Finally, advocates of deferral and exemption argue that if U.S. corporations are taxed in the way that we suggest, U.S. residents will simply buy the shares of foreign corporations operating under more benign taxing regimes. We have previously advanced a proposal for coping with this tactic by, in essence, expanding the current PFIC provisions.[2]

In addition to our arguments above, "real" worldwide taxation (i.e., no deferral) is supported by the ability-to-pay fairness concept. This concept asserts that all income should be treated the same regardless of its geographical source. Interested readers are directed to our forthcoming (late fall 2001) Florida Tax Review publication entitled *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income.*

COUNTERPOINT: THE UNITED STATES SHOULD NOT TAX U.S. CORPORATIONS ON THEIR WORLDWIDE INCOME

*by Herman B. Bouma, Washington, DC**

The main arguments for taxing U.S. corporations on their worldwide income relate to the benefits purportedly afforded to such corporations in the United States (such as the protection of U.S. business law and access to U.S. capital markets) and to the possible adverse consequences of a territorial system for investment in the United States. However, these do not constitute valid reasons for taxing U.S. corporations on their worldwide income, and therefore U.S. corporations should be taxed in the same way as foreign corporations, *i.e.,* on a territorial basis.

Under the Internal Revenue Code, a business entity that is a corporation for tax purposes is a "U.S. corporation" if it was "created or organized in the United States or under the law of the United States or of any State." Section 7701(a)(4). Pursuant to section 7701(a)(5), if a corporation is not a U.S. corporation, then it is a "foreign corporation."

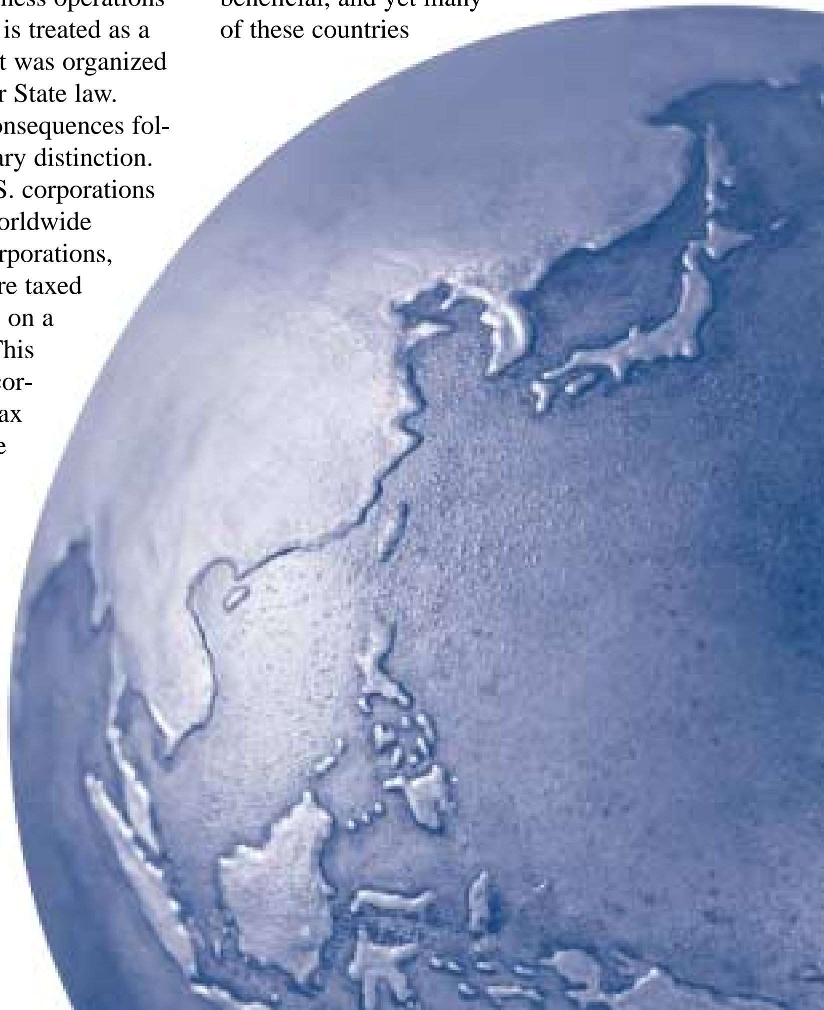
Whether a corporation is a U.S. corporation has absolutely nothing to do with the location of the corporation's property, employees, or business operations. Rather, it is based entirely on the jurisdiction in which the corporation was organized. Thus, a corporation that has all of its property, employees, and business operations in the United States is nevertheless treated as a foreign corporation if it was organized pursuant to a foreign law. Similarly, a corporation that has all of its property, employees, and business operations in a foreign country is treated as a U.S. corporation if it was organized pursuant to a U.S. or State law.

Significant tax consequences follow from this arbitrary distinction. Under the Code, U.S. corporations are taxed on their worldwide income. Foreign corporations, on the other hand, are taxed by the United States on a "territorial basis." This means that foreign corporations pay U.S. tax only on their income effectively connected with the conduct of a U.S. trade or business ("ECI") and on certain income that is not effectively connected with the conduct of a U.S. trade or business but is U.S.-source income ("U.S.-source non-ECI"). U.S. and foreign corporations with otherwise identical operations can thus have dramatically different U.S. tax liabilities, simply based on where they were organized.

Several reasons have been proffered in justification of this extreme dichotomy between the U.S. tax treatment of U.S. and foreign corporations.

First, it has been argued that the application of the business law of the United States or of a State ("U.S. business law") to a U.S. corporation justifies taxing it on its worldwide income. It is true that being organized pursuant to a law of the United States or of a State generally results in the application of U.S. business law, which may be considered beneficial to the corporation. However, that does not justify taxing the U.S. corporation on its worldwide income.

Many foreign jurisdictions also have business laws that are beneficial, and yet many of these countries



2 *See* Peroni, Fleming, & Shay *supra* note 1, at 507-12.

* The author gratefully acknowledges the very able research assistance of Robert B. Williams, Jr., summer associate from the University of Virginia School of Law.

tax business entities either on a territorial basis, *e.g.*, the Netherlands and France, or not at all, *e.g.*, Bermuda and the Cayman Islands. (In fact, the business laws of some of these jurisdictions might be even more beneficial from the perspective of management if they have fewer protections for minority shareholders, and more beneficial from the perspective of shareholders if they treat shareholders more like debtors than does U.S. business law.) Thus, by being organized pursuant to the law of one of these jurisdictions, a business entity can avoid worldwide taxation by the United States and yet still be subject to beneficial business law.

Moreover, if one truly wanted the application of U.S. business law, such as that of Delaware, it might be possible to organize a business entity in a foreign jurisdiction that taxed on a territorial basis (or not at all), and provide in the articles of association that the business law of Delaware is to apply to the resolution of all disputes arising under the articles. Thus, one could have the benefit of U.S. business law and at the same time avoid worldwide taxation by the United States.

Second, it has been argued that the fact that a U.S. corporation has "access" to U.S. capital markets justifies taxing it on its worldwide income. However, a business entity is not denied access to U.S. capital markets simply because it was organized pursuant to the law of a foreign jurisdiction.

As a factual matter, many foreign business entities do have access to U.S. capital markets. The New York Stock Exchange, the NASDAQ, and the American Stock Exchange all list business entities that were organized abroad. Foreign business entities may be listed in the same way as a U.S. corporation by meeting the minimum capitalization requirement imposed by the specific exchange and by completing the necessary disclosures required by the Securities and Exchange Commission. Currently, 441 foreign business entities, representing 52 countries, are traded on the New York Stock Exchange, including Tyco International Ltd. and Global Crossing Ltd., two companies organized in Bermuda but with substantial operations in the United States.

Moreover, foreign business entities are also able to raise capital from within the United States from other sources, such as U.S. venture capital funds. Venture capitalists will tell you that the jurisdiction where a company was organized does not affect the fund's investment decision, as long as the jurisdiction does not raise questions about political stability, ownership rights, and expropriation risk. Investors understand that people choose places like Bermuda for tax reasons, and many successful public companies, including those organized primarily by U.S. persons, have been organized in such places. Thus, access to U.S. capital markets cannot be a basis for taxing U.S. corporations on their worldwide income.

Third, it has been argued that a U.S. corporation receives a number of benefits from the U.S. government, such as military protection and export promotion assistance, and these benefits justify taxing it on its worldwide income. However, the value of these "benefits" is extremely uncertain.

The question of whether the United States will provide military protection to a business entity will generally be resolved on strategic grounds, and the fact that the entity was organized pursuant to the law of Delaware, for example, is likely to be only an incidental factor. Similarly, the various programs offered by the Department of Commerce to promote exports focus on the export of products made in the United States; it is far from clear that a foreign corporation with a significant U.S. presence will not receive assistance with respect to products it manufactures in the United States. In addition, as others have pointed out, even if a U.S. corporation does receive such benefits, the "user fee" of residual taxation of foreign-source income is grossly out of proportion to the benefits that are supposedly received.

There are also many detriments to being a U.S. corporation, including the need to comply with trade embargoes, anti-boycott legislation, the Foreign Corrupt Practices Act, and the myriad reporting requirements imposed by the Department of Commerce. It is very possible, therefore, that even if there are benefits, they are outweighed by the detriments.

Finally on this point, there is considerable evidence that informed taxpayers do not believe that the benefits received by a U.S. corporation are so significant. More and more start-up companies are organizing pursuant to foreign laws even though they anticipate having their headquarters in the United States and being traded on a U.S. stock exchange. There have been a number of "expatriations" of U.S. corporations in recent years, and in negotiations concerning a merger of equals, such as Chrysler and Daimler-Benz, "there is a strong bias against the survival of the U.S. corporation." Willard B. Taylor, *Corporate Expatriations–Why Not?*, TAXES, March 2000 at 146, 157. As Robert Perlman, Vice President for Tax, Licensing & Customs for Intel Corporation, stated in testimony before the Senate Finance Committee on March 11, 1999, if Intel had it to do all over again, it would organize overseas. *Multinationals Beg Finance to Simplify International Tax Laws*, TAX NOTES, March 15, 1999 at 1539.

The truth of the matter is that many established U.S. corporations remain U.S. corporations not because they appreciate the "benefits" of being a U.S. corporation but because the "toll charge" under section 367(a) makes reincorporation abroad prohibitive. It is unfair to continue to subject such corporations to worldwide taxation just because they happen to be "trapped" by section 367. They should not be disadvantaged

compared to newly-formed or expatriated business entities (or indeed long-established foreign companies) just because they made the unfortunate mistake, perhaps 50 or 100 years ago, of being organized pursuant to a U.S. or State law. It is true, as Messrs. Fleming, Peroni, and Shay state, that some U.S. corporations face no foreign competition, but the fact remains that many U.S. corporations *do* face foreign competition. Why should *they* be at a competitive disadvantage?

Fourth and lastly, it has been argued that U.S. corporations should continue to be taxed on their worldwide income so that they do not have an incentive to shift operations abroad. This argument is focused on U.S. corporations that are "trapped" by section 367, since those that are not so "trapped" can avoid worldwide taxation by simply reincorporating abroad.

However, under existing law U.S. corporations already have a strong incentive to shift operations abroad. By shifting operations abroad and placing them in a foreign subsidiary, a U.S. corporation can obtain indefinite deferral of the U.S. tax on the income produced by those operations (subject, of course, to the "Subpart F" regime). Thus, it is extremely unlikely that changing to a territorial approach for U.S. corporations would significantly increase the incidence of operations being shifted abroad.

Moreover, even if taxing U.S. corporations on a territorial basis did provide an incentive to shift operations abroad, this should not be dispositive of the issue. The critical question is whether there is any *conceptual basis* for the United States to treat U.S. and foreign corporations differently. If not, then it is "cruel and unusual punishment" (not to mention harmful to their international competitiveness) to prevent U.S. corporations from doing what foreign corporations can do, namely, locate operations abroad without being subject to residual U.S. tax.

Suppose, for example, the United States were to tax all corporations on a territorial basis except for *Texas* corporations, which were taxed on a worldwide basis. Even if it were true that changing to territorial taxation would give Texas corporations an incentive to shift operations abroad, that would not be a valid reason for continuing to tax them in a discriminatory fashion on a worldwide basis. There would be no legitimate reason for treating Texas corporations differently, and thus it would be appropriate to tax them also on a territorial basis. Similarly, there is no conceptual basis for treating U.S. corporations differently from foreign corporations.

Messrs. Fleming, Peroni, and Shay apparently agree that the mere fact that a corporation has been organized pursuant to a U.S. or State law is not a valid basis for taxing it on a worldwide basis. They point out that, as a result of "informed planning," a corporation can be a U.S. corporation even though it has no assets or operations in the United States and no U.S. shareholders. (Far more likely as a result of "informed planning" is that a corporation will be a *foreign* corporation even though it has substantial assets and operations in the United States and substantial ownership by U.S. shareholders.) They argue that the definition of a U.S. corporation could be changed so that a corporation is a U.S. corporation if a certain percentage of its value is owned by U.S. persons. A definition based on the nature of a corporation's shareholders, however, would be administratively impractical for today's publicly-traded global corporations and certainly anti-competitive. Alternative definitions of "U.S. corporation" present their own problems. A definition based on the location of assets, for instance, would be detrimental to the U.S. economy, since it would encourage corporations *not* to invest in the United States.

The fact remains that it makes no sense for U.S. corporations, *as currently defined by the Code*, to be taxed on their worldwide income. There should be no distinction between U.S. and foreign corporations, and all corporations should be taxed by the United States on a territorial basis. ■