Moving to Bermuda

Savvy CEOs or Benedict Arnolds?

by Rajib Sanyal and Alfred Quinton

Early last spring, as the venerable Stanley Works, a Connecticut-based manufacturer of tools and hardware, decided to move its place of incorporation to Bermuda, it drew fresh attention to a trend that since 1994 has seen more than 20 large U.S. firms reincorporate in low- or no-tax countries.

Critics call such corporate conduct "unpatriotic" and "the great tax evasion." They want to eliminate what they call the "Bermuda tax triangle." Supporters answer that moving abroad to reduce taxes is a perfectly legal response to onerous tax rules and a sensible way to stay competitive in a global economy. The spotlight shines on this issue at a time of great consternation over corporate governance, bogus accounting, and unscrupulous managers at some of the country's leading firms (e.g., Enron, WorldCom, Adelphia, and Tyco) and the lax role played by auditing agencies, investment firms, and regulatory bodies. In this environment, reincorporating abroad to reduce tax obligations to the U.S. government, is seen by many as yet another indication of corporate social irresponsibility.

Why would Stanley Works, a 159-year-old company, want to join other well-known American firms such as Ingersoll-Rand and Tyco, which have incorporated in Bermuda? The main reason: reduced tax liabilities. These firms are not apologetic about it and they shouldn't be. After all, tax competition is a fact of life. Within the U.S., companies relocate to states with lower tax rates, just as people do. Retirees flock to Florida, for both the sunshine and its low tax rates. Eyebrows rarely rise when a firm decides to relocate from its home state to Delaware—a low tax state.

Stanley Works, in a statement issued February 2, said: "Today, the company pays an excessive amount of tax relative to our foreign competitors. If the company is not competitive, there are no taxes, and no jobs." Certainly, the move to Bermuda would reduce the company's effective tax rate from 32 to 23 percent, saving about $30 million a year in U.S. taxes. In addition, this action reflects the growing international scope of the activities of American firms generally and Stanley Works in particular.

The company's chief executive officer, John Trani, explained the decision to seek shareholder approval to shift the incorporation to Bermuda, saying, "This strategic initiative will strengthen our company over the long term. An important portion of our revenues and earnings are derived from outside the United States .... Moreover, an increasing proportion of our materials are being purchased from global sources. This change will create greater operational flexibility, better position us to manage international cash flows, and help us to deal with our complex international tax structure. As a result, our competitiveness ... will be enhanced. The business, regulatory, and tax environments in Bermuda are expected to create considerable value for shareowners." Trani continued, "In addition to operational flexibility, improved worldwide cash management and competitive advantages, the new corporate structure will enhance our ability to access international capital markets, which is favorable for organic growth, future strategic alliances and acquisitions ...." The captains of the other businesses that have moved offshore certainly would agree.

Why Bermuda?

Apart from not imposing income or capital gains taxes, Bermuda offers several advantages to American firms. It is politically stable, friendly to business, and easily accessible from North America and Europe. It has a legal framework based on the English system, and shareholder rights are similar in important respects to our own. Of course, when an American firm reincorporates in Bermuda, it becomes a Bermudan company, and civil penalties imposed by a court in the U.S. are not automatically enforceable in Bermuda. Bermuda law rather than New Jersey or Connecticut law then would govern shareholder rights.

That firms have moved to Bermuda or any of the many tax haven countries around the world to reduce tax liabilities grates on critics because in the new place of incorporation, the firm operates no tangible business at all. In effect, it is a mailbox with no employees, no factories, no offices, and no actual work. The Bermudan government charges modest incorporation and maintenance fees to provide this privilege. Tax haven countries, usually resource poor, thus have found a revenue source with little cost attached by offering both businesses and individuals refuge from disparate and high taxes around the

Selected Tax Havens

There are over 100 tax haven countries, territories, and jurisdictions around the world. Some of the most commonly used tax haven locations are:

- Bermuda
- Cayman Islands
- Cook Islands
- Cyprus
- Dominica
- Gibraltar
- Guernsey
- Isle of Man
- Panama
- Saint Kitts and Nevis
- Seychelles

world. In many quarters, tax havens have an odious whiff about them. Tax returns may not be made public and tax disclosures may be inscrutable. Financial statements may not be fully transparent. Indeed, in some cases, unscrupulous individuals and businesses have taken advantage of restrictive disclosure rules to engage in illegal activities such as money laundering.

U.S. tax rules

The U.S., unlike most industrial nations, taxes businesses and individuals on their worldwide income, not on what they make only in the U.S. Thus, if a U.S. company makes $100 in the U.S., $50 in Japan, and $50 in Germany, the Internal Revenue Service will assess tax on the worldwide income of $200. However, if the U.S. firm moves to a tax-haven country such as Bermuda, it pays U.S. taxes only on the $100 it makes in the U.S. and no taxes to Bermuda. (It also has to pay taxes to Japan, but only on the $50 it makes there. The same applies to Germany.) That's the way most foreign firms doing business in the U.S. are taxed. In a global economy where firms are competing intensively in multiple markets, U.S. tax rules put U.S.-based multinational firms at a disadvantage with foreign rivals in overseas markets.

The process of reincorporating, referred to as "corporate inversion," is perfectly legal under U.S. law and is done in a systematic and transparent manner with shareholders having to approve it. The firms that seek "inversion" are most likely to have been structured originally for operations that were primarily domestic in focus and in markets without foreign competition. These "old time" firms now find competition from abroad intense and are looking for ways to retain an edge. Domestic tax policies present a hurdle and one way to jump it is to move to low- or no-tax locations. New firms such as Accenture and Global Crossing, created with global aspirations from the outset, are incorporated in tax haven countries right away, and thus they have no need for "inversion."

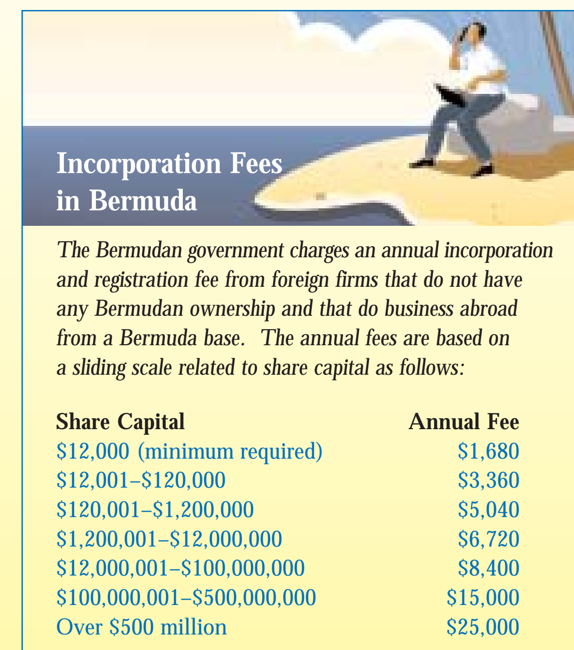
Tax collection authorities around the world are wary of tax havens partly because multinational firms can transfer profits from their worldwide activities to such locations to reduce tax liabilities in individual countries. This technique, called "transfer pricing" in international business, is commonplace, complicated, and controversial.

Here's how it works in a hypothetical example. Let's say Honda makes car engines in Japan and "sells" them to its American operations to install in cars assembled in Honda's factory in Ohio. At what price should Honda in Japan sell the engines to Honda in America? Because tax rates in Japan and the U.S. are not the same, the company has an incentive to price the engines in a way that increases profits in the low-tax country and reduces profits in the high-tax country. In the Honda example, let us assume that taxes in the U.S. are 35 percent and in Japan 25 percent. It would make sense for the company to have Honda in Japan make a larger profit than Honda in America. Thus, the engines shipped to the U.S. would be priced very high so that the profits go to Honda in Japan and leave little or no profits for Honda in America. The high-priced engine that Honda in America buys increases the cost of the car, and reduces the profit margin when it's sold in the U.S. The Japanese company profits at the expense of the U.S. treasury.

Using this same logic, if the firm can "transfer" its profits to a country where there is no income tax, it would do so. This is another reason why a tax haven is attractive. The Internal Revenue Service and its counterparts in other countries attempt to regulate any extravagant efforts by firms to transfer price inter-corporate business transactions to avoid paying legitimate taxes. Major industrial countries are engaged in coordinated efforts to make tax havens reform their rules to prevent criminals and unsavory characters from finding a refuge there. As a result, important progress has been made to make investment rules more transparent and information disclosure more complete.

Patriotism vs. business sense

Corporate inversion certainly reduces, in the short term, the tax revenues of the U.S. government. Concerned about this, many critics are now saying a business should pay its "fair share" of taxes, which, if it reincorporates abroad, it would escape. U.S. Senator Paul Wellstone of Minnesota, wrapped his criticism of Stanley Works in the Stars and Stripes by saying, "You are not being very patriotic when you are not willing to pay your fair share of taxes." *The New York Times*, editorializing on Stanley Works's plans to relocate, used the same analogy of treasonous conduct. It compared the company's action to that of Revolutionary War hero-turned-traitor Benedict Arnold, who, unmasked, fled to England—by way of Bermuda. Capitalizing on public indignation at corporate scandals, politicians have introduced bills in Congress to punish firms that reincorporate offshore. They have stalled as opponents argue that the problem is not with corporations, but with the U.S. tax code.



Incorporation Fees in Bermuda

The Bermudan government charges an annual incorporation and registration fee from foreign firms that do not have any Bermudan ownership and that do business abroad from a Bermuda base. The annual fees are based on a sliding scale related to share capital as follows:

Share Capital	Annual Fee
$12,000 (minimum required)	$1,680
$12,001–$120,000	$3,360
$120,001–$1,200,000	$5,040
$1,200,001–$12,000,000	$6,720
$12,000,001–$100,000,000	$8,400
$100,000,001–$500,000,000	$15,000
Over $500 million	$25,000

Of course, there are lots of incentives to relocate abroad and many, and not just corporate chiefs, blame the tax code for this. Indeed, the Secretary of the Treasury, Paul O'Neill, a former CEO of a Fortune 500 company, said "This is about competitiveness and complications in the tax code that put U.S.-based companies out of step with their foreign competitors. I don't think anyone wants to wake up one morning and find every U.S. company headquartered offshore because our tax code drove them away and no one did anything about it." Secretary O'Neill has it right: The correct solution to the problem is to fix the internal revenue code. It is worth noting that tax reduction is not an issue only in the U.S.; other countries also have to come to grips with it.

Since this tax reduction technique is entirely lawful, some claim the problem is one of loopholes that must be plugged. But should one be obligated to pay more taxes than the law imposes? As individuals, many of us chafe at the variety and amount of taxes we pay and we seek professional help to reduce our tax liabilities. Businesses do also, and they have the added responsibility to their shareholders to improve the firm's competitiveness and enhance shareholder value. If that requires the firm to move offshore, it is hard to characterize it as an unpatriotic act. Would it be an act of patriotism to stay home and go out of business?

Even when it moves offshore, a firm continues to pay taxes on its U.S. operations. Its U.S. shareholders will pay taxes on their dividends and their employes pay taxes on what should be higher wages and bonuses. The unmistakable conclusion is that companies are being pragmatic, making a cool-headed business decision, and responding to competitive pressures.

The "patriotism" argument being used against corporations is a red herring; it obscures the main issue, which is this: For American business to compete successfully, our tax policies urgently need overhauling. Instead of maligning businesses for not paying their "fair share" of taxes, or blaming them for their lawful tax reduction strategy, Congress ought to be making the tax system fair.

Shareholders and managers

This brings us to the question of why a firm's shareholders tend to favor reincorporating. Institutional shareholders (e.g. pension funds such as Calpers or TIAA-CREF) often own big chunks of a company's shares for the long haul. Because they have a fiduciary responsibility to obtain as large a return on their investment as possible, they encourage corporate actions that increase shareholder value by increasing profitability and cutting costs. And of course, higher share prices benefit all investors, large and small alike. To the extent going offshore increases the value and profitability of the firm, the directors would be negligent not to listen to their shareholders.

As a firm's sales and profits from international operations rise, the primacy of its "home" market diminishes. Senior managers begin to pay more attention to international issues. If the playing field is not level, it is their responsibility to find ways to make it so. That may mean moving offshore, since U.S. tax law has not kept pace with the changing environment of global business.

Why the uproar?

If the promise of economic efficiency inherent in locating to a low-tax country is realized, that should contribute to fresh investments, new products, and new employment in the U.S. So why the uproar, the condemnation, the rush to judgment? Cynics might say that large corporations are a convenient whipping boy of American society, especially when the economy has slowed and a few spectacular cases of corporate failure have grabbed headlines. Others would say that when tax cuts appear to favor wealthier Americans and corporations over "average" citizens, having corporations leave to reduce taxes is offensive. But more realistically, many people simply do not (and cannot be expected to) understand the complexities of tax policies and their impact in a global economy marked by intense competition. Optimists look forward to a hastened revision of American tax rules that recognizes international realities.

Selected Companies Reported as Using Offshore Tax Havens

Company Name	Country of Incorporation	Year of Inversion
Tyco International	Bermuda	1996
Fruit of the Loom	Cayman Islands	1999
PX Re	Bermuda	1999
TransOcean Sedco Forex	Cayman Islands	1999
Accenture	Bermuda	2001
Foster Wheeler	Bermuda	2001
Ingersoll-Rand	Bermuda	2001
Cooper Industries	Bermuda	2002

What's to be done?

Stanley's efforts to reincorporate in Bermuda touched off a major national debate. At a time of heightened public scrutiny prompted by high-profile scandals, Stanley abandoned its plans to relocate. While pledges by politicians to bar firms from relocating or impose various penalties if they do may well be bluster, the effect has been to chill, at least for now, any plans to incorporate offshore. On a more positive note, the issue has raised to national prominence the need to overhaul the corporate tax regime. While the U.S. has championed liberalization of global trade and investment, and helped weave the worldwide web of competition, its tax laws have not kept pace.

Just as high tax rates can discourage voluntary tax compliance and encourage a black market economy, lower tax rates can do the opposite. They can induce Americans and American firms to incorporate and remain incorporated in the U.S. and still succeed. Now is a perfect opportunity to revisit the impact of these rates and policies on our corporations. Corporate managers are way ahead of our political leaders on this issue; it is time for public policy to catch up with the imperatives of global economy.

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