

WHEN GOOD TAX LAW GOES BAD: STANLEY WORKS' RECENT DILEMMA AND HOW THE INTERNAL REVENUE CODE DISADVANTAGES U.S. MULTINATIONAL CORPORATIONS FORCING THEIR FLIGHT TO FOREIGN JURISDICTIONS

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INTRODUCTION

In this time of corporate scandal, the scrutinizing eyes of the public are evaluating the activities of corporations and questioning motivations as some corporations and investors scramble to stay afloat as the stock market plunges in the post-Enron Era.¹ Corporations are being advised to seek ways to reduce their liabilities and increase their profits.² One clever way that recently caught the attention of the public is a paperwork transaction that turns a United States-based corporation into a foreign one, which has major tax consequences.³ This tactic, known as an inversion, can greatly reduce a corporation's taxes.⁴ However, in the wake of the recent terrorist attacks and corporate scandals, the public and Congress is calling these offshore moves unpatriotic and dishonest.⁵ Regardless of the unpopularity in public opinion, corporations and shareholders are finding themselves considering this maneuver to remain competitive and to take advantage of the rather

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1. Susan Pulliam, *U.S. Companies Increasingly Seek Offshore Tax Havens*, WALL ST. J. EUR., Feb. 20, 2002, at M6.

2. *Id.*

3. Corporate Inversion Transactions: Tax Policy Implications (2002), at www.ustreas.gov/press/releases/docs/inversion.pdf (last visited Jan. 10, 2004) [hereinafter Corporate Inversion Transactions].

4. *Id.*

5. See William M. Welch, *Offshore Tax Shelters Under Fire*, U.S.A. TODAY, July 31, 2002, at B3.

large economic benefits.⁶

Reincorporation in a foreign country is not a new concept to corporate America. However, this tactic has recently been considered by many corporations.⁷ The desire to reincorporate stems from a loophole in the U.S. tax code, which presents a significant tax advantage for a domestic multinational corporation that converts into a foreign corporation.⁸ In some cases, this maneuver allows a mere paper transaction to reduce a corporation's tax liability by millions of dollars.⁹ Due to the recent downturn in the stock market, some corporations are struggling to stay afloat amidst the scandals.¹⁰ Any opportunity to minimize an expense, albeit a tax one, has U.S.-based corporations scurrying to reincorporate in a more tax-friendly environment without losing the benefits of operating in the U.S.¹¹

Many U.S.-based multinational corporations have traded in their stars and stripes to take advantage of the tax benefits that come from being a foreign corporation.¹² One of the most notorious attempts to reincorporate was by the Stanley Works Corporation.¹³ Stanley Works is a U.S.-based multinational corporation that has operated as a domestic corporation for 160 years.¹⁴ Recently, Stanley Works shocked the public by announcing that it intended to take advantage of the tax savings by reincorporating as a Bermuda corporation.¹⁵ Although not the first of its kind, the Stanley Works proposal has received much attention during this era of heightened scrutiny of corporate activity and become the "corporate whipping boy" for trying to exploit this legal tax loophole.¹⁶ Congress has begun to consider legislation that would stop these inversions and keep U.S.-based companies from reincorporating

6. Pulliam, *supra* note 1, at M6.

7. See Corporate Inversion Transactions, *supra* note 3.

8. *Id.*

9. *Id.*

10. David C. Johnston, *U.S. Companies File in Bermuda to Slash Tax Bills*, N. Y. TIMES, Feb. 18, 2002, available at <http://query.nytimes.com/gst/abstract.html?res=F60B1FFA355B0C7B8DDDDAB0894DA404482> (last visited Jan. 10, 2004).

11. *Id.*

12. Corporate Inversion Transactions, *supra* note 3.

13. Pulliam, *supra* note 1, at M6.

14. John M. Trani, Chairman and Chief Executive Officer of Stanley Works Corporation, July 10 Proxy Statement, at <http://www.sec.gov/Archives/edgar/data/93556/000095013002004933/0000950130-02-004933.txt> (last visited Jan. 10, 2004).

15. Johnston, *supra* note 10, at A1.

16. *Stanley Works – Even In Bermuda*, CHI. TRIB., June 6, 2002, at 26.

in foreign jurisdictions.¹⁷

Stanley Works Corporation reports that its prime motivation for reincorporating in Bermuda stems from the favorable tax treatment of its foreign source income.¹⁸ Stanley Works claims that its proposed move was stimulated by the actions of its rivals and the necessity to maintain a competitive edge.¹⁹ As the emphasis is on a global economy, critics have begun to question whether the U.S. international tax rules are hindering the ability of U.S.-based corporations to compete in the global marketplace.²⁰

This article will attempt to describe how the U.S. international tax system hinders the competitiveness of U.S.-based multinational corporations in the global economy by increasing their economic burdens. Additionally, this article will discuss how these corporations have expatriated themselves to lower tax jurisdictions to increase competitiveness in the global market. The Stanley Works Corporation's recent proposal to reincorporate in Bermuda to decrease its own tax liability will be used as an example. Part I of this article provides a brief overview of the two main methods employed by countries to tax income derived by its own corporations from their operations in other countries: the exemption system and the worldwide system. Part II explains the system of international taxation embodied in the U.S. Internal Revenue Code.²¹ Part III will describe how corporations change their country of residence to take advantage of the tax reduction. Specifically, this section discusses the methods that U.S. corporations undertake to remove themselves from the full taxing jurisdiction of the United States and how the setup of the Internal Revenue Code makes it advantageous for corporations to undertake this maneuver. Part IV discusses the recent attempt of the Stanley Works Corporation to move to another country to reduce the amount of tax it pays to the U.S. Government. Part V explains how the recent wave of corporate inversions has affected the U.S. economy because of the large reduction of corporate tax base. Part VI examines how the U.S. Government plans to respond to this corporate epidemic and the reform measures planned to remedy future considerations. Finally, section VII describes a

17. Phyllis Plitch & Glenn R. Simpson, *Bowing to Pressure, Stanley Works Drops Plan for Bermuda Tax Move*, WALL ST. J., Aug. 2, 2002, at A1.

18. Trani, *supra* note 14.

19. Jonathan Weisman, *Patriotism Raining on Tax Paradise; Lawmakers are Chafing at Firms that Exist Offshore Only on Paper*, WASH. POST, Aug. 21, 2002, at E1.

20. Corporate Inversion Transactions, *supra* note 3.

21. 26 U.S.C. § 7852 (2001).

proposal for reform that would increase the ability of U.S. multinational corporations to compete in the global marketplace while retaining a significant amount of corporate tax dollars to help sustain the U.S. economy.

I. THE TAX TREATMENT OF FOREIGN INCOME

Many corporations are expanding beyond their domestic borders and branching out into multinational corporations.²² Therefore, the taxation of income derived from foreign sources has become much more significant as corporations search for a home with the most favorable tax treatment.²³ As the corporate emphasis shifts to a global economy, many countries have implemented tax breaks to ease the burden of possible double taxation on its domestic corporations.²⁴ However, these attempts to reduce the economic burden do not always produce optimal results for the multinational corporation's bottom line. The corporation may pay a higher overall tax rate depending on the domestic country's treatment of foreign source income.²⁵

As many countries depend on tax dollars from corporations to help sustain their economies, two approaches have developed to alleviate added economic pressure that multiple countries' income tax systems may place on a corporation competing in the global marketplace.²⁶ The two most widely used programs developed to deal with domestic corporations who have foreign income are the exemption system and the worldwide system.²⁷

A. THE EXEMPTION SYSTEM

The exemption system is a taxation scheme that does not tax the income that a resident multinational corporation earns outside of the

22. INDIVIDUAL TAXATION 13-37, (James W. Pratt & William K. Kulsrud eds., ARC Publishing Company, Inc. 2000) (1999).

23. *Id.*

24. The double taxation discussed here is that of paying a tax to the foreign country from which the income is derived but also paying an additional tax to the corporations' home country. Corporate Inversion Transactions, *supra* note 3. This situation would create an additional economic burden on the company; therefore, many countries have adopted systems to alleviate this problem. *Id.*

25. See generally Terrence R. Chorvat, *Ending The Taxation of Foreign Business Income*, 42 ARIZ. L. REV. 835 (2000). The term "source" of income was introduced in the short-lived 1894 Tax Law and is used as shorthand for the location from which income is derived. JOSEPH ISENBERGH, INTERNATIONAL TAXATION 9 (Foundation Press 2000).

26. Chorvat, *supra* note 25, at 838.

27. *Id.* at 839.

borders of the resident country.²⁸ The only income that is subject to income tax in the country of residence is the income derived from operations within its territorial borders.²⁹ This serves as an incentive for corporations to expand its operations into other countries because there are no additional tax consequences in their home country.³⁰

The exemption system can be very advantageous to a multinational corporation.³¹ However, potential for abuse exists within this system as it provides an opportunity for corporations to evade the tax consequences of the worldwide system, as discussed *infra*, by becoming a resident of a country with this type of international tax system while retaining its significant operations in other jurisdictions.³² For example, the Netherlands has a tax system that illustrates the exemption system in action.³³ Although the corporate tax rate in the Netherlands is relatively high at 35%, the resident multinational corporations in the Netherlands pay no income tax on their non-passive foreign income.³⁴ Therefore, this high rate is only assessed on the income made by the corporation in the Netherlands.³⁵

B. THE WORLDWIDE SYSTEM

The worldwide system is one where a domestic corporation must pay income tax to its home country on all income regardless of the source from which it was derived.³⁶ Under a worldwide system, a multinational corporation is usually given credit for the amount of taxes that it pays to the foreign country, on its foreign source income, where the subsidiary is located and the income is derived.³⁷ Although the corporation pays the same amount it would if the income was derived from within the borders of the residence country, it pays tax to both the foreign country and the country of residence.³⁸

28. Chorvat, *supra* note 25, at 842.

29. *Id.*

30. *Id.*

31. *Id.*

32. *Id.* at 841.

33. Chorvat, *supra* note 25, at 840.

34. *Id.*

35. *Id.*

36. *Id.*

37. *Id.* at 839.

38. The same overall tax rate is paid when the tax rate in the foreign country is less than that of the residence country because of the limits that are placed on the amount of credit that can be taken. If the foreign country taxes at a higher rate than the residence country, the amount of foreign tax credit will only be to the amount of the residence country's tax. Chorvat, *supra* note 25, at 839-40; *see also* I.R.C. § 901.

For example, if the corporation of Country A paid tax to Country B for the income it derived from Country B, then Country A would reduce the amount of tax that the corporation would pay to Country A by the amount of tax the corporation paid to Country B.³⁹ In essence, this process will give the corporation a credit for the tax it already paid.⁴⁰ To give a numeric example, if the corporation owed a total of \$5 of income tax to its residence country (Country A) on the income earned in Country B, but it had already paid \$2 in tax on that same income to Country B, then the corporation would only owe Country A \$3 in taxes because of the credit received.⁴¹ This credit is limited and usually cannot exceed the tax that would be paid on the foreign-source income in the residence country.⁴² One example of this system is embodied in the Internal Revenue Code of the United States.⁴³

II. THE U.S. INTERNATIONAL TAX SYSTEM

The United States uses the worldwide system to tax foreign income earned by corporations.⁴⁴ Since a substantial portion of the world's business transactions and investments are affected by some measure of U.S. taxation, it is important to understand some of the basic concepts that affect these activities in the global economy.⁴⁵ The Internal Revenue Code taxes all income of U.S.-based multinational corporations regardless of the location of the source of that income.⁴⁶ The U.S. then provides a credit for the tax that is paid to a foreign country up to a certain limit.⁴⁷ The income of U.S. corporations is taxed at a 35% rate; therefore, the credit is available up to 35%.⁴⁸

39. Chorvat, *supra* note 25, at 839–40.

40. *Id.*

41. This example is a very simplified variation on the example provided by Chorvat. In his article, the more elaborate example goes as follows:

To illustrate, assume that A, a U.S. MNE [multinational enterprise], earned \$100 in Hong Kong and \$100 in the United States. Hong Kong will tax the \$100 of income earned within its borders at a rate of 17%. The United States will tax A's worldwide income of \$200 at a rate of 35%. However, because of the foreign tax credit, A will only have to pay an additional tax of \$53, rather than \$70. *Id.* at 839.

42. Pratt, *supra* note 22. For example, in the United States the foreign tax credit cannot exceed the 35% corporate income tax rate. See Chorvat, *supra* note 25, at 839–40.

43. Chorvat, *supra* note 25, 841–42.

44. See I.R.C. §§ 1, 11, 61, 901 (2001).

45. ISENBERGH, *supra* note 25, at 3.

46. See I.R.C. § 11 (2001).

47. See I.R.C. § 901 (2001).

48. Chorvat, *supra* note 25, at 843; see also Weisman, *supra* note 19, at E1.

Although the U.S. tax system uses the foreign tax credit system to ease the burden of possible double taxation, paying this much tax on the income derived not only from domestic operations but from foreign sources as well puts U.S. corporations at a significant disadvantage in comparison to foreign corporations who are taxed at 35% on only the amount of U.S. source income.⁴⁹

For example, (assuming a 35% U.S. rate and 20% rate in the foreign country) a U.S. corporation that made \$1,000,000 from its U.S. operations and \$1,000,000 income from foreign operations would, pay a total of \$700,000 in taxes; whereas, a foreign corporation with the same statistics would pay \$550,000 in total taxes.⁵⁰ As the example demonstrates, the foreign corporation has an advantage over the U.S. corporation because it pays \$150,000 less in taxes from identical operations merely because the corporation is a resident of a foreign country rather than the United States. Though this example presents a very simplistic comparison of the income tax disparity between a U.S. multinational and a foreign counterpart, it explains the type of situation that is driving the U.S. corporations to consider converting to foreign corporations to exploit these advantages.⁵¹

The Internal Revenue Code provides a deferral for most earnings derived from foreign subsidiaries.⁵² The earnings are not taxed until they are repatriated into the U.S.⁵³ This deferral is intended to encourage the reinvestment of capital in the foreign subsidiary so the company may continue to increase its operations.⁵⁴ However, under the U.S. system, some passive business income is lumped into the company's total income and the company ends up paying taxes on these earnings.⁵⁵ As a result, this deferral does not necessarily produce an optimal result for the corporation.⁵⁶

The resident country for a corporation has momentous tax

49. Chorvat, *supra* note 25, 842–43; *see also* I.R.C. § 882 (2001).

50. In this example, the total tax that the U.S. corporation would pay in U.S. tax would be \$500,000 while the other \$200,000 would be paid to the foreign country and the corporation would be given a credit for this tax. *See* I.R.C. § 901 (2001). The foreign corporation would pay \$350,000 in U.S. tax and \$200,000 to the foreign country. *Id.*

51. Chorvat, *supra* note 25, at 845.

52. *Id.*

53. The repatriation usually occurs in the form of dividends that are distributed to the shareholders and are then taxed at the shareholder level. *Id.* at 841.

54. *Id.*

55. *Id.*

56. The company can end up paying tax on income regardless of whether it has been repatriated into the U.S. This occurs when there is passive business income (i.e. interest and royalties paid by foreign affiliates). Chorvat, *supra* note 25, at 857.

consequences within the U.S. tax code.⁵⁷ As discussed *supra*, a domestic entity is subject to U.S. tax on its worldwide income.⁵⁸ However, a foreign corporation will only pay tax on income derived from U.S. investment or operation.⁵⁹ In the U.S. corporate tax arena, no other bases for taxing corporations is considered, including nationality of owners, principal place of business, or where the primary management occurs.⁶⁰ This opens up the U.S. system to the possibility of abuse by corporations that may take advantage of such an enormous loophole.⁶¹ Because a corporation is no more than a piece of paper that is granted separate legal status, this simple basis for taxing corporations has been criticized for having such large tax consequences depending solely on which sovereign issued the document rather than any other criteria.⁶²

The U.S. international tax system was designed to respond to changes in how business operations and investments are carried out across international boundaries.⁶³ However, this tax system has recently been criticized as archaic and in desperate need of reform.⁶⁴ Despite unanticipated and rapidly changing pathways of international commerce, this system has remained relatively unchanged since its development over thirty years ago.⁶⁵

III. CORPORATE INVERSION

Corporate inversion, as it relates to U.S. multinational corporations, is defined by the Treasury Department as “a transaction that alters the corporate structure of a U.S.–based multinational company so that a new foreign corporation, typically located in a low- or no-tax country, replaces the existing U.S. parent corporation as the parent of the corporate group.”⁶⁶ The motivation for such a transaction is mainly the economic benefits that come from the lower tax on foreign source income resulting from this maneuver.⁶⁷ The movement of the

57. ISENBERGH, *supra* note 25, at 25.

58. *Id.*; I.R.C. § 7701(a)(4) (2001).

59. ISENBERGH, *supra* note 25, at 25.

60. *Id.*

61. Chorvat, *supra* note 25.

62. *Id.*

63. ISENBERGH, *supra* note 25, at 3.

64. See generally Corporate Inversion Transactions, *supra* note 3.

65. *Id.*

66. JUDITH LOHMAN, *Stanley Works Reincorporation Proposal*, July 19, 2002, at <http://www.cga.state.ct.us/2002/olrdata/fin/rpt/2002-R-0636.htm> (last visited Jan. 10, 2004).

67. See generally Corporate Inversion Transactions, *supra* note 3.

multinational's ownership of its foreign operations accompanying the corporate inversion to a foreign entity removes the income from foreign operations from the U.S. tax base.⁶⁸

Corporate inversion through foreign reincorporation is achieved in several different ways and generally has no real effect on the operation of the company itself.⁶⁹ These transactions are merely used to achieve the desired result, an escape of excess taxation.⁷⁰ There are three main methods that are used to accomplish the reincorporation step: Stock Transactions, Asset Transactions, and Drop Down Transactions.⁷¹

Stock Transactions involve exchanging the stock of the newly formed foreign company for the stock of the U.S. company.⁷² This transaction merely converts the ownership from that of a U.S. corporation to that of a foreign corporation.⁷³ Asset Transactions are the direct reincorporation of the U.S. parent company in a foreign jurisdiction.⁷⁴ In general, this transaction involves the formation of a

68. See generally Corporate Inversion Transactions, *supra* note 3.

69. *Id.*

70. *Id.*; see also ISENBERGH, *supra* note 25, at 185.

71. Corporate Inversion Transactions, *supra* note 3, at 4–5.

72. The stock transaction type of inversion is explained by the Treasury Department as: The reincorporation step in many of the transactions that have occurred to date involves interposing a newly-formed holding company located in Bermuda or another low-tax jurisdiction (the “foreign parent”) between the current U.S. parent corporation (the “U.S. parent”) and that corporation’s shareholders. The newly formed foreign parent acquires the outstanding stock of the U.S. parent either directly or through a reverse subsidiary merger (a merger of a transitory U.S. subsidiary of the new foreign parent into the U.S. parent), with the U.S. parent surviving as a subsidiary of the new foreign parent and the shareholders of the U.S. parent exchanging their U.S. parent stock for stock in the new foreign parent. After the transaction is complete, the U.S. corporate group generally is unchanged except that the new foreign parent holds the stock of the former U.S. parent. The shareholders hold stock of the new foreign parent instead of the former U.S. parent.” *Id.*

73. This is usually achieved through the use of a transitory subsidiary that is indirectly owned by the foreign parent through an intermediate holding company that may be either U.S. or foreign. *Id.*

74. The asset transaction is further defined by the Treasury Department as: The second category of [inversion] transaction that has been used to implement the reincorporation step in several, generally smaller, transactions is the direct reincorporation of the U.S. parent in a foreign jurisdiction. 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.

new foreign corporation and the merger of the U.S. corporation into the new corporation, similar to a basic merger transaction of non-related corporations.⁷⁵ As a result of this transaction, the shareholders will hold the stock of the foreign parent in accordance with state corporate law because the former U.S. corporation is now merely a subsidiary of the foreign corporation.⁷⁶

Drop Down Transactions involve elements of both Stock and Asset Transactions and usually occur when the U.S. company transfers its assets to a newly formed foreign parent company and then a portion of those assets is transferred back to the new U.S. subsidiary company.⁷⁷ As a result, the original U.S. parent company no longer exists and the stock is merged with that of the new foreign parent; therefore, the shareholders hold the same interest in the newly formed corporation as they did in the former U.S. company.⁷⁸ Essentially, this method is a hybrid of the first two categories.⁷⁹

The reincorporation step is the main step in a corporate inversion.⁸⁰ However, it must be accompanied by some restructuring to affect the tax treatment of the corporation under U.S. tax law.⁸¹ The restructuring at the corporate level usually does not involve any change in the operations of the company.⁸² This task is normally accomplished by transferring ownership of existing foreign subsidiaries to the new foreign corporate group; again, this action does not change the operations of the corporation and is achieved merely through a

parent. Corporate Inversion Transactions, *supra* note 3, at 4–5.

75. *Id.* at 3.

76. *Id.* at 4–5.

77. Drop down transaction inversions are explained by the Treasury Department as: The third category of transaction that has been used to implement the reincorporation step involves elements of both stock and asset transfers. In this type of transaction, the U.S. parent transfers its assets to a new foreign corporation, and then a portion of those assets is contributed immediately to a U.S. subsidiary of the new foreign parent. To the extent that assets are contributed to a U.S. corporation, and therefore effectively remain in U.S. corporate solution, the result generally is the same as in a Stock Transaction (i.e., the interposition of a foreign corporation between the existing U.S. group and the current shareholders). To the extent the foreign corporation directly holds some of the assets of the former U.S. parent, the result generally is the same as in an Asset Transaction. *Id.* at 5.

78. *Id.*

79. Corporate Inversion Transactions, *supra* note 3, at 4–5.

80. *Id.*

81. *Id.*

82. *Id.*

paperwork transaction.⁸³

The inversion itself does trigger some tax consequences as the corporation seeks to relocate outside the United States' taxing jurisdiction.⁸⁴ However, the potential tax consequences for inversion are usually less significant than the overall tax savings available to a U.S.-based company reincorporating in a no-tax foreign jurisdiction.⁸⁵ Therefore, many corporations determine that the benefit outweighs the immediate tax cost.⁸⁶

This tax can be felt at either the corporate or shareholder level depending on the structure of the transaction.⁸⁷ The tax will be the result of the built-in gain involved in the exchange of stock or assets at the shareholder or corporate level, respectively.⁸⁸ For example, in a stock transaction, the shareholder must recognize gain equal to the excess of the fair market value of the stock over the shareholder's adjusted basis.⁸⁹ In an asset transaction, the corporation must recognize the gain on the disposition of assets as if they had been sold for fair market value at the time of the inversion and the shareholders are not subject to a tax.⁹⁰

In a drop down transaction, the shareholders must recognize a gain on the change in value of the stock the same way as in stock transactions and the corporation must recognize the gain on the transfer of assets similar to the asset transaction requirements.⁹¹ This deterrent was implemented in the 1990s to reduce the incentive for the shareholders to vote in favor of an inversion.⁹² However, with the recent turmoil in the stock market amidst corporate scandals, the prices of stock have been depressed, the capital gains and the associated tax consequences would be minimized, and shareholder opposition to the

83. Corporate Inversion Transactions, *supra* note 3, at 5–6.

84. The tax consequences that result from this vary depending on the method of reorganization. In some instances, the company will pay a gains tax on the recognized gain from the disposition of its assets. In other cases, the tax will fall to the shareholders immediately on the gain from their old stock to the new stock. *Id.* at 7.

85. *Id.*

86. *Id.*

87. *Id.*

88. Corporate Inversion Transactions, *supra* note 3, at 21.

89. I.R.C. § 367 (1999).

90. *Id.*

91. *Id.*

92. In the mid-1990s, the U.S. enacted a “toll charge” directed at the expatriating company's stockholders where they would pay the capital gains tax on the difference between the value of the shareholder's basis in the stock and the value of the stock at the time of the company's reincorporation in a foreign country. Pulliam, *supra* note 1.

move would be less likely because of this “toll charge.”⁹³

For these reasons, corporate inversion has become a much more popular phenomenon in recent years as many U.S. multinational corporations have discovered that their bottom lines can considerably be improved by the significant tax savings achieved by moving the foreign subsidiaries outside the taxing jurisdiction of the United States.⁹⁴ For example, the Stanley Works Corporation has estimated that it will save \$30 million dollars a year in taxes by reincorporating in Bermuda.⁹⁵ With the U.S. international tax system placing such a heavy burden on its resident corporations, many multinational operations are making this move in order to maintain a competitive edge in the global marketplace.⁹⁶ As this maneuver becomes more commonplace, the impact on the U.S. economy and tax base is tremendous as it is estimated that corporate inversions have eroded the tax base by approximately \$70 billion dollars.⁹⁷ Some governmental analysts have recognized the marked increase in inversion activity as a corporate outcry for tax reform in the U.S. international tax arena because of the competitive pressure on U.S. resident corporations that compete in the global marketplace.⁹⁸

IV. STANLEY WORKS CORPORATION

U.S. corporations are finding themselves faced with competitive pressure to consider corporate inversion to take advantage of more favorable tax treatment that results from reincorporating as a foreign corporation.⁹⁹ One recent example of a U.S. company facing this dilemma is the Stanley Works Corporation. Their relocation proposal

93. Weisman, *supra* note 19. As noted by one tax practitioner, when stock values are depressed because of troubled economic times, shareholders may have little or no tax consequences as a result of an inversion transaction, therefore causing such corporate responses to become more attractive to shareholders. Stuart Anolik et al., *Attack on U.S. Companies Moving Offshore*, at http://www.gtlaw.com/pub/alerts/2002/anoliks_06.asp (last visited Jan. 10, 2004).

94. Weisman, *supra* note 19.

95. Ross Kerber, *Stanley Abandons move to Bermuda Now Sees Little Benefit to Reincorporation*, BOSTON GLOBE, Aug. 3, 2002, at E1.

96. Corporate Inversion Transactions, *supra* note 3, at 27–28.

97. Glen Johnson, *Congress Looks to Plug Tax Loophole Bill Targets Advantages Sought by U.S. Firms that Incorporate Offshore*, BOSTON GLOBE, Mar. 12, 2002, at D1.

98. Corporate Inversion Transactions, *supra* note 3, at 2–3.

99. The corporate inversion considered by Stanley Works would achieve the objective of reclassifying a significant portion of its income that is derived from foreign sources outside of the reach of the U.S. tax system. Corporate Inversion Transactions, *supra* note 3, at 2; Trani, *supra* note 14.

caught the attention of the public and brought the inversion debate to the forefront.¹⁰⁰ Unfortunately, as a result, Stanley Works became the named villain associated with tax avoidance, as inversion activity became the latest corporate misdeed.¹⁰¹

Stanley Works Corporation was founded in 1843 by Frederick Stanley and incorporated in Connecticut in 1852.¹⁰² Stanley Works Corporation is a worldwide producer of tools and door products with an estimated annual income of close to \$2 billion dollars per year.¹⁰³ The Stanley Works Corporation recently proposed a plan to its shareholders to reincorporate the company in Bermuda to reduce its tax liability.¹⁰⁴ Under the proposed plan, Stanley Works Corporation would reincorporate as Stanley Works Ltd., a Bermudan Corporation and a resident of Barbados.¹⁰⁵

Following the lead of many other companies, Stanley Works' plan was to be a Bermudan corporation in name only, leaving its headquarters and operations as they currently exist in the U.S.¹⁰⁶ Stanley Works executives projected that this maneuver would result in a reduction of their tax rate from 32 percent to approximately 23–25 percent.¹⁰⁷ This reduction has significant monetary advantage since Stanley Works had worldwide sales of \$2.6 billion in 2001.¹⁰⁸

A. THE STANLEY WORKS' PROPOSAL¹⁰⁹

Stanley Works wanted to accomplish its corporate inversion using the stock transaction method as discussed earlier by converting its U.S.

100. *Stanley Works – Even In Bermuda*, *supra* note 16.

101. *Id.*

102. Trani, *supra* note 14.

103. *Id.*

104. *Id.*

105. *The Stanley Works Shareowners Overwhelmingly Approve Changes in Place of Incorporation to Bermuda*, The Stanley Works Company News, at http://www.stanleyworks.com/a_news_050902.asp (last visited Jan. 10, 2004).

106. Trani, *supra* note 14. Similar to the inversions recently completed by Tyco, Ingersoll-Rand, and Cooper Industries, the operations of the Stanley Works Corporation in terms of management, manufacturing facilities, and corporate offices were not anticipating being changed once the inversion was completed. *Id.* Other notable corporations who have taken advantage of inversion to minimize their tax liability include: McDermott, Inc., Helen of Troy, Inc., Triton Energy Corporation, and Fruit of the Loom, Inc. Anolik, *supra* note 93.

107. Trani, *supra* note 14.

108. *Id.*

109. This is a simplified explanation of the actual proposed transaction only intended to give an overview of the inversion transaction not an in-depth explanation of its mechanics. See generally Trani, *supra* note 14, for a more detailed explanation.

stock into stock in its newly formed Bermuda based corporation.¹¹⁰ In its proposal, Stanley Works (“Stanley Connecticut”) will become a wholly owned subsidiary of the newly formed Stanley Bermuda Company.¹¹¹ The transaction also includes the use of a conduit company, Stanley Mergerco, used to merge Stanley Connecticut into Stanley Bermuda.¹¹² Then Stanley Connecticut will be the surviving entity and become a wholly owned indirect subsidiary of Stanley Bermuda.¹¹³ All outstanding stock of Stanley Connecticut will be converted into shares of Stanley Bermuda so the shareholders will own the same proportion of the new corporation that they did in Stanley Connecticut.¹¹⁴ The shareholders will merely be required to exchange their stock certificate for certificates representing their newly acquired stock in the Bermuda Corporation.¹¹⁵

The shareholders of Stanley Works will bear the brunt of the tax burden from the conversion due to the capital gains that the shareholders will be subject to under the tax code.¹¹⁶ However, the impact on the shareholder is minimized because Stanley Works’ stock price is down from its 1998 peak.¹¹⁷ Many of the stockholders would not have to worry about the accelerated gains tax because of its current reduced market price.¹¹⁸

B. MOTIVATIONS FOR REORGANIZATION

In a recent letter to its stockholders, Stanley Works cited several reasons for its proposal to reincorporate outside the United States.¹¹⁹ The statement by Stanley Works noted that the tax treatment of foreign source income by the U.S. tax system does not enable U.S.-based multinational corporations to compete on a “level playing field” in an increasingly globalized economy.¹²⁰ Stanley Works also admitted that its move was motivated by the actions of its most significant competitors, Ingersoll-Rand and Cooper Industries, who recently

110. Trani, *supra* note 14.

111. *Id.*

112. *Id.*

113. *Id.*

114. *Id.*

115. Trani, *supra* note 14.

116. I.R.C. § 367 (1999).

117. *Id.*

118. Pulliam, *supra* note 1.

119. Trani, *supra* note 14.

120. *Id.*

employed this same strategy to reduce their tax liability.¹²¹

Stanley Works' proposed plan to become a Bermuda-based company has been estimated to save the Stanley Works Corporation approximately thirty million dollars per year in taxes.¹²² Stanley Works' foreign source income consists of approximately \$200 million and forty-eight percent of its work force outside of the United States. Thereby, avoiding U.S. taxes on its foreign source profits presents a lucrative opportunity.¹²³

C. MANIPULATION OF THE U.S. TAX RULES

As occurs with the numerous companies who have preceded Stanley Works in this type of transition, the operations and management of Stanley Works would not change as a result of the inversion.¹²⁴ The transition would merely be a paper transaction that would save the company significant tax dollars.¹²⁵ Under U.S. tax law, a company is considered a foreign corporation even if its presence in the foreign country consists of "a file drawer and a lawyer."¹²⁶ Basically, a mail drop in Bermuda can turn a U.S. corporation into a Bermudan Corporation and effectively avoid substantial taxes to the United States government.¹²⁷ In reference to their move, an Ingersoll-Rand executive noted that the company did not even need to set up an office in Bermuda; the only thing they needed was a service to pick up their mail.¹²⁸

D. WHY BERMUDA?

Bermuda has become the reincorporation location of choice for recent inversion transactions.¹²⁹ Reincorporation in Bermuda is nothing new; the first offshore company was established there in 1935.¹³⁰ This

121. Trani, *supra* note 14.

122. Pulliam, *supra* note 1; Johnston, *supra* note 10.

123. The financial data came from the financial statement footnotes in the information provided to the shareholders. Trani, *supra* note 14; *see also* Johnson, *supra* note 97.

124. Corporate Inversion Transactions, *supra* note 3.

125. *Id.*

126. Weisman, *supra* note 19.

127. Michael Miller, *Bermuda-Bound Companies Dodge their Duty*, PUGET SOUND BUS. J., at <http://seattle.bizjournals.com/seattle/stories/2002/05/27/editorial3.html> (last visited Jan. 10, 2004).

128. *Id.*

129. Allan Sloan, *The Tax-Free Bermuda Getaway*, NEWSWEEK, Apr. 15, 2002, at 41.

130. Johnson, *supra* note 97.

trend is known as the Bermuda Triangle of tax loopholes.¹³¹ Many analysts believe that Bermuda is the favorite island tax haven due to its close proximity to the U.S., the stable political system, and the similar legal system to that of the United States.¹³²

In addition to the sand, sun, and beaches, this exotic locale offers an unbelievable monetary advantage; reincorporation in Bermuda offers a land of no income tax, no capital gains tax, and very little business regulation.¹³³ Additionally, the legal liability for corporate executives is reduced.¹³⁴ Shareholders simply cannot sue corporate officers and directors and Bermuda refuses to enforce U.S. judgments against them.¹³⁵ Although some shareholders and critics are concerned about the potential alteration of the rights of the shareholders, many corporations have faced little opposition during the voting process once the economic realities and potential benefits of the situation were revealed.¹³⁶ Corporate shareholders have been willing to give up their legal rights in exchange for the forecasted economic gain.¹³⁷

E. THE UNFAVORABLE PUBLIC RESPONSE

As a result of its proposed relocation tactic, Stanley Works Corporation received criticism from the public concerning its seeming effort to disavow its loyalty to the United States in an attempt to avoid paying its taxes.¹³⁸ Many critics have used the timing of these types of maneuvers in a post-September 11th atmosphere to question the patriotism of these Bermuda-bound corporations.¹³⁹ Many politicians and government officials have tried to play the proverbial “heart-strings” of U.S. corporations that reincorporate in foreign countries by questioning their loyalty to the United States and its citizens in a post-September 11th era.¹⁴⁰

131. Press Release, Rep. Scott McInnis (Repub. – Colo.), McInnis to Stanley Works - ‘Revote should consider Patriotism’, (May 13, 2002), *available at* <http://www.house.gov/mcinnis/press/2002/pr020513.htm> (last visited Jan. 10, 2004).

132. Johnston, *supra* note 10.

133. Johnson, *supra* note 97.

134. *Id.*

135. *Id.* There is no Bermuda law or treaty with the U.S. that provides for the enforcement of a monetary judgment entered by a U.S. court. Trani, *supra* note 14. Critics believe that this results in a reduced protection of the shareholders rights. *Id.*

136. Trani, *supra* note 14; Kerber, *supra* note 88.

137. *Id.*

138. Johnston, *supra* note 10.

139. Welch, *supra* note 5.

140. *Id.*; Sloan, *supra* note 129, at 41; *see also* McInnis, *supra* note 131.

In an increasingly competitive market, the choice of patriotism versus capitalism is becoming an important consideration for U.S. companies.¹⁴¹ Corporations are struggling as to whether the consumer backlash from this “unpatriotic” move outweighs the ultimate monetary benefit the corporation’s shareholders will enjoy from the significant tax reduction.¹⁴²

Patriotism seems to be the angle that politicians are using to rally the public to deter U.S. companies from expatriating.¹⁴³ Representative Charles B. Rangel of New York stated:

[S]ome companies flying the Stars and Stripes renounce America when it comes to paying their taxes[.] They choose profits over patriotism. . . Supporting America is more than about waving the flag and saluting – it’s about sharing the sacrifice. That’s true of soldiers, citizens, and it should be true of big companies, too.¹⁴⁴

Realistically, to stay competitive in a global market, companies must look beyond paying homage to their home country and concentrate on staying afloat in a cutthroat market. In response to an inquiry about the reincorporation of domestic companies to a foreign tax haven, Kate Barton, a partner with Ernst & Young, said, “Is it the right time to be migrating a corporation to an offshore location? A lot of companies feel that. . . the improvement on earnings is powerful enough to say that maybe the patriotism issue should take a back seat.”¹⁴⁵ A representative from Ingersoll-Rand seemed to echo the sentiment of most of the expatriating companies when he was questioned about that corporation’s decision to abandon the U.S. and reincorporate in Bermuda.¹⁴⁶ Ingersoll-Rand executive Jerry Swimmer stated, “The question isn’t what is wrong with a company that would do this, but what’s wrong with a tax system that gives a better result to one who is domiciled outside the U.S.”¹⁴⁷

In the wake of the mass inversion activity and the public outcry for governmental intervention, the U.S. government has recognized the need for international tax reform.¹⁴⁸ Some proposals have been brought before Congress as a means to alleviate some of the incentive for a U.S.

141. Weisman, *supra* note 19.

142. *Id.*

143. Johnston, *supra* note 10.

144. *Id.*

145. Weisman, *supra* note 19.

146. Pulliam, *supra* note 1.

147. *Id.*

148. Plitch, *supra* note 17.

multinational to reincorporate overseas including some punitive measures for corporations that recently completed an inversion, discussed in more detail *infra* Part V.¹⁴⁹

F. STANLEY WORKS BACKED DOWN TO POLITICAL PRESSURE

Despite receiving the majority shareholder approval to move the company, the Stanley Works Corporation, under intense political pressure from the public and politicians, ultimately decided to cancel its plans to reincorporate in Bermuda.¹⁵⁰ Although Stanley Works' executives reiterated their contention that the U.S. tax code creates inequities for U.S.-based companies, but the decision to abandon the plan was in anticipation of forthcoming reform.¹⁵¹

The Stanley Works Corporation bowed to the political pressure from the legislature, which threatened to penalize companies that relocate to achieve tax avoidance.¹⁵² The new tax laws are expected to eliminate the tax benefit that comes from the move.¹⁵³ As discussed *infra* in more detail in Part VI, Congress has begun to consider penalizing corporations that seek to exploit the tax haven loophole by preventing them from entering into contracts with the government as well as enacting laws that change the criteria for determining the country of residence.¹⁵⁴

Stanley Works reconsidered its plan because of pressure from the general public, the legislature, and its own labor unions.¹⁵⁵ Although Stanley Works tried to reassure its workers that their jobs were not being threatened, many labor unions expressed concern that U.S. jobs may be in danger once the move was completed.¹⁵⁶ Enhanced pressure and complaints coming from these organizations was another factor in Stanley Works' ultimate decision to scrap the move to the sunny shores of Bermuda.¹⁵⁷

Stanley Works is anticipating legislative action, which will address the motivations that caused it to consider relocation to Bermuda.¹⁵⁸ The

149. Plitch, *supra* note 17.

150. *Id.*

151. *Id.*

152. *Id.*

153. *Id.*; Kerber, *supra* note 95.

154. Plitch, *supra* note 17. Section VI of this article, *infra*, discusses the government plans for action in more detail than the broad overview presented here.

155. *Id.*

156. *Id.*

157. *Id.*

158. *Id.*

company is turning the tables and pressuring the legislature to change the tax laws so that it can remain competitive.¹⁵⁹ Stanley Works is awaiting reformed tax measures that eliminate the incentive for U.S. corporations to leave the country.¹⁶⁰ Stanley Works, along with several other companies that previously considered ultimately moving offshore, halted plans for the time being because of the expectation of legislative backlash toward expatriated corporations.¹⁶¹ Stanley Works' shareholders felt the pinch after the withdrawal of the proposed move was made public.¹⁶² After the decision to drop the inversion plans was announced, shares in Stanley Works fell \$1.30 to close at \$34.42 per share.¹⁶³

V. THE EFFECT OF INVERSION ON THE U.S. ECONOMY

The recent epidemic of corporate inversions has detrimental implications for the U.S. Economy.¹⁶⁴ The government has begun to recognize a need for reform in the area of international tax law in order to protect the economy from further devastation.¹⁶⁵ The recent Stanley Works proposal has brought this issue to the forefront as more U.S. multinational corporations are embracing the financial incentives available to them as a foreign corporation rather than their patriotic duty to pay taxes.¹⁶⁶ Stanley Works was planning to join the long list of U.S. multinationals, which have already completed their transition and are reaping the tax benefits of foreign incorporation.¹⁶⁷

The numerous companies that left the U.S. to find no-tax or low-tax homes are slowly eroding the U.S. corporate tax base.¹⁶⁸ The companies that completed their corporate inversion have reduced the U.S. tax base by \$70 billion dollars and counting.¹⁶⁹ Ingersoll-Rand Co., Cooper Industries, and Tyco International are the most significant

159. Kerber, *supra* note 95.

160. *Id.*

161. Plitch, *supra* note 17.

162. Kerber, *supra* note 95.

163. *Id.*

164. There is a significant amount of tax revenue that has already been lost on foreign source income to date and unless some reform is made, this erosion of a large portion of the tax base may continue to erode past the millions that the U.S. government has already lost. Corporate Inversion Transactions, *supra* note 3, at 29.

165. *Id.* at 3.

166. *Stanley Works – Even In Bermuda*, *supra* note 16.

167. Johnston, *supra* note 10.

168. Johnson, *supra* note 97.

169. *Id.*

expatriating nomads, expecting to save approximately \$450 million dollars collectively in tax.¹⁷⁰ Ingersoll-Rand Co. of New Jersey, one of Stanley Works' competitors, will save \$40 to \$60 million a year due to its reincorporation in Bermuda.¹⁷¹ As a result of its reincorporation abroad, a spokesperson for Cooper Industries, another of Stanley Works' competitors, said that it has saved about \$13 million in taxes during the last fiscal quarter ending June 30.¹⁷² Tyco International Ltd. has estimated that it will save an estimated \$400 million in U.S. taxes as a result of its conversion to a Bermudan Corporation.¹⁷³

VI. THE U.S. GOVERNMENT'S PLANS TO REMEDY THE INVERSION EPIDEMIC

In response to the exodus of corporations, the U.S. Treasury Department issued an article focusing on corporate inversion and seeking reform in U.S. tax policy to prevent American corporations from seeking relocation to foreign homes.¹⁷⁴ Numerous scholarly articles have been published regarding much needed reform in this area, suggesting that U.S. corporations are suffering in the global market due to this outdated tax scheme.¹⁷⁵ Legal publications are abundant with criticism and suggestions that seem to have been disregarded by the government.¹⁷⁶ Even this note suggests that the U.S. tax system should be reevaluated to reflect a more global economy and to prevent the need for U.S. corporations to attempt this maneuver.¹⁷⁷ Now that this issue has been brought to the forefront, Congress has begun considering alternatives to the current tax regime, as well as methods to penalize companies who have already moved offshore or those who are planning to relocate in the future.¹⁷⁸

The Stanley Works proposal started a storm of controversy about

170. Weisman, *supra* note 19; Kerber, *supra* note 95; David L. Lupi-Sher, *Bermuda Tax Strategies Expose Practitioner's Differences and Concerns* (May 17, 2002), available at <http://www.taxanalysts.com/www/readingsintaxpolicy.nsf/0/D135029E25594DB585256BF4006EBA90?OpenDocument> (last visited Jan. 10, 2004).

171. Weisman, *supra* note 19.

172. Kerber, *supra* note 95.

173. Lupi-Sher, *supra* note 170.

174. Corporate Inversion Transactions, *supra* note 3.

175. Chorvat, *supra* note 25; see also James Leonard, *The Anti-Competitive Effect of the Internal Revenue Code on United States-Based Multinational Corporations*, 20 DENV. J. INT'L L. & POL'Y 493 (1992).

176. Leonard, *supra* note 175.

177. Corporate Inversion Transactions, *supra* note 3.

178. Plitch, *supra* note 17.

corporate inversions during a time when corporate America has been vilified for employing creative financial maneuvers.¹⁷⁹ In this case, Congress has decided to fight back.¹⁸⁰ With several proposals in the works, Democrats and Republicans have banded together to implement legislation aimed at preventing these offshore moves.¹⁸¹

Lawmakers are considering legislation that would eliminate the need and motivation for corporate inversion by U.S. multinational corporations.¹⁸² Proposals have been brought before Congress recommending certain measures that would deter corporate inversion activity by penalizing expatriated corporations.¹⁸³ For example, one measure considers banning the ability of foreign-based corporations to obtain government contracts.¹⁸⁴ Other proposed legislation would change how the country of residence is determined for tax purposes by looking to the significance of its U.S. presence rather than its country of incorporation.¹⁸⁵ These proposals are intended to eliminate or reduce the incentive for companies to invert without eliminating any of the current tax base and, in some cases, recapture some tax revenue that would otherwise be lost.¹⁸⁶

179. Welch, *supra* note 5.

180. Plitch, *supra* note 17.

181. *Id.*

182. *Id.* The proposed anti-inversion legislation includes: Corporate Patriot Enforcement Act of 2002, H.R. 3884, 107th Congress (2002) (amending the Internal Revenue Code of 1986 to prevent corporations from avoiding the United States income tax by reincorporating in a foreign country); H.R. 3857, 107th Congress (2002) (amending the Internal Revenue Code of 1986 to treat nominally foreign corporations created through inversion transactions as domestic corporations); Save America's Jobs Act of 2002, H.R. 3922, 107th Congress (2002) (amending the Internal Revenue Code of 1986 to prevent corporations from avoiding the United States income tax by reincorporating in a foreign country); S. 2050, 107th Congress (2002) (amending the Internal Revenue Code of 1986 to treat nominally foreign corporations created through inversion transactions as domestic corporations); Reversing the Expatriation of Profits Offshore Act, S. 2119, 107th Congress (2002) (amending the Internal Revenue Code of 1986 to provide for the tax treatment of inverted corporate entities and of transactions with such entities, and for other purposes); Uncle Sam Wants You Act of 2002, H.R. 4756, 107th Congress (2002) (amending the Internal Revenue Code of 1986 to impose a moratorium on the ability of United States corporations to avoid the United States income tax by reincorporating in a foreign country). Each of these bills generally proposes to treat the expatriating corporation as a domestic corporation for tax purposes to eliminate the motivation for the inversion transaction. Anolik, *supra* note 93.

183. Plitch, *supra* note 17.

184. *Id.*; see also H.R. 4831, 107th Congress (2002) (prohibiting certain expatriated corporations from being eligible for the award of federal contracts).

185. Lupi-Sher, *supra* note 170.

186. The proposals discussed here would either undercut the tax savings by eliminating the ability of the inverted corporation from obtaining government contracts or, under the

A. ELIMINATION OF CONTRACTS WITH INVERTED CORPORATIONS

One governmental attempt to condemn expatriated companies is embodied in legislation that would ban former U.S.-based multinational corporations that recently expatriated from obtaining government contracts.¹⁸⁷ The motivation for this legislation stems from the realization that ten of the biggest corporations that relocated received approximately \$1 billion dollars in revenue from the federal government.¹⁸⁸ This sanction would force companies with significant income from government contracts to lose a significant portion of the benefit that inverting provides.¹⁸⁹ For example, Accenture, a recent expatriate, earned \$282 million dollars from the government in 2001 and could potentially lose this source of income if this legislation is adopted.¹⁹⁰

Although this punitive legislation would have a great impact on some expatriated corporations, this strategy may not be as effective as a deterrent as the legislature intended.¹⁹¹ Larger companies have noted that the tax savings from the move far exceed the profits earned from dealings with the U.S. government.¹⁹² Ingersoll-Rand, which could potentially lose \$20 million dollars in contracts with the government, said that it has no plans of moving back to the United States because it will save \$60 million in taxes as a result of its reincorporation in Bermuda.¹⁹³ For corporations whose bottom lines are significantly enhanced by this strategy, the inability to contract with the federal government will be an ineffective measure in preventing inversion.¹⁹⁴ Therefore, this proposed legislation may not carry enough weight to serve its ultimate purpose.¹⁹⁵

other proposal, would reclassify former expatriates with significant U.S. operations as domestic corporations for tax purposes, which eliminates the motivation for the move. Plitch, *supra* note 17; Lupi-Sher, *supra* note 170.

187. Plitch, *supra* note 17.

188. Of the \$1 billion dollars of revenue shelled out to these corporations by the government, almost three-fourths were for homeland security and military contracts. Welch, *supra* note 5.

189. Plitch, *supra* note 17.

190. Accenture is the former consulting firm of Arthur Andersen. Mike Godfrey, *Stanley Works Backs Off Bermuda Move*, Aug. 2, 2002, at <http://www.tax-news.com/asp/story/story.asp?storyname=8966> (last visited Jan. 10, 2004).

191. Plitch, *supra* note 17.

192. Weisman, *supra* note 19.

193. *Id.*

194. *Id.*

195. *See id.*

*B. TAX LAWS TO EVALUATE REALITY RATHER THAN
REINCORPORATION*

Another legislative proposal to reduce the desirability of corporate inversion is a bill that will treat corporations with a significant portion of its shareholders in the United States as domestic corporations for tax purposes.¹⁹⁶ For most corporations, this legislation would “slap a moratorium on reincorporation” because of the high level of ownership by U.S. shareholders, and also eliminate the main economic benefit of moving offshore.¹⁹⁷ Legislators believe that by treating the inverted corporations as domestic corporations, the tax loophole will close and the corporate inversion epidemic will cease.¹⁹⁸

Although these proposals may stop inversions, critics of the proposals believe that the legislature is simply ignoring the underlying cause driving corporations out of the country in the first place.¹⁹⁹ The often cited reason corporations give for making the unpopular decision to expatriate is that their competitive edge is being undermined by staggering tax liabilities to the U.S. government.²⁰⁰ United States multinational corporations fall victim to their foreign competitors who are not subject to the added tax expense and can operate at a lesser expense than their U.S. counterparts.²⁰¹

Critics believe that blocking reincorporation alone will create problems for U.S. companies, since they will “become more susceptible to takeovers by foreign corporations.”²⁰² Prior congressional attempts to remedy this situation have caused companies considering inverting, such as Stanley Works, to postpone plans until this controversy has been resolved.²⁰³

VII. PROPOSAL

Although elimination of the corporate income tax is not an option, the U.S. could adopt the exemption system. This system is dependent upon corporate tax revenue in order to sustain governments, and thereby, excludes foreign income from the taxable income of the

196. Weisman, *supra* note 19.

197. *Id.*

198. Lupi-Sher, *supra* note 170.

199. Corporate Inversion Transactions, *supra* note 3, at 2.

200. *See* Plitch, *supra* note 17.

201. Corporate Inversion Transactions, *supra* note 3, at 29.

202. Weisman, *supra* note 19.

203. *See* Plitch, *supra* note 17.

corporation.²⁰⁴ This would effectively “level the playing field” by putting U.S. corporations in the same position as their foreign counterparts while maintaining the competitive nature of the global marketplace.²⁰⁵ This solution is a favorite among tax experts because the exemption system is the most widely used taxation system evidenced by the wide use of the exemption system by our most significant competitor countries.²⁰⁶ The adoption of this type of system would put U.S. corporations in a situation similar to its foreign-based competition.²⁰⁷

The goal must be to ensure that a U.S. corporation is not paying a higher tax on income earned in the same marketplace as its foreign counterpart. The problem with this solution is that it represents a significant reduction in corporate tax base.²⁰⁸ Although the U.S. economy is losing some of its tax revenue from corporations that have already inverted or are considering inverting in the future, the adoption of this system eliminates this type of revenue from all U.S. corporations.²⁰⁹ The exemption system would lead to severe consequences for the U.S. economy, while not providing any additional incentive for corporations to remain residents of the United States.²¹⁰ Though this remains a possible solution to the problem, it does not achieve the desired result or attain Congress’ goal of retaining the tax base.²¹¹

Another option would be to reduce the corporate tax rate for U.S.-based companies to 25%, while continuing the 35% tax for foreign companies. This would deter the companies who maintain a significant portion of their business within the U.S. from becoming a foreign corporation because while they would be reducing their tax from worldwide income, those companies would be paying an additional percentage for income derived in the U.S. Also, to prevent possible

204. See Chorvat, *supra* note 25.

205. *Id.*

206. *Id.*

207. *Id.* The dominant argument here suggests that the best way for U.S. companies to remain competitive with foreign corporations that are subject to different systems of taxation is to mirror the systems of the countries that present our fiercest rivals. Miller, *supra* note 127. The suggestion is that we adopt the exemption system similar to Germany, Japan and the United Kingdom where foreign source income is excluded for the most part but certain exceptions (i.e. for passive source income) are made to prevent an abuse of the system. *Id.*

208. See generally Chorvat, *supra* note 25.

209. *Id.*

210. *Id.*

211. See Corporate Inversion Transactions, *supra* note 3.

abuse of this system, no subsidiary of a foreign parent would be allowed to use the lower percentage. Only resident corporations of the United States would be allowed to pay the lower income tax. For companies that generate most of their income from U.S. operations, the 10% savings may generate more of an incentive to stay in the U.S. than incorporating elsewhere. Although this will also serve as a reduction in the overall U.S. corporate tax base, it would provide a disincentive for corporations to expatriate outside of the U.S. taxing jurisdiction altogether. This proposal can realistically be implemented and would accomplish the primary objectives of Congress and corporate America.

CONCLUSION

Corporations are finding themselves torn between allegiance to their country and allegiance to their shareholders.²¹² The reality of the situation is that as long as the tax system remains unchanged, U.S. corporations will continue to be faced with this dilemma. The criticism directed at U.S. corporations relocating abroad is misplaced and is better aimed at the deficiencies of the U.S. corporate system.

The U.S. tax system for foreign income needs to be reexamined to reflect the changes that have occurred in the global marketplace.²¹³ The focus needs to be centered on enhancing the competitiveness of the U.S. multinational corporations rather than maximizing corporate tax revenue.²¹⁴ The recent Stanley Works dilemma brought to the forefront the issue of corporate inversion as a result of a tax system not allowing U.S. multinational corporations to easily compete with foreign corporations.²¹⁵ Until this problem is resolved, U.S. multinationals may be forced to evaluate their options and exploit any loopholes, whether tax-related or not, regardless of the condemnation of the government or the public.²¹⁶

It is easier to blame the evil corporate monster in the midst of all the recent scandal and sympathize with the government. The reality of the situation is that the government has sat idle while the economy and the marketplace have changed. The government is now attempting to shift the blame to the corporations who are finding that competitive pressure necessitates the exploitation of regulatory loopholes in order to survive. This issue will not be resolved by preventative legislation, as it

212. See generally Weisman, *supra* note 19.

213. See Leonard, *supra* note 175, at 514.

214. *Id.*

215. See generally Pulliam, *supra* note 1.

216. See generally Leonard, *supra* note 175.

requires a major reevaluation of our problematic tax rules beginning with the treatment of foreign source income.

The U.S. tax code is forcing U.S. multinationals to seek the advantages of reincorporating in foreign jurisdictions. By looking at the Stanley Works proposal, one can see how lucrative such a maneuver could be to a U.S. corporation. The tax system needs to be reformed so that U.S. multinationals, such as Stanley Works, are not forced to choose “profits over patriotism.”²¹⁷

217. See generally Johnston, *supra* note 10.