

# CORPORATE EXPATRIATIONS—THE TIP OF THE ICEBERG:<sup>1</sup> RESTORING THE COMPETITIVENESS OF THE UNITED STATES IN THE GLOBAL MARKETPLACE

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## INTRODUCTION

The economic and political future of the United States is at risk.<sup>2</sup> In reaction to outdated international tax laws, multinational corporations are abandoning America and relocating their corporate headquarters overseas.<sup>3</sup> Many unincorporated United States businesses are choosing to incorporate in foreign countries, largely in an attempt to decrease their tax liability.<sup>4</sup> Companies that do not relocate experience a growing threat of takeovers by foreign companies;<sup>5</sup> in fact, foreign takeovers of American companies amounted to an astounding \$340 billion in the year 2000 alone.<sup>6</sup> In addition to relocating their headquarters, companies must also relocate jobs, capital investments, and research and development activities to areas outside of the United

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1. *Corporate Inversions: Hearing Before the House Comm. on Ways and Means*, 107th Cong. 42 (2002) [hereinafter *Hearing*] (statement of Gary Hufbauer, Reginald Jones Senior Fellow, Institute for International Economics), available at <http://waysandmeans.house.gov/Hearings.asp>.

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2. See *Hearing*, *supra* note 1, at 41–43 (statement of Gary Hufbauer).

3. See generally *Corporate Inversion Transactions: Tax Policy Implications*, Office of Tax Policy, Dep't of the Treas. (May 2002), at [www.treas.gov/press/releases.docs.inversion.pdf](http://www.treas.gov/press/releases.docs.inversion.pdf) [hereinafter *Treasury Report*].

4. See *id.* at 2.

5. See *id.*

6. Foreign acquisitions of U.S. companies amounted to \$90.9 billion, \$234 billion, \$266.5 billion, and \$340 billion, in years 1997, 1998, 1999, and 2000 respectively. See 36 MERGERS & ACQUISITIONS ALMANAC 37 (Feb. 2001).

States.<sup>7</sup> This exodus of resources poses an increasing threat to America's competitive position in the world economy.

Members of Congress have introduced numerous bills in response to this alarming trend. Such proposed legislation aims to halt the amount of corporate exodus through a combination of three methods: (1) retroactively prohibiting expatriations; (2) preventing future expatriation by imposing a moratorium; and (3) penalizing corporations for expatriating.<sup>8</sup> Unfortunately, however, the legislative proposals made to date address only the consequences of an underlying problem, and not the problem itself, namely, our country's outdated corporate tax laws.

Unlike many of its trading partners, the United States still taxes its companies according to their worldwide income.<sup>9</sup> This archaic tax policy does not withstand the pressures of today's political and business environment.<sup>10</sup> United States tax law places its own resident multinational corporations at a competitive disadvantage compared to foreign multinationals.<sup>11</sup> American multinational corporations are subjected to higher rates of taxation than their foreign competitors, forced to deal with complicated and sometimes incomprehensible tax laws, and consequently expend tremendous resources on tax compliance.<sup>12</sup> As a result, the United States has become an undesirable location for corporate headquarters.<sup>13</sup> As Treasury Secretary Olson recently stated, "U.S. business must be more efficient just to be able to be competitive."<sup>14</sup>

Despite extensive global economic and political changes in recent decades, including the collapse of the Soviet Union, the economic and political unification of Europe, globalization, and the burst of

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7. See *Hearing, supra* note 1, at 42–43 (statement of Gary Hufbauer).

8. See discussion *infra* Part VI.B and accompanying notes for examples of proposed legislation.

9. "[A]ll income from whatever source derived" includes income earned or received from any geographic source. 26 U.S.C. § 61(a) (2004).

10. See *infra* Parts II, III.D, and VII.

11. *Hearing, supra* note 1, at 45–48 (statement of Steven C. Salch, Partner, Fulbright & Jaworski, LLP).

12. See *infra* Part III.D (discussing tax burdens and complications of U.S. tax system).

13. "Purely from a tax standpoint, few attorneys today would recommend putting the headquarters of a multinational firm in the United States. Why subject your foreign subsidiaries to the U.S. worldwide tax system? Why deny yourself the advantages of earnings stripping?" *Hearing, supra* note 1, at 42 (statement of Gary Hufbauer).

14. Press Release, Remarks by Treasury Assistant Secretary Pam Olson to Conference on U.S.-German Relations (Mar. 25, 2003), at <http://www.treas.gov/press/releases/js129.html> [hereinafter Olson Remarks].

electronic commerce, the United States international tax laws have remained substantially unmodified for nearly forty years.<sup>15</sup> This article argues that corporate exodus has been a logical response to outdated United States international tax laws.

As a result, the United States must amend its international tax laws to restore American competitiveness. First, the United States should remove foreign earnings by U.S. multinationals from the corporate income tax base, as many countries have done already.<sup>16</sup> Second, to avoid a significant decrease in tax revenues, the United States should simultaneously increase the statutory tax rates applicable to income earned by corporations within the United States.<sup>17</sup> As a corollary, the United States must address the fact that its effective tax rates on corporate earnings are among the highest of member countries in the Organization for Economic Co-operation and Development (OECD).<sup>18</sup> Therefore, the United States should eliminate the tax on dividends in order to decrease the effective rates at which corporate earnings are taxed.<sup>19</sup>

Part I of this Article will present a theoretical and historical background of relevant U.S. tax laws. Part II will demonstrate how the world in general, and the United States in particular, has changed since these laws were first enacted. The difficulties faced by U.S. multinationals in dealing with international U.S. tax law will be explained in Part III. Part IV will describe the resulting corporate exodus. The consequences of this corporate exodus on companies, their shareholders, and the United States will be evaluated in Part V. Part VI will analyze the public debate and selected legislative proposals addressing the corporate exodus. The real issues that cause corporate exodus will be presented in Part VII. Part VIII will present proposed changes to existent U.S. corporate income tax law. Finally, Part IX will evaluate this Article's proposal from the traditional perspectives of equity, efficiency, and simplicity.

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15. See *infra* Part II.

16. See *infra* Part VIII.B.

17. See *infra* Part VIII.C.

18. "[T]he United States is [one of the] highest corporate tax rate countr[ies] in the OECD." *Hearing, supra* note 1, at 41 (statement of Gary Hufbauer).

19. This section of the article builds on the Government's recent decrease in tax rates applicable to dividend income, which was a necessary first step in decreasing the effective rates applicable to corporate earnings. See *infra* Part VIII.C.2.

## I.

## BACKGROUND

A. *Theoretical Models for Taxing Foreign Income*

When asserting their right to assess and collect taxes, nations rely on two main types of jurisdictional systems:<sup>20</sup> residence and source.<sup>21</sup> Most nations use a combination of residence and source systems with one dominating the process.<sup>22</sup> Under a system of taxation based solely on the residence of the taxpayer, a nation asserts its right to tax the worldwide income of its residents.<sup>23</sup> For example, assume that X (whether an individual or a corporation) is a resident of country A. Further, assume that X earns \$100 in country A, \$100 in country B, and \$100 in country C. If country A were to enforce a system of taxation based on residence, it would claim the right to tax the total of X's worldwide earnings, or \$300.

Under a system of taxation based solely on the source of income, a nation asserts its right to tax any and all income generated within its territory regardless of whether that income was generated by residents or nonresidents.<sup>24</sup> Hence, source systems are sometimes referred to as territorial systems. For example, assume that X is a resident of country A, Y is a resident of country B, and Z is a resident of country C, and each earns \$100 in country B. If country B relied on a territorial, or source, system of taxation based solely on where the income was generated, it would claim a right to tax the total income that was generated within its borders, or \$300.

B. *The Evaluation of Residence and Source Jurisdictional Bases*

Each system has its advantages and disadvantages. Traditionally, tax systems are evaluated by considering the three fundamental principles of taxation: equity (the equal treatment of taxpayers with equal amounts of income),<sup>25</sup> efficiency (the attempt to minimize the extent to which the law alters taxpayer behavior),<sup>26</sup> and simplicity (the de-

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20. BORIS I. BITTKER & LAWRENCE LOKKEN, *FUNDAMENTALS OF INT'L TAXATION* 65-2-65-3 (2002 ed.).

21. *See id.* at 65-3-65-4.

22. H. David Rosenbloom, Principal Paper, *From the Bottom Up: Taxing the Income of Foreign Controlled Corporations*, 26 *BROOK. J. INT'L L.* 1525, 1533 (2001).

23. *See BITTKER & LOKKEN, supra* note 20, at 65-2-65-3.

24. *See id.* at 65-4.

25. "[P]ersons who stand in the same place insofar as the relevant target of tax is concerned are treated similarly by the tax regime." Rosenbloom, *supra* note 22, at 1527.

26. "This recalls Colbert's 'art of plucking the goose so as to get the largest possible amount of feathers with the least possible squealing.'" *Id.* at 1527 n.2.

gree of administrative burden the law places on taxpayers and the government).<sup>27</sup>

### 1. *Evaluation of Residence-Based Jurisdictions*

A residence-based system better accommodates equity among taxpayers and generally tends to be efficient. Overall, however, residence-based taxation systems are quite weak when evaluated from a simplicity perspective, but effectively preserve equity by treating taxpayers with the same amount of income equally<sup>28</sup> regardless of the geographical source of that income.<sup>29</sup> In the previous example, X earned \$100 in country A and \$100 in country B. Additionally, assume Y (also a resident of A) earned \$200 in country A. Recognizing that both X and Y earned the same amount of money, country A would tax X and Y equally ignoring the fact that X earned half of its income abroad.

In addition, a tax system based on residence accommodates progressive taxation better than a system based on the source of income. Progressive taxation levies higher rates of taxation on taxpayers with higher income.<sup>30</sup> To illustrate, assume that country A, which follows a residence system, and country B, which follows a source system,

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27. [F]avoring less complex over the more complex to the extent a choice is available. Simplicity, like efficiency but perhaps not quite like equity, is a general goal, not capable of being attained in anything resembling a pure state. It is valuable in its own right and also because it contributes to other aspects of a well-functioning tax system: administrability (the capability of government officials themselves to understand the relevant rules and see their implementation in practice) and transparency (the ability of the public to understand the rules, so that obligations are clear and the companion goals of efficiency and equity can be evaluated and intelligently discussed).

*Id.* at 1528.

Clearly, the goal of simplicity is best served by rules that do “rough justice” in the sense of assimilating different inputs into categories—persons, circumstances, amounts, etc.—even though it is known, indeed obvious, that there are differences within the categories and that item A is not at all the same as item B, but only similar to item B in a particular way.

*Id.* at 1529.

28. This is commonly referred to as horizontal equity, defined as “[t]he concept that people in the same income group should be taxed at the same rate.” INTERNAL REVENUE SERVICE, I.R.S. GLOSSARY, at [http://www.irs.gov/app/understandingTaxes/jsp/s\\_tools\\_glossary.jsp](http://www.irs.gov/app/understandingTaxes/jsp/s_tools_glossary.jsp).

29. “[R]esidence-basis taxation is hard to quarrel with as a matter of tax policy. Such taxation certainly is equitable, since it treats equally taxpayers having similar amounts of income, irrespective of where that income was derived.” Rosenbloom, *supra* note 22, at 1533. See also BITTKER & LOKKEN, *supra* note 20, at 65-2–65-3.

30. See WILLIAM H. HOFFMAN ET AL., *INDIVIDUAL INCOME TAXES* 1-5 (West 2002).

both institute progressive systems of taxation. Both A and B accomplish this progression by taxing income up to \$20,000 at 10% and income above \$20,000 at 20%. Assume X and Y are both residents of country B. X makes \$20,000 in country B and another \$20,000 in country A, whereas Y makes \$20,000 in country B. Using a territorial, or source-based tax system, country B will assess \$2,000 in taxes on both X and Y. X will not have to pay any taxes to country A since A follows a residence system of taxation. Thus, because country B follows a source system of taxation, X and Y will pay the same taxes even though X's total income is twice Y's income. Even if country A also applied a source-based system, X would only pay an additional \$2,000 to A because the applicable rate for X's additional \$20,000 is still only 10%, not 20%. Consequently, X will pay a total of \$4,000 in taxes. However, if X were a resident of A, X would owe a total of \$6,000 in taxes (\$2,000 on the first \$20,000 of income at 10%, and \$4,000 on the additional \$20,000 at 20%). These results illustrate how a residence-based tax system is more equitable than a source system.

Residence-based systems of taxation also tend to satisfy the efficiency standard. A country that follows residence taxation policies will tax its residents on income regardless of where that income was generated. Thus, residence-based taxation systems generally do not alter taxpayers' investment-making decisions.

However, from a simplicity perspective, residence-based systems of taxation present some disadvantages. Although a country may be in a better position to audit and assess taxes on its residents because it will have access to more information than another country exposed to only isolated parts of the taxpayer's transactions, governments find it complicated and expensive to administer worldwide taxation when taxpayers engage in worldwide tax minimization strategies. It may also be true that the country of residence deserves to tax worldwide income to compensate that country for the many services it provides to its residents.<sup>31</sup> The difficulty is caused primarily by the complexities in verifying the foreign income and expenses of taxpayers, which fosters abuse and undermines the integrity of the country's entire tax system.<sup>32</sup>

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31. "Residence-basis taxation relies on the notion that the country where the taxpayer resides legitimately may impose tax in order to support the normal government activities that residents enjoy." Rosenbloom, *supra* note 22, at 1533. See also Thomas S. Adams, *The Taxation of Business*, 11 NAT'L TAX ASS'N PROC. 185, 187 (1918).

32. "The most common objection—that the worldwide taxation implied by residence basis jurisdiction creates difficult problems for tax administration because in-

## 2. *Evaluation of Source-Based Jurisdiction*

A system of taxation based on the source of income has its own advantages and disadvantages. While advantageous from a simplicity perspective, source-based systems tend to draw criticism in the areas of equity and efficiency.

It is easier for a government to verify a taxpayer's local income and expenses than those generated abroad. Consequently, it is cheaper to administer and easier to comply with source-based taxation. Furthermore, the country where the income is generated is better suited to collect taxes because it is closer to the transactions that give rise to the income. Hence, the supporters of tax systems based on income source argue that equitable and efficient systems are useless if they cannot be effectively administered.<sup>33</sup>

Source countries are entitled to tax income generated within their borders. The source country provides the necessary environment for business transactions to take place, including laws, government departments, courts, police, mail, and other important services. Furthermore, it is logical to tax income under the laws of the country where it was earned.

Nevertheless, a system of taxation based on income source has some disadvantages. One traditional criticism is that this system encourages taxpayers to earn income abroad, excluding such income from the home country's tax base.<sup>34</sup> Since foreign income will not be taxed by a home country, taxpayers are encouraged to make foreign rather than domestic investments.

Another criticism comes from the equity perspective. Source-based systems do not accommodate progressive taxation as effectively as residence-based systems.<sup>35</sup> Some countries, however, try to correct this injustice by adopting what is known as an "exemption with progression system," by considering foreign income only for the purpose of determining the applicable income tax rate for domestically earned income.<sup>36</sup>

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come sources outside the country cannot be easily verified—has validity." Rosenbloom, *supra* note 22, at 1534.

33. *Id.* at 1528, 1534.

34. *Id.* at 1533 (discussing how "modern technology and communications" afford residents with foreign-source income an advantage in a system relying exclusively on source-based taxation that was not previously possible).

35. *See supra* Part I.B.1.

36. Julie Roin, *Rethinking Tax Treaties in a Strategic World with Disparate Tax Systems*, 81 VA. L. REV. 1753, 1761 n.27 (1995).

Thus, both systems of taxation have their strengths and weaknesses. Residence-based systems generally tend to be more equitable and efficient, while source-based systems are considered significantly simpler.

### C. Double Taxation

There is an obvious cross-national conflict between residence and source systems. At a minimum, countries using residence-based systems and those using resource-based systems can simultaneously claim a right to tax the same income, which, without any external intervention, results in double taxation. As previously discussed, however, source countries have the primary claim to this income.<sup>37</sup> To alleviate the hardship of possible double taxation and to promote international trade, residence countries generally yield to source countries in taxation of income.<sup>38</sup> This is usually achieved through either (a) exemption of foreign income from the tax base of the residence country,<sup>39</sup> (b) utilization of foreign tax credit provisions, or (c) a combination of the two. Countries traditionally implement these methods through international treaties.<sup>40</sup>

To illustrate the mechanics of each approach, consider the following example. Assume again that X, a resident of A (a country imposing residence-based taxation) earned \$10,000 in B (a country imposing source-based taxation). A imposes a 20% rate on income up to \$30,000; B's corresponding rate is 10%. The \$10,000 X earned is potentially subject to taxation by both countries. To avoid double taxation, the residence country, A, would generally yield its right to tax this income to country B, the source of the income. If A chooses to utilize the exemption method, A would exclude income earned in B from X's tax base. X would only owe \$1,000 in income taxes to B (\$10,000 multiplied by 10%) and nothing to A. If A, however, chooses to utilize foreign tax credit provisions, A would offset the tax X pays to B against the total tax X owes to A on the income X earned in B. Using the facts from this example, A would first calculate the tax X owed on the \$10,000 it earned in B, or \$2,000 (\$10,000 multiplied by A's 20% income tax rate). A would then subtract the \$1,000 X paid to B from the \$2,000 X owes to A. Pursuant to the foreign tax credit provisions, X would owe an additional \$1,000 to A. Thus, X would pay a total of \$2,000 in taxes (\$1,000 to A and \$1,000 to B).

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37. See BITTKER & LOKKEN, *supra* note 20, at 65-5.

38. *Id.*

39. *Id.*

40. See Roin, *supra* note 36, at 1762.

*D. United States International Tax Law as It Applies to  
Multinational Corporations*

The United States subjects its multinational corporations to myriad tax laws. These laws are designed to ensure proper collection of tax revenues, prevent double taxation (to the extent possible), and minimize opportunities for taxpayer abuse.

Almost since the inception of its international tax law, the United States has relied on residence-based taxation principles.<sup>41</sup> U.S. taxpayers are obligated to report and pay taxes on income “from whatever source derived.”<sup>42</sup> Thus, the geographical location of the income’s origin is irrelevant under the United States tax code (hence the term “worldwide taxation”).<sup>43</sup> This worldwide taxation is, therefore, applicable to U.S. corporations doing business overseas.<sup>44</sup>

With few exceptions, the tax laws of the United States view corporations as being separate and distinct from their shareholders, regardless of whether the shareholders are individuals or other corporations.<sup>45</sup> As a result, shareholders are only taxed on the income of foreign companies when they distribute dividends<sup>46</sup> or when U.S. shareholders sell their stock in the foreign companies.<sup>47</sup> This deferral mechanism (i.e., the taxation of U.S. shareholders in the year when foreign profits are repatriated to the United States, as opposed to the year when profits are generated) is well established and has survived constitutional attack.<sup>48</sup> Therefore, as a general rule, U.S. multinational corporations are only taxed on the income of their foreign subsidiaries when foreign profits are transferred to the United States in the form of dividends.<sup>49</sup>

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41. See BITTKER & LOKKEN, *supra* note 20, at 65-2.

42. 26 U.S.C. § 61 (2004).

43. See BITTKER & LOKKEN, *supra* note 20, at 65-3.

44. *Id.*

45. *Id.* at 65-9. See also Robert J. Peroni et al., *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455, 459 (1999).

46. See BITTKER & LOKKEN, *supra* note 20, at 65-9; see also Peroni, *supra* note 45, at 459.

47. See BITTKER & LOKKEN, *supra* note 20, at 65-9. If foreign affiliates do not distribute dividends, the market value of their stock increases by the amount of undistributed earnings. Consequently, taxing gains from sale of foreign subsidiaries’ stock is equivalent to the direct taxation of foreign earnings.

48. See *Moline Props., Inc. v. Comm’r*, 319 U.S. 436 (1943). See also BITTKER & LOKKEN, *supra* note 20, at 65-11.

49. See BITTKER & LOKKEN, *supra* note 20, at 65-11.

However, Subpart F of the Internal Revenue Code provides an exception to this rule.<sup>50</sup> The exception ends the deferral and orders the immediate taxation of U.S. shareholders on the undistributed income of foreign corporations if certain conditions are met.<sup>51</sup> For example, if over 50% of a foreign company's value is owned by U.S. shareholders having 10% or more of the voting power<sup>52</sup> (in fact or by attribution), these shareholders will be taxed on their pro rata share of the foreign company's undistributed income, to the extent that this foreign income is not from manufacturing.<sup>53</sup> Thus, U.S. parent companies that fall under Subpart F rules may experience current U.S. taxation of their foreign subsidiaries' extraterritorial income.<sup>54</sup>

The foreign country following the source-based principles of taxation is also likely to tax the local income of the U.S. multinational corporation. To prevent this double taxation, the United States has enacted the world's most elaborate foreign tax credit provisions.<sup>55</sup> In addition, the United States Internal Revenue Code (Code) contains a multitude of rules designed to ensure that the U.S. tax liability on U.S. earned income will not be decreased by the foreign taxes the corporation will pay on foreign income.<sup>56</sup> To achieve this, the Code provides that U.S. tax liability on a corporation's foreign net income serve as the upper limit for allowable foreign tax credits.<sup>57</sup> To further ensure that there is no cross-crediting between foreign income earned in countries with low and high tax rates, Congress enacted complex basketing rules.<sup>58</sup> Under these rules, taxpayers are required to segregate their income into specified categories and then separately determine the appropriate amount of foreign tax credit for each category.<sup>59</sup>

The Code also subjects U.S. multinational corporations to elaborate rules that govern the allocation of expenses between their American and foreign affiliates. These rules were designed to limit multinational corporations' abilities to transfer income from relatively high to relatively low tax jurisdictions, while simultaneously benefit-

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50. See I.R.C. §§ 951–964 (West 2004) (collectively known as Part III Subpart F—Controlled Foreign Corporations).

51. See *id.*

52. See BITTKER & LOKKEN, *supra* note 20.

53. See I.R.C. §§ 951–964.

54. See *id.*

55. See I.R.C. § 901 (West 2004). See also Olson Remarks, *supra* note 14.

56. See BITTKER & LOKKEN, *supra* note 20.

57. See I.R.C. § 904 (West 2004).

58. See I.R.C. § 904(d) (West 2004). These basketing rules were modified recently by the American Jobs Creation Act of 2004, H.R. 4520, 108th Cong.

59. See I.R.C. § 904(d).

ing from the deferral regime.<sup>60</sup> Thus, while expenses are generally allocated to the country in which they are utilized to generate income,<sup>61</sup> pursuant to the Code a corporation must allocate any interest expense between its U.S. and foreign entities based on the relative proportions of assets that the corporation holds outside the United States.<sup>62</sup>

In summary, the U.S. government taxes the worldwide income of multinational corporations. While the United States generally follows the principle that there is no taxation until repatriation, Subpart F sometimes authorizes the immediate taxation of foreign income. U.S. tax laws do attempt to protect multinational corporations from double taxation<sup>63</sup> and, simultaneously, try to ensure that the corporation does not abuse the system.

*E. Historical Interplay of International Tax Laws Enacted by the United States and its Major Trading Partners*

Generally, businesses incorporated and doing business overseas are not subject to taxation by the U.S.<sup>64</sup> The United States has no tax jurisdiction over foreign nationals who do not generate income within

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60. For example, interest on the inter-company debt is deducted from income by a subsidiary that borrows money and included in income by a subsidiary that lends. The difference in the tax brackets of two subsidiaries produces desired tax savings, especially after the time value of money facilitated by the deferral mechanism is taken into consideration. To illustrate, assume that X is an American company that is subject to an effective 35% tax rate. Also assume that X's affiliate, company Y, is incorporated in country B (which follows source-based taxation system and has a 20% applicable tax rate). In addition, assume that X earned \$1,000 in taxable income in the U.S. X has to pay \$350 in income taxes to the U.S. Treasury (\$1000 times the applicable 35% tax rate). However, if X borrows \$10,000 at 10% from Y, then X would have a deductible interest expense in the amount of \$1,000 (\$10,000 times 10%) and, therefore, no taxable income in U.S. Y will have to pay taxes on the \$1,000 of the interest income it receives from X. However, Y will only owe \$200 to B (\$1,000 times 20%, B's applicable tax rate). Thus, X&Y Company, as a whole, saves \$150 in current tax expenses (\$350 X would have paid to U.S. vs. \$200 Y ended up paying to country B). Even if this interest income will later be repatriated back to the U.S., the present value of taxes X will pay upon repatriation will be less than the present value of taxes X would pay on the same income currently.

61. See generally Treas. Reg. §1.861-8 (as amended in 2001).

62. See I.R.C. § 864(e) (West 2004).

63. See *infra* Part III.B for a discussion of the ineffectiveness of these and other currently existing U.S. tax rules.

64. See Treasury Report, *supra* note 3, at 11. See also Press Release, U.S. Taxation of International Business—The Need for Reform, Remarks by Kenneth W. Dam, Deputy Secretary of the Treasury, Delivered to The Tax Foundation's 65th National Conference (Nov. 14, 2002), at <http://www.treas.gov/press/releases/po3524.htm> [hereinafter Dam Remarks].

its borders.<sup>65</sup> Once they do, the United States (a source country) will exercise its sovereign right to tax that income. Thus, if Y were a company incorporated outside of the United States and had \$20,000 of taxable income from its U.S. operations, the U.S. would tax that income. The U.S., however, has no jurisdiction to tax any income Y generates outside of its borders.

If a multinational corporation is based in a country that follows source-based taxation principles, then the extraterritorial income generated by the corporation is not subject to an additional layer of taxation by its home country.<sup>66</sup> Assuming that Y is incorporated in B, a country that follows source-based taxation, and earns \$20,000 in Bermuda, a jurisdiction that does not levy income taxes,<sup>67</sup> neither Bermuda nor B will tax the income Y made in Bermuda. If Y were incorporated in the U.S., however, Y's income from Bermuda would be taxable by the U.S.

This example illustrates the inherent disadvantage that U.S. multinational corporations experience compared to their foreign competitors: the foreign income of a U.S. multinational corporation is subject to taxation by its home country while the extraterritorial income of a foreign multinational corporation is not. This disadvantage was created by our own government and has been in existence for nearly fifty years.<sup>68</sup>

## II.

### THE WORLD THEN AND NOW

When the U.S. adopted its international tax laws, the world was a very different place.<sup>69</sup> At the time, most businesses operated domestically and few operated internationally.<sup>70</sup> Consequently, most companies were rarely exposed to the intricacies of the international tax laws.<sup>71</sup>

The effects of World War II on European infrastructure gave America and its companies an edge over their European competitors

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65. See I.R.C. § 61 (West 2004).

66. See Treasury Report, *supra* note 3, at 12.

67. See *Introduction to Bermuda*, Bermuda Monetary Authority, at [www.bma.bm/bmawww.nsf/WebPages/Introduction?OpenDocument](http://www.bma.bm/bmawww.nsf/WebPages/Introduction?OpenDocument).

68. See Olson Remarks, *supra* note 14.

69. See *id.* See also Treasury Report, *supra* note 3, at 28.

70. See Treasury Report, *supra* note 3, at 28.

71. See *id.*

for many years.<sup>72</sup> The U.S. economy dominated the world, “accounting for over half of all multinational investment . . . .”<sup>73</sup> Despite burdensome international tax laws, American companies were thriving and the U.S. Treasury was content with the revenues it was collecting. As a result, the United States had little incentive to analyze its international tax laws.<sup>74</sup>

Today, globalization, electronic commerce, and the political and economic unification of Europe are just a few examples of the developments that have fundamentally modified the international businesses arena and put tremendous pressure on U.S. international tax laws.<sup>75</sup> Companies throughout the world are struggling with investor expectations.<sup>76</sup> These expectations have left businesses with little choice but to expand into foreign markets. Economies of scale dictate that the corporations with the highest worldwide sales have the lowest costs and become the most profitable.<sup>77</sup> Consequently, high-cost producers have gradually been forced to leave the marketplace. Thus, the globalization of the business world has turned corporations’ successful foreign operations from a matter of choice into a matter of survival.<sup>78</sup>

Businesses are now generally understood to be global operations. Money, goods, and services seamlessly cross international borders with the help of ever-evolving technologies and the explosion of electronic commerce.<sup>79</sup> International borders are practically nonexistent in today’s business environment.<sup>80</sup> As a result, it is difficult, if not impossible, to find a U.S. business with a significant level of operations that does not find itself struggling with the complexity of U.S. international tax laws.<sup>81</sup>

U.S. international tax laws, when viewed as natural extensions of U.S. foreign policy, need reexamining. The end of the Cold War and the demise of the Soviet Union impacted the United States’ allocation

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72. See generally Christopher Conte & Albert R. Karr, *The U.S. Economy: A Brief History*, in AN OUTLINE OF THE U.S. ECONOMY, available at <http://usinfo.state.gov/products/pubs/oecon/chap3/htm> (last modified Feb. 2001).

73. Treasury Report, *supra* note 3, at 28.

74. See generally Olson Remarks, *supra* note 14.

75. See *id.* See also Treasury Report, *supra* note 3, at 28.

76. Ken Brewer, *Treason or Survival of the Fittest? Dealing with Corporate Expatriation*, 26 TAX NOTES INT’L 465 (2002) (“In assessing competing corporate investments, an investor will choose the one that promises the best return on investment.”).

77. *Id.* at 466 (“To prosper and, therefore, to survive in a free-market economy, the corporation must constantly strive to be the ‘low cost producer.’”).

78. *Id.*

79. See Olson Remarks, *supra* note 14.

80. See Treasury Report, *supra* note 3, at 28.

81. See *id.*

of capital worldwide and, consequently, U.S. multinational corporations as well. The world no longer desired U.S. economic and political preponderance because the world no longer needs the United States to counter-balance the threat of the former Soviet Union. On the contrary, historic partners of the United States are forming new alliances to contain the political and economic expansiveness of the United States and its multinational corporations.<sup>82</sup>

The economic and political unification of Europe has further complicated the global business environment. U.S. companies are losing bidding wars to their European competitors,<sup>83</sup> and the European Union's introduction of its own official currency, the Euro, has created additional challenges for the already troubled U.S. dollar.<sup>84</sup> Meanwhile, the days of the United States as a predominantly capital-exporting nation are gone, as U.S. exports and imports are now practically balanced.<sup>85</sup>

Finally, because of the steady growth of international terrorism, U.S. multinational corporations are now incurring costs beyond those incurred by foreign companies (with the exception of Israel-based companies). They do so in order to protect their operations, workers, and assets throughout the world.<sup>86</sup> Growing anti-American sentiment has also created additional burdens on U.S. multinationals,<sup>87</sup> as buyers in certain parts of the world reject goods and services simply because the producers are American.<sup>88</sup>

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82. Charles Bremner, *Paris and Berlin Prepare Alliance to Rival NATO*, *TIMES* (London), Apr. 23, 2003, at 16 (discussing plans between Germany and France to form military and economic alliance excluding the United States).

83. See, e.g., James Wallace, *Aerospace Notebook: Airbus Zooms Past Boeing in Plane Deliveries*, *SEATTLE POST-INTELLIGENCER*, Jan. 7, 2004, at 2, available at [http://www.seattlepi.nwsourc.com/155549\\_air07.html](http://www.seattlepi.nwsourc.com/155549_air07.html) (describing the recent successes of Airbus).

84. See *Euro vs. Dollar: Looming Storm Clouds of Battle for the Position of the Key Currency*, at [http://about.reuters.com/japan/trader.backnumber.td\\_980910\\_64/p4e.html](http://about.reuters.com/japan/trader.backnumber.td_980910_64/p4e.html) (Sept. 10, 1998).

85. See INT'L TRADE ADM., U.S. TRADE IN GOODS 1976-2002, CENSUS BASIS TABLE, available at <http://www.ita.doc.gov/td/industry/otea/usfth/aggregate/H02T03.html>.

86. See Deborah Cohen, *America's Corporate 'Icons' Brace for War Backlash*, COMMON DREAMS NEWS CTR., Reuters, Mar. 8, 2003, available at <http://www.commondreams.org/headlines03/0308-04.htm> (noting safety concerns at American fast-food chains in the Middle East and elsewhere); Stuart Chirls, *Importers, Exporters, on Front Line of Fight on Terror*, J. COM. ONLINE, June 17, 2003 (on file with the New York University Journal of Legislation and Public Policy).

87. Stuart Elliott, *Advertising: American Companies Are Adjusting Almost Everything That Represents Them Overseas*, N.Y. TIMES, Apr. 4, 2003, at C5. See also Cohen, *supra* note 86.

88. See Elliott, *supra* note 87, at C5. See also Cohen, *supra* note 86.

Thus, the world is very different from the way it was at the beginning of the Twentieth Century, when the U.S. first instituted its current international tax laws. America's economic and political standing on the worldwide arena has changed as well. Yet, U.S. international tax laws, which impact the success of the United States and its companies, have remained largely unchanged. As a result, the archaic nature of U.S. international tax law has caused tremendous problems for American companies and, accordingly, for the entire country.<sup>89</sup>

### III. THE DIFFICULTIES U.S. MULTINATIONAL CORPORATIONS FACE

United States tax law places U.S. multinational corporations at a competitive disadvantage.<sup>90</sup> U.S. corporations pay higher tax rates on their earnings,<sup>91</sup> submit to "absurd"<sup>92</sup> tax laws, and bear greater costs to comply with these tax laws.<sup>93</sup>

#### A. *Higher Rates of Taxation*

The higher rate of taxation is a product of the United States taxing foreign income regardless of whether that income has already been taxed elsewhere. If the amount of U.S. taxes due on this foreign income exceeds the amount of taxes paid to source countries on that income, the U.S. will assess and collect additional taxes.<sup>94</sup>

For example, suppose X is a German multinational corporation that earns \$100 in country A, a jurisdiction that imposes a 20% income tax. X has to pay \$20 to A and nothing else to Germany, because Germany follows the source-based principle of taxing foreign income. However, if X were a U.S.-based company, then X would have to pay \$20 to A and, at a minimum,<sup>95</sup> an additional \$15 to the U.S. (assuming that the U.S. applies a 35% tax rate and X receives full

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89. See *infra* Part V.B.3.

90. "[A] U.S.-based business with multinational operations today generally faces a higher rate of worldwide income taxation of its net income than does a foreign-based competitor with the same operations, business locations, and employee locations." *Hearing, supra* note 1, at 45 (statement of Steven Salch).

91. See *infra* Part III.A.

92. See *Hearing, supra* note 1, at 42 (statement of Gary Hufbauer).

93. See Olson Remarks, *supra* note 14.

94. The recently enacted American Jobs Creation Act of 2004 allows a temporary 85% dividends-received deduction for dividends received by U.S. corporations from their foreign-controlled subsidiaries.

95. See *infra* Part III.B.

credit for the income taxes it paid to A), because the U.S. follows a residence-based taxation policy. Thus, even if the U.S. and Germany were assessing identical 35% tax rates on the income generated within their respective borders, X, as a German company, would pay an effective 20% income tax rate, while X, as an American company, would pay the much higher 35% effective tax rate.

### B. *Ineffectiveness of Foreign Tax Credit Rules*

The highly elaborate U.S. provisions for foreign tax credit do not always prevent double taxation. For instance, U.S. corporations may not receive a full credit for foreign taxes paid due to “generally unfavorable interest allocation rules.”<sup>96</sup> For determining the income derived from any particular country, companies are generally required to allocate their interest expense proportionately to their worldwide income, not to the specific countries in which they borrowed or used the funds.<sup>97</sup> This mandatory allocation may decrease the income from a particular country and, consequently, decrease the amount of allowable foreign tax credit.<sup>98</sup>

Even if U.S. tax rates were the same as the foreign tax rates, U.S. corporations would almost certainly have to pay additional taxes to the U.S. government if, under U.S. income sourcing rules, the Internal Revenue Service (IRS) deems the income to have been derived from the U.S. source and therefore not eligible for a foreign tax credit.<sup>99</sup> Hence, U.S. tax laws significantly restrict corporations’ ability to obtain credit for the foreign taxes they pay and, consequently, expose these corporations to double taxation.

### C. *Subpart F Rules*

Subpart F rules create additional disadvantages for U.S. corporations. Under residence-based taxation policies adopted by other countries, foreign income is taxed by the home country only when that income is brought home.<sup>100</sup> However, the U.S. often taxes foreign income of U.S. corporations even prior to their repatriation of that income. This happens when the foreign income falls under Subpart F rules.<sup>101</sup> Thus, holding everything else equal and considering the time

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96. See Carol P. Tello, *The Upside Down World of Corporate Inversion Transactions*, 30 TAX MGMT INT’L J. 161 (2001).

97. I.R.C. § 904(a) (West 2004).

98. See Roin, *supra* note 36, at 1768–81 (discussing foreign tax credit rules).

99. See *id.*

100. See Olson Remarks, *supra* note 14.

101. See *supra* Part I.D.

value of money, U.S. corporations pay more taxes than even those corporations that are also based in countries taxing worldwide income.<sup>102</sup>

*D. Compliance With the U.S. Tax System Is Overly Expensive*

The U.S. system of taxing foreign income is extremely complex. U.S. companies expend enormous resources complying with the law.<sup>103</sup> As the U.S. Treasury Department stated, “no country has rules for the immediate taxation of foreign-source income that are comparable to the U.S. [Subpart F] rules in terms of breadth and complexity.”<sup>104</sup> It has further acknowledged that “[t]he foreign operations of a U.S.-based company . . . are subject to a [tax related] burden not borne by local competitors.”<sup>105</sup>

Their higher taxes and related expenses make it very difficult for U.S. corporations to compete with foreign-based businesses in an environment where only the “fittest survive.”<sup>106</sup> Despite outcry by and on behalf of American corporations, U.S. international tax laws have not been meaningfully reformed. However, in the changed economic and political world, U.S. corporations no longer have the luxury of remaining complacent about international tax laws. In order to rid themselves of the burdens created by their own country’s tax laws, U.S. corporations have begun to vote with their feet.

#### IV.

#### CORPORATE EXODUS

Businesses are discarding their U.S. nationality in increasing numbers.<sup>107</sup> Spurred by the globalization-induced “mobility of corporate nationality,”<sup>108</sup> corporations are relocating their headquarters to countries with friendlier tax laws.<sup>109</sup> The three most common meth-

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102. See generally Olson Remarks, *supra* note 14. If foreign companies delay repatriation of profits long enough, the effective rate of taxation on those profits can be close to zero.

103. “[T]he direct cost for all corporations in complying with the federal corporate income tax was \$40.3 billion in 1999.” JOHN S. BARRY ET AL., TAX FOUND., THE CORPORATE ALTERNATIVE MINIMUM TAX, FISCAL POL’Y MEMO (Nov. 5, 2001), at <http://www.taxfoundation.org/camt.html>; ARTHUR P. HALL, TAX FOUND. SPECIAL REP., THE HIGH COST OF TAX COMPLIANCE FOR U.S. BUS. (May 16, 1994) at <http://www.taxanalysts.com/www/readingtaxpolicy.ncf>.

104. Treasury Report, *supra* note 3, at 28.

105. *Id.* at 27–28.

106. See Brewer, *supra* note 76, at 605–07.

107. See Treasury Report, *supra* note 3, at 1.

108. See Brewer, *supra* note 76, at 604.

109. See Treasury Report, *supra* note 3, at 2.

ods by which U.S. businesses are acquiring foreign nationality are (a) initial incorporations abroad, (b) corporate inversions, and (c) foreign buyouts.<sup>110</sup>

### A. *Initial Incorporations Abroad*

Electronic commerce provides unprecedented opportunities for businesses of any size to conduct operations on a worldwide basis.<sup>111</sup> Thus, it no longer comes as a shock when a new company generates a portion of its income from foreign operations. However, the anticipation of foreign profits creates a real dilemma for the incorporators.

On one hand, it seems natural for businesses that originated in the United States to be based in the country. It is also generally desirable for a company to take the form of a U.S. corporation if the business plans to conduct substantial operations in the U.S., the world's most desirable marketplace.<sup>112</sup> On the other hand, U.S. citizenship comes with a very high price tag via taxes. Consequently, the unfriendliness of the U.S. tax laws toward income from foreign sources induces many businesses to incorporate abroad.<sup>113</sup> Thus, initial incorporation overseas became an "obvious choice" for international communications companies.<sup>114</sup>

### B. *Corporate Expatriations*

Well-established U.S. corporations are also expatriating themselves. Although corporate expatriation in itself is not a new phenomenon, the recent volume and magnitude of these transactions is a cause for concern.<sup>115</sup> Major U.S. corporations are giving up their U.S. citizenship in return for freedom from the country's worldwide tax web.<sup>116</sup> These corporations employ corporate inversions or foreign buyouts to change their nationality.

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110. *See supra* Part III.

111. *See* Brewer, *supra* note 76, at 605.

112. *See generally* Olson Remarks, *supra* note 14 (discussing the transition from a closed to a global economy).

113. *See* Willard B. Taylor, *Corporate Expatriations—Why Not?*, TAXES, 146, 146 (Mar. 2000).

114. *Id.* at 153.

115. "While the so-called corporate inversion transactions are not new, there has been a marked increase recently in the frequency, size, and profile of the transactions." Treasury Report, *supra* note 3, at 1.

116. "Cooper Industries, Seagate Technologies, Intersoll-Rand and Price-waterhouseCoopers Consulting . . . have also become pseudo-foreign corporations for the sole purpose of saving tax dollars." *Hearing, supra* note 1, at 36 (statement of Richard Blumenthal). Other examples of expatriated companies include: Accenture, McDermott International, Tyco, Foster Wheeler, Leucadia National, Noble, and Wea-

### 1. *Inversions*

Inversion is a process that enables an existing corporation to change its country of residence by removing the ultimate parent company from the U.S. and placing it abroad.<sup>117</sup> To date, corporate inversions have taken three forms: stock-for-stock inversion,<sup>118</sup> asset inversion, or drop-down inversion.

In a stock-for-stock inversion, a new foreign corporation is chartered overseas; the shareholders of the old U.S. parent company then exchange their shares for the shares of the new foreign corporation. The result is that the old U.S. corporation becomes a subsidiary of the new foreign corporation, and the former shareholders of the U.S. corporation hold shares in the foreign corporation.<sup>119</sup> Fruit of the Loom, Inc., for example, reincorporated in the Cayman Islands using this stock-for-stock inversion technique.<sup>120</sup>

The second form of inversion is known as an asset transaction.<sup>121</sup> In this transaction, the U.S. corporation is effectively reincorporated abroad. This reincorporation is accomplished either through the merger of the U.S. parent corporation with a newly formed foreign parent corporation, or through some other mechanism under the corporate law of the foreign country.<sup>122</sup> The result is that the U.S. corporation no longer exists, and its former shareholders now hold shares in

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therford. See Ways & Means Committee Democratic Office and Office of Rep. Richard E. Neal, Corporate Runaways and FY 2002 Federal Contracts (July 14, 2003), at <http://www.house.gov/neal/news/news33.html>.

117. Treasury Report, *supra* note 3, at 3. Others define corporate inversions as “a hyper-technical term for corporations exploiting tax law loopholes and corporate directors and management profiting and protecting themselves from proper accountability.” *Hearing, supra* note 1, at 35 (statement of Richard Blumenthal).

118. See Treasury Report, *supra* note 3, at 4–5. For example, Triton Energy Corporation, Fruit of the Loom, Inc., Gold Reserve Corporation, PXRE Corporation, and Everest Reinsurance Holdings have undergone corporate inversions by means of stock-for-stock transactions. See Taylor, *supra* note 113, at 149–51.

119. “Simply put, in a cross-border inversion, the shareholders of a domestic corporation exchange their shares for the shares of a foreign corporation.” Gregg D. Lemein & John D. McDonald, *Taxable Inversion Transactions*, TAXES, Mar. 2002, at 7.

120. See Taylor, *supra* note 113, at 150.

121. See Treasury Report, *supra* note 3, at 9.

122. As a corporate law matter, that may be accomplished either through a merger of the U.S. parent into a newly-formed foreign corporation, with the existing shareholders of the U.S. parent receiving stock of the new foreign corporation, or pursuant to conversion and continuation procedures under state corporate law. After this transaction, the new foreign parent holds the corporate group previously held by the former U.S. parent, and the shareholders hold stock of the new foreign parent instead of stock of the former U.S. parent.

Treasury Report, *supra* note 3, at 5.

the foreign corporation. The AmerInst Insurance Group, Inc. and White Mountain Insurance Group used the asset form of inversion when they reincorporated in Bermuda.<sup>123</sup>

Finally, the third form of inversion is known as a drop-down transaction, which involves elements of the other two forms of inversion.<sup>124</sup> Shareholders of the U.S. corporation acquire shares of the foreign corporation, but the U.S. corporation survives as a subsidiary.<sup>125</sup> Transocean Offshore, Inc. used this form of inversion to move its headquarters to the Cayman Islands.<sup>126</sup>

## 2. *Foreign Mergers and Buyouts*

United States corporations are changing their nationality through mergers with and buyouts by their foreign competitors.<sup>127</sup> After these transactions, the foreign corporations become the parent company of the newly created organization.<sup>128</sup> As a result, the foreign income of the former U.S. corporation is no longer subject to U.S. income tax. These “outbound” mergers and buyouts have been on the rise.<sup>129</sup>

The latest merger between the German Daimler Corporation and the American Chrysler Corporation is a case in point. When two corporations merge, the parties must select a domicile for the merged entity. The newly created Daimler-Chrysler Corporation was incorporated in Germany, mainly because of the U.S. tax laws.<sup>130</sup>

Daimler-Chrysler is not unique; in fact, the list of cross-national mergers is expanding. Foreign acquisitions of U.S. companies amounted to \$90.9 billion, \$234 billion, \$266.5 billion, and \$340 billion, in years 1997, 1998, 1999, and 2000 respectively.<sup>131</sup> Of course, there are reasons other than (or in addition to) taxes that motivated these foreign buyouts. These numbers, however, cannot be ignored when one analyzes the implications of the existing U.S. tax law.

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123. See Taylor, *supra* note 113, at 151–52.

124. In this type of transaction, the U.S. parent transfers its assets to a new foreign corporation, and then a portion of these assets is contributed to a U.S. subsidiary of a new foreign parent. See Treasury Report, *supra* note 3, at 9.

125. See *id.*

126. See Taylor, *supra* note 113, at 151–52.

127. See Treasury Report, *supra* note 3, at 19.

128. See *id.*

129. See *id.*

130. See Tello, *supra* note 96, at 161 n.5.

131. See Treasury Report, *supra* note 3, at 19 (citing MERGERS AND ACQUISITIONS 2001 ALMANAC, Vol. 36, No. 2, at 37 (Feb. 2001)).

## V.

## THE CONSEQUENCES OF THE CORPORATE EXODUS

A corporate exodus has tremendous consequences for all stakeholders. The corporation, its shareholders, creditors, and consumers, and even the economic and political standing of the United States are affected. Not all consequences, however, are intended or even apparent.

A. *Expected Consequences*

The parties intend a corporate expatriation to create additional value for both the corporation and its stakeholders by moving the new entity's extraterritorial income outside of the tax jurisdiction of the United States. Corporations that relocate to a jurisdiction that does not levy income tax, such as Bermuda, expect to enjoy hundreds of millions of dollars in untaxed profits.<sup>132</sup>

As a result, the corporations expect to have more residual income to invest in their operations and to pass on to its consumers through reduced prices.<sup>133</sup> The expected increase in the corporation's profitability causes an increase in the price of the corporation's stock, which, in turn, enriches the shareholders.<sup>134</sup> Stanley Works, for example, estimated that its stock price would appreciate by 11.5% solely because of the company's expatriation, and the management of other expatriating companies have articulated similar expectations.<sup>135</sup>

A more fundamental change, however, comes about as a result of the corporate exodus. By escaping U.S. taxation, these corporations are also eliminating the core competitive advantage that their foreign competitors once held—the advantage that the U.S. government granted to foreign corporations through its tax policies.<sup>136</sup> This expatriation, as the next section illustrates, is not the optimal solution for either the corporations or their stakeholders. Expatriation is, however, the only solution currently available.

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132. *Hearing, supra* note 1, at 36 (statement of Richard Blumenthal).

133. Some commentators even argue that corporate expatriations save American jobs because instead of steadily losing competitive ground, such corporations prosper through increased profitability and competitiveness. *See Brewer, supra* note 76.

134. “[P]rofits may increase as a result of this foreign reincorporation gimmick . . . .” *Hearing, supra* note 1, at 36 (statement of Richard Blumenthal).

135. *Id.*

136. *See supra* Part III.

## B. *The Adverse Consequences*

Corporate exodus has significant disadvantages as well. These disadvantages, however, are not always readily apparent to the companies or their stakeholders; some are only now becoming apparent to the United States government,<sup>137</sup> as our country's economic and political standing deteriorates.<sup>138</sup>

### 1. *The Impact on the Expatriating Corporations*

Expatriations can inflict negative consequences on the expatriating corporations. An immediate tax liability, the increased cost of capital, and decreased business opportunities are just a few examples of such consequences. Careful planning, however, may decrease the severity of the damage the expatriation causes.

#### a) *The Immediate Tax Liability*

A corporation is likely to owe taxes to the U.S. government for the year in which expatriation takes place if the corporation is inverted through either the asset transfer or the drop-down method.<sup>139</sup> Pursuant to section 367 of the Internal Revenue Code, a corporation is required to recognize for tax purposes any built-in gain (though not loss) associated with assets transferred to a foreign corporation. The amount of this built-in gain is the difference between the fair market value and the adjusted basis of assets at the time of the transfer.<sup>140</sup>

Congress created this exit toll to discourage expatriations by making them more costly.<sup>141</sup> Intelligent planning, however, may neutralize the intended effect of this section. For example, a company may execute the expatriation when the fair market value of the transferred assets is low compared to the adjusted basis of these assets. In such a case, there would be little built-in gain for the government to tax.

#### b) *The Non-Tax Consequences*

The non-tax consequences of an expatriation may be discrimination and higher cost of capital. First, subsequent to the expatriation, the corporation will no longer be American. Depending on the type of market a particular corporation serves, this status may have an impact

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137. *See id.*

138. *See supra* Part II.

139. I.R.C. §§ 367(a)(2), (3)(c)(ii)(I) (2004).

140. I.R.C. §§ 367(a)(2), (3) (2004).

141. *See Brewer, supra* note 76, at 147.

on the corporation's business if consumers discriminate against a Bermudian corporation in favor of American suppliers.<sup>142</sup>

Second, the cost of capital may be higher for some of the offshore-based corporations than for their competitors because lenders may find it riskier and potentially more expensive to do business with an offshore-based corporation. For example, the corporate law of Bermuda favors management over creditors.<sup>143</sup> This unfriendly legal environment may make it more difficult for lenders to recover their invested capital in the event that the corporation defaults on its obligations. As a result, lenders may demand a higher interest rate on their loans to compensate for the increased risks involved, and these increases in interest rates may result in the decreased profitability of the expatriated corporations.

Certain expatriated corporations may be able to mitigate the increased risks perceived by the owners of capital by having their loans guaranteed by a related U.S. corporation with a high credit rating. The ability of such guarantees might be the reason that not all corporations experience decreased access to U.S. capital markets following their expatriations.<sup>144</sup> In the absence of an ability to mitigate cost increases, expatriated corporations may simply hope that the increased profitability achieved through tax savings will offset increased costs.<sup>145</sup> Given the number of variables and unknowns, it is extremely difficult to predict the net effect of expatriation on any given corporation.

## 2. *The Impact on Shareholders of the Expatriated Corporation*

A corporate expatriation can create problems for the shareholders of the corporation. Often unbeknownst to them, shareholders may be subject to substantial capital gains tax liabilities and decreased protection of their rights as shareholders, resulting in an increased risk.<sup>146</sup> These consequences may not be obvious to all shareholders, as corporations may lead them to believe that a corporate expatriation affects only the corporation's tax liability.<sup>147</sup>

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142. *Id.*

143. *See id.*

144. *See* Treasury Report, *supra* note 3, at 15.

145. *See id.*

146. *See Hearing*, *supra* note 1, at 36–37 (statement of Richard Blumenthal) (discussing reincorporated tax implications for shareholders and differences in shareholder rights afforded by Bermuda and U.S. laws).

147. "In pitching reincorporation, management has repeatedly misled shareholders—failing to reveal the real long term costs, and concealing even the short term financial effects." *Id.* at 36.

a) *The Exit Toll*

The shareholders of an expatriated corporation are likely to owe additional taxes to the U.S. government because they are deemed to have sold or exchanged the shares of the U.S. corporation for the shares of the newly formed foreign corporation.<sup>148</sup> As a result, these shareholders must pay U.S. taxes on a realized gain.<sup>149</sup> It was estimated that the shareholders of Stanley Works would owe approximately \$150 million in taxes to the U.S. government as a result of the corporation's inversion.<sup>150</sup>

A further complication is that not all of the shareholders may have enough liquid assets to satisfy their new tax liabilities.<sup>151</sup> Some shareholders may have to sell a portion of their shares in order to pay the tax bill, and as a result they will retain diminished participation in the future growth of the new company.<sup>152</sup> This immediate taxation of the realized gain is another manifestation of the government's efforts to discourage expatriations. However, shareholders can carefully plan the timing of the expatriation, thereby decreasing their tax liabilities.<sup>153</sup> For example, the corporation can execute the expatriation when the price of the corporation's stock is depressed. If the fair market value of the stock is near, at, or below the stock's old cost basis, there is little, if any, realized gain for the U.S. government to tax. Thus, the general economic downturn and the resulting depressed stock prices currently experienced in the United States may be encouraging expatriations.<sup>154</sup>

b) *Decreased Protection for Shareholders and its Impact on the Underlying Investment*

Corporate expatriation is also likely to result in shareholders losing many of their rights and privileges.<sup>155</sup> The vast majority of reincorporations take place offshore, in countries such as Bermuda

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148. See Treas. Reg. §§ 1.367(a)-3(a), -3(c) (1997).

149. A realized gain is the difference between the taxpayer's historical cost of shares in the former U.S. corporations and the fair market value of the shares she owns in the newly formed foreign corporation. Recognition of loss is not allowed and is instead preserved in the basis of the stock. See Treasury Report, *supra* note 3, at 8-9.

150. Increase in Stanley Works' stock price was estimated to result in a "\$17.5 million gain in CEO John Trani's stock option value while shareholders [faced] \$150 million in capital gains taxes." *Hearing, supra* note 1, at 36 (statement of Richard Blumenthal).

151. See *id.*

152. *Id.*

153. See Tello, *supra* note 96, at 173.

154. See Treasury Report, *supra* note 3, at 1.

155. See *Hearing, supra* note 1, at 36-37 (statement of Richard Blumenthal).

and the Cayman Islands.<sup>156</sup> These countries do not give the shareholders of its companies the same rights afforded by the United States to the shareholders of U.S. companies.<sup>157</sup>

Bermuda does not give shareholders the right to influence some of the key management decisions that may fundamentally alter the future of any corporation.<sup>158</sup> For example, shareholders do not have the right to vote on whether the corporation should dispose of a major portion of its assets.<sup>159</sup> Furthermore, Bermuda law barely limits insider transactions by management, and the law restricts the circumstances under which the shareholders may bring derivative lawsuits.<sup>160</sup> For these reasons, “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.”<sup>161</sup> Because of this pro-management legal environment, the immediate increase in the value of the expatriating corporation’s stock may be transitory in nature. One major scandal may cause the value of the expatriating corporation’s stock to plummet.

The investors who acquired appreciated shares of a company’s stock after its expatriation may therefore lose substantial portions of their investments. The same may be true for shareholders who owned the corporation’s stock prior to the expatriation. Thus, a decrease in the protection for shareholders may offset the immediate benefits that expatriation brought.

### 3. *The Impact of Corporate Exodus on the Economic and Political Standing of the United States*

The corporate exodus threatens the position of the United States as an economic and political superpower. Specifically, the exodus may cause significant decreases in tax revenues and economic growth. A weakened U.S. economy is likely to weaken the country’s political standing.

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156. *See supra* Part IV.

157. “One expatriating company warned in an SEC filing, ‘Our shareholders may have more difficulty protecting their interests in Bermuda than would shareholders’ in the U.S.” *Hearing, supra* note 1 (statement of Hon. Richard E. Neal).

158. *Hearing, supra* note 1, at 37 (statement of Richard Blumenthal).

159. *See id.*

160. *See id.* at 36–37 (noting difficulty in obtaining information about Bermuda law, partly due to lack of official reporters of its court decisions).

161. *Id.* at 36.

a) *The Impact on Tax Revenues*

The U.S. tax base is significantly depleted due to corporate exodus. First, the foreign income of former U.S. corporations is no longer subject to taxation by the U.S. Second, some U.S.-sourced income will escape U.S. income tax because of the increased opportunities for tax evasion.

A corporation that changes its nationality is no longer a U.S. corporation for tax purposes—it is a foreign national. Consequently, the United States can no longer tax the corporation's worldwide operations. While the United States will retain its tax jurisdiction over its U.S.-sourced income, the corporation's foreign income will now be excluded from the U.S. tax base.

This decrease in the U.S. tax base is likely to be considerable, because a significant portion of multinational corporations' worldwide earnings is generated outside of U.S. borders. According to the Internal Revenue Service, the foreign-source taxable income of U.S. corporations that claimed foreign tax credit amounted to \$165.7 billion in the year 1999 alone.<sup>162</sup> Thus, a removal of foreign earnings from the U.S. base is not likely to go unnoticed.

Increased tax evasion may be one of the most alarming consequences of corporate exodus because the resulting damage to the U.S. tax base extends far beyond the immediate loss of tax revenues from the cheating expatriates. The corporate exodus, combined with a general belief that the IRS is unable to effectively enforce currently existing laws, fosters tax evasion.<sup>163</sup> Even now, foreign multinational corporations illegally decrease the amount of taxes they pay to the U.S. on income earned in the United States because the foreign-based corporate structure facilitates the global management of the corporation's income. For example, expatriated corporations are better able to utilize illegal "earnings stripping" techniques,<sup>164</sup> a process whereby corporations transfer income from a subsidiary located in a high tax jurisdiction to a subsidiary that operates in a low tax jurisdiction.<sup>165</sup> Corporations can transfer these earnings in a number of ways. One way is to utilize inter-company debt as a vehicle; the subsidiary that borrows the money deducts the interest from its income while the subsidiary that lent the money includes the interest in its income.<sup>166</sup> The

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162. See Brian Raub, *Corporate Foreign Tax Credit, 1999*, STATISTICS OF INCOME, SOI BULLETIN, Sept. 22, 2003, at 205, at <http://www.irs.gov/pub/irs-soi/99cftcar.pdf>.

163. See Taylor, *supra* note 113, at 156.

164. See Treasury Report, *supra* note 3, at 21.

165. See *id.*

166. See *id.* at 25.

difference in the tax brackets of two subsidiaries produces desired tax savings.

To illustrate, assume that an expatriated U.S. company, X, is now incorporated in country B (which follows source-based taxation and has applicable 20% effective income tax rate). Further, assume that X's U.S. operations are conducted through its subsidiary Y, which is incorporated in the United States (which for the purposes of this illustration has a 35% applicable tax rate). In addition, assume that Y earned \$1,000 taxable income in the United States and has to pay \$350 in income taxes to the U.S. However, if Y borrows \$10,000 at 10% from X, then X would have a deductible interest expense in the amount of \$1,000 (\$10,000 times 10%) and, therefore, no taxable income in the United States. Y will have to pay taxes on the \$1,000 of the interest income it receives from X. However, Y will only owe \$200 to country B (\$1,000 times 20%, B's applicable tax rate). Thus, the X&Y company, as a whole, saves \$150 in tax expenses (\$350 Y would have paid to the United States compared to \$200 X ended up paying to country B). Through the mere issuance of an inter-company note, and without any real movement of assets, the corporation can shift income away from the U.S. and into a jurisdiction with a lower tax rate.<sup>167</sup> More sophisticated ways of transferring income around the globe become available to expatriated companies.<sup>168</sup>

Tax evasion perpetrated by even a handful of expatriated companies undermines the integrity of the entire U.S. tax system.<sup>169</sup> Other taxpayers may feel that they are subsidizing the expatriates' tax evasion through their own continuing compliance with U.S. tax laws. As a result, many taxpayers are likely to begin looking for ways to illegally reduce their own tax bills.

*b) The Impact on the Economy and Political Standing of the U.S.*

Corporate exodus weakens the economic and political position of the United States. When corporations relocate their headquarters overseas, they often do more than just change their mailing address. "Where headquarters are located, key corporate functions of strategy, law, finance, distribution and [research and development] activity are

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167. *See id.*

168. These include the use of intangible assets and difficulties in their valuations, *see id.* at 7, and "effectively connected" rules and arm's length pricing arrangements, Taylor, *supra* note 113, at 156.

169. *See* Treasury Report, *supra* note 3, at 21.

likely to follow. For the high-skilled, high-tech society of [modern] America, these are critical functions."<sup>170</sup>

Specifically, expatriations endanger American jobs.<sup>171</sup> When corporations choose countries other than the United States as the location for their corporate headquarters, certain economic and social activities relocate abroad. The newly established headquarters and its personnel inevitably begin to use the services of local professionals, rather than Americans. As a result, there are fewer business opportunities for American lawyers, accountants, doctors, and builders.

Furthermore, as individual corporations leave the United States other U.S. corporations may feel competitive pressures to leave as well.<sup>172</sup> No corporation can afford to fall behind in the race for the enhanced competitiveness, so even isolated expatriations may create a domino effect on the rest of the corporate community. Meanwhile, initial incorporations abroad put into question the future of the corporate businesses in the United States. There is tremendous risk that the new generation of companies, which will lead this country into the future, will be foreign-based.<sup>173</sup>

The likely decline in U.S. economic activity will result in further decreases in tax collections by federal, state, and local governments. Consequently, these governments will have less money to pay for socially desirable programs, such as medical coverage for the elderly or street safety patrols.

The corporate exodus also changes the political balance between the United States and other countries. The more economic activity and human capital diverted to other countries, the stronger those countries become. The stronger other countries are, the more leverage they will have in their dealings with the United States; this increased lever-

170. See *Hearing*, *supra* note 1, at 43 (statement by Richard Blumenthal).

171. See Olson Remarks, *supra* note 14, at 5.

172. See Treasury Report, *supra* note 3, at 17.

173. It is . . . important to recognize that companies like Intel and Microsoft were early stage ventures not long ago and, with the rapid pace of technological change, it is conceivable that 10 years from today the New York Stock Exchange and the NASDAQ may be dominated by businesses that do not even exist today. The question then is whether it would be regrettable if ultimately the vast majority of those businesses, 10 years from now, are foreign-based because of a tax policy decision by the United States . . . .

Brewer, *supra* note 76, at 605.

Back in March of 1999, the former Tax V.P. of Intel testified at a Senate hearing that 'if I had known at Intel's founding (over 30 years ago) what I know today about the international tax rules, I would have advised that the parent company be established outside the U.S.'

*Id.* at 606.

age may result in the United States receiving less favorable terms in negotiations. Thus, while making the U.S. economy weaker, corporate exodus simultaneously tends to make the economies of other countries stronger.

Finally, a weakened economy undermines the political strength of the United States. The U.S. government will have less money to safeguard its people from terrorism,<sup>174</sup> to fight wars, or to encourage politically desirable behavior by other countries. This weakened political standing of the United States is likely to result in political instability in many parts of the world. Thus, the continuing corporate exodus may undermine the economic and political stability of not only the United States, but also the world.<sup>175</sup>

While it may be the only available cure, the corporate exodus is certainly not the optimal solution for resolving the crisis that U.S. multinational corporations currently experience. Corporate exodus has significant side effects, which negatively impact expatriated corporations, their stakeholders, and the economy and politics of the United States. Therefore, as sometimes happens when free market forces are not able to achieve a socially desired outcome, governmental intervention becomes warranted.

## VI.

### PUBLIC AND LEGISLATIVE BACKLASH

The corporate exodus has not gone unnoticed. The exodus has caused a flurry of public and political debates. Most of these debates are concentrated on the artificiality of the expatriation process and, consequently, have highlighted the need to put an end to it.<sup>176</sup>

#### A. *The Public Debate*

Generally, inversions do not result in any substantive changes within a company.<sup>177</sup> As one outraged observer noted: “[corporations] 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.”<sup>178</sup> Not surprisingly, critics

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174. See, e.g., *Faso Says Fight Terror by Building Economy*, THE BUS. REV. (Albany), Sept. 26, 2001, at <http://albany.bizjournals.com/albany/stories/2001/09/24/daily27.html>.

175. See generally Olson Remarks, *supra* note 14, at 6.

176. See, e.g., *Hearing*, *supra* note 1, at 36 (statement by Richard Blumenthal).

177. See *supra* Part IV.B.1.

178. *Hearing*, *supra* note 1, at 36 (statement by Richard Blumenthal).

equate expatriation with tax fraud<sup>179</sup> and excoriate the directors of corporations.<sup>180</sup> These critics view the appeals to competition as mere ploys to reduce corporate tax liability.<sup>181</sup>

Critics raise moral issues as well, charging corporations with “abrogat[ing] their moral responsibility” to the United States and being unpatriotic.<sup>182</sup> A consensus on the solution does seem to emerge among these critics. During the Congressional Hearings on corporate inversions, Richard E. Neal (D-MA) summarized the consensus as follows: “the solution is common sense—stop these corporate traitors by shooting down the loophole now, and permanently. . . . A plug to this loophole is needed today, tomorrow, and forever.”<sup>183</sup>

### B. *The Proposed Legislation*

Elected officials quickly joined the public criticism, making numerous legislative proposals.<sup>184</sup> While proposals differed, all of them pursued a common goal: to stop expatriations. They ranged from retroactively prohibiting expatriations to imposing penalties on the expatriated corporations.

Some proposals have attempted to revoke those expatriations that have already taken place for the purpose of levying U.S. taxes. For example, Rep. Bill Thomas (R-CA) introduced the American Jobs Creation Act of 2004.<sup>185</sup> The Act treats inverted corporations as domestic ones and, therefore, subjects them to U.S. tax jurisdiction if

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179. “It is a sham, a ‘virtual’ foreign corporation—and our tax laws not only allow this ridiculous charade, they encourage it. This is a tax law that has run amok. It is a tax loophole that must be slammed shut.” *Id.*

180. *See id.* at 37. *See also* *Hearing, supra* note 1 (statement of Hon. Richard E. Neal).

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

*Hearing, supra* note 1, at 36 (statement of Richard Blumenthal). *See also* *Hearing, supra* note 1 (statement of Hon. Richard E. Neal).

182. *Hearing, supra* note 1, at 35.

183. *Id.* (statement of Hon. Richard E. Neal).

184. *See, e.g., id.* *See also* *Hearing, supra* note 1, at 35–37 (statement of Richard Blumenthal).

185. As this article was going to print, Congress passed The American Jobs Creation Act of 2004 into law. H.R. 4520, 108th Cong. (2004).

certain conditions are satisfied.<sup>186</sup> Similar provisions were made by Rep. Richard Neal (D-MA) in his Corporate Patriot Enforcement Act of 2003,<sup>187</sup> Rep. Scott McInnis (R-CO) in his Corporate Patriot Enforcement Act of 2002<sup>188</sup> and Sen. Charles Grassley (R-IA) and Sen. Max Baucus (D-MT) in their Reversing the Expatriation of Profits Offshore Act.<sup>189</sup>

Other legislative proposals have attempted to prevent future expatriations. For example, Rep. Nancy Johnson (R-CT) introduced The Uncle Sam Wants You Act of 2002.<sup>190</sup> The bill proposed to “impose a moratorium on the ability of United States corporations” to expatriate themselves.<sup>191</sup> Rep. Bill Thomas (R-CA) similarly proposed a moratorium in his American Competitiveness and Corporate Accountability Act of 2002.<sup>192</sup>

A third category of proposals have attempted to penalize corporations for their expatriations. For example, Rep. Jim Turner (D-TX) introduced the Patriotic Purchasing Act of 2002.<sup>193</sup> In this act, Rep. Turner proposed to make former U.S. corporations ineligible to do business with the U.S. government.<sup>194</sup> In addition, Rep. Charles Rangel (D-NY) introduced legislation that would penalize expatriated corporations by imposing new taxes on them.<sup>195</sup> The 2004 Act imposed an excise tax on the value of insiders’ options and stock in companies that participate in certain forms of corporate inversions.<sup>196</sup>

In summary, the public and political debate has concentrated on the supposed artificiality of corporate expatriations and the selfishness of the corporations engaged in such actions. The vast majority of legislative proposals aim to stop such expatriation.<sup>197</sup>

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186. For example, a company will be subjected to U.S. tax jurisdiction if, after March 4, 2003, it completed an inversion in which the domestic corporation’s former shareholders received 80% or more of the newly formed foreign company’s stock. *Id.* at § 801.

187. H.R. 3857, 107th Cong. (2002).

188. *Id.*

189. S. 2119, 107th Cong. (2002).

190. H.R. 4756, 107th Cong. (2002).

191. *Id.*

192. H.R. 5095, 107th Cong. (2002).

193. H.R. 4831, 107th Cong. (2002).

194. *Id.*

195. H.R. 4880, 107th Cong. (2002) (proposing to treat assets of companies that reincorporate offshore as being sold for fair market value on the day prior to incorporation).

196. H.R. 4520, 108th Cong. § 4985 (2004).

197. *See* H.R. 5095; Reversing the Expatriation of Profits Offshore Act, S. 2119, 107th Cong. (2002); H.R. 4880; H.R. 4831; Uncle Sam Wants You Act of 2002, H.R. 4756, 107th Cong. (2002); H.R. 3857, 107th Cong. (2002).

### C. *The Problems with the Recent Legislative Proposals*

The aforementioned proposed legislation is short-sighted and constitutes a quick-fix approach to lawmaking. A prohibition on expatriations will not achieve the contemplated outcome. Patriotism is not the missing link to the explanation of or the cure for expatriations.

Yes, expatriations are undesirable for the United States.<sup>198</sup> A moratorium and an ultimate ban on inversions, however, will be even more harmful to the U.S.<sup>199</sup> Subsequent to expatriations, companies remain under American ownership and management.<sup>200</sup> If a corporation's ability to expatriate itself and leave U.S. tax law unchanged is revoked, it becomes a perfect victim for a foreign corporation to swallow.<sup>201</sup> Presumably, even more American jobs will be lost if foreign corporations acquire the ownership and management of U.S. corporations.<sup>202</sup> Thus, a ban on expatriations would create even more favorable grounds for the downfall of U.S. enterprises and, consequently, the U.S. economy.<sup>203</sup>

Moreover, patriotism (or lack thereof) has nothing to do with the problems that the U.S. economy is experiencing. As renowned Judge Learned Hand once said, "[a]ny one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."<sup>204</sup> Corporations that choose to operate under a structure that results in paying higher taxes to their home countries are

198. *See supra* Part IV.B.

199. *See generally* *Hearing, supra* note 1, at 45–48 (statement by Steven Salch).

200. "[P]reserving U.S. ownership of business, a classic inversion can also directly and indirectly save U.S. jobs and business that would be lost if the same business came under foreign ownership." *Id.* at 48.

201. The United States has some of the world's most complicated rules on international taxation. These rules originate, in part . . . from a misguided belief that we can keep capital in the United States [through] restrictive tax regimes. We are still—the system we impose in American-based firms sometimes provides advantages to foreign companies that want to buy up American companies.

*Hearing, supra* note 1, at 4–5 (statement of Hon. Bill Thomas, Chairman, House Comm. on Ways and Means).

202. *Id.* at 48 (statement by Richard Salch).

203. [U]nless Congress can also enact a moratorium on foreign purchases or acquisitions of U.S. businesses, a moratorium on inversions that precludes U.S. businesses with substantial foreign operations from engaging in the classic inversion will merely provide foreign purchasers an opportunity to extend their present competitive advantage in purchasing and operations during the moratorium period.

*Id.*

204. *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

not necessarily more patriotic than corporations that try to minimize their tax liabilities legally in order to remain competitive. In the absence of a threat to national security or other similar overriding concerns, management's primary responsibility is to the company's shareholders. All else being equal, shareholders generally care most about the return on their investment, not about self-destructive—though patriotic—corporate behavior.<sup>205</sup> Moreover, many U.S. companies have foreign investors.<sup>206</sup> It is unreasonable to expect these foreign investors to be loyal to the United States and to vote against expatriation. The only way for the United States to prevent expatriations is to understand and address those forces that induce corporations to expatriate.

## VII.

### THE REAL CAUSE OF CORPORATE EXODUS

“The sad truth is that our international tax rules no longer serve our national interest.” —Kenneth W. Dam, U.S. Deputy Treasury Secretary<sup>207</sup>

Unfortunately, recent legislative proposals target the symptoms of the underlying problem, not the problem itself. The problem is the adherence of the U.S. to a system of taxation based on residence.<sup>208</sup> Until this system is changed, the U.S. will continue to experience economic and political difficulties.<sup>209</sup>

Expatriations signal that the U.S. is not a good place for international businesses to be incorporated.<sup>210</sup> The U.S. has lost its competitive edge because, unlike other countries, it has not kept its tax laws competitive.<sup>211</sup> “In a true free-market economy, nations need to compete for profitable corporate citizens.”<sup>212</sup> Unfortunately, the U.S. has

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205. “In assessing competing corporate investments, an investor will choose the one that promises the best return on investment.” Brewer, *supra* note 76, at 604.

206. Olson Remarks, *supra* note 14.

207. See Dam Remarks, *supra* note 64.

208. A “core [issue is] U.S. taxation of income from business activity *entirely outside* the United States (the extraterritorial income problem) . . . .” *Hearing, supra* note 1, at 41 (statement of Gary Hufbauer).

209. See *supra* Part V.B.3.b.

210. “[S]uch remedies do not address the underlying problem—the fact that, from a tax standpoint, the United States is not a good location for headquartering a multinational corporation.” *Hearing, supra* note 1, at 42 (statement by Gary Hufbauer).

211. “Most other developed countries of the world are concerned with setting a competitiveness policy . . . .” Olson Remarks, *supra* note 14.

212. Brewer, *supra* note 76, at 606.

been sleeping while other countries have been modernizing their tax laws.<sup>213</sup>

U.S. tax laws reduce the competitiveness of U.S. businesses and, consequently, the competitiveness of the U.S. economy.<sup>214</sup> As was illustrated above, the foreign income of U.S. companies is subject to taxation by the United States upon the repatriation of that income to the United States.<sup>215</sup> Only half of the OECD countries have accepted this practice of taxing worldwide income.<sup>216</sup> As a result, U.S. companies are subjected to a “hurdle [that] foreign competitors in territorial tax systems do not face, and a hurdle foreign competitors investing in the U.S. do not face”<sup>217</sup> when they repatriate profits to their home countries.

Therefore, “[t]he perceived inhospitability of the U.S. tax system to multinational business requires a different response than the response to expatriation transactions.”<sup>218</sup> This response must be comprehensive. U.S. tax laws must be fundamentally changed.<sup>219</sup>

## VIII. THE PROPOSAL

The central belief of the proposed reforms is that “it’s far more important for the United States to retain its position as the nerve center for multinational corporations than to collect whatever revenue is gathered from the activities of foreign subsidiaries by the cumbersome U.S. system of taxing worldwide income.”<sup>220</sup>

### A. *Some Preliminary Distinctions and Definitions*

This proposal addresses the problems that underlie U.S. international tax law through the lens of the revenue collection process; after all, collection of revenues is the primary justification for taxes.<sup>221</sup> A basic revenue collection model consists of three components: a tax

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213. See generally Olson Remarks, *supra* note 14.

214. See generally *id.*; Dam Remarks, *supra* note 64; Hearing, *supra* note 1 (statement of Gary Hufbauer).

215. See *supra* Part I.D.

216. Olson Remarks, *supra* note 14.

217. *Id.*

218. Taylor, *supra* note 113, at 146.

219. “[W]ith today’s global economy, the bottom line is clear. If we want U.S. businesses, and thus the U.S. economy, to be competitive in international transactions, then we have to reconsider our international tax rules.” Dam Remarks, *supra* note 64.

220. Hearing, *supra* note 1, at 43 (statement of Gary Hufbauer).

221. EUGENE WILLIS ET AL., WEST’S FEDERAL TAXATION: COMPREHENSIVE VOLUME 1-3-1-4 (West 2004).

base, a tax rate, and the resulting tax revenue.<sup>222</sup> The tax base is essentially what is being taxed. For example, for a gift tax, the tax base represents the monetary value of the gift; for a sales tax, it is the monetary value of the transaction.<sup>223</sup> The tax rate can be defined as the fraction of the tax base that the taxing authority collects.<sup>224</sup> To put it differently, the tax rate is the percentage applied against the tax base.<sup>225</sup> The resulting tax revenue is the money the tax collection process generates, and is the product of multiplying the tax base by the tax rate.<sup>226</sup> Individual components of the basic tax formula can be manipulated in order to arrive at the desired values of the other components. Generally, the desired value of the revenue dominates the equation. After all, the government should not collect more tax revenues than it determines to be reasonably necessary.

Broadly speaking, the U.S. government generates corporate income tax revenues by applying tax rates to the income generated by corporations. The total corporate income tax base consists of the U.S. income of both U.S. and foreign corporations, and the foreign income of U.S. corporations.<sup>227</sup> The U.S. government's taxation of the foreign income of U.S. corporations is what causes numerous problems for U.S. multinational corporations.<sup>228</sup>

This proposal consists of three parts. In Part One, I propose to remove the foreign-sourced income from the total corporate income tax base.<sup>229</sup> In order to maintain the desired level of total corporate income tax revenues, I propose in Part Two to modify the rates applicable to the total corporate income tax base which, subsequent to the implementation of Part One of the proposal, will consist of income from U.S. sources only. Part Two also outlines a blueprint for a more comprehensive corporate earnings tax reform, which aims to decrease the effective rates at which the earnings of U.S. corporations are taxed. Finally, Part Three proposes a temporary moratorium on the taxation of the foreign income of U.S. multinational corporations until Congress reevaluates and addresses currently existing U.S. international tax laws.

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222. *See id.*

223. *See id.*

224. *See id.* at 1-5.

225. *See id.*

226. *See id.* at 1-6.

227. *See supra* Part III.A-B.

228. *See supra* Part III.C.

229. This idea builds on numerous arguments made to date for the transition of U.S. international tax laws to a territorial system of taxation. *See, e.g., Hearing, supra* note 1, at 41-43 (statement of Gary Hufbauer).

*B. Part One: The Removal of Extraterritorial Income From the Total Corporate Income Tax Base*

The extraterritorial earnings of U.S. corporations must be exempted from U.S. income tax. This change is necessary to allow U.S. corporations to compete on a “level playing field”<sup>230</sup> and simplify the complex U.S. tax laws.

The removal of extraterritorial income from the total corporate tax base eliminates the competitive disadvantage that U.S. multinational corporations experience. This extraterritorial income will no longer be subject to a second layer of taxation once that income is repatriated to the United States. Subpart F issues will immediately evaporate as well, since these rules apply only to taxation of extraterritorial income.

The exemption of extraterritorial income from U.S. taxation will in turn significantly reduce, if not completely stop, expatriations. Corporations will no longer need to change their nationality in order to be competitive, and shareholders will no longer need to increase the risks in their investments<sup>231</sup> in order to improve their returns. Finally, the alarming trend of foreign corporations buying out U.S. corporations and U.S. businesses incorporating abroad will significantly decline.

In summary, the removal of extraterritorial income from the total corporate income tax base will remove a core competitive disadvantage burdening U.S. multinational corporations, as well as the related economic and political problems experienced by the U.S. government.

*C. Part Two: Modification of Rates Applicable to the U.S. Sourced Income*

This section will discuss the need to change the U.S. tax rates applicable to the total corporate income tax base. Part 1 of this section will lay out a proposal to increase U.S. statutory corporate income tax rates in order to compensate for the anticipated decreases in the total corporate income tax revenues as a result of implementing Part One of this proposal. Part 2 of this section will briefly address a seemingly unrelated dividend tax issue. As this section will illustrate, the issues underlying the proposals to eliminate a dividend tax and this article’s proposal to remove extraterritorial income from the total corporate tax base are much related and, consequently, warrant a concurrent consid-

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230. Dam Remarks, *supra* note 64.

231. Expatriation reduces shareholder rights and, therefore, increases the risk. *See supra* Part III.B–C.

eration and resolution. Both issues will be addressed in the proposed comprehensive corporate earnings tax reform.

### 1. *The Increase in Statutory Corporate Income Tax Rates*

The exemption of extraterritorial earnings from taxation comes at a price of a decrease in total corporate income tax revenues.<sup>232</sup> It would be desirable, of course, to remove extraterritorial income from the total corporate tax base while preserving the total corporate income tax revenues. One way to do so is to increase the corporate tax rates. Therefore, I propose to increase the statutory corporate income tax rates currently applicable to the income earned in the United States.

Congress must raise the tax rate as much as necessary to preserve the total income tax revenue. As a precursor to raising the rates, we must estimate the decrease in revenue from the exclusion of extraterritorial income.<sup>233</sup> In making this estimate, we must keep several things in mind. For example, there would be decreases in the expenditures our government incurs while administering the current taxation of extraterritorial earnings. This amount will offset some of the decrease in revenue. After estimating the net decrease, we must determine the increase in the tax rate that will recoup the net loss. Fortunately, the remaining tax base is much greater than the extraterritorial income that will be exempt from taxation.<sup>234</sup> As a result, compensating for the lost tax revenues will require only a relatively small increase in the statutory tax rates.

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232. Although the extraterritorial earnings of U.S. companies may be significant, the resulting overall tax collections by the U.S. government on these earnings (while still burdensome on individual companies) are not substantial. See Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1586–97 (2000).

233. The relative values of U.S. companies' foreign earnings will normally change from year to year. Therefore, the rate determined at the time this proposal is adopted will have to incorporate projected future changes to U.S. companies' foreign earnings. Therefore, the selected rate will have to enable the collection of future desired tax revenues based upon a projected U.S. tax base.

234. Many commentators argue that while the amount of foreign income generated by U.S. corporations may be significant, the resulting tax collections on this income are not. Although U.S. multinationals pay taxes on extraterritorial income, these corporations have been successfully employing sophisticated tax planning strategies which decrease the amount of taxes they have to pay on their foreign sourced income. For example, in order to take advantage of the fact that, as a general rule, foreign income is taxed only upon its repatriation to the U.S., companies routinely undercapitalize their foreign subsidiaries and, consequently, apply foreign earnings toward the subsidiaries' capital, instead of repatriating those earnings home.

## 2. *The Reform of Taxes on Corporate Earnings*

### a) *The Background of the Tax on Dividends*

The U.S. taxes income generated by corporations at two different levels: first, on the corporate level through corporate income tax,<sup>235</sup> and second, on the individual level through personal income tax (a dividend tax).<sup>236</sup> This two-layered taxation is commonly referred to as a double taxation.<sup>237</sup>

It would be fruitless to reiterate all of the arguments made to date in favor of the elimination of the dividend tax (elimination of double taxation).<sup>238</sup> It will suffice to summarize the key points made by various commentators. First, the United States assesses some of the highest corporate earnings tax rates within OECD.<sup>239</sup> There are only two other countries within OECD that tax corporate earnings on both corporate and shareholder levels, Switzerland and Ireland.<sup>240</sup>

Second, the high taxation of corporate earnings has a significant effect on the way businesses conduct their operations in the U.S.<sup>241</sup> Increasing preferences are given to non-corporate forms of business operations.<sup>242</sup> Double taxation also impacts companies' methods of raising money, with increasing preferences given to debt rather than equity capital.<sup>243</sup> As a result of the capital formation process being heavily biased towards debt, U.S. corporations are becoming excessively leveraged and, consequently, are becoming more vulnerable to general economic and specific business downturns.<sup>244</sup>

The newly adopted Jobs and Growth Tax Relief Reconciliation Act of 2003<sup>245</sup> decreased the tax rates applicable to "qualifying dividends."<sup>246</sup> Concerns surrounding taxation of dividends nevertheless

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235. RAY M. SOMMERFELD ET. AL., INTRODUCTION TO TAXATION 82 (5th ed. 2002).

236. *See id.* at 83.

237. *See id.*

238. *See, e.g.,* Olson Remarks, *supra* note 14. *See also* Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, §§ 301-303, 117 Stat. 752, 758-64 (2003).

239. *See* Olson Remarks, *supra* note 14.

240. "This combination gives the United States the highest combined corporate and individual tax burden on distributed earnings . . ." *Id.*

241. *See supra* Part VII. Without a doubt, the enactment of the Jobs and Growth Tax Relief Reconciliation Act was an improvement from the status quo. Nevertheless, the presence of a dividend tax, even in a reduced form, tends to create economic inefficiencies.

242. *See* Olson Remarks, *supra* note 14.

243. *See id.*

244. *See id.*

245. Pub. L. No. 108-27, 117 Stat. 752 (2003).

246. Dividends received from domestic and qualifying foreign corporations are eligible for decreased applicable rates. *Id.* §§ 301-302, 117 Stat. at 758-64.

remain. First, since a dividend tax still exists, the new law simply decreases the relative magnitude of the problems caused by this tax. Second, the decrease in the dividend tax rates is temporary in nature. Rates are scheduled to return to “normal” after December 31, 2008.<sup>247</sup>

*b) A Net Decrease in Effective Tax Rates Applicable to Corporate Earnings*

Although it may not be immediately apparent, closer consideration reveals a commonality of issues underlying taxation of dividends and a taxation of extraterritorial income. Both taxes hinder the competitiveness of U.S. enterprises.<sup>248</sup> Both taxes create inefficiencies and resulting problems for the U.S. economy and its stakeholders.<sup>249</sup> Finally, and most importantly for our purposes, both taxes are assessed on corporate earnings, and modification of either tax will alter the effective rate at which these earnings are taxed. Consequently, since both taxes are applied against essentially the same base (i.e., corporate earnings) and cause practically identical problems, it may be wise to address and deal with the dividend tax and the extraterritorial earnings tax concurrently.

Therefore, I propose that our government implement a package of reforms, which on a net basis will decrease the effective rates at which the United States taxes corporate earnings. Specifically, I propose that the U.S. government reform the taxation of corporate earnings by simultaneously eliminating the dividend tax, ending taxation of extraterritorial earnings, and increasing the statutory tax rates applicable to the income earned in the United States by U.S. and foreign corporations. While the statutory corporate income tax rates at which income of U.S. and foreign corporations is taxed will be slightly increased,<sup>250</sup> as a result of this reform there will be an exemption of foreign earnings from U.S. income tax,<sup>251</sup> along with a net decrease in the effective tax rates at which earnings of the U.S. companies are taxed (since a relatively minor increase in the statutory corporate income tax rates will be overwhelmingly outweighed by the elimination of the dividend tax).

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247. *Id.* § 303, 117 Stat. at 764.

248. *See supra* Part III.

249. *See supra* Part V.B.3.

250. *See supra* Part VIII.B.

251. *Id.*

*D. Implementation of Parts One and Two of this Proposal*

The U.S. Treasury Department will need to undertake a formal study and produce a comprehensive report that will lay out mechanical intricacies as well as precise empirical evaluations of this reform. This report will be similar to the reports that the U.S. Treasury Department prepares each time it is about to make a major change in tax law. However, for the purposes of illustration, the fundamentals of this proposal can be presented utilizing aggregates, averages, and a number of assumptions.

First, assume that USA Corps. represents an entire population of all U.S. companies. These companies distribute all available earnings through dividends<sup>252</sup> and have, in aggregate, \$1 million of U.S. taxable income and \$100,000 in extraterritorial taxable income. Also assume that F Corps. represents an entire population of foreign companies and that these companies have, in aggregate, \$100,000 in U.S. taxable income. Lastly, assume that the U.S. grants tax credits to U.S. corporations for all foreign taxes they pay, and that the applicable tax rates in aggregate and on average are as follows: the U.S. corporate income tax rate equals 35%; foreign countries' local income tax rates equal 25%; and the individual U.S. income tax rate equals 30%.<sup>253</sup>

Using the above data, under the current system the total U.S. corporate income tax base is \$1,200,000.<sup>254</sup> The U.S. Treasury collects a total of \$395,000<sup>255</sup> in corporate income taxes and \$111,000<sup>256</sup> in individual income taxes through a dividend tax, a total of \$506,000.

252. For simplicity purposes, the author assumes that U.S. shareholders receive no dividends from foreign companies.

253. For the purpose of this illustration, the author ignores the temporary decrease in rates applicable to "qualifying dividends."

254. One million dollars in U.S.-sourced income of USA Corps. plus \$100,000 of foreign-sourced taxable income of USA Corps., plus \$100,000 in U.S.-sourced income of F Corps.

255. This amount is calculated as follows: (1) \$350,000 in taxes collected on U.S.-sourced income of USA Corps. (\$1,000,000 income times 35% rate); plus (2) \$10,000 in taxes collected on foreign-sourced income of USA Corps. (\$100,000 income multiplied by 35% rate less \$25,000 tax credit of \$25,000 for foreign taxes paid. The \$25,000 of foreign taxes paid is calculated as \$100,000 of foreign-sourced income times 25% foreign tax rate); plus (3) \$35,000 in taxes collected on \$100,000 of U.S.-sourced income of F Corps. (\$100,000 times 35%).

256. This amount is calculated as follows: the total amount of distributed dividends \$740,000 (\$1,100,000 of total earnings of USA Corps. less \$360,000 in total taxes paid on these earnings to the U.S. and foreign governments), times 15% dividend tax rate. See *supra* Part VIII.C.2.(a).

The effective tax rate on the worldwide earnings of USA Corps. is 43%.<sup>257</sup>

If, as proposed in Part One, the foreign earnings of USA Corps. are removed from the total corporate tax base, a new total corporate tax base will amount to \$1.1 million (\$1 million in U.S. income of USA Corps. and \$100,000 in U.S. income of F. Corps.). In order for the U.S. Treasury Department to collect the same \$395,000<sup>258</sup> in total corporate income tax revenues from this decreased tax base, the new average statutory corporate income tax rate must be 36%.<sup>259</sup> Thus, utilizing the assumptions made above,<sup>260</sup> Congress would need to increase the average U.S. statutory corporate income tax rate by only one percent.<sup>261</sup>

Subsequent to the implementation of the reform, however, the new effective rate at which the U.S. government will tax the earnings of USA Corps. will be 34% (total tax collections by the U.S. government of \$371,000<sup>262</sup> on the total worldwide earnings of the USA Corps. of \$1.1 million) instead of 43%, a decrease of 9%.<sup>263</sup> The implementation of the reform using the above made assumptions will result in (1) the exemption of extraterritorial income of U.S. companies from taxation, (2) one percent increase in the average statutory corporate income tax rates, and (3) a 9% decrease in the average effective income tax rates at which corporate earnings of U.S. companies are taxed.

Therefore, a proposed change in the taxation of earnings of U.S. companies is achieved through two steps. Step one consists of an exemption of extraterritorial income from the U.S. corporate income tax, backed by a relatively minor increase in the U.S. statutory corporate income tax rates. Although step one can be implemented on its own, I would like to see this step implemented in conjunction with a two-step

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257. Total taxes collected on worldwide earnings of USA Corps. by the U.S. government of \$471,000 (\$1.1 million in worldwide earnings of USA Corps. times 35% corporate income tax rate less \$25,000 credit for taxes paid to foreign governments [\$100,000 of foreign income times 25% tax rate] plus a dividend tax of \$111,000) divided by the total earnings of USA Corps., \$1,100,000.

258. See *supra* Part VIII.C.2.(a).

259. This arises from \$395,000 (the total corporate income tax collections prior to implementation of Part One of the Proposal) divided by the new corporate income tax base of \$1,100,000. See *supra* Part VIII.B.

260. See *supra* Part VIII.C.2.(a).

261. The difference between the necessary 36% and starting 35% average statutory corporate income tax rates.

262. Since there will no longer be a dividend tax, this amount is now calculated as follows: \$1.1 million of U.S. and foreign income times the new 36% corporate income tax rate less \$25,000 in foreign tax credits. See *supra* VIII.C.2.

263. See Olson Remarks, *supra* note 14.

proposal to completely eliminate a dividend tax, as both proposals, at their core, aim to restore the competitiveness of the United States and U.S. corporations through a modification of income tax rates applicable to the earnings of U.S. corporations.

*E. Part Three: The Temporary Moratorium on the Taxation of Extraterritorial Income of U.S. Corporations*

Congress must urgently reevaluate currently existing tax laws applicable to foreign income of U.S. corporations. This reevaluation, however, will not occur overnight. In order to decrease the ongoing damage to U.S. economic and political interests, this article also proposes a temporary moratorium on taxation of U.S. multinationals' foreign income, irrespective of whether Parts One and Two of this proposal are adopted. This moratorium would give Congress sufficient time to address issues raised in this article while decreasing the cost of lengthy deliberations, by eliminating a core incentive companies currently have to leave the United States. A one year moratorium should be sufficient to allow Congress to undertake a thorough evaluation and develop appropriate solutions to the corporate exodus crisis currently experienced by the United States.

IX.

EVALUATION OF THE PROPOSAL

This proposal, much like any other proposal or currently existing system of taxation, necessitates certain compromises and tradeoffs. Consequently, a thorough evaluation of this proposal from the traditional equity, efficiency, and simplicity perspectives is warranted. This section presents such an evaluation.<sup>264</sup>

*A. An Equity Perspective*

The tax burden (whether actually paid on the corporate or individual level) is borne by the owners of capital.<sup>265</sup> Therefore, the potential impact of this proposal on shareholders (owners of capital) will vary depending on the unique tax characteristics of individual shareholders. As is true with most previously enacted tax reforms, the overall impact of this article's proposal will be neutral (no change in

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264. For a discussion of the pros and cons of a dividend tax, see Olson Remarks, *supra* note 14. See also Proposal, Council of Economic Advisors, Eliminating the Double Tax on Corporate Income (Jan. 7, 2003), at <http://www.ustreas.gov/press/releases/docs/exclusion.pdf>.

265. DAVID F. BRADFORD, *UNTANGLING THE INCOME TAX* 133 (Harvard Univ. Press 1986).

tax burden) for some shareholders, positive (decrease in tax burden) for others, and negative (increased tax burden) for yet another group of shareholders.

Take, for example, shareholders of U.S. corporations that generate approximately the same amounts of U.S. and foreign taxable income. These shareholders should not experience significant changes in their tax burden once the foreign income is exempt from taxation and the statutory corporate income tax rate is slightly increased because the two changes are expected to have offsetting consequences.

However, shareholders of U.S. corporations that do not generate foreign taxable income (or corporations with a smaller fraction of their income coming from foreign sources than the average U.S. corporation), or shareholders of foreign corporations that generate U.S. taxable income, are all likely to experience an increase in the tax burden on earnings of corporations they own. This is because, as a result of Part I of the Proposal, the companies they own will be required to pay more in corporate income tax while not receiving any or enough offsetting benefits from extraterritorial income exempted from U.S. income tax.

This proposal certainly makes a significant tradeoff between equity on one hand and efficiency and simplicity on the other, favoring the latter two. After all, by exempting foreign income from taxation, this proposal gives preferential treatment to the U.S. companies (and, therefore, their shareholders) that do business overseas.<sup>266</sup> This intrinsic inequity, however, is an inherent ingredient of almost all exemption provisions, which, in one form or another, end up treating differently items of income that are similar in nature. Nevertheless, despite their biases, exemptions are routinely employed in the U.S. income tax laws where they aim to achieve overriding policy objectives.

Take, for example, an exemption of life insurance proceeds from individuals' gross income. As a general rule, when a person whose

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266. It is worth mentioning that, in theory, it is possible to address the inequity of exempting foreign income of U.S. multinationals by putting in place a requirement that U.S. statutory corporate income tax rates would be increased only for companies that have foreign earnings, or foreign earnings above a certain threshold amount. A difficulty with such a system would arise from a practical, and therefore simplicity, perspective. It would be very difficult for U.S. taxing authorities to verify the existence or the exact amount of foreign income of foreign companies. Applying such requirement solely to U.S.-based companies would be problematic as well. Although it would be easier for U.S. taxing authorities to verify foreign taxable income of U.S. companies, such a proposal would, once again, create an incentive for companies to leave the United States, since only U.S. companies with foreign income over a certain threshold amount would be subjected to higher rates of taxation.

life is insured under the policy dies, the policy's beneficiaries receive life insurance proceeds free of income tax.<sup>267</sup> Beneficiaries experience an increase in their wealth similar to that which they would experience upon winning a lottery, or upon receiving a return on the investment account that was opened by the policy holder in their names. In both cases, beneficiaries have to pay taxes on the income the lottery or the investment account generates while (economically similar) life insurance proceeds are generally excluded from taxation.

Moreover, this exemption of life insurance proceeds causes enormous tax abuses.<sup>268</sup> Tax planners have transformed traditional life insurance policies into investment products commonly utilized to transfer wealth from one taxpayer to another free of federal income taxes.<sup>269</sup> Nevertheless, despite its cost, the exemption of life insurance proceeds is well justified. The justification comes mainly from an overriding policy objective of encouraging people to “[protect] loved ones against the potentially devastating consequences of death.”<sup>270</sup>

Similarly, overriding policy objectives justify the exemption of foreign-source income of U.S. multinationals. Although economically identical to the U.S.-source income, foreign earnings of U.S. companies should be exempted from the U.S. income tax in order to protect the economic and political well-being of the United States. If foreign earnings are exempt from U.S. taxation, the major reason for the corporate exodus will be eliminated and the economic and political standing of the United States will be protected.

Even if foreign earnings of U.S. multinational corporations will not be exempt from taxation legislatively, they will be exempt by default. U.S. companies that generate business overseas will continue to expatriate. Even if a ban on expatriation were instituted, the foreign income of U.S. multinational corporations would continue to leave the American tax jurisdiction through foreign mergers or initial incorporations abroad.<sup>271</sup> This proposal's by-products (increased tax burdens

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267. See I.R.C. § 101(a) (2004).

268. “Unfortunately some individuals have used the cover of insurance . . . for the purpose of avoiding taxes on investment income.” Press Release, Office of Public Affairs, Treasury and IRS Continue to Crackdown on Abuse of Life Insurance and Annuity Contracts (July 29, 2003), at <http://www.treas.gov/press/releases/js605.htm> (quoting Pam Olsen, Treasury Assistant Secretary for Tax Policy).

269. See *id.*

270. *Id.*

271. Another likely comment, which theoretically can be linked to the equity-related observation, is that U.S. companies with no foreign taxable income will experience an increase in U.S. statutory corporate income tax rates—a measure designed to pay for lost tax revenue of companies that do generate taxable income from their operations

for some taxpayers) should be viewed as a necessary price to pay for the restoration of our country's welfare. Thus, the overriding policy objectives justify the implementation of the Proposal even from the equity perspective.

### B. Efficiency Perspective

A number of comments can be made from the efficiency perspective as well. First, a tax exemption of foreign income creates a bias in favor of foreign rather than U.S. investments.<sup>272</sup> That is, given the same pre-tax rate of return, people would be encouraged to invest overseas rather than in the United States because foreign investment would produce a higher after-tax return. This conclusion, however, ignores the impact of other nations' tax laws on a corporation's investment decisions. Once the interplay of other nations' tax systems is taken into consideration, comments regarding the inherent bias in the proposed exemption begin to lose their force.

The traditional bias argument assumes that the foreign income is either not taxed at all by foreign nations, or taxed at a rate lower than it would have been taxed in the United States. However, the income generated overseas can still be subject to local source-based taxation.<sup>273</sup> If the effective rate at which that income is taxed equals or exceeds the effective rate at which the same income would have been taxed in the U.S., there will be no incentive to invest abroad.

Another likely efficiency-related concern may arise because the proposal advocates an offsetting increase in statutory corporate income tax rates. Specifically, an increase in corporate income taxes may discourage foreign companies from investing in the United States. Taxes, however, do not drive investors out. It is the relative increase in the level of taxation that may produce negative conse-

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overseas. To put it differently, U.S. companies that have no foreign income will be asked to pay taxes of the companies that do have foreign income. The preferred treatment for the companies that have foreign income has been acknowledged and addressed. See *supra* notes 238-247 and accompanying text. Similarly, foreign companies will experience an increase in U.S. statutory corporate income tax rates applicable to their U.S. sourced income. Today, U.S. shareholders own a significant portion of foreign multinational corporations. Consequently, as a result of this proposal, the effective tax rates applicable to earnings of foreign multinationals will be decreased as well, to the extent of the tax free dividends distributed by these companies to U.S. shareholders. Foreign shareholders, however, will not experience a similar offsetting benefit. See *infra* note 273 and accompanying text for a discussion of impact on foreign investors.

272. Passive income is outside the scope of this proposal and therefore will remain subject to worldwide taxation by the United States.

273. See Olson Remarks, *supra* note 14.

quences. As previously stated, an offsetting increase in the U.S. statutory corporate income tax rates is expected to be relatively insignificant and, consequently, should not alter the United States' attractiveness to foreign investors.

Taxes, moreover, are by no means the only factors that companies consider when making their investment decisions. The U.S. has been, and is likely to continue to be, a uniquely attractive location for investments. It offers a very strong consumer market with unparalleled spending power.<sup>274</sup> Its relatively stable currency, regulatory infrastructure, and political stability make and will continue to make the United States a preferred destination for investments.

This proposal also addresses an even more significant efficiency-related problem caused by the existing tax laws. The current tax system disturbs the otherwise economically- and politically-based decisions as to the location of corporate headquarters and related economic and business activities.<sup>275</sup> The current system causes corporate exodus and myriad related problems for the United States.<sup>276</sup> Therefore, the implementation of this proposal should result in a substantial overall improvement of U.S. international tax laws from the efficiency perspective.

Finally, this proposal aims to restore the competitiveness of the United States and its stakeholders while relying on free market principles, which are fundamental to the successes the United States has consistently enjoyed. The proposal is grounded on the firm belief that each country should capitalize on its strengths in designing its tax systems. Thus, this proposal further encourages tax competition among countries, as competition promotes efficiency and value.

### C. *Simplicity Perspective*

Simplicity is the most important of the three fundamental elements for assessing tax policy.<sup>277</sup> After all, a perfectly equitable and efficient tax system cannot exist if the government cannot effectively administer a tax system and taxpayers cannot comply with it. Compliance-related difficulties caused by existing U.S. tax laws foster corpo-

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274. *See supra* Part VII.

275. For discussion on the consequences of corporate exodus, *see supra* Part V.B.2. 276. Currently existing foreign tax credit rules, while ultimately achieving results similar to those achieved by the exemption (due to deferred taxation of foreign income, *see supra* Part V.B.3(b)), cause other countries to raise their tax on the income of U.S. enterprises to at least the level at which the United States will tax that same foreign income. *See Roin, supra* note 36, at 1769.

277. *See Rosenbloom, supra* note 22, at 1528.

rate exodus, tax evasion, and fraud.<sup>278</sup> Taxpayer fraud is lethal to any system that has a self-compliance mechanism at its backbone.<sup>279</sup>

The primary advantages of this proposal come from the simplicity perspective. As a result of this proposal, the U.S. tax system would be greatly simplified. In addition, taxpayers and the government will realize enormous compliance- and administration-related benefits, as foreign income and the related expenses will no longer have to be declared, substantiated, and verified. Also, subsequent to the implementation of this proposal, the difficulties caused by the Subpart F and foreign tax credit rules would be entirely eliminated.

Additionally, this proposal is also practical, and would not necessitate complex transitional rules. Although immense in its approach and results, the proposal does not turn the existing U.S. tax system upside-down. Thus, the implementation of the proposal will result in enormous achievements from the simplicity perspective.

To summarize, the proposal makes implicit tradeoffs. These tradeoffs are made within equity, efficiency and simplicity categories. The proposal favors enormous simplicity and overall efficiency benefits<sup>280</sup> over the residual equity considerations.

## X.

### CONCLUSION

“Corporate inversions are not the fundamental problem; they are simply a wake-up call.”<sup>281</sup>

The continued taxation of extraterritorial income earned by U.S. corporations endangers the country’s economy and political standing. “[I]t’s far more important for the United States to retain its position as the nerve center for multinational corporations than to collect whatever revenue is gathered from the activities of foreign subsidiaries by the cumbersome U.S. system of taxing worldwide income.”<sup>282</sup> United States tax laws subject U.S. corporations to the highest rates of taxation in the developed world. In addition, the enormous complexity of U.S. tax laws causes the U.S. government and U.S. corporations to incur unparalleled expenses for administration and compliance respectively. As a result, U.S. corporations find themselves at a competitive disadvantage relative to foreign corporations and are leaving the United States.

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278. *See id.* at 1527.

279. *See id.*

280. The proposed system will not force companies to expatriate.

281. *Hearing, supra* note 1, at 43 (statement of Gary Hufbauer).

282. *Id.*

The corporate exodus, therefore, is not the essential problem; rather, it is a signal that the United States should reform its tax laws so that U.S. corporations can compete in the world economy. The approach, however, must be comprehensive and address taxation of corporate earnings at all levels. Thus, the government should exclude the extraterritorial earnings of U.S. corporations from its tax base. Simultaneously, the U.S. government should increase corporate income tax rates to compensate for the exclusion of extraterritorial income. In addition, the government should eliminate the dividend tax. Subsequent to the implementation of this proposal, the United States will have a source-based system of taxation with decreased effective rates applicable to corporate earnings.<sup>283</sup> “Failure to get [the] job done will eventually lead to the collapse of the government and perhaps even the nation.”<sup>284</sup>

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283. See *supra* Part VIII.C.

284. Brewer, *supra* note 76, at 606.