking major steps to curb them. In brief outline, here are some of the changes that could put a real crimp in corporate tax sheltering.

- For starters, we don’t have to let a mail drop in Bermuda turn an American corporation into a foreign corporation. Instead, Congress should simply follow the lead of countries such as Germany, Japan and the United Kingdom, and treat any ostensibly “foreign” corporation whose shares are mostly owned by Americans as, well, American.
- Next, we should substantially strengthen our general anti-abuse laws to disallow U.S. tax deductions for interest, royalties, etc. ostensibly paid to offshore affiliates. (A limited example of this kind of change is one of the few salutary provisions of the Thomas bill.)
- We should consider scrapping our impossibly complex “transfer-pricing” rules in favor of a simpler and more effective formula approach. Formulary apportionment is not a panacea, but it could have major benefits if we can persuade our trading partners to participate.
- We could establish an “economic substance” test for tax shelters, so that deals entered into mainly for tax avoidance would be disallowed. Such a rule is often invoked by the courts, but statutory authorization might be helpful, so long as the rule remains flexible enough to deter crafty lawyers and accountants.
- More fundamentally, we ought to scrap the antiquated rule that lets American companies indefinitely “defer” reporting their foreign profits on their U.S. tax returns. As noted earlier, it’s not that we really want to tax actual foreign earnings we give companies a full tax credit for the taxes they pay to foreign governments if they ever report the foreign income. But deferral opens up the door

to other scams companies use to shift their American profits on paper to tax-haven countries, and our current anti-abuse rules are far too weak. Eliminating deferral would stem abuses and hugely simplify the corporate tax laws to boot. That's exactly what the Kennedy administration unsuccessfully proposed back in the early sixties, and what both the House and Senate passed in the mid-seventies unfortunately not at the same time.

—Finally, the IRS needs considerably more resources to fight against abusive corporate tax sheltering. The payoff from such an investment, both in revenues and in renewed public respect for the tax system, would be enormous.

#### CONCLUSION

Most Americans probably believe that multinational corporations, whether U.S. or foreign owned, ought to pay taxes on their American profits just like purely domestic companies. Unfortunately, we learn more every day about how severely that goal has been undermined by aggressive tax sheltering on the part of unscrupulous corporate bosses and their accountants often with at least implicit congressional assent.

Despite foot-dragging on corporate reform by the Bush administration and the House leadership, the well-publicized accounting and tax scandals of the past few years present a rare opportunity for real reform. We encourage the members of the Subcommittee to push hard to take advantage of this opportunity.

Senator DORGAN. Next, we will hear from Mr. Martin Regalia, Vice President for Economic Policy and Chief Economist for the U.S. Chamber of Commerce.

Mr. Regalia?

#### **STATEMENT OF MARTIN A. REGALIA, VICE PRESIDENT FOR ECONOMIC POLICY AND CHIEF ECONOMIST, U.S. CHAMBER OF COMMERCE, WASHINGTON, DC**

Mr. REGALIA. Thank you.

Mr. Chairman, we have heard a number of witnesses testify as to the differences in the Tax Code, the territorial nature of foreign tax codes and the worldwide nature of ours, and how that places U.S. multinationals at a disadvantage and has led some of those companies to invert and domicile overseas for tax purposes.

Opponents of the inversions have criticized this behavior on the grounds that it reduces the U.S. tax base, that it demonstrates a lack of patriotism, and that it enables corporations to escape their obligations and pay their fair share of taxes.

Congress has responded to these inversions by suggesting a number of restrictions or penalties that otherwise discourage corporate inversions. They include treating inverted corporations as if they were still domestic, imposing moratoriums on corporate inversions, treating inverted companies' property as being sold for fair market value on the date before the move takes place, denying use of International Tax Treaty benefits, and barring Federal contracts from certain inverted companies.

We oppose the attempts by Congress for a number of reasons. Not only is it permissible for a corporation to plan to minimize its taxes, but it really is a matter of fiduciary responsibility for a corporation's managers to do so in order to maximize corporate competitiveness and value for its shareholders. It is important to keep in mind that corporate inversions result in permissible tax avoidance under the Internal Revenue Code, not tax evasion. It is a perfectly legal and valid strategy.

A corporate inversion does not excuse the U.S. corporation from paying taxes on its domestic operations; in fact, it remains legally obligated to do so. At the State level, property and sales tax, in-

come taxes, continue to be levied on plants, facilities, and domestic business operations.

What an inversion does is place a U.S. corporation on an equal footing with its foreign competitors. The U.S. Chamber urges Congress to reject these counterproductive legislative measures previously discussed. We believe that corporations should be free to incorporate where they choose, without the Federal Government imposing economic penalties on their free exercise of prudent business decisionmaking, and assert that Congress certainly should not favor foreign firms over their U.S. competitors.

These measures are a poor substitute for needed systemic reform of the U.S. Tax Code's archaic international provisions which currently put our corporations at a competitive disadvantage and provide great incentive for them to leave the country.

In addition, our tax structure also has the deleterious consequence of encouraging takeovers of our corporations by foreign interests or providing new businesses with the motivation to initially incorporate in countries other than the United States.

Congress' varied plans to stem the tide of corporate inversions have a common single, glaring, critical flaw. In each case, enactment of the legislative proposals would perpetuate the inequality between the U.S. worldwide tax system and its foreign territorial counterparts, leaving U.S. multinational corporations disadvantaged vis-a-vis their foreign multinational competitors.

While this disparity remains in effect, we can expect to see a continued increase in mergers and acquisitions that place foreign interests in functional control of U.S. businesses.

We believe that the proper response should be the undertaking of serious and overdue tax reform through the restructuring of the international provisions of the U.S. Tax Code, such as conversion of the U.S. Code to a system that is based on territoriality. This would help achieve a much-needed parity between U.S. and foreign corporations and simplify our tax structure.

Undertaking the task of formulating a more appropriate international tax structure would have significant beneficial effects on the U.S. economy through its ability to attract and retain corporate parents of multinational groups.

In sum, our overriding goal should be to fashion a tax system that will attract businesses to the United States rather than drive them away.

Thank you very much.

Senator DORGAN. Mr. Regalia, thank you very much.

And let me also say, Mr. Regalia, as I indicated in my opening statement, that we did invite a number of other people who would have had the same opinion as you—I wanted to have a balanced panel—but you were the only one willing to come and take that position publicly. We certainly tried and invited a number of others, and I will expand on that if necessary.

Prepared statement

I wanted to have a balanced panel here, but it was hard to find someone who would come and provide the testimony that you have provided. I appreciate you being here, and I will ask some questions, of course.

[The statement follows:]

## PREPARED STATEMENT OF MARTIN A. REGALIA, PH.D.

The U.S. Chamber of Commerce is the world's largest business federation, representing more than three million businesses and organizations of every size, sector, and region.

More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 71 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross-section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business—manufacturing, retailing, services, construction, wholesaling, and finance—numbers more than 10,000 members. Also, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. We believe that global interdependence provides an opportunity, not a threat. In addition to the U.S. Chamber of Commerce's 94 American Chambers of Commerce abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross-section of Chamber members serving on committees, subcommittees, and task forces. Currently, some 1,800 business people participate in this process.

My name is Dr. Martin A. Regalia, and I am Vice President and Chief Economist of the U.S. Chamber of Commerce. The U.S. Chamber is the world's largest business federation, representing more than three million businesses and organizations of every size, sector and region. This breadth of membership places the Chamber in a unique position to speak for the business community. Mr. Chairman, Senator Campbell and Members of this Subcommittee, we appreciate this opportunity to express our views on the issue of corporate inversions, and we commend you for holding these hearings.

## THE IMPETUS FOR CORPORATE INVERSIONS

The United States subjects its corporations to taxation on their worldwide income, while "territorial" systems utilized by many of our trading partners and other foreign countries only tax their resident corporations on income earned within their borders. A U.S. corporation, therefore, has income from its foreign operations taxed both here and in the foreign country in which such income was earned. Double taxation may be avoided to some extent via foreign tax credits allowed, within limitations, against the U.S. tax, and by provisions of tax treaties. Typically, this credit for taxes paid to a foreign jurisdiction does not fully offset the U.S. taxes on that foreign income.

Consider a situation in which a U.S.-based multinational group produces goods and/or services in the U.S. and abroad, and a foreign-based multinational group produces exactly the same things, in the same amounts, for the same prices, in the same places as the U.S.-based group. Typically, the foreign-based group incurs a lower overall tax bill than the U.S.-based group. This disparity occurs because of tax rate differentials and the fact that both the United States and the foreign jurisdiction subject the foreign-earned income of the U.S.-based multinational group to taxation. To the extent that the U.S. tax credit against taxes paid to foreign countries fails to fully alleviate this double taxation, the U.S.-based group is placed at a distinct disadvantage, as compared with the foreign-based group.

These tax disadvantages have caused some U.S.-based multinational corporations to reincorporate and relocate their domiciles abroad. These reincorporations are achieved through transactions known as corporate inversions.

Corporate inversions replace the U.S. parent of a multinational corporate group with a foreign parent, with the U.S. corporation thereby becoming its subsidiary. This has the effect of removing foreign operations income from the more onerous U.S. taxing jurisdiction, since the parent is no longer U.S.-based. The resulting tax savings help "level the playing field" for the corporate group, allowing the multinational operations to attain tax rates enjoyed by its foreign competitors.

## CONGRESSIONAL RESPONSE

Congress has responded to these inversions by concocting a number of schemes to penalize or otherwise discourage corporate inversions. They include tax bills that would, among other things:

- treat inverted corporations as if they were still domestic (i.e., as if the inversion transactions had not taken place);
- impose “moratoriums” on corporate inversions—in other words, disregard the tax inversion for a predetermined period of time;
- treat inverted corporations’ property as being sold for fair market value on the date before the “move”; and
- deny the use of international tax treaty benefits.

Furthermore, a recent trend is for Congress to include language in non-tax legislation that would bar federal contracts to certain inverted U.S. companies (the resulting U.S. subsidiaries). Examples are the Treasury-Postal and Defense appropriations bills, and legislation to establish the Department of Homeland Security. However, some legislators from both sides of the aisle have had second thoughts about the wisdom of this tact, and stripped this provision out of the Defense appropriations bill in conference, on the rationale that some corporations are forced offshore by a U.S. tax code that puts them at a disadvantage with foreign corporations.

## ASSERTED RATIONALE FOR THE CONGRESSIONAL PROPOSALS

Proponents of the foregoing assert a number of rationales in support of their proposals. They assert that corporate inversions must be thwarted, because they:

- reduce the U.S. tax base;
- demonstrate a lack of “patriotism” for the corporation’s U.S. home; and
- enable escape from the corporation’s obligation to pay its “fair share” of taxes for the protections, rights, and benefits of infrastructure that are accorded it in doing business within the U.S.’s borders.

## RESPONSE TO CONGRESSIONAL RATIONALE

The often-quoted and esteemed Judge Learned Hand had something to say about the propriety of planning to minimize one’s tax burden. Hand wrote, “Over and over again courts have said that there is nothing sinister in so arranging one’s affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demand: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.” *Commissioner v. Newman*, 159 F.2d 848 (2d Cir., 1947, dissenting opinion).

Not only is it permissible for a corporation to plan to minimize its taxes—and thereby reduce the U.S. tax base—but it is a matter of fiduciary obligation for a corporation’s managers to do so, in order to maximize corporate competitiveness and value for its shareholders. It is important to keep in mind that corporate inversions result in permissible tax avoidance under the Internal Revenue Code—not tax evasion. It is a perfectly legal and valid strategy.

Nor do corporate inversions demonstrate a lack of “patriotism” for the United States. Tax planning is merely a function of business decision-making. Taxes are levied by the tax code and are measured by its provisions, not by the depth of sentiment for our country.

Indeed, imposing and retaining punitive levels of taxation that place U.S. corporations at a competitive disadvantage when compared to their foreign rivals is unpatriotic. Denying government contracting opportunities to U.S. corporations that take steps to achieve tax parity with their foreign competitors is unpatriotic. Either way, the corporation is harmed. This double-edged sword of loss of tax dollars versus loss of business revenue penalizes the U.S. corporation by depriving it of vital sources of revenue, with the attendant loss of jobs and restriction on ability to fund growth and attract future business opportunities—while penalizing the investor through the resulting drag on the value of the corporation’s stock and the U.S. economy. True patriotism would be demonstrated by steps our government could—and should—take to enable our corporations to thrive internationally in the global economy.

It is important to keep in mind that a corporate inversion does not excuse the U.S. corporation from paying taxes on its domestic operations. In fact, it remains legally obligated to do so. Payment of these taxes continues to support the functions and operations of our government, and compensate it for the protections, rights, and benefits of infrastructure that are bestowed upon corporations operating here—whether the corporation is a product of an inversion, a company acquired by a foreign corporation, or merely a domestic corporation that has no foreign operations.

At the state level, property, sales, and income taxes continue to be levied on plants and facilities, and on domestic business operations.

A MORE APPROPRIATE AND BENEFICIAL SOLUTION

The U.S. Chamber urges Congress to reject the short-term and counterproductive legislative measures previously discussed. We believe that corporations should be free to incorporate where they choose, without the federal government imposing economic penalties upon their free exercise of prudent business decision-making, and assert that the U.S. Congress certainly should not favor foreign firms over U.S. firms in the tax code. These measures are a poor substitute for needed systemic reform of the U.S. tax code's archaic international provisions which currently put our corporations at a competitive disadvantage internationally and provide great incentive for them to leave this country. In addition, our tax structure also has the deleterious consequences of:

- encouraging takeovers of our corporations by foreign interests; or
- providing new businesses with the motivation to initially incorporate in countries other than the United States.

Congress's varied plans to stem the tide of corporate inversions have in common one glaring, critical flaw. In each case, enactment of the previously discussed legislative proposals would perpetuate the inequality between the U.S. worldwide tax system and its foreign territorial counterparts, leaving U.S. multinational corporations disadvantaged vis-à-vis their foreign multinational competitors. While this disparity remains in effect, we can expect to see a continuing increase in mergers and acquisitions that place foreign interests in functional control of our U.S. businesses.

We believe that the proper response should be the undertaking of serious and overdue tax reform through restructuring the international provisions of the U.S. tax code, such as conversion of the U.S. tax system to one based on territoriality. This would help achieve much-needed parity between U.S. and foreign corporations and simplify our tax structure. It is only fair that foreign operations of a U.S.-based company not be subject to a burden not borne by its competitors.

CONCLUSION

Undertaking the task of formulating a more appropriate international tax structure would have significant beneficial effects on the U.S. economy, through its ability to attract and retain corporate parents of multinational groups. When the resulting decisions affecting the future location of new investment, operations and facilities, and employment opportunities are made by U.S.-based companies, U.S. interests will be promoted. In sum, our overriding goal should be to fashion a tax system that will attract businesses to the United States, rather than drive them away.

Senator DORGAN. Finally, we welcome William Gale, Senior Fellow and Deputy Director for Economic Studies at The Brookings Institution.

Thank you for being here, Mr. Gale, and please proceed.

**STATEMENT OF WILLIAM G. GALE, SENIOR FELLOW AND DEPUTY DIRECTOR FOR ECONOMIC STUDIES, THE BROOKINGS INSTITUTION, WASHINGTON, DC**

Mr. GALE. Thank you very much for inviting me to testify at this hearing.

International taxation is complicated, even for experts, and because of that, I will try to focus on a few broad intuitive themes and try to focus on the forest rather than the trees here.

The single bright line in international tax policy has to be that features of the Tax Code that affect the taxation of offshore income should not be allowed to erode the taxation of domestic income. That is, we should avoid at all cost features of the tax system that let U.S. firms strip their earnings out of the U.S. and into foreign tax havens.

How we tax foreign-source income is a separate issue that is also important, but if we leave the domestic tax base up for attack by

allowing firms to move revenues offshore, we are in for a very long and difficult set of problems in the tax system.

I think—and I emphasize “think”—that everyone on the panel agrees with this, but I would like to know in particular whether Marty Regalia does or not.

The second point is that corporate inversions are legal. They may be repugnant. Flag-burning may be repugnant, but it is legal. And in a strict, narrow, financial sense, it often makes sense from a firm’s perspective.

Regardless of the legality of the transactions, they are troubling from a policy viewpoint. That is, it is one thing to say that they are legal; it is another thing to say that they are a desirable thing to have happen. I think it is very clear that they are an undesirable thing to have happen, because inversions allow firms not only to reduce or eliminate taxes on their foreign income, but also to eliminate and reduce taxes on their domestic income.

I thought that Assistant Secretary Olson’s emphasis on the domestic earnings-stripping this morning was both notable and laudatory.

Another thing to add is that inversions create these incentives without creating any change in real economic activity. We have energy incentives because we want firms to invest in certain types of energy. We have other incentives. We subsidize health care because we want firms to provide health insurance. Inversions give firms tax benefits while engaging in no socially redeemable, socially valuable behavior.

So it is a pure tax avoidance mechanism, and as such, it is very bad public policy to allow these things to occur.

Let me emphasize the incentives for inversion. The cause of U.S. earnings-stripping is not the overall competitiveness of the U.S. tax system. Our tax system is about on average in its competitiveness in terms of how it taxes foreign income relative to our major trading partners. Some tax it more heavily, some tax it less heavily.

The competitiveness is a complete red herring as far as incentives for inversions are concerned. The incentive to strip earnings is based only on the statutory tax rate, and that is not on the effective tax rate. The way to think about this is that a firm makes an investment, it gets some deductions, and then it gets the income, and the income is taxed. The incentive to strip the earnings out depends only on the statutory tax rate that applies to that income. The deductions have already been taken in earlier years.

So even if we made the system “more competitive,” quote-unquote, by increasing deductions, increasing depreciation, the incentive to strip earnings out would still be there because that incentive depends only on the statutory tax rate, not on the effective tax rate.

What should we do about this? Treasury suggests that we restrict earnings-stripping via interest payments, but they make no mention of earnings-stripping via royalty payments. Instead, they suggest that we move to a territorial system instead of the worldwide system.

I want to emphasize that a territorial system does not solve the inversion problem. Under domestic systems, firms still pay domestic taxes on their foreign passive income; under inversion, they

would not. And of course, inversions are also, as has been discussed, put in place to reduce taxes on domestic income, which a territorial system does not address.

Basically, going to a territorial system as a response to corporate inversions is like choosing to reduce the crime rate by legalizing certain crimes. It is not a solution in any substantive sense.

We can talk for a while about other solutions. The one I would like to suggest be put on the table is to consider a change in the definition of corporate residency. Currently, it is based on where a firm files its incorporation papers. There is another possibility, which is where the day-to-day management and control of the firm occurs. If residency were defined on this basis, the inverting firms would still be considered U.S. firms, Accenture would still be considered a U.S. firm. This is a much harder criterion to avoid than simply filing papers in a different jurisdiction. It is consistent with what our trading partners do, which is important for any unilateral change in international tax rules. And this would catch new establishments like Accenture as well as existing establishments that have already inverted.

#### PREPARED STATEMENT

So there are other proposals, but I would like to put that one on the table for consideration.

Thank you.

[The statement follows:]

#### PREPARED STATEMENT OF WILLIAM G. GALE

Mr. Chairman and Members of the Committee: Thank you for inviting me to testify at this hearing. Corporate inversions have increased in recent years and raise a number of difficult and sometimes confusing issues. My testimony aims to provide background on both the institutional and economic aspects of inversions.

*Inversions.*—Corporate inversions occur when firms move their legal headquarters out of the U.S. solely for tax purposes. Although they are not illegal and often make sense from the firm's perspective, inversions are particularly troubling from a policy viewpoint. Specifically, inversions allow firms not only to reduce or eliminate taxes on their foreign source income, but also to reduce or eliminate taxes on their domestic income. And they create these incentives without requiring any sort of change in "real" economic activity. The economic incentive for inversions is not due to the overall taxation of corporate income, it is due only to the statutory tax rate.

*Policy response.*—New laws should strive to eliminate the tax savings from inversions. Several legal options are available, but the most often-discussed options—reducing the effective tax rate on capital, moving to a territorial tax system or implementing fundamental tax reform—would not resolve the basic incentives for, or problems with, inversions.

*Territorial tax system.*—It is natural to consider more broad-based reforms to the tax system as a response, but moving to a territorial system is not a helpful way to deal with corporate inversions. Territorial systems generally make it more difficult to defend the domestic tax base from attack, since moving offshore results in a bigger tax savings under a territorial system than a world-wide system. That is, territorial systems enhance and legitimize methods of tax avoidance and evasion that should be curtailed under any sensible policy rule toward inversions. Going to a territorial system as a response to corporate inversions is like choosing to reduce the crime rate by legalizing certain crimes. Thus, although there are reasons to consider territorial tax systems, stopping inversions are not among them.

*Fundamental tax reform.*—Replacing the corporate income tax with a value-added tax raises many important issues, including the impact on economic growth, the distribution of tax burdens, tax complexity and so on. A VAT, however, would not relieve the demand for corporate inversions by very much, if at all. Some businesses would see their statutory tax rate on income fall, which would reduce demand for inversions, but others would see their tax liabilities skyrocket under a VAT and thus would have increased incentives to shift profits out of the U.S.

*International features of the U.S. tax system*

The United States taxes the world-wide income of its individual and corporate residents. Although this may sound simple in theory, in practice it raises a number of difficult issues.

To avoid having the foreign source income of its residents taxed twice, the U.S. provides a foreign tax credit for income taxes paid to foreign governments. To ensure that the credit does not reduce tax on domestic income, the credit cannot exceed the tax liability that would have been due had the income been generated domestically. Firms with credits above that amount in a given year have “excess” foreign tax credits, which can be applied against their foreign source income for the previous 2 years or the subsequent 5 years. To limit the ability of firms to use foreign tax credits for one type of foreign source income to reduce taxes on a different type of foreign income, the foreign tax credit limitation is calculated separately for nine different “baskets” of income.

Foreign branches of U.S. corporations are considered U.S. residents and therefore are subject to immediate taxation on foreign source income and eligible for the foreign tax credit. In contrast, controlled foreign corporations (CFCs, which are American-owned, separately incorporated foreign subsidiaries of U.S. corporations) are not considered U.S. residents. Their profits, therefore, are not taxable as long as the earnings are retained and reinvested locally in active lines of business. That is, U.S. income tax (and foreign tax credits) on such income is deferred until the income is repatriated to the U.S. parent.

Deferral of taxes and credits on retained earnings is intended to allow foreign subsidiaries to compete on a more even basis with local firms. To ensure that the benefits of deferral are used only to achieve that goal, the law provides complex and extensive limits on the ability to defer income. These rules (subpart F) make deferral available only on active business income that is reinvested locally. Certain forms of income are “deemed distributed” and thus denied deferral. These include passive income broadly defined, and including portfolio interest and dividends.

Because the tax treatment of domestic and foreign income differ under the U.S. system, firms have incentives to shift income to low-tax jurisdictions and deductions to high-tax jurisdictions. Income can be shifted via the transfer prices at which internal firm transactions are recorded. As a result, the U.S. imposes an extensive set of rules, that essentially require that transfer prices correspond to the prices that would have occurred in an arms-length transaction. These rules, however, are notoriously difficult to enforce and, in some cases, to interpret. The U.S. also imposes rules regarding the allocation of deductible expenses—such as research and development costs and interest payments—across jurisdictions. U.S. corporations may allocate only a portion of their expenses to domestic operations, with the rest being allocated against foreign income.

The U.S. generally treats exports as taxable income and imports as deductible expenses. But, relative to the rules above, the U.S. subsidizes exports in two ways. First, the sales source rule allows taxpayers that manufacture in the U.S. and sell outside the U.S. to report 50 percent of the income from the sale as foreign income. For firms with sufficient excess foreign tax credits, this provision eliminates U.S. income tax on half of export sales. The U.S. also provides a subsidy for extra-territorial income. Taxpayers are allowed to exclude a portion of their income that is attributable to “foreign trading gross receipts” (FTGR) or net income from FTGR. A firm cannot generally benefit from both the ETI regime and the sales sourcing rules. Firms with excess foreign tax credits will generally save more through the sales sourcing rules. The ETI rules thus mainly benefit taxpayers that do not have excess foreign tax credits—that is, those who either operate in low-tax foreign countries or do not have foreign operations.

The U.S. taxes foreigners on income from their active business operations in the U.S. The U.S. imposes 30 percent withholding taxes on interest (but not portfolio interest, which is untaxed), royalties, and dividends that flow to foreigners, but frequently reduces or eliminates the withholding tax rate through bilateral tax treaties.

*Background on inversions*

“Inversions” refer to a complicated set of procedures that allow firms not only to reduce their taxes on foreign source income, but to reduce taxes on domestic income

<sup>1</sup>Due to time constraints in the development of this testimony, I do not provide references to particular publications used throughout the text. Rather, the sources listed at the end of the text include the publications that I referenced in developing these comments.

as well. Here is how a typical inversion works. First, a domestic corporation creates a foreign parent in a country like Bermuda—which has no income tax and no tax treaty with the United States. This allows it to eliminate U.S. taxes on foreign source income. Second, the domestic corporation sets up a foreign subsidiary of the foreign parent in a third country—often Barbados or Luxembourg—that has a treaty with the United States and has lax residency requirements. To qualify as a resident of Barbados, for example, the company just has to meet there once a year. The reason the third country and its U.S. tax treaty are important for this scheme is that the tax treaty eliminates withholding taxes on flows of royalties or interest payments from the U.S. to the third country. Thus, once the funds are transferred to Bermuda, which does not have a treaty, there is no access to the funds by U.S. government.

With the new foreign parent in place and the existing foreign subsidiaries turned over to the foreign parent, the inversion works in two steps. First, the American company “sends profits” to the foreign subsidiary in the third country. Sending profits means the American company makes payments to the subsidiary that are deductible under U.S. tax law. Note that this reduces the American company’s American taxes on domestic operations. These payments could include interest payments, royalties for use of the company logo, and so on. No taxes are withheld on these transactions because of tax treaties with the U.S. and the third country. Second, the foreign subsidiary then sends the funds to the foreign parent in Bermuda, which has no income tax. As a result, taxable American profits have been shifted to Bermuda and escape U.S. taxation.

*Inversions: Notes on economic analysis*

This section discusses several economic aspects of inversions. First, inversions have nothing to do with a lack of competitiveness of our tax system. Competitiveness, if it means anything, should refer to the effective rate of taxation on businesses. The effective rate of taxation depends on the statutory tax rate, depreciation rules, whether the corporate and personal taxes are integrated. The ETR does not affect the incentive for inversions. Rather, inversions depend on the statutory tax rate. That is, U.S. firms have incentives to shift profits out of the U.S. because of the 35 percent statutory corporate tax rate. This would be true even if investments were expensed, which would reduce the effective tax rate on capital income to below zero, since some investment is debt-financed.

Second, there is a natural break on the tendency of firms to invert. Firms that invert create forced stock sales by their shareholders, who have to pay capital gains taxes on those sales. Thus, the presence of substantial capital gains and/or a high rate of tax on capital gains would inhibit inversions. Given the large declines in the stock market recently, the number of companies whose shareholders have large capital gains would have diminished over the last few years. Thus, the decline in the asset prices could encourage inversions by reducing or eliminating the capital gains taxes that shareholders would have to pay. Equally important, a low capital gains tax rate makes it easier for firms to invert, since it creates a smaller tax liability upon forced realization. Other things equal, a higher capital gains tax rate would reduce the incentive for firms to invert.

*Territorial versus world-wide taxation*

As noted above, the U.S. operates its tax system on what is essentially a world-wide basis. No country, though, operates a pure territorial or world wide system. About half of OECD countries operate systems that are essentially territorial, while the other half operate systems that are basically world-wide in nature. In theory, the differences between a pure world-wide system and a pure territorial system are large. A world-wide system taxes all income of residents regardless of where it is earned, gives credits for foreign income taxes paid, and defers taxation of foreign subsidiaries until the funds are repatriated. As noted above, these rules lead to complex provisions regarding foreign tax credit limitations, anti-deferral rules, and income and expense allocation. In contrast, a territorial system only taxes income earned within the country’s borders and only allows deductions for expenses incurred within the borders. While a territorial system sounds simpler in theory, in practice it often turns out not to be. First, territorial systems have to define the income that is exempt. In practice, territorial systems tend to apply only to active business income. Even within that category, the territorial system may only exempt active business income (a) if it faces taxes above a certain threshold level in the host country, (b) from a certain type of business (e.g., e-commerce), and/or (c) from certain countries. Second, the treatment of non-exempt income must be specified. Third, the allocation of income and expenses across jurisdictions takes on heightened importance in a territorial system. For all of these reasons, territorial systems

end up with complex rules regarding foreign tax credits, anti-deferral mechanisms, and allocation of income and expenses.

Although the two systems are not as different in practice as in theory, they do have different tendencies that are worth noting. First, in a world of sophisticated and mobile transactions and firms, neither system is easy to operate. A territorial system is based on being able to define the geographic area where income is earned and expenses are incurred. A world-wide system is based on being able to define the geographic area where a corporation is resident. Both concepts are becoming increasingly difficult to assign and monitor and increasingly easy for firms to manipulate.

Changing to a territorial system would be a curious and flawed response to corporate inversions (and corporate shelters more generally). Territorial systems make it harder to protect the domestic tax base. In a world-wide system, if firms go abroad, their income is still taxable. In a territorial system, it is not. Thus, going to a territorial system as a response to inversions would not make the underlying problem go away, it would simply ignore it by legitimizing and enhancing opportunities for behavior that should instead be prohibited or curtailed. It would be like legalizing a criminal activity as a way of reducing the reported crime rate.

Finally, it should also be noted that territorial systems are not generally much simpler than world-wide systems, for reasons noted above. In addition, moving to a territorial system may generate difficult transition issues with respect to deferred income, deferred losses and accumulated tax credits in the old system. It may also require the renegotiation of numerous tax treaties. For all of these reasons, although there may be many reasons to consider a territorial tax system, switching to one does not seem to be a useful way to address the problems raised by export subsidies or inversions.

#### *Fundamental tax reform*

In recent years, increased attention has been given to fundamental tax reform. Usually, this refers to the idea of eliminating the individual income tax, corporate income tax, and estate tax (and sometimes payroll and excise taxes, too) and replacing them with broad-based, low-rate taxes on consumption.

Four main alternatives have emerged in recent years. A national retail sales tax (NRST) would tax all sales between businesses and households. A value added tax (VAT) would tax each firm on the difference between the sales of goods and its purchases of goods from other businesses. (Alternatively, firms pay VAT on their sales of goods and receive tax credits for the VAT that they paid on their input purchases.)

The NRST and VAT are similar in economic substance. First, the retail price of a good represents the entire value added of that good. Thus, the NRST collects all tax on the value added at the final sale to the consumer. The VAT, in contrast, collects the same amount of tax (if VAT and NRST rates are the same), but collects it at each stage of production. Second, both are consumption taxes.

The similarity in structure between the VAT and the NRST indicate why it is appropriate for European countries to rebate VAT on exports. No one would expect a country to charge a retail sales tax on its exports. Thus, by rebating the VAT payments made up to the point of exports, European countries are giving firms the same treatment under a VAT as they would get under a retail sales tax.

A third approach to fundamental tax reform—the flat tax—is probably the most well known and the best conceived. Essentially, the flat tax is a VAT that is divided into two parts. The flat tax would tax non-wage value added at the firm level and wages at the household level. There are some other differences (the VAT taxes pension contributions when made, the flat tax taxes pension contributions when they are consumed; the VAT is destination-based whereas the flat tax is origin-based), but essentially the flat tax is a two-part VAT. This means that the flat tax is also a consumption tax, though it may not appear that way to consumers or businesses.

A fourth approach is the so-called U.S.A. (unlimited saving allowance) tax, which combines a personal consumption tax and a VAT on businesses. Since both of these taxes are consumption taxes, the overall system would be a consumption.

In considering replacements for the corporate income tax, however, there are only two fundamental reform options: the NRST and the VAT. The flat tax and U.S.A. tax would not be implemented without repeal of the individual income tax, too. For purposes of this testimony, therefore, I focus on the NRST and VAT. Moreover, since all European countries that experimented with national retail sales taxes eventually switched to a VAT, I focus exclusively on switching the corporate tax to a VAT in this testimony.

Replacing the corporate tax with a VAT raises numerous issues. The main result, however, should be clear. The VAT would not be a panacea and although it offers

the potential for improvement, it provides no guarantees of that, and indeed it creates several other identifiable problems.

Although VATs can be described simply (see above), in practice VATs are extremely complex. Thus, one should compare existing corporate taxes to VATs as they would likely be created, not as they exist on paper.

Basically, the broader the tax base (i.e., the fewer the number of zero-rated or exempt goods), the lower the tax rate can be and (with a few exceptions) the simpler the tax system can be. But if the VAT is the only tax affecting corporations, one can expect to see pressure to allow corporations to deduct health insurance payments, payroll taxes and State and local taxes as they currently do. If these deductions were allowed, the required rate would jump significantly. This in turn would create pressure to exempt certain goods—e.g., food, health insurance, housing—which would raise rates further. In addition, items like energy subsidies and other forms of “corporate welfare” could be implemented through the VAT. Unless some mechanism were developed to keep such subsidies out, the VAT base would be eroded like the corporate base currently is and rates would be quite high.

Even if the VAT base is kept broad (and it is not in most European countries), there would be a fundamental conflict in the U.S. system with having an individual income tax but a VAT at the corporate level. Essentially, income could be sheltered indefinitely via retained earnings in corporations. This problem does not arise in Europe because European countries have a corporate income tax as well as a VAT.

Also, under a VAT, firms have incentives to report any cash inflow as an interest receipt and any cash outflow as a deductible expense. This would give firms incentives, in their transactions with government, non-profits, and foreigners, to relabel cash flows. Zodrow and McLure in a 1996 paper declared that this feature of the flat tax (it is also a feature of the VAT) offered unacceptable opportunities for abuse. Again, these issues do not arise with VATs in Europe because those countries have corporate income taxes (that tax interest income).

Switching from the corporate income tax to a VAT would likely be regressive. The ultimate incidence of the corporate income tax is unclear, but most estimates suggest it is borne by capital owners. The VAT, in turn, would be borne by consumers. In addition, the appearance of changes in distributional effects might prove very important: it would be hard to make the political case, for example, for a tax that raised the cost of food and health care for low-income families in order to reduce the costs for a multinational corporation to invest in a foreign country.

The impact on growth of a switch would likely be positive, if the VAT were implemented in a simple broad-based way. But if a U.S. VAT ends up looking like a European VAT, the net effects on growth may be substantially smaller. Many papers suggest that replacing the entire U.S. tax system with a clean, broad-based, low-rate consumption tax would raise the size of the economy by about 1–2 percent over the next 10–15 years. Certainly, replacing only one small portion of that system—the corporate tax—with a complex VAT would have significantly smaller effects.

Unlike the current corporate or individual business taxes, the VAT does not attempt to tax profits as commonly understood. Changing the entire logic and structure of business taxation will create several situations that will be perceived as problems by taxpayers and firms, even if they make perfect sense within the overall logic of the VAT. First, some businesses will see massive changes in their tax liabilities. For example, the developers of the flat tax, Hall and Rabushka, note that General Motors’ tax liability would have risen from \$110 million in 1993 under the current system to \$2.7 billion under a 19 percent flat tax—and the flat tax offers deductions for wages, which a VAT would not.

Some businesses with large profits will pay no taxes. This will occur because calculations of profit (before Federal taxes) include revenue from all sources and subtract expenses for a variety of items, including fringe benefits, interest payments, payroll taxes, and State and local income and property taxes. In the VAT, only revenues from sales of goods and services is included (financial income is omitted) and expenses on fringe benefits, interest payments and other taxes are not deductible. Thus, firms may be in the enviable position of reporting huge profits to shareholders, while paying no Federal tax. This sort of situation makes perfect sense within the context of the VAT. However, in the past, precisely this situation led to the strengthening of the corporate and individual alternative minimum taxes, which are universally regarded as one of the most complex areas of the tax code. It is hard to see why those same pressures would not arise in the VAT.

Conversely, some firms with low or negative profits may be forced to make very large tax payments. Again, this makes sense within the context of the VAT, but will not be viewed as fair by firm owners who wonder why they have to pay taxes in years when they lose money and who will push for reforms.

Finally, converting the corporate income tax to a VAT would raise difficult transition with respect to unused depreciation allowances, interest payments on previously incurred debt, net operating loss carryovers, excess foreign tax credits and so on.

Turning to international issues, the generally lower tax rate on a VAT would cause firms to set transfer prices to shift some income into the U.S. But even with a lower-rate VAT, there would be big incentives for corporate inversions, especially for firms whose tax burdens rise under a VAT relative to the current system.

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Senator DORGAN. Mr. Gale, thank you very much.

Well, your testimony has offered a lot of opportunity for questions. Let me begin by asking Professor Avi-Yonah: Why now? Why are we hearing about inversions now? Were there inversions 5 years ago, 10 years ago, by large corporations?

Mr. AVI-YONAH. No, there were not. I mean, there were inversions as far back as the eighties, but really, what changed things was Tyco, because when Tyco inverted in 1997, people realized—before that, people thought there would be a relocation cost of coming to Bermuda in terms of corporate governance and the other issues that Attorney General Blumenthal mentioned. Tyco inverted, and suddenly, their stock price went through the roof, and as was also mentioned, that has an influence on management stock options and various things like that. There has now been an empirical study done about the impact of inversion on stock price decisions, and generally, the impact is favorable.

The other thing that happened, as the Secretary also mentioned, was that the reduction in the value of shares in the stock market recently has meant that the fact that the IRS in 1994 put a capital gains tax on the shareholders on inversion has not been a sufficient deterrent, because a lot of people even before that were tax-exempt, but now a lot of people do not have a lot of gain in their shares, and therefore, putting a tax at the shareholder level makes no dif-

ference. I also think that in general, management cares more about a reduction in the corporate tax than they care about what happens to shareholders.

Senator DORGAN. I used the term “renouncing their U.S. citizenship”; is that a fair term?

Mr. AVI-YONAH. I think that is a fair term. I mean, basically, what is happening is that the parent corporation becomes a Bermuda corporation, and the American corporation remains a subsidiary, with no change in the operations, but in terms of formal citizenship, and certainly—taxation without representation—citizenship goes with paying taxes, and the effect of this is to reduce the tax.

Senator DORGAN. And we invented corporations in this country as artificial persons who could contract and be contracted with. And so, Mr. Gale, you are not an artificial person; what happens if you renounce your citizenship? Are there consequences to that for you?

Mr. GALE. I would presume so, and very severe consequences in terms of being able to vote, being able to benefit from certain Government programs.

Senator DORGAN. So an artificial person that we have created here—and I support its creation—can contract, be contracted with, can sue and be sued. We have created this structure called an artificial person. It has citizenship rights and responsibilities as well. A real person, such as an Attorney General of Connecticut, if the real person renounces his or her citizenship, I assume there are consequences to that.

It sounds to me as if the only consequence to the renouncement of citizenship by an artificial person—that is, a corporation—is that they are able to pay lower U.S. taxes.

Is that the case, Mr. Attorney General?

Mr. BLUMENTHAL. Well, they pay lower U.S. taxes, Senator, but they also have the self-interest or self-benefits of being above and beyond certain laws that otherwise would affect them.

Senator DORGAN. The point you made in your testimony was very interesting, and I think a lot of people do not understand that point. Shareholders lose—the corporate entity gains by being able to avoid certain U.S. tax obligations, but shareholders lose certain rights. Can you amplify on that?

Mr. BLUMENTHAL. They lose certain rights that are critical to holding management accountable. Whenever management engages in self-dealing or malfeasance, right now, a shareholder can bring a derivative action, can sue the management and enforce those rights under our Federal and State securities laws. That effort becomes much more difficult, if not impossible, if a corporation inverts to Bermuda.

Just to give you one very specific and concrete example, my office went to court on behalf of our pension funds, essentially, because Stanley Works issued misleading and potentially deceptive statements. We would not have been able to do so probably as effectively, and perhaps not at all, if Stanley Works had been at that time already reincorporated in Bermuda.

So the enforcement of legal rights becomes much more problematic, and that is why the status quo really is unacceptable.

Senator DORGAN. Were you taking legal action on behalf of shareholders, and did that result from shareholders gathering together and asking you to take legal action?

Mr. BLUMENTHAL. We took legal action on behalf of the pension funds of the State of Connecticut, as well as the State, and on behalf of shareholders, and employees and shareholders of Stanley were misled about certain critical factors. One of them was the payment of capital gains, another was the loss of shareholder rights, and still a third was what exactly a non-vote meant in that context.

But I think the central point that you are making, Senator, is that there are tremendously profound and far-reaching changes that occur legally once a corporation renounces its United States citizenship, and it is not only in the area of tax policy; it goes to basically holding citizens accountable, as we do in this country, more directly and immediately through our courts and our legal system.

Senator DORGAN. But my point is that it is not to the disadvantage of the corporation itself, the structure of the corporation. That disadvantage would be to the shareholder.

Let me put up a couple of charts if I might, because I want to address the question that Mr. Regalia has raised, and I think it is a question that others raise on behalf of those who invest.

The first chart shows the share of the Federal tax burden, corporation versus payroll taxes. You will see that what is happening over a period of 50 years is that the share of corporate taxes a percentage of what we are collecting in this country is going down, down, way down; payroll tax is up, up, way up.

So the fact is that corporations are by and large bearing a smaller percentage of the requirement to raise the income necessary for our Government.

But the next chart shows that corporate income tax revenue as a percentage of gross domestic product—and this shows a whole range of countries—you cannot see it very well—but the yellow line is the United States, and we are somewhere closer to the bottom, certainly, than the midpoint or the top. Our corporate income tax revenue as a percentage of our GDP relative to other OECD member countries is relatively small.

In light of that, let me ask you, Mr. Regalia—you and others, and Ms. Olson also, made the point that our tax system renders our corporations at a disadvantage when competing against other countries. How does that square with, for example, this chart which shows that, related to other OECD countries, we are relatively low, coming in with corporate income tax revenue? How does that square with the notion that we are somehow anticompetitive in our tax system?

Mr. REGALIA. Senator, in the spirit of balance, I will assume that I can take four times the amount of time to answer so I can address each and every criticism up here.

First of all, with respect to your chart, it would be very interesting if you were to plot the relative GDP growth rates of those same countries, too, to see what it is about corporate tax rates and GDP that would correlate as well.

With regard to what is happening in terms of that chart, it does not really show the relative tax vis-a-vis an individual corporation and its competitor in those countries as well.

What is alluded to by Ms. Olson and myself is that if you take two companies in exactly the same situation, with operations here and operations abroad, it is unequivocal that the company that is domiciled abroad in that situation, whose headquarters is domiciled abroad, has a tax advantage over the one that is domiciled here. Otherwise, there would not be this issue, and there would not be this hearing, because there would not be any inversions if that were not the case.

You have all admitted that in fact, the reason why companies inverted was to save money on taxes. I do not see how we can contend, then, that there is not an advantage to that.

I think the question really is what should we do about it; what is the issue? Is the issue inversions? Is the issue earnings-stripping? And I think that a specific response to that problem would show that if we adjust our tax system, if we reform it in a way that removes the tax decision from where a company domiciles, we would not have this issue. And I think that that is at the heart of the matter, is why do companies invert. They invert because there is a disadvantage. It is not a question of patriotism.

I think that the whole citizen question is an interesting spin on it, except that when I took civics, I learned that citizens get a chance to vote. Corporations do not vote. They provide income and jobs to individuals who do, but the corporation itself does not vote, and I think that that is a big difference when you talk about corporate citizenship versus determinations of business decisions as to where to domicile.

Senator DORGAN. Mr. Regalia, I actually have plenty of time, so you will have plenty of time. But you actually answered a question I did not ask and then answered a question you posed, so let me see if I can straighten it out, because you covered that and then a lot of additional ground.

You indicated that because someone can invert, a corporation can renounce its citizenship and go somewhere to save taxes, that means by definition that our tax system is unfair and places our corporations at a disadvantage to corporations domiciled in other countries. The fact point that a corporation can find a country someplace where it might save on taxation is one thing. I admit that that is the case. But that by itself does not suggest that we have a tax system that is fundamentally anticompetitive vis-a-vis other countries.

The last time I asked the GAO to examine the tax burden of large U.S.-based companies, they found that 30 percent of the large U.S.-controlled companies—that is, with assets of \$250 million or more—doing business in the U.S. paid no U.S. income taxes. Now, I assume they are not at a competitive disadvantage to anyone. Would you agree with that? If you have companies with \$250 million in assets, 30 percent of them paying no U.S. income taxes, they are hardly at a competitive disadvantage.

Mr. REGALIA. Companies that pay no tax because they have had loan losses that they carried forward, or depreciation allowances that are still in existence when the economy turns down and their

profits go down and do not pay any taxes—that has nothing to do, really, with whether, over the course of time and the course of the economic cycle, a particular tax code is advantageous or disadvantageous to companies locating in one locale or another. So I think it is a different question, Senator.

Senator DORGAN. In the last 10 years, if you were owning a company, running a company, would you sooner have been doing it in the United States or in Japan?

Mr. REGALIA. It really depends on what product I was producing, Senator.

Senator DORGAN. Well, just generally.

Mr. REGALIA. I think that in general, given where I am and where I live, I would rather be producing in the United States. And in fact, many of the companies that have inverted, and many of the companies that compete internationally, do produce significant products in the United States.

My own preference, being that I do not speak a foreign language, is that I would prefer to live in the United States. But once again, we are not really discussing, I do not think, where we want to live or where we want to domicile companies. I thought we were discussing the specific question of inversions in the Tax Code and whether the Tax Code is in need of reform in order to provide a level playing field for companies domiciled in the United States versus companies that produce the same products, compete in the same markets, but are domiciled elsewhere. That is the issue that I am prepared to discuss today.

Senator DORGAN. Fair enough. I was asking the question because all of us understand that corporations largely have done better in the United States than in Japan in the last 10 years given the two economies, including the tax codes of both countries.

But aside from that, let me just ask quickly—and then I will ask a number of other questions of the other witnesses, too—do you get any tinge of concern or angst about seeing the kinds of things you saw on the video screen, where people say that patriotism probably ought to take a back seat here, that this is all about money and tax burden, and maybe patriotism has to take a back seat. Does that give you any tinge of concern or angst as a citizen?

Mr. REGALIA. Well, as I saw what was on the screen—and I do not mean to be mincing words, but words are important—they did not say that companies should renounce their U.S. domicile and move abroad, that they should ignore any patriotic implications. They said that in fact the overwhelming advantages in some cases have led some companies to make the decision.

So I do not think that anyone on the screen was advocating that companies not be patriotic. In fact, I think companies, even those that are domiciled abroad, that maintain jobs and create income in the United States are doing something very patriotic.

Senator DORGAN. Let me read the statement, though, because you have misrepresented the statement. This is the statement by the partner, Kate Barton, at Ernst and Young, and she says: “The improvements on earnings are powerful enough to say that maybe the patriotism issue should take a back seat.” Do you have a problem with that?

Mr. REGALIA. Has led some companies to say that maybe the patriotism issue should—they were not saying—

Senator DORGAN. No. That video was to clients, talking about whether they ought to invert or not, and she said “maybe the patriotism issue should take a back seat.”

Does that cause you any pangs at all?

Mr. REGALIA. Well, I am sorry, Senator, but as I saw it, I did not see the person say that.

Senator DORGAN. I am reading it to you. We can play it again.

Mr. REGALIA. Well, we can play it again, sir, but I am sorry—what I heard was somebody saying that the interpretation was that there were significant earnings differences, after-tax earnings differences, that have led some companies to make that decision to invert.

I did not see anything where it said patriotism should take a back seat. I do not think it makes a difference, because—

Senator DORGAN. I do not have the foggiest idea how you and I can have a discussion if we do not hear the same thing. The excerpt I played was clear.

“Maybe patriotism should take a back seat,” the advisor says, and I am just asking the question, the value question, here about whether you have some pangs about that.

Let me ask one additional question—

Mr. REGALIA. I do not believe patriotism should take a back seat, and I do not believe American companies believe that patriotism should take a back seat, nor do I believe even that inverted companies would say that patriotism should take a back seat, because I do not think that creating jobs and providing income for U.S. citizens is an unpatriotic act. And I do not believe that providing the best rate of return possible within the law for U.S. investors is an unpatriotic act.

So yes, we do have a difference of opinion on what was said on that screen. We can play it again, but I believe that companies in the U.S. and companies that do business in the U.S. and create jobs in the U.S. are behaving in a patriotic manner.

Senator DORGAN. Well, let me ask Mr. McIntyre, is it the case that a company that decides to change its mailbox and become a citizen of Bermuda is creating new jobs?

Mr. MCINTYRE. No. They do not create any jobs at all except perhaps for Ernst and Young and maybe a part-time job for somebody to check the mail in Bermuda. What they do is stop paying taxes on their U.S. profits, and that is what we are talking about here today. The question is whether companies, like people, should have to pay something to support this country.

Now, I guess, if you think that we have to make our corporate system identical to the tax system of, let us say, Barbados, that we take the revenues, from what is already their second-lowest in the last six decades, down to zero, let us say, that we could then replace the revenue with—well, doggone if I know; that has not been brought up—but let us say we are talking about, once the economy comes back, \$150 billion a year in revenue we need to replace. According to the Chamber of Commerce, we should take it to zero because that would be the competitive position. Well, yipes—that would mean raising income taxes on ordinary people by quite a bit,

or it would mean eliminating half the Department of Defense. Take your pick.

Senator DORGAN. Mr. Avi-Yonah, you and Mr. Regalia of the Chamber of Commerce have a disagreement in your testimony, I think, about whether or not our tax system is out of sync or out of balance or unfair, and therefore, it is our fault that these inversions are occurring.

Describe the difference, and how do we resolve the difference in your testimony with Mr. Regalia?

Mr. AVI-YONAH. Well, I think this chart is quite telling. These inversions are not to Germany and they are not to France. They are to Bermuda. Nobody is seriously suggesting that we adopt the taxes of Bermuda, except maybe Secretary O'Neill, who thinks we should not have a corporate income tax—but I do not think that is on the table.

What is on the table is adopting, quote, "territoriality." Now, let me make an offer to Mr. Regalia. Why don't we actually adopt the system of France? The French tax overseas earnings of noncontrolled but 10 percent held subsidiaries of their corporation on all income with a tax rate that is below, say, 75 percent of the French tax rate, with an exception for companies that have real business activity and market growth in the country where they are.

I think I would be quite supportive of our adopting that. That would mean that all the insurance companies and all the finance companies and all of those nice companies that are sitting in the Cayman Islands and in Barbados would pay American tax, and it would be much more restrictive than anything that we have today under Subpart F.

It is the same with the Germans and the same with all of those so-called territorial systems. If you look at the details, and if you talk with people actually in Europe who complain bitterly about the competitive disadvantage of their companies vis-a-vis our companies because of their tax system, you hear that in fact there is a range. We are somewhere at the lower end of that range, exactly like on this chart, in terms of how tough our rules are—even some rules where we are notoriously tough, it turns out if you look at it that other countries have rules that are just as tough or tougher.

It is just not accurate to say that we are at a competitive disadvantage with other countries.

Senator DORGAN. Mr. Gale—I am going to ask Mr. Regalia to feel free to respond to that—but Mr. Gale, again from the standpoint of international competitiveness, is there an issue here?

Mr. GALE. The issue is that competitiveness is not the issue. If we, for example, allowed firms to expense all their investment in the first year it was taken, then, the effective tax rate on new investment would be negative. It would be zero if it were just expensed and financed out of equity, but because you can finance it by borrowing and deduct the interest, you would have a negative effective tax rate on new investments. That is the standard, cost of capital, Dale Jurgenson type of economic result that I think we can all agree on.

Doing that would reduce the cost of new investment in the United States below that of any of our major trading partners by far. It would have virtually no effect on the incentive for firms to

invert. It would still be the case that our statutory rate would be higher than the statutory rate in Barbados or Bermuda, and there would still be huge incentive for firms to invert and to strip earnings out, either by interest payments or royalty payments, to strip earnings out of the United States and into a second or third country.

So the competitiveness issue relates only to the effective tax rate on new investment. The incentive to invert depends on something entirely different, which is the statutory tax rate. Therefore, competitiveness is not the cause of inversions, or at least, it is not the cause of inversions that are designed to strip U.S. earnings out of the U.S. tax system.

Senator DORGAN. Mr. Regalia, you may respond to those comments, but I would also ask you to respond to the idea that Mr. Gale advanced some while ago of changing the residency determination of corporations, which I think is an idea that has been kicked around some, and an interesting idea. Mr. Gale is saying that a corporation's residence is where they are doing their business, where their offices are, where their executives are, where they park their cars, where they get their mail in the morning. What is wrong with that?

Mr. REGALIA. I will respond to the questions in order. First, with regard to the chart and the comments by Mr. Avi-Yonah, that chart shows the corporate income tax revenue as a percentage of GDP in those countries. So it is the corporate taxes paid to those countries by the companies working in those countries.

This issue is about a U.S. company that operates multinationally versus a foreign company that operates multinationally and the tax each has to pay, not to everybody else but to the U.S. And in the U.S., the company that is domiciled in the U.S. has to pay taxes on its worldwide income and taxes on its U.S. income; whereas the foreign—

Senator DORGAN. Mr. Regalia, wait. Let us stop at that point just to clear it up. We do have a worldwide system with tax credits for all foreign taxes paid.

Mr. REGALIA. No, not for all foreign taxes paid. We have a limited tax credit system that in almost no case compensates 100 percent. So it does not bring the two back to ground zero. And that does not address the issue, of course, of earnings stripping or the ability to shift earnings to low-tax areas.

But what I am trying to address is why that particular chart does not apply to this question—

Senator DORGAN. Could we stay on that point for just a moment? Can we just clear up that point? Our foreign tax credit you are saying does not really cover the issue because U.S. corporations doing business abroad are paying a tax on some residual foreign income that the foreign tax credit does not cover.

Can you describe for me how much income that is and what kind of a problem it is?

Mr. REGALIA. No, I cannot, because I cannot describe it for each company without knowing each company's internal books. But—

Senator DORGAN. I am talking about the aggregate. Are there aggregate numbers that you have?

Mr. REGALIA. No, I do not have aggregate numbers.

Senator DORGAN. Then, what is the basis for saying that?

Mr. REGALIA. The basis for saying it is that it is in everybody's testimony. It was in Ms. Olson's testimony earlier, it was in the testimonies delivered to the House of Representatives when they had a hearing on this issue, where the limitations on the foreign tax credits are such that the foreign tax credit does not fully offset the worldwide nature of our tax system. And I do not have figures on it, but it is a—

Mr. GALE. Could I intervene for a second? There are two ways in which the foreign tax credit does not cover everything. One is if the—you can only offset foreign taxes in the current year to the extent that they equal what your U.S. taxes would have been. So if you pay 100 in foreign taxes, but your U.S. liability would have been only 80, you can take the 80 this year, and you take the 20 carrying forward.

Senator DORGAN. That is right. You can carry it forward or back.

Mr. GALE. That is right. So that is one way in which it is limited in this particular year.

The other way is that I don't think foreign non-income taxes are applicable to the foreign tax credit. I think it applies only to foreign income tax.

Mr. REGALIA. I think there are certain limits on passive losses as well.

Mr. GALE. I understand that, but that is a Subpart F issue, not a—

Senator DORGAN. I want to understand this issue. My understanding has always been that although we talk about a worldwide system, we are not trying to import a tax burden that belongs to some other country. We are saying to a corporation: If you pay taxes over here, we are going to give you a tax credit for the taxes you paid for income you earned in another country.

And I know it is highly complicated—the foreign tax credits are not a very straightforward part of the law—they are very complicated, but I do not think it is fair to say that we are importing all kinds of income from around the world.

In fact, the studies that I have had done—I have had several of them done—suggest that there is a great deal more “nowhere” income around the world than anything else. The biggest problem is no tax on income in significant parts of the world.

Mr. REGALIA. The issue—again, the chart vis-a-vis everything else—that chart is what corporations pay foreign governments. It is not an issue as to how much they pay—how one company vis-a-vis a multinational company domiciled in another area, what their tax burden would be. And that is different, and if it were not different, we would not be here. There would be no reason to invert.

Senator DORGAN. I agree with that point, but the point has been made that if that is the circumstance under which you make judgments, then, everybody should go to Bermuda, where they have a 27-person armed forces.

Mr. REGALIA. If in fact tax were the only reason, the answer would be yes; but the fact is the taxes are not the only reason, but they are a reason.

Senator DORGAN. But your whole testimony today is to say that the tax system is the juice by which these people are moving. And if that is the case——

Mr. REGALIA. Well, Senator, yes, it is. At the margin for those companies that have moved, it has been a big issue. That is an undeniable fact.

Senator DORGAN. But if that is the case, and there are no other issues with respect to—everything else is amoral or no ethics issues—then, why doesn't everybody go to Bermuda? And you would not object to that, I assume.

Mr. REGALIA. Everybody does not go to Bermuda because everybody is not in the same situation. Everybody does not have the same marginal impact of the Tax Code. But for those companies that have moved to Bermuda or other offshore domiciles, it has been, and the question is why.

Now, you can try the "lock the door" method, and that is what has been suggested—let us lock the door; let us lock the door by changing the residency issue from one of tax to one of residency, or let us just lock the door, or let us exclude them from getting government contracts. But what the "lock the door" method does not address is the fact that there is a discrepancy and that that discrepancy is not addressed.

In other words, it addresses the idea that you do not like a company moving, but it does not address why that company is moving. And I think what the testimony at least tried to suggest was that rather than addressing this with symptomatic salve and a bandaid, let us go at the disease or let us go at the issue itself and say why do they move.

Senator DORGAN. But Mr. Regalia—and I am going to come to some other questions as well—but I guess I have two points on that. One, if I am a corporation, and I decide I want to invert or renounce my citizenship and go to Bermuda to save on taxes, one of the obvious reasons for that is that living in the United States, they have part of the obligation to bear the burden of a Defense Department that is going to pay out \$360 billion this year for U.S. security. And when they go to Bermuda, they have an opportunity to support a defense department that has 27 soldiers.

Mr. REGALIA. And to the extent that they work and create jobs and sell product and have operations in the United States, they pay U.S. taxes.

Senator DORGAN. No——

Mr. REGALIA. Now, if what you are saying is will they shift the taxes, then, let us address the tax shift and not the inversion issue. Locking the door does not address the tax shift. The biggest part of the tax shift in this country is, then, what foreign companies pay and what they do not pay vis-a-vis what U.S. companies pay and what they do not pay. The Tax Code ought to be fair. It ought to treat these different companies that operate in the U.S. equally.

Senator DORGAN. Except that the purpose of inversion is to shift, as you know. But let me ask you this——

Mr. REGALIA. Well, I do not believe it is the only purpose. It certainly is one of the——

Senator DORGAN. I have letters from companies—I assume they are members of the Chamber of Commerce; they are pretty sizeable companies—that I will ultimately put in the record.

Mr. REGALIA. Well, they may or they may not be, sir. I would have to take a look at them.

Senator DORGAN. But are you speaking for all—

Mr. REGALIA. I am speaking for the members of the U.S. Chamber of Commerce, and they represent about 3 million members.

Senator DORGAN. Will those 3 million members support what you are saying today?

Mr. REGALIA. I think the 3 million members believe that the U.S. Tax Code should be adjusted to address this question so that they all pay a fair amount of tax, and that the companies in the same economic situation pay the same tax.

Senator DORGAN. I was in Fargo yesterday. I will bet there are some Chamber members in Fargo that think it is disgraceful and unpatriotic to go through inversion and renounce your citizenship. What do you think of that? Do you think there are some who feel that way?

Mr. REGALIA. I think there are individuals and individual companies that are on all sides of this issue—there always are in a free country with freedom of thought; everybody has a different opinion—but I think that the majority of members believe that the taxes that are levied on corporations ought to be levied in a consistent fashion, and I think that that is what we are asking for.

Senator DORGAN. Mr. Blumenthal, you have heard this discussion. You come at this from a slightly different perspective, because you are a chief law enforcement officer of the State of Connecticut. I was interested in your testimony because you talked about shareholders' rights, which is something that almost no one has focused on. Most of the articles that we see written talk about patriotism and talk about post-9/11 corporate issues and so on.

I started this—and I want to say this for Mr. Regalia's purposes as well—I think there are some great companies in this country, some really great companies. I was on an airplane a while back, and a fellow two rows ahead of me whom I had never met before sent his business card back to me, and he had written on the back of it: "I am the president of a corporation. I am honest, I work very hard and try to do the best job I can, and most corporate executives do the same."

And I sent him a note back and thanked him for it. And I understood why he sent me that card, because there is so much discussion about the corporations that have cheated and played fast and loose. My expectation is that inside the Chamber, for example, you must chafe and get angry about what has been disclosed by the board of directors of Enron itself, saying what happened there was appalling—

Mr. REGALIA. Absolutely.

Senator DORGAN [continuing]. And shame on those people who did it.

So we do not want to tarnish everyone here. There are a lot of great businesspeople out there who do create jobs, run good businesses, and I admire them. Especially in the last several years and in recent months, these disclosures of enablers—yes, Arthur Ander-

sen enabling certain things to be done inside Enron that they should not have enabled, and law firms, and executives and so on—have, I think, created a climate in which the inversion question in terms of public policy is debated in a far different way than it would have been 2, 5, or 10 years ago. And that is fine with me, because I think these are basic questions about who we are and what we are doing and what kind of obligation we have as people, what kind of obligation corporations have as citizens of this country.

So you come at this in a slightly different way. You, seeing a corporation in Connecticut talking publicly about inversion, go to court on behalf of shareholders. I guess what I would like to ask you is do you think this is a case, as Mr. Regalia suggests, of trying to slam the door shut in terms of what we are talking about in public policy here, trying to prevent inversions, instead of fixing other issues such as the Tax Code, or is it a circumstance, do you think, of corporations trying to take advantage of loopholes and trying to find a way to slide through the crevice and just avoid taxes?

Mr. BLUMENTHAL. I think that it is an effort to take advantage of a loophole that exists in the law and that should be shut. The loophole creates the opportunity for tax avoidance, and Mr. Regalia may be right that there is a fiduciary duty on behalf of corporate management to maximize profits for shareholders. That is one way to view the duty of management, but it is not necessarily the top priority of all management.

And I agree with you that there is a significant body of corporate managers who may not want to put profits above patriotism, especially in the wake of 9/11 and many of the moving and inspiring statements that have been made by the President and other public officials, Members of the Senate, and State officials.

But most important, I feel that we cannot postpone fixing this problem in the Tax Code until we do a complete overhaul and reform of the entire Tax Code. Mr. Regalia and I can agree that there ought to be a more equal footing for American companies vis-a-vis foreign competitors, and that perhaps there are other ways that the Tax Code should be improved to make that footing more equal. But I think this loophole has to be fixed now for the sake of companies like Stanley Works, just to put it in very specific and concrete terms, that is at a competitive disadvantage vis-a-vis its competing companies that produce the same products—Cooper Industries and Ingersoll-Rand—and I suspect that that kind of comparison can be made in a variety of other contexts.

So I would opt for fixing the broken leg now, even though, ultimately, the patient may need a hip repair or something more fundamental, and make sure that at least the patient can walk evenly and fairly.

Senator DORGAN. Mr. Avi-Yonah—we have a vote starting in just a matter of moments, so I will not be able to continue this much longer—but the issue of competitiveness with respect to tax structures is a real issue. I do not know the real answer, but I know that it is a question that is worthy of asking. But tell me how important is the issue of the competitiveness of the tax structure in a global economy relative to the competitiveness of wages, environmental regulations, worker safety issues.

One can make the case that, gee, we are just anticompetitive as heck, because we can find people who will make shoes for 16 cents an hour in some parts of the world with respect to minimum wages.

Mr. AVI-YONAH. I completely agree with that.

Senator DORGAN. So, where do taxes fit into all this competitive discussion?

Mr. AVI-YONAH. Taxes is one element of a company's cost structure, and the ability of companies to make a profit is one element of a Nation's overall competitiveness. But what we really care about is the overall competitiveness of the United States' economy, which includes, for example, the ability of foreign corporations to come here and make products and other things.

There is no clear reason why subsidizing U.S. multinationals is the best way of improving the competitiveness of the U.S. economy, as opposed to investing in our workers, investing in our infrastructure, luring companies to put their research and development here, and many, many other ways in which we can use the Tax Code to encourage activities that have a proven beneficial—what the economists call “positive externalities”—a proven beneficial effect on other people.

If we encourage companies to come here and train people, then, these people can walk away from that company that trained them and take those skills and go somewhere else and use that to the benefit of the overall economy. If we give a company a tax break, maybe they will use that money to advantage the U.S. society; maybe they will distribute it as a dividend to their shareholders. Most American companies now have a lot of foreign shareholders. It is not at all clear that this would be something that would give a competitive advantage to U.S. society as a whole.

Senator DORGAN. Mr. McIntyre, in your testimony, you talked about the growth of abusive tax shelters and your great concern about that, inversion being only one of them. Can you expand on that?

Mr. MCINTYRE. Well, it looks like between inversions and various other activities that companies are engaging in, some of them legal, some of them illegal, some of them right on the edge, it is probably about a \$50 billion a year loss to the government these days from offshore shelters.

They got a big boost in the late 1990's with a mistaken Treasury regulation that basically opened the door to doing almost anything you wanted and getting around all of our Subpart F anti-abuse rules by routing it through a real country.

We have now run shelters that go through Germany on their way to Liechtenstein due to a mistake by the Clinton Treasury that, when they tried to correct it, the House Ways and Means Committee said: Oh, no. You can open loopholes up by mistake, but you sure as hell cannot close them.

That one was huge. Nobody knows—the articles at the time when that was discovered called it “the end of the corporate income tax.” It has not gotten there yet, but it is on its way.

So it is a huge problem, and it needs to be addressed, and it can be addressed very straightforwardly. Right now, we just have so many holes in our Swiss cheese of anti-abuse rules that we need

to step back a couple steps and say, wait a minute—we have anti-deferral for this, but no anti-deferral for that, so companies call this that, and they win.

How about if we just get rid of deferral and tax companies on what they make, worldwide, as it is said, but with a full credit for foreign taxes paid so that—the rounding error on how much American companies pay on their foreign income, with the rounding error, the amount paid is zero. I am not sure—it might be slightly negative, possibly \$100 million a year, but I think probably closer to minus-something.

So that, yes, we tax companies on their foreign profits, or what they would like to call their foreign profits, and we say they are not foreign because they are not, but we do not tax them on real foreign profits. They know that, and they are just trying to re-characterize their income.

Anyway, back to what you started with—I am rambling here—but the foreign offshore tax shelter issue is threatening to swallow the whole corporate income tax. Bermuda fortunately has focused the public's attention on it. We need to strike while the iron is at least slightly warm, or we will be looking for ways to pay for our government and will not be able to find them in the future.

Senator DORGAN. Mr. Regalia, finally, why are we unable to find anyone other than you to come to a hearing, and assume that side of the debate?

Mr. REGALIA. Sir, that is a question I cannot possibly answer. I do not even know who you invited. I know that we at the U.S. Chamber feel strongly about this issue. We were very happy to be able to come here and represent the business community, and we thank you very much for the opportunity to do so.

Senator DORGAN. I appreciate you being here. In fact, I should just say that everyone we invited turned us down except for you, so I do appreciate you coming.

One last question. Do you think that all of these newspaper stories, and the tone of this hearing and the question of patriotism are all unfair to business?

Mr. REGALIA. Well, I think that business plays such a central role in the economy that issues like this are always going to be of great concern, both to individuals, to people in political positions, and to the people who have jobs at those businesses and whose incomes depend on those businesses being competitive.

So I think it is important to look at issues like this, and it is important to try to formulate solutions that meet everyone's concern, that leave our businesses paying taxes to support the public goods that the government provides and also to leave businesses competitive to create jobs for our citizens and create income so that they can pay taxes, too.

So I certainly believe that it is an issue and a concept that deserves to be explored.

Senator DORGAN. And is it fair, do you think, to make the point that if we pay 10 times more for defense than England or France, somebody has to pay that, and American business feels that it has a responsibility to bear a part of that burden because it also benefits from our country having the capability to make sure that their

assets are not appropriated overseas and elsewhere—do you agree—

Mr. REGALIA. Absolutely, and I agree that foreign companies that do business in the United States and share the benefits of our great work force, our very productive economy, our tremendous rule of law, and our national defense should be on the same competitive basis with their U.S. counterparts.

Senator DORGAN. And there is perhaps a reason why we have a higher tax burden on corporations in the United States than in Bermuda; would you agree with that?

Mr. REGALIA. Oh, certainly. I think that the issue of what our corporate tax rate is vis-a-vis what others' corporate tax rate is is not really the issue at debate here today. The issue at debate here today is the issue of inversions and the issue of one multinational's relative tax relative to another multinational's, based solely on their country of domicile.

Senator DORGAN. Mr. Gale, I have long admired your work at The Brookings Institution, and you are a Senior Fellow and Deputy Director of Economic Studies. That sort of takes this several steps up in terms of loftiness, I guess—maybe I am wrong about that.

Mr. GALE. "Deputy Director" is a long title with not many responsibilities.

Senator DORGAN. I see. Give me your summary of where we are now on this matter, which I think is an important issue. We have legislation, we have a debate about whether inversions are a problem. The Assistant Secretary today said that inversions are cause for concern which, was, I think, a change in response from Treasury, and I appreciate that change in response.

I think Treasury, like others, is beginning to be concerned about the ramifications of all this. They understand that we face some pretty daunting challenges. We have a reduced income stream at the Federal level, and surpluses have turned to deficits, so we have got to be concerned about tax shelters, inversions, our revenue base at the Federal level. And the Treasury Department today, on the issue of inversions, said that they are concerned about them and the potential revenue loss.

Mr. GALE. I think you summarized very nicely. I will just add a couple of things. One is that not only did the Treasury indicate that it is a problem, but they indicated that the loss of domestic tax revenue on domestic operations is a big problem. To me, that is very important, because that crosses a huge line about inversions and what is motivating them and what the proper policy response is.

I think it is important to keep in mind that competitiveness is not the issue in stripping earnings out of American subsidiaries into foreign parents. It is a statutory tax rate issue.

I think most of the proposed solutions miss the mark. In particular, I think Treasury's comes up short in not dealing with royalties and in advocating a territorial system.

I will just mention one other thing that has not come up, but I think it is important. When a firm does invert, the shareholders of the American subsidiary have forced realizations. They have to pay capital gains taxes on the realization. That capital gains tax acts

as a natural break, as a disincentive for firms to invert. That means that lower capital gains tax rates encourage inversions.

So we hear the routine bowing in the favor of lower capital gains taxes. People like me have said for years that they have unintended consequences. One of the unintended consequences is that they have encouraged firms not to pay out dividends, which has led to Enron-type things. Another of the unintended consequences is that they encourage firms to invert.

So, as we think about tax policy more generally, we need to think about all the pieces of the puzzle.

Senator DORGAN. You are just trying to start another one-hour debate with Mr. Regalia.

Mr. REGALIA. It would take much longer than that, sir.

Mr. GALE. We have had that debate; that is right.

#### ADDITIONAL SUBMITTED STATEMENTS AND QUESTIONS AND ANSWERS

Senator DORGAN. Let me thank all the witnesses for appearing today. Your full statements will be a part of the permanent record.

We have statements from others and, by consent, I will keep the record open.

Accenture, while they did not want to appear, have submitted a written statement.

The AFL-CIO has submitted a written statement.

We will keep the record open until the close of business today for the inclusion of other statements that are sent to us.

[The statements follow:]

#### PREPARED STATEMENT OF THE AFL-CIO

The AFL-CIO is pleased to have the opportunity to express our concerns about American companies reincorporating to tax havens such as Bermuda. We commend the Subcommittee for holding this important hearing. While there are a variety of issues raised by corporate flight from the United States, our testimony will focus on the corporate governance implications of these arrangements. Though some argue these corporate inversions are in the interests of corporations and their investors, we believe they shelter corporate management from accountability to investors and that is why they are opposed by leading institutional investors and have become increasingly difficult to effectuate in the face of growing shareholder opposition.

The 13 million members of the AFL-CIO's member unions participate in benefit funds with over \$5 trillion in assets. Our members' funds have lost tens of billions of dollars as a result of the collapse of corporations where there appears to have been significant wrongdoing. In this context, our funds and our members' corporate governance rights in the companies we invest in are critical both to preventing wrongdoing and to recovering lost assets if wrongdoing does occur.

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

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

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

For these reasons, the AFL-CIO and its member unions have in the last 6 months led efforts by shareholders at two companies, Nabors Industries and Stanley Works, to oppose efforts at reincorporation in Bermuda.

On June 14, 2002, only 65 percent of the shares at Nabors Industries approved the company's proposal to reincorporate to Bermuda, a very low vote total for a management proposal. A coalition of institutional investors—the Amalgamated Bank, the AFL-CIO, the Central Laborers' Pension Fund and the Laborers' International Union of North America—opposed the move based on concerns about its adverse impact on shareholder rights and doubts over the economic benefits of the reincorporation. The principle reason Nabors gave for reincorporating is lower tax bills, although Nabors did not quantify the savings.

In our effort to preserve shareholder rights and corporate accountability at Nabors, we gained the support of several influential public pension funds. These public funds included the New York State Common Fund, New York City funds (all five), Connecticut Retirement Plans and Trust Funds, State of Wisconsin Investment Board and California Public Employees Retirement System. Also due in part to our efforts, the investment management community is becoming increasingly concerned about the effects of these reincorporations on shareholder rights.

We believe the disclosure about the impact on shareholder rights and the tax effects did not comply with Federal securities law or with Nabors fiduciary duties of disclosure under Delaware law. The AFL-CIO has joined a lawsuit brought by individual investors of Nabors in Federal District Court in Houston, and that lawsuit is proceeding.

Following the Nabors efforts, the AFL-CIO joined together with our affiliated union the International Association of Machinists and Aerospace Workers, which represents Stanley Works employee shareholders, and the Connecticut Retirement Plans and Trust Funds to oppose the reincorporation of Stanley Works. The company agreed to a revote after the Attorney General of Connecticut raised concerns that the company misrepresented facts regarding the vote to its employees. The first vote approved the reincorporation by less than one percent. But then following a large demonstration by Stanley Works employee owners against reincorporation on July 29, 2002, the company abandoned its efforts to reincorporate in Bermuda. We believe they did so because they could not win the shareholder vote.

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

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

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

By incorporating in Bermuda companies may make it more difficult for shareholders to hold companies, officers and directors legally accountable in the event of wrongdoing. It is crucial that shareholders have ability to pursue legal remedies to deter wrongdoing. If a company reincorporates to Bermuda, it may be more time consuming and expensive to hold that company or its officers and directors accountable in U.S. courts for several reasons. A judgment for money damages based on civil liability rendered by a U.S. court is not automatically enforceable in Bermuda. The U.S. and Bermuda do not have a treaty providing for reciprocal enforcement of judgments in civil matters. A Bermuda court may not recognize a judgment of a U.S. court if it is deemed contrary to Bermuda public policy, and Bermuda public policy may differ significantly from U.S. public policy.

Unlike Delaware, Bermuda does not generally permit shareholders to sue corporate officers and directors derivatively—on behalf of the corporation—to redress actions by those persons that harm the corporation. Shareholder derivative suits

recognize that a corporation is unlikely to pursue claims against the same officers and directors who control it and provide, we believe, a critical mechanism for remedying breaches of fiduciary duty, especially breaches of the duty of loyalty.

A derivative lawsuit under the laws of the jurisdiction of incorporation is the primary remedy available to shareholders if an officer or director of their company is stealing from the business. Federal securities laws do not provide a direct remedy for this most basic form of wrongdoing. Bermuda law limits derivative lawsuits to a narrow set of specific circumstances primarily involving acts that are beyond the authority of the officers and directors to take as a statutory matter. As a result, we believe, though we cannot be sure in light of the secretive nature of Bermuda's legal system, that no derivative actions have been filed by shareholders against the officers and directors of either Tyco or Global Crossing.

In addition, in Delaware and many other States the shareholder lawsuit has evolved to give investors remedies in a variety of situations, such as in circumstances where company management may be interfering with shareholders' exercising their proxy voting rights, or where management may be misleading shareholders in an effort to obtain their consent to a corporate action. It is unclear at best whether shareholders have these important rights of action under Bermuda law. Thus the steps that were taken both by shareholders and by the State of Connecticut to protect shareholders' rights after the first tainted Stanley Works reincorporation vote would probably not have been possible had Stanley Works actually been a Bermuda corporation.

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

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

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

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

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

We understand there is bi-partisan support for a legislative response to this problem, and we encourage Congress to take swift action. The AFL-CIO is in full support of S. 2119, Reversing the Expatriation of Profits Offshore Act, and H.R. 3884, the Corporate Patriot Enforcement Act.

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

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

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PREPARED STATEMENT OF ACCENTURE LTD.

Accenture recognizes the legitimate concerns being raised regarding corporate inversions. Since we have been mischaracterized as a corporate inversion, we respectfully submit written comments to the Subcommittee on Accenture's incorporation and previous structure as well as our views on legislative proposals designed to address the corporate inversion issue.

*Accenture Did Not Engage in a Corporate Inversion Transaction*

Accenture is one of the world's largest management and technology consulting organizations with more than 75,000 employees worldwide, including 26,000 in the U.S. Accenture is, and always has been, a global organization. Accenture has never been a U.S.-based or operated organization and has never operated under a U.S. parent corporation. The majority of Accenture's partners, employees and revenues are outside the U.S. and were never a part of Accenture's U.S. operations. Further, the majority of Accenture's partners and employees are not U.S. citizens.

Accenture newly incorporated in Bermuda in 2001; Accenture did not reincorporate in Bermuda. Before incorporation, Accenture operated as a group of more than 40 locally-owned partnerships and other entities in 47 countries coordinated by contract through a Swiss-based entity.<sup>1</sup> In 2001, Accenture's 2,500 partners, more than half of whom were non-U.S. citizens, chose to move to corporate form and seek a public listing in order to build the capital structure necessary to fuel the company's continued growth. With thousands of partners and employees of many nationalities, it was particularly important, as a cultural matter, for the organization to select a neutral place of incorporation for its parent company. Accenture's partners voted to incorporate the parent company, Accenture Ltd, in Bermuda.

On October 1, 2002, the General Accounting Office (GAO) issued a report that identified those of the top 100 publicly traded Federal contractors incorporated offshore. GAO identified three that "have engaged in transactions that have been characterized as inversions."<sup>2</sup> Accenture was not one of the three. GAO also accurately describes Accenture's previous structure and incorporation.

*No Income Previously Subject to U.S. Tax was Removed from the U.S. Tax Base*

Today, as in the previous structure, each Accenture entity pays tax in the country in which it operates. Accenture pays, and has always paid, U.S. tax on income generated by its U.S. operations. Accenture operates in the U.S. through its subsidiary Accenture LLP. Under the prior structure, Accenture LLP paid U.S. taxes through its individual U.S. partners. Currently, taxes are paid on income earned by Accenture's U.S. subsidiary through the U.S. corporation that owns it. Further, none of the income generated by Accenture's non-U.S. partnerships or entities was ever subject to U.S. tax. Therefore, no U.S. income or non-U.S. income previously subject to tax was removed from the U.S. tax base by the incorporation of Accenture. Even the GAO recognized that companies incorporated offshore "may have U.S. based subsidiaries that pay U.S. taxes".<sup>3</sup>

*Accenture Does Not Oppose Enactment of Legislation or Implementation of Regulations to Appropriately Address Tax Issues*

Concerns have been raised that offshore incorporation and complicated corporate structures can be used to reduce income in the U.S. and thus reduce the payment of U.S. taxes. Accenture did not intend to use, and is not using, its structure to achieve "earnings stripping". Like most multinational companies, Accenture Ltd and its subsidiaries engage in usual and customary cross-border transactions in the ordinary course of business. These transactions are executed in full compliance with all applicable tax laws of the U.S. and other countries. To the degree there is a conclusion that the existing U.S. tax laws and regulations are not adequate to prevent abuse, Accenture does not object to appropriately addressing those concerns. For this reason, Accenture is not opposed to S. 2119, the Reversing the Expatriation of Profits Offshore Act, approved by the Senate Finance Committee on June 28, 2002.<sup>4</sup>

<sup>1</sup>This structure has been in place since at least 1989, when Accenture separated from the Arthur Andersen firms. In 1990, the U.S. Securities and Exchange Commission formally recognized Accenture as an entity separate and distinct from Arthur Andersen LLP. In August 2000, based on an arbitrator's decision in the International Chamber of Commerce proceedings commenced by Accenture in 1997, all remaining historical contractual ties between Accenture and Andersen Worldwide, and as a result, Arthur Andersen, were completely severed.

<sup>2</sup>GAO-03-194R Federal Contractors Incorporated Offshore (Washington, DC: October 1, 2002), at 3.

<sup>3</sup>Id. At 1.

<sup>4</sup>By using a 50 percent shareholder ownership threshold to define "limited inversions", S. 2119 may cover certain transactions that are not inversions. As the Tax Section of The New York State Bar Association stated in Report on Outbound Inversion Transactions, "imposing extraordinary remedies at the lower end of the 50 percent-80 percent scale frequently will not be appropriate and that considerations should be given to raising the minimum threshold from 50 percent to 60 percent to reduce the number of legitimate mergers and acquisition transactions caught in their grasp." Report No. 1014 (Albany, NY: May 24, 2002), at 61.

Accenture also does not oppose the Department of Treasury proposals to address earnings stripping.<sup>5</sup>

*Accenture Strongly Opposes Efforts to Ban the Award of Federal Contracts to U.S. Subsidiaries of Foreign Companies*

Accenture strongly opposes, however, the proposals to ban the award of Federal contracts to offshore entities or their U.S. subsidiaries, and is deeply concerned about the unintended consequences on communities across America that could result from such a ban. Many of Accenture's U.S.-based employees work with Federal, State and local agencies to implement technology solutions and provide other services that make governments more efficient and effective. Companies that completed legal and legitimate transactions in full compliance with current law should not be barred on a blanket basis from contracting with the Federal government. Such a sanction would be extreme and without precedent. Moreover, the Federal procurement system is designed to promote the use of contractors "who have a track record of successful past performance or who demonstrate a current superior ability to perform," while promoting competition.<sup>6</sup> Eliminating world-class competitors on a blanket basis without regard to their capability to perform could deprive the U.S. of receiving the best goods and services at the best prices.

Thank you for the opportunity to provide our comments on the corporate inversion issue.

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QUESTION SUBMITTED TO PATRICIA OLSON

QUESTION SUBMITTED BY SENATOR BEN NIGHTHORSE CAMPBELL

*Question.* In your statement, you mentioned the obvious tax disadvantage of domestic companies to compete with foreign counterparts. Do you believe the major underlying motivation for corporate inversions is the ability to compete with foreign competitors? If so, do you believe that we should legislate a system that enables these corporations to compete internationally when their procedure is currently legal?

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

We cannot just address strategies that inappropriately minimize U.S. income, however. We must also address the tax disadvantages imposed by our international tax rules on U.S.-based companies with foreign operations. The burden imposed by our international tax rules on U.S.-based companies with foreign operations is disproportionate to the tax burden imposed by our trading partners on their companies' foreign operations. The recent inversion activity and the increased foreign acquisitions of U.S. multinationals evidence that fact and the significant consequences that may have for U.S. businesses and the U.S. economy. The U.S. rules for the taxation of foreign-source income are unique in their breadth and complexity. It is time to revisit them. Our rules should not disadvantage U.S.-based companies competing in the global marketplace.

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

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QUESTION SUBMITTED TO WILLIAM GALE

QUESTION SUBMITTED BY SENATOR RICHARD C. SHELBY

*Question.* Many government contracts are awarded to companies that take advantage of offshore tax havens. How can we ensure that companies that take advantage of offshore tax havens do not place U.S. companies at a competitive disadvantage

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<sup>5</sup> Testimony of Pamela Olson, Acting Assistant Secretary (Tax Policy), United States Department of Treasury before the House Committee on Ways and Means, on Corporate Inversion Transactions (Washington, DC: June 6, 2002), at 3–8.

<sup>6</sup> FAR 1.103.

when there is a competition for federal contracts? Do you believe that our current contracting policy gives due consideration to U.S. based companies?

Answer. The best way to ensure that companies that try to take advantage of offshore tax havens do not place U.S. companies at a competitive disadvantage when competing for federal contracts is to stipulate that companies that have their management and executive offices housed in the United States will be treated for tax purposes as if they were incorporated in the U.S. These companies benefit from America's educated workforce, public services, defense, infrastructure, and so on, and the companies acknowledge this implicitly by choosing to house their corporate offices here. Simply changing the definition of a U.S. corporation to one that is based on where their management is located, rather than one that files incorporation papers here, would solve most of these problems.

I believe that our current policy toward federal contracting gives too much weight to inverted companies if it treats them on an equal basis with companies that have not inverted.

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QUESTION SUBMITTED TO REUVEN AVI-YONAH

QUESTION SUBMITTED BY SENATOR RICHARD C. SHELBY

*Question.* Many government contracts are awarded to companies that take advantage of offshore tax havens. How can we ensure that companies that take advantage of offshore tax havens do not place U.S. companies at a competitive disadvantage when there is a competition for Federal contracts? Do you believe that our current contracting policy gives due consideration to U.S. based companies?

Answer. Companies that take advantage of offshore tax havens have a competitive advantage in bidding for Federal contracts because of the lower tax costs they face. Given that there is no economic substance to such companies' presence in the tax havens, and no meaningful difference between them and their U.S.-based competitors other than the tax differential, this advantage is unfair. I would therefore support banning such companies from bidding on U.S. government contracts.

CONCLUSION OF HEARING

Senator DORGAN. I thank the witnesses for appearing.

This hearing is recessed.

[Whereupon, at 12:08 p.m., Wednesday, October 16, the hearing was concluded, and the subcommittee was recessed, to reconvene subject to the call of the Chair.]

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