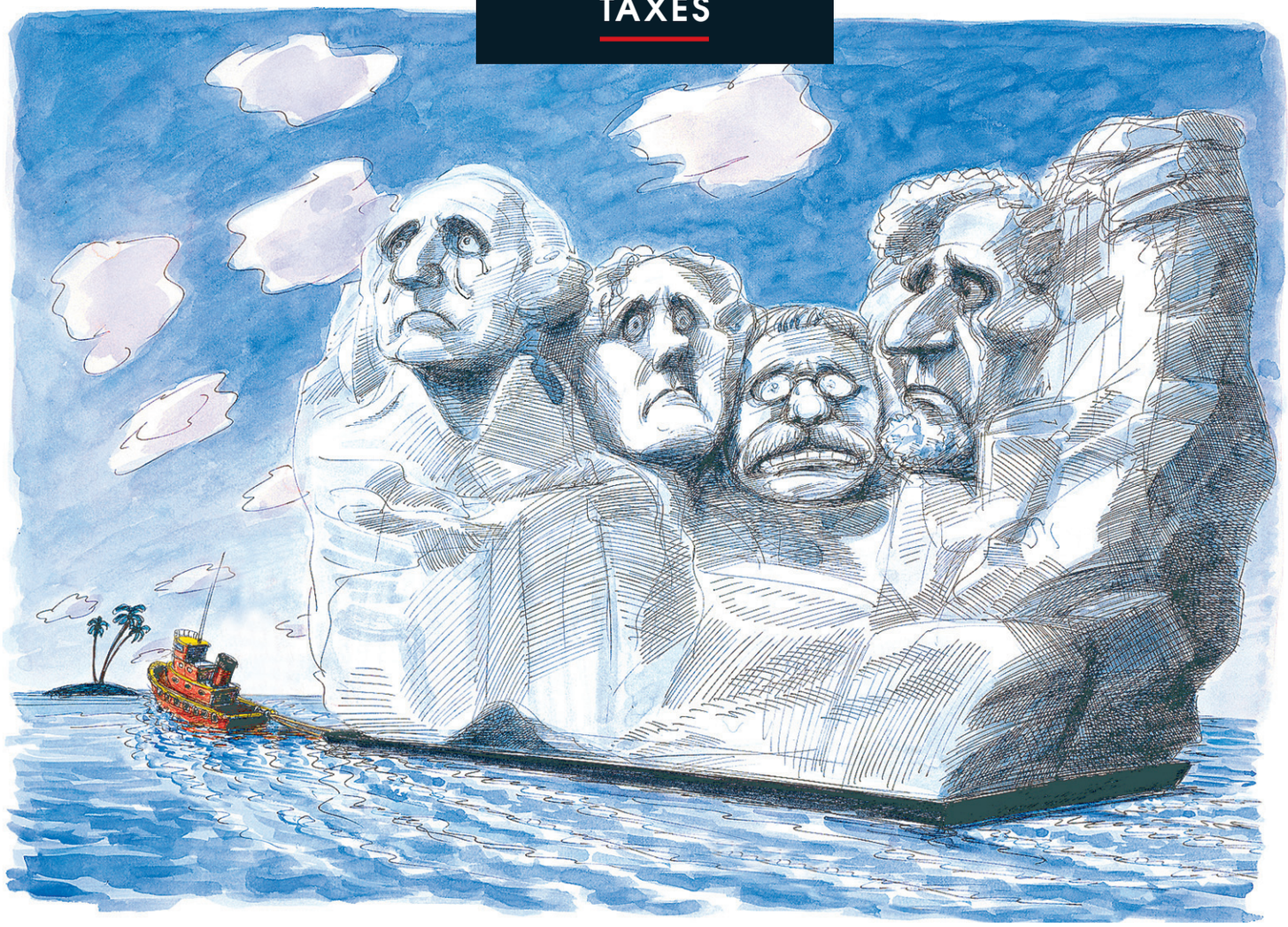

Nationalities *of* convenience

By Hal Lux

U.S. companies like Ingersoll-Rand are turning — poof! — into Bermuda corporations. At a time of war, this is bound to raise hackles.

Illustrations by Victor Juhasz

"There is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant." **— Judge Learned Hand**

On November 5, 2001, less than two months after the terrorist attacks on America, Martin Huddart, general manager of Ingersoll-Rand Co.'s Recognition Systems subsidiary, submitted prepared testimony to the U.S. Senate's aviation subcommittee meeting in Morgantown, West Virginia. Chaired by West Virginia Democrat Jay Rockefeller, the subcommittee was meeting to discuss technological methods for improving safety at U.S. airports.

"As our nation moves forward following the tragic events of September 11,"

Huddart instructed, "the overriding security issue will be to better manage people and access within the complex environment of a commercial airport."

"Our nation"? Maybe not. What Huddart neglected to mention, while subtly pitching his company's expertise, was that venerable Ingersoll-Rand would be leaving the good old U.S.A. — on paper, anyway — to avoid paying taxes on income earned overseas.

Incorporated in New Jersey in 1905, the Woodcliff Lake–based company has played more than a passing role in the pageant of American history. Ingersoll-Rand jackhammers carved out the presidential faces on Mount Rushmore. Its Thermo King refrigeration trucks made possible the rise of the American frozen food industry. And Ingersoll's New York Stock Exchange listing is one of the ten oldest on the Big Board.

But on October 16 Ingersoll's board of directors had voted to become a Bermuda corporation. The reincorporation took effect on December 31.

Ingersoll isn't actually moving to the island nation. The company's headquarters and CEO, Herbert Henkel, will stay in New Jersey. The industrial conglomerate will continue to employ 35,000 people in 24 states. As for Ingersoll's balmy new domicile, three weeks after the company reincorporated, its Web site directory listed phone numbers for Bosnia and Cambodia but not for Bermuda. Still, Ingersoll is now a full-fledged Bermuda company, which is a fortuitous thing to be when tax time rolls around in the United States of America.

American companies, like individual citizens, have to pay taxes. And like American citizens, companies try to minimize what they pay, through whatever means they can manage. Paying taxes on domestic earnings is a fairly simple matter. It gets trickier with income earned overseas.

America is rare among nations in taxing individuals and companies on income that they earn anywhere in the world. The U.S. government gives American companies credits for taxes they have already paid to foreign governments, but the system is complicated and flawed. For example, companies must allocate interest expenses against foreign income, even if the capital isn't being deployed overseas. That requirement can wipe out a company's foreign tax credit for an entire country. So Ingersoll-Rand, which earns 40 percent of its income outside the U.S., can end up paying more than it should have to. Many tax experts say the U.S. laws are so unfair that American companies have a right, maybe even a duty to their shareholders, to look for ways to cut their taxes. "It arguably doesn't make sense to impose U.S. corporate level tax on income that has already been taxed once in a foreign country and will be taxed again when it is distributed to U.S. shareholders," says David Hariton, a tax partner at Sullivan & Cromwell. "Three taxes makes a crowd."

But there is an easy way out. A U.S. corporation can create a shell holding company that is incorporated in Bermuda, "transfer" its overseas operations to the Bermuda company and merge its U.S. company into the Bermuda shell. What was an American company is now, on paper, Bermudan. And Bermuda companies don't pay U.S. taxes on their international income.

Companies relocate all the time to cut taxes. They move from state to state in return for a break on local taxes or to take advantage of some favorable corporate regulation or court system. New York City has offered numerous tax breaks to Wall Street firms to fend off a predatory New Jersey. Boeing Co. recently moved its headquarters from Seattle to Chicago after securing a large tax break. For some time hedge funds and insurance companies have been quietly slipping off to Bermuda for tax reasons. But the hedge funds are private entities managing offshore money, and so far only a handful of small reinsurance companies have gone to Bermuda.

What is happening now appears to be a movement of another order. The companies that are moving are mainstream, heartland names. Foster Wheeler Corp., an engineering company and builder of large gas and oil field projects, founded in New York City in 1927, reincorporated as a Bermuda corporation in May. In January Houston-based oil drilling contractor Nabors Industries, a Standard & Poor's 500 company with a $4 billion market cap and 18,000 employees, said it would reincorporate in Bermuda later this year. Then there's Houston-based Cooper Industries, which traces its origins to an 1830s Ohio iron foundry: In June Cooper announced plans to leave for Bermuda, but the move was postponed because of an unsolicited takeover offer from Danaher Corp. The takeover fell through, and Cooper may still go.

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Experts expect more companies to follow. "It will start out as a trickle," predicts Monitor Group consultant Michael Jensen, a former Harvard Business School professor who has analyzed relocations for corporate governance issues within the U.S. "It always does. And then it will be a rush."

Leaving the country for a tax break sure seems to carry a bad taste now, when many American businesses are conspicuously wrapping themselves in the flag. Insurance companies have been lobbying Congress for a federal backstop to cover claims related to terrorist acts. At the same time, they've been investing billions in start-up reinsurance companies that hope to profit from soaring policy rates. The reinsurers have been set up in Bermuda and won't pay U.S. taxes.

Companies say American tax laws are outdated, even nutty, in the era of globalization. And Ingersoll says that its decision to shed its U.S. citizenship was wrenching. "We thought very long and hard about it," says chief financial officer David Dev-

onshire. "Our main domicile will still be the U.S. We have no intention of moving our operations to Bermuda. At the end of the day, we were dealing with a competitive disadvantage, and we have a duty to shareholders."

But critics say there are plenty of strange laws and nutty taxes on the books in the U.S. What these companies are doing is essentially trading their corporate citizenship for a flag of convenience — and a tax break. Ingersoll will save $40 million to $50 million per year on taxes. And, according to one analyst's projections, Nabors will cut $40 million to $70 million.

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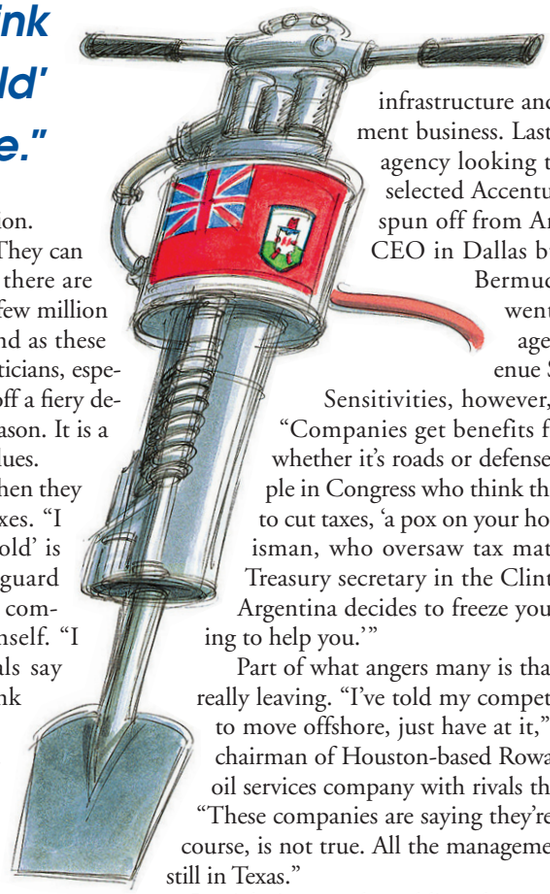

Companies can rationalize these moves legally. They can rationalize them financially. But some critics say there are greater values and principles at stake than saving a few million in taxes. As more and more companies do this, and as these moves become better known to the public and politicians, especially at a time of war, the tactic seems likely to set off a fiery debate. Because in the end, patriotism is not about reason. It is a gut-level attachment to home, place and familiar values.

Even sophisticated capitalists can be outraged when they hear about companies relocating to pare their taxes. "I find it appalling. I think the term 'Benedict Arnold' is appropriate," says Jack Bogle, founder of Vanguard Group, the country's second-largest mutual fund company, and a renowned corporate cost-cutter himself. "I think it's outrageous when American individuals say they're not Americans for tax purposes, and I think it's outrageous when companies do it."

Even discussing such moves gets people angry. Former Intel Corp. tax chief Robert Perlman got himself into hot water two years ago when he told the Senate Finance Committee: "If I had known at Intel's founding [in 1968] what I know today about the international tax rules, I would have advised that the parent company be established outside the U.S. Our tax code competitively disadvantages multinationals simply because the parent is a U.S. corporation." When Perlman suggested the company could have set up shop in the Cayman Islands, New York's then-senator Daniel Patrick Moynihan, a former ambassador to India and the United Nations, upbraided the Intel executive, asking Perlman if he expected the Marines to show up in the Caymans in case of trouble. Says an unrepentant Perlman, "I should have said 'Ireland.'"

For the most part, however, these corporate moves have occurred without publicity or scrutiny. "Ingersoll-Rand is a significant event," says a senior congressional tax aide. "Until now you've just had insurance companies doing this. Now you have a big mainline company reincorporating. People in Washington aren't paying attention to this. But they should be."

Ingersoll's timing certainly stinks. While it was becoming officially Bermudan, the company, a leader in airport security technology, was pitching the U.S. government for business. In November it even got California Representative Adam Schiff to demonstrate a handprint-reading device at a multicompany showcase at the Burbank-Glendale-Pasadena Airport. Did Schiff care, or know, about the company's reincorporation? He didn't respond to a request for comment.

These moves raise the question of what it means to be a corporate citizen, especially in an era of globalization. For companies reincorporating in Bermuda, there are few day-to-day changes. Bermuda has respected laws and courts; in the U.S. the companies still get the same access to roads, infrastructure and police — and government business. Last summer a government agency looking to redesign its Web site selected Accenture (the consulting firm spun off from Andersen), which has its CEO in Dallas but was incorporated in Bermuda when the company went public last July. The agency? The Internal Revenue Service.

Sensitivities, however, are a different matter. "Companies get benefits from being in the U.S., whether it's roads or defense. There are a lot of people in Congress who think that if you go offshore just to cut taxes, 'a pox on your house,'" says Jonathan Talisman, who oversaw tax matters as acting assistant Treasury secretary in the Clinton administration. "'If Argentina decides to freeze your assets, we're not coming to help you.'"

Part of what angers many is that the companies are not really leaving. "I've told my competitors [that] if they want to move offshore, just have at it," says C. Robert Palmer, chairman of Houston-based Rowan Cos., an NYSE-listed oil services company with rivals that have moved offshore. "These companies are saying they're in Bermuda, which, of course, is not true. All the management of the companies are still in Texas."

It might interest the public to know that some administration policymakers don't have hard feelings about these moves. "These transactions do evoke a strong reaction — that these companies are somehow abandoning the U.S.," concedes Barbara Angus, international tax counsel at the Treasury Department. "We need to understand if there are aspects of our tax system that are driving companies to consider these transactions."

Most companies are not going to reincorporate. Many U.S. companies pay no tax on foreign income, because they're able to take advantage of tax credits and other rules. And for some companies, leaving wouldn't make financial sense. The IRS now imposes a one-time "toll charge," which can be substantial for companies with longtime shareholders or high stock prices.

Other companies would probably never risk the public relations black eye: Coca-Cola Co., for example, which earns 72 percent of its income abroad, or McDonald's Corp., which gets 55 percent of its income from outside the U.S. Their American identity is central to their branding. "Companies have to con-

sider the potential stigma," says Lehman Brothers tax specialist Robert Willens. "It does seem unpatriotic to people. There is a lot of emotional baggage that comes with this transaction."

For decades corporate America mostly stayed put. Millions of U.S. jobs moved overseas, but few companies relinquished their American corporate identities, even though the favorable tax consequences have long been available and understood. Although no one tracks the number of U.S. companies moving offshore, bankers say that the first American company to reincorporate overseas in recent memory was a New Orleans–based oil company, McDermott International, which changed its legal domicile to Panama in 1982. McDermott has a $750 million market cap and an NYSE listing, and it still operates out of the U.S.

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In 1994 Helen of Troy, an El Paso, Texas–based beauty supply company, announced plans to reincorporate in Bermuda. The IRS, fearing that many more companies would follow, laid down new regulations, since dubbed the Helen of Troy rules, that require shareholders and companies to pay a one-time toll charge in the form of an immediate capital gains tax on the transfer of the assets and stock. (Ingersoll-Rand paid no toll charge on the corporate level, but the company's shareholders were stuck with a $100 million capital gains hit, according to a shareholder lawsuit that has since been settled.) The toll charge is steep enough that expatriating wouldn't make sense for many companies. But a bad economy and stock market can whittle away most of the toll charge for a company and its shareholders. "If a company has a couple of bad years in a row, it gets attractive," says former Intel tax chief Perlman. "That's why you're seeing companies do this now."

Bermuda is especially attractive for relocators. "It's like having Greenwich in the middle of the Caribbean," says a private equity banker. The success of large Bermuda insurance companies like Ace and XL Capital in recent years has made a Bermuda domicile seem safe to much larger U.S. corporations. Even so, Lehman's Willens — who has worked on corporate expatriations — estimates that since the Helen of Troy rules, only 25 to 30 companies have reincorporated offshore to take advantage of taxes.

"There is definitely a perception of a stigma," says an investment banker who has worked on these transactions. "But it's hard to know whether there's an actual stigma, because what high-profile companies have tried it?"

The biggest company to move to Bermuda has been a success. In 1997 conglomerate Tyco International acquired Bermuda-based security system company ADT Security Services in a reverse merger that shifted Tyco to Bermuda. It seems clear that the reason for the reverse merger was to reduce taxes. Some shareholders complained about having to pay the capital gains tax, but the company sliced its effective tax rate from 36 percent to 25 percent. "There doesn't seem to be a stigma about Tyco being in Bermuda," says UBS Warburg analyst David Bleustein. Tyco didn't buy ADT for tax reasons, however, and the parent company is not exactly a household name.

Corporate governance experts say that making companies act like citizens will just lead to runaway taxation and angry shareholders. "Companies are not citizens," says Monitor Group consultant Jensen. "We don't want them to be. It's like saying we should have only one car company. You want competition among localities to provide services." Being angry at Ingersoll-Rand for leaving after September would be an example of "irrational patriotism," he adds.

Some tax policy experts are also concerned that a debate about patriotism will obscure more fundamental issues related to ducking the country's overseas tax rules. "The real issue is that this is disastrous if you believe in keeping manufacturing jobs in this country," notes one tax lawyer. "The unions haven't caught on to this, but if your top company is now offshore, you have a lot more economic incentive to build your next plant in Asia."

After the ascendancy of free-market economics and years of cross-border mergers that routinely change the nationality of parent companies (including Institutional Investor, which was acquired by Euromoney, a British publishing company, in 1997), many business types seem startled to be asked about the patriotic angle on taxes. "As a shareholder, I would be steamed if a company changed a business decision because of September 11," says University of Chicago law professor David Weisbach.

Moreoever, almost every business uses tax havens in some way. In May 2001, at the urging of a group of U.S. insurers, two members of the House — Massachusetts Democrat Richard Neal and Connecticut Republican Nancy Johnson — introduced legislation aimed at foiling Bermuda tax ploys by insurance companies. "We think the system is broken," says Robert Marzocchi, chief tax executive of Chubb Insurance Co., which has been lobbying Congress to crack down on reincorporations in the reinsurance business. "At some point Congress is going to get tired of the Fortune 500 moving to Bermuda."

But it's hard to resist that country's allure. Although Chubb itself may be staying put in Hartford, it has invested in a reinsurer called Allied World Assurance Co. It's in Bermuda.

How do average Americans feel about these actions? That's hard to say. Ingersoll's reincorporation received little publicity except on the Yahoo! message board for the company, where those who posted were split but very emotional. "Bad time to kiss off the U.S. and evade taxes," said one anonymous writer.

Corporate identities will grow increasingly blurry in an age of multinational business and borderless capitalism. But even some very sober tax experts believe that the appeal of grassroots patriotism should not be dismissed by Wall Street sophisticates. "I think it's a reasonable question," says Reuven Avi-Yonah, a former Wall Street lawyer who is now a professor of international tax law at the University of Michigan Law School. "This is more than just a tax question. It goes to the issue of whether multinational companies still have a nationality. I think the common intuition has a point here." **ii**