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Patriotism Raining On Tax Paradise; Lawmakers Are Chafing at Firms That Exist Offshore Only on Paper

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Ernst & Young LLP partner Kate Barton was gushing over the economic advantages of reincorporating a company in sunny tax havens like Bermuda or the Cayman Islands when another voice spoke up to ask about the downside.

Well, she replied, on a Nov. 30 broadcast posted on the accounting giant's Web site, patriotism, for one.

"Is it the right time to be migrating a corporation to an offshore location?" Barton said. "A lot of companies feel that . . . the improvement on earnings is powerful enough to say that maybe the patriotism issue should take a back seat."

The exchange — recorded electronically by Democratic aides and shared widely — neatly captures the shift in the political landscape of corporate taxation in recent months. Corporations that once saw no downside to a paper relocation to Bermuda are now finding that patriotism does not fit well in the back seat, especially when politicians take notice.

As one prominent business lobbyist put it, businesses that have bolted for island tax havens in recent months have found that Sept. 11 put patriotism at a premium. The return of the federal budget deficit raised concerns about the government's fiscal health. A wave of accounting scandals turned the public's jaundiced eye on once largely invisible corporate boardrooms. And the stock market's slide has just plain made people mad.

When Stanley Works Inc., the New Britain, Conn., toolmaker, proposed in February to reincorporate in Bermuda, the issue exploded.

"What has happened on this issue is part of the much larger issue of corporate accountability," said Rep. James H. Maloney (D-Conn.), who has made the issue a centerpiece in his difficult reelection campaign. "Whether

it's Enron abusing partnership rules, WorldCom abusing expensing rules or Stanley Works abusing the tax code, the public sees corporate abuse."

Last summer, the Bush administration pressured its allies in the 30-nation Organization for Economic Cooperation and Development to drop the group's campaign to force offshore tax havens to end special tax breaks for foreign companies and investors. Now, politicians who once made tax cuts and Internal Revenue Service-bashing their stock and trade are tumbling over each other to crack down on corporate tax avoiders.

"The companies are right from the standpoint that they're not doing anything illegal, but I take a position that it is immoral and unethical," said Sen. Charles E. Grassley (R-Iowa), the ranking Republican on the Senate Finance Committee, who co-authored legislation to thwart tax-haven reincorporation. "Some companies are willing to stay and pay. Other companies dash and stash the cash. And that makes the former into a sucker."

Reincorporation — also known as corporate inversion or corporate expatriation — has been around for decades, but the accounting maneuver has become increasingly popular as economic conditions lower the costs and raise the rewards.

At least 25 major corporations have reincorporated or set up shop in Bermuda or the Cayman Islands in the past decade, 11 of them since 2000. Treasury Department officials decline to estimate how much those reincorporations have cost the government in lost tax revenue, but the congressional Joint Committee on Taxation estimates that legislation to combat flight offshore would reap between $1.5 billion and $8 billion in revenue over the next decade.

The benefits to reincorporation are stark. The United States, with its 35 percent corporate income tax and its byzantine rules for taxing worldwide profits, is not a particularly friendly tax environment, especially compared with Bermuda, where there is no corporate income tax. Under U.S. tax law, a company can be headquartered in Bermuda even if its presence on the island consists of a file drawer and a lawyer. European and Canadian companies would have to move their head offices — or "central mind and management" — to the Caribbean to pull it off, said Brian Arnold, an international corporate tax expert and emeritus professor of law at the University of Western Ontario.

By creating a foreign "parent" corporation in Bermuda, a U.S. company can greatly reduce its taxes on foreign sales. More importantly, it can sharply reduce taxes on U.S. operations. Through accounting maneuvers, the parent

company can shift its debt disproportionately to its U.S. “subsidiary,” then deduct the interest payments from its American taxes.

Before Stanley Works announced this month that it would call off its reincorporation, it predicted that the move to Bermuda would shave about $30 million a year off its U.S. tax bill. But the company paid only about $7 million in taxes last year on foreign income. The implication: More than three quarters of the projected tax savings would have come from U.S. profits.

“That is where the real juice is on these inversions,” a Treasury Department official said.

But there is a cost. When a company reincorporates, its shareholders must pay a capital gains tax as if they had sold their shares in the old U.S. company, then bought new shares in the Bermuda parent corporation. Connecticut Attorney General Richard Blumenthal estimated that the cost of reincorporation for Stanley shareholders would have been $150 million in capital gains taxes.

For that reason, the plunging stock market has provided a powerful incentive for the recent wave of reincorporations. With stock prices depressed, the capital gains hit would be tempered, and shareholders would be more likely to approve the transaction.

The recent wave of reincorporations began at the height of the go-go 1990s, when tax avoidance became a central route to meeting Wall Street profit forecasts. Some of the recent corporate expatriates include companies caught in the net of accounting scandals, such as Tyco Ltd., the New Hampshire conglomerate that reincorporated in Bermuda in 1997, and telecommunications company Global Crossing Ltd., which also set up shop on the Atlantic island that year and is now under Chapter 11 bankruptcy protection.

Moreover, once one company does it, rivals feel forced to follow. Stanley Works made its move after two of its competitors, Cooper Industries Inc. of Houston and Ingersoll-Rand Co. of New Jersey, bolted for Bermuda. Those companies made it offshore before the political gale began to blow. That left Stanley marooned, forced to pay its full tax load while Ingersoll-Rand saves $40 million to $60 million a year.

Lawmakers and economists fiercely debate whether these companies have been driven offshore by the U.S. tax code — a position championed by Treasury Secretary Paul H. O’Neill — or whether they are merely being opportunistic.

Testifying before the House Ways and Means Committee in June, Gary Hufbauer of the Institute for International Economics said only Japan, Belgium and Italy have higher corporate tax rates than the United States among developed economies. Unlike most other western economies, the United States taxes dividends that are returned to a U.S. parent company from its foreign subsidiaries. And complex international tax rules end up reducing the tax credit U.S. companies can claim on taxes paid abroad.

"It's not surprising that some U.S. parent corporations are jumping ship," Hufbauer said.

Nonsense, other tax experts say. U.S.-based multinational corporations are the most powerful in the world. Arnold pointed to Sweden and France as having far more onerous policies on foreign profits.

U.S. companies that flee to tax havens are taking advantage of U.S. tax law, not fleeing it, Arnold said. If the government would merely put the constraints on flight that the Europeans and Canadians have, they wouldn't go.

While the experts debate, Washington smells blood. Half a dozen bills have been drafted in Congress to yank corporate runaways back to the mainland. Lawmakers from both parties have attached amendments to bills that would deny federal defense and homeland security contracts to companies incorporated in tax havens.

Other bills simply state that if 80 percent of a company's shareholders are in the United States, the company will be treated as American for tax purposes, no matter where it is incorporated. The leading House Republican bill would apply that rule until 2004, in effect slapping a moratorium on reincorporation. The leading Democratic bill has no such expiration date. It would also apply retroactively to companies that reincorporated offshore before Sept. 11, beginning in 2004.

"They're talking about changing a tax law that firms use to enhance profits, legally and aboveboard, and changing it at a time when they should be cutting taxes and encouraging more investment," said Martin Regalia, chief economist for the U.S. Chamber of Commerce. "There's this sense that this inversion thing is a great political liability. Well, I'd think a recession may be equally problematic. They ought to think twice about bashing the job-generating sector more than they already have."

The Bush administration and an increasingly isolated group of Republican lawmakers contend that corporate flight is merely a symptom of a much broader problem with the U.S. tax code.

"These companies are inverting precisely to keep jobs in the U.S. and pension funds in the U.S.," protested Rep. Bill Thomas (R-Calif.), chairman of the House Ways and Means Committee. "People are making political hay trying to expose people who are just trying to survive."

To block reincorporation alone, they contend, would only create more problems. U.S. companies would become susceptible to takeovers by foreign corporations eager to use an American subsidiary to reduce taxes on its U.S. sales. American companies could even put themselves on the block or simply reincorporate in countries like Ireland, where the corporate tax is low and a tax treaty would protect companies from political retaliation.

"There is a serious risk that measures targeted too narrowly would have the unintended effect of encouraging a shift to other forms of transactions and structures to the detriment of the U.S. economy in the long run," said Pamela F. Olson, Treasury's acting assistant secretary for tax policy.

Instead, they propose to take away the tax advantages from reincorporation. The Treasury Department and Thomas propose to put new rules on companies to prevent U.S. subsidiaries from carrying too much debt. That would undermine the main economic benefit to relocation: debt shifting to reduce U.S. taxes.

The Treasury Department also plans to develop new rules to prevent U.S. subsidiaries from shifting corporate assets or business deals to the books of their offshore parent companies to minimize their U.S. tax burden.

"You don't just punish people and act like you're addressing the issue," Thomas said. "You have to go to the fundamental cause."

Meanwhile, Democrats are pressing forward with their blunter approach to the problem.

"I buy the argument that you can't only do expatriation. You have to look at the whole tax code," Maloney said. "But corporate expatriation is the fire on the third floor, and the first thing you've got to do is put out the fire."

Even some Republicans are not buying the Thomas argument. Grassley accused Thomas of mixing the reincorporation issue with more complicated tax matters precisely to scuttle the entire package.

Accusations like that have pushed Republican leaders to pressure Thomas to shelve a broad, international tax reform bill in favor of a measure aimed solely at corporate runaways.

And Thomas's resistance may be weakening. Where once he vowed to deal with the reincorporation problem only in the context of a broader corporate tax measure, he now says a stand-alone bill is not "necessarily a mistake."

So far, the companies are undeterred. Ingersoll-Rand stands to lose $20 million in government contracts if Congress approves a ban on contracting with Bermuda companies, said company spokesman Paul Dickard. But its tax savings from reincorporation is as high as $60 million a year. The calculation, he said, is pretty simple: "We do not have plans to reincorporate back in the United States."

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