Harvard Club - Box 126
27 West 44th Street
New York, NY 10036
December 26, 2017

Certified Mail – Return Receipt
STRICTLY PRIVILEGED AND CONFIDENTIAL

The Hon. William C. Dudley, President
Federal Reserve Bank of New York
33 Liberty Street
New York, NY 10045

Dear Sir:

Re: Will The Federal Reserve Permit Another Economic Meltdown Caused By Supposedly "Offshore" Funds Generated By U.S.-Based Multi-National Companies From Exporting American Jobs?

Just like the 2008 Economic Meltdown, $4 TRillion - $5 TRillion is the amount by which American companies that did not export American jobs are about to be forced, once again, to reduce their payroll and capital expenditures within a 2-3 year time frame.

In order to assure you that I know what I am talking about --

- I am the former long-time Ernst & Young Senior International Tax Partner (Technical).
- I also chaired 1994-1996 the American Bar Association's International Tax Committee comprising the nation's top 300 international tax lawyers and featuring 22 working sub-committees.
- In addition to teaching part-time for N.Y.U. School of Law, I was a frequent author and served as an editor for publications by Prentice-Hall and Warren, Gorham & Lamont.
- I majored in Economics before attending Harvard Law School. I also ranked 2nd nationally on the Fall 1971 Uniform C.P.A. Examination among 28,788 participants after obtaining an MS in Accounting.

I and Ernst & Young and the other "Big Four" CPA Firms designed the structure for U.S.-based multi-national companies (US-MNC's) to export American jobs while capturing virtually all of their worldwide profits in tax-haven subsidiaries (principally non-resident Singapore subsidiaries) which contracted with factories in such low-wage countries as China to manufacture the US-MNC's products using the US-MNC's technology to the US-MNC's specifications under the US-MNC's supervision.

Accordingly, virtually all of the worldwide profits of such US-MNC's were not, by virtue of being captured in a tax-haven subsidiary, subject to U.S. corporate income taxation until such time, if ever, that the profits were repatriated to the US parent corporation as a dividend or a "constructive dividend." "Constructive dividends" were "investments in U.S. property" which were deemed by Sec. 956 of the Internal Revenue Code to be the functional equivalent of dividends, such as loans to the U.S. parent corporation or investments in U.S. property that is leased to the U.S. parent corporation.

The regular 35% income tax on the profits of the tax-haven subsidiary was not recorded as a "deferred tax liability" under "generally-accepted accounting principles" so long as they were "permanently reinvested" outside the U.S. This test was satisfied with a few brief “boiler plate” paragraphs comprising “pipe dreams” about such things as possible acquisitions and locked away for safekeeping in case an auditor should bother to inquire.

As a practical matter, Sec. 956 of the Internal Revenue Code restricted the US MNC’s that have exported American jobs to have their tax-haven subs loan their accumulated profits from exporting American jobs to UNRELATED American companies that did not export American jobs or, in a few cases, invest the profits in U.S. government T-bills.

[US-MNC auditors dutifully recorded that the tax-haven profits were “permanently reinvested” in loans to the US companies that had not exported American jobs and/or in US Government T-bills.]

By 2004, these tax-haven profits had reached the level of $4 TRillion - $5 TRillion. Indeed, Microsoft alone had more than $1 TRillion in its tax-haven subs, causing its stock analysts, as reported prominently and often in the financial press, to analyze Microsoft as a bank rather than as a software company.

Both the amounts and the character of such investments “stuck out like sore thumbs” in the US MNC’s Form 10-K’s filed each year with the US Securities and Exchange Commission.

At the end of 2004, Congress enacted the so-called American Jobs Creation (sic) Act which permitted the US MNC’s to have their tax-haven subs pay “cash dividends” during the next 12 months of the profits that had piled up over a decade or so from exporting American jobs subject to a special one-time 5.25% corporate income tax rate rather than the normal 35% rate.

As you can appreciate, the American companies that had NOT exported American jobs were not in a position to repay the loans from the tax-haven subs of the US MNC’s within the typically 90-day commercial-paper loan terms.

However, virtually all of the US MNC’s that had exported American jobs decided that it was unwise to involve a Bankruptcy Court and instead dictated stiff terms based on how quickly the American companies that had not exported jobs could reduce their payroll and capital expenditures. The $4 TRillion - $5 TRillion of reductions in American payroll and American capital expenditures largely occurred during 2005-2007.

The requirement in the American Jobs Creation (sic) Act to pay $4 TRillion - $5 TRillion in “cash dividends” during 2005 was satisfied by having the banks of the US MNC’s, for a small fee, book a loan to the tax-haven subs equal to the portion of their loans to the American companies that had not exported jobs that could not be repaid immediately and then book an off-setting loan from the US MNC’s after they had immediately received those same amounts as “cash dividends” from the tax-haven subs. “Cash”, of course, in a modern economy is nothing more than a wire transfer and has no more tangibility than a book entry for a “loan.”

The only other significant requirement in the American Jobs Creation (sic) Act was for the dividends from the tax-haven subsidiaries to be invested in American payroll or capital expenditures. This, of course, did not produce an increase in American payroll or capital expenditures because the dividends were “traced to” or “matched with” the normal level payroll and capital expenditures that the US MNC’s have. And the normal cash flow that would normally have funded the normal level of payroll and capital expenditures was now “freed up” on a tracing/matching basis to redeem stock of the US MNC’s.

The American Jobs Creation (sic) Act of 2004 was the result of lobbying by Price Waterhouse (another of the “Big Four” CPA firms) on behalf, initially, of their US MNC’s, though many non-client US MNC’s joined the group. Price Waterhouse hired Bill Archer, the recently-retired Chairman of the House Ways & Means Committee, to do the actual lobbying.

Bill Archer “sold” the key decision makers in Congress on the argument that earnings in the tax-haven subs would be "brought home" to create American jobs, that the earnings would otherwise remain "offshore," and that tax revenue (albeit at only a 5.25% rate) could be generated but 5.25% is better than nothing.

The "elephant in the room" that nobody in Congress investigated was whether the $4 TRillion - $5 TRillion was really "offshore" or whether it had already been loaned to the American companies that had not exported jobs to pay for payroll and "bricks and mortar." And whether "round tripping" the $4 TRillion - $5 TRillion from the American companies that had not exported jobs to the US MNC's to redeem their stock would actually result in a NET REDUCTION in American payroll and American capital expenditures of $4 TRillion - $5 TRillion.

[Cynics might suggest that nobody in Congress wanted to ask the obvious question of whether the $4 TRillion - $5 TRillion was "stuffed in mattresses" located in Singapore because they were more interested in receiving "campaign contributions" from Bill Archer's clients but it is possible that none of them was smart enough to think of the obvious question.]

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THE REST IS HISTORY

Congress was in such a panic that only days after the House of Representatives re-convened in January 2008, it passed the Economic Stimulus Act of 2008 providing most taxpayers with immediate $300 rebates ($600 for most married couples) and investment incentives for businesses. It passed the Senate a week later and was signed into law on 2/13/2008.

The Act was futile!!!

If Congress was going to force, however inadvertently, the American companies that had NOT exported American jobs to reduce payroll and capital expenditures by $4 TRillion - $5 TRillion in order to repay their loans from the MNC's that had exported American jobs, then since that amount was approximately a reduction over 3 years of 30% of the 2008 level of GDP, Congress was effectively compelling a 10% reduction in GDP.

And if Congress was going to compel 10% of the American work force to be terminated, then of course their home mortgages were going to be foreclosed whether or not there had ever been a sub-prime mortgage.

And of course, the real estate market would tank along with the American economy because there would be no "new hires" to buy all the homes whose mortgages were being foreclosed.

The "proof on the pudding"???

It might be argued that theoretically the $4 TRillion - $5 TRillion of tax-haven earnings that were used by the US MNC's that had exported American jobs to redeem stock and pay extraordinary dividends during 2005-2007, might have been used by the recipients of those stock redemptions and extraordinary dividends in such a way that those amounts eventually found their way back as loans to the American companies that were otherwise being forced to reduce their American capital expenditures and their American work force.

There are two answers to this theoretical argument.

First, a theoretical answer.

Most of the investors in the stock market (e.g., pension funds, university endowment funds, and individual retirement funds) are, as a practical matter, forced to re-invest such funds in the stock market. Accordingly, the stock market saw a temporary "bubble" of approximately $4 TRillion - $5 TRillion, which promptly "went up in smoke" as the stock market tanked.

Second, the empirical answer.

Throughout the Economic Meltdown, THE FEDERAL RESERVE lamented the fact that the American companies that were being forced to reduce American capital expenditures and their American work force WERE IN DESPERATE NEED OF LOANS WHICH THEY COULD NOT OBTAIN!!!

Of course they couldn't obtain loans. Commercial banks had long-since been largely displaced as lenders to American companies by the US MNC's that had exported American jobs, so the commercial banks had concentrated instead on such things as credit cards, auto loans, etc.

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SO WILL YOU AND YOUR REGIONAL FEDERAL RESERVE BANK CAUSE ANOTHER MELTDOWN IN YOUR REGION???

Your Regional Federal Reserve Bank has authority to make loans to businesses in your region.

Yes, Congress has once again passed Corporate Income Tax Provisions that are predicted by The Administration to result in dividends from the tax haven subsidiaries of the US MNC's that have exported American jobs of "at least $4 TRillion -- we actually think a lot more."

So once again, Congress is the primary perp.

HOWEVER, under the legal doctrine of "last clear chance," The Federal Reserve once again has the opportunity to avert an Economic Meltdown by making loans to the American companies that otherwise will have to reduce American capital expenditures and their American work force by $4 TRillion or more!!!

You are herewith put on notice about what your Duty to America requires.

And yes, printing $4 TRillion - $5 TRillion of new dollars in order to make the replacement loans to the American companies will undoubtedly have implications for whether The Fed's Open Market Committee should increase interest rates dramatically and/or The Fed's Board of Governors should increase commercial-bank "reserve requirements" to produce an offsetting money-supply contraction of $4 TRillion - $5 TRillion.

But such considerations will not absolve you of your sin if you fail to provide the immediate emergency care the American economy will require!!!

Thank you for your consideration.

Respectfully submitted,

John S. Karls
JD, Harvard Law School, 1967
Who's Who in American Law, 1988-2003
Who's Who in America, 1988-2003
Who's Who in the World, 1994-2003

JSK:em

NB: An identical letter is being sent Certified Mail - Return Receipt to each of the Presidents of the other Regional Federal Reserve Banks.