

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

BILL ANALYSIS

Senate Bill 640

Senator Burton (As amended 9/3/03)

Position:

Support

Proponents:

State Treasurer (Sponsor), CalSTRS, CalPERS, and 20 other organizations in support

Opponents:

Ingersoll-Rand Corporation, Tyco International

SUMMARY

Senate Bill 640 prohibits state agencies from entering into agreements or contracts with publicly-held companies that move their place of incorporation from the United States to tax haven countries where they have no substantial business operations, unless an existing corporation provides specified shareholder rights and other legal and financial arrangements, or the contract serves a compelling public interest.

HISTORY

SB 1061 (Revenue and Taxation) repeals the water's edge contract requirement and treats the water's edge election like other tax elections. A taxpayer would be permitted to elect water's edge treatment for a period of seven years, after which the taxpayer could continue for another seven years or return to the worldwide method for at least seven years.

SB 1067 (Speier) prohibits publicly-held companies that move their place of incorporation from the United States to countries defined as tax havens from making a "water's-edge" election for purposes of determining state corporate income taxes, and instead requires such companies to pay their taxes on a more expensive worldwide unitary basis.

AB 2375 (Cardoza—2002) would have prohibited an expatriate corporation from being eligible for state public works, goods, or services contracts, unless the head of the awarding agency found specific conditions necessitated the contract. The bill was held in the Senate Appropriations Committee.

SUMMARY OF AMENDMENTS

Recent amendments restate legislative findings and declarations on the effect expatriate corporations' actions have on taxpayers and investors. Defines "state agency" for the bill's purposes, removes requirements that vendors annually submit a declaration to the Department of General Services stating it is eligible to contract with the state under the bill's provisions, and instead requires any vendor that is offered a state contract to submit a declaration of eligibility to

the contracting agency. Amendments also add provisions of SB 1061 (Revenue and Taxation) that would revise the water's-edge election procedures foreign corporations use to calculate their California income tax, and includes technical language to avoid chaptering-out conflicts.

CURRENT PRACTICE

During the last few years, a small number of American companies have moved their headquarters to offshore havens such as Bermuda, the Cayman Islands and others in an effort to avoid state and federal taxes. These companies are commonly referred to as "expatriate" or "offshore" corporations. Many companies promoted the idea that relocating would help the bottom line for corporate shareholders at a time when corporate scandals and loss of confidence even in well-managed companies has reduced investment returns throughout the financial markets.

In previous filings to the Securities and Exchange Commission, the Tyco Corporation indicated that because of its expatriate status, its shareholders "may have more difficulty protecting their interests" than would shareholders of U.S.-domiciled corporations. For example, in the offshore haven of Bermuda, corporate officials are accountable only to the corporation instead of shareholders. Expatriate corporations are also allowed to sell-off major corporate assets without shareholder approval, and their directors and officers are not required to disclose to shareholders personal interests in corporate contracts or transactions. In addition, Bermuda law greatly restricts shareholders' ability to sue corporate officials for breach of fiduciary duty, waste and other illegal acts.

Currently, North Carolina bans state contracts from being awarded to expatriate American companies, and legislation is pending in Congress and several other states to prohibit government contracting with these companies. Meanwhile, the tax benefits that do exist may soon evaporate. The IRS recently announced it is stepping up efforts to collect taxes from expatriate corporations, and legislation is pending in Congress that would result in hundreds of millions of dollars in new taxes on these companies. Supporters of these initiatives believe that expatriate companies should not be able to obtain large government contracts while avoiding paying their fair share of state and federal taxes.

A number of state treasurers have also asked Standard & Poor's to remove expatriate companies from its S&P 500 Index. Their request follows the policy guidelines of the Russell 3000 Index, which does not include companies incorporated outside the U.S. These policies directly affect institutional investors such as the California State Teachers' Retirement System (CalSTRS), which have predominantly indexed equity portfolios.

DISCUSSION

Specifically, Senate Bill 640:

- Declares, among other things, that expatriate companies have diminished their shareholders' rights and that their actions are part of a larger pattern of deceptive corporate practices that undermines the confidence of investors in the integrity of financial markets.
- Defines an expatriate corporation as a publicly traded foreign incorporated entity when:
 - The U.S is its principal market for public trading.
 - It has no substantial business activities in its country of incorporation; and
 - It was incorporated through a transaction or transactions in which it acquired substantially all of the properties held by a domestic company and immediately after the acquisition more than half of the publicly traded stock was held by the same shareholders or partners that owned the domestic company.
- Prohibits state agencies and departments from entering into any agreement or contract with an expatriate corporation or its subsidiary unless it expatriated before January 1, 2004, uses worldwide combined reporting to calculate the income on which it pays taxes to the state, and provides the following shareholder protections:
 - A fiduciary relationship between corporate directors and officers and shareholders.
 - Shareholder approval of transactions in which a corporate director has an interest, or the sale of virtually all of the entity's assets.
 - A description of shareholder rights on the company's website or in its Securities and Exchange Commission filings, and shareholder access to company records.
 - A right for shareholders to bring derivative proceedings on behalf of the company, and the company's consent to have court cases brought by or on behalf of shareholders held in state or federal court. In addition, the company must have sufficient assets, as specified, and insurance available in the United States to satisfy judgments imposed by a state or federal court.
 - An agreement that no more than a quarter of annual shareholder meetings be held outside the United States, and that specified access be provided to shareholders when such a meeting is held outside the United States.

- Requires any vendor that is offered a state contract to submit a declaration of eligibility to the contracting agency.
- Defines “state agency” as a state office, department, division, bureau, board, commission, and the California State University, not including the University of California, the Legislature, the courts or judicial branch agency.
- Allows a state agency or department director to waive the prohibition and enter into an agreement or contract with an ineligible vendor when necessary to meet a "compelling public interest.”
- Adds provisions of Senate Bill 1061 (Revenue and Taxation) that would revise the water’s-edge election procedures foreign corporations use to calculate their California income tax, and includes technical language to avoid chaptering-out conflicts. It also includes provisions that would allow expatriate corporations to terminate their “water’s edge” elections for purposes of becoming a qualified vendor in the event SB 1061 is not chaptered.

According to the sponsor, “These companies desire all the benefits of the American system, but they are unwilling to play by its rules. Companies that avoid their tax obligations and look for ways to duck their legal responsibilities would not think twice about harming their investors...The State of California, as a major institutional investor, must use the power of the purse to bring about an end to this misconduct.”

Opponents argue that companies reincorporate outside the U.S. to enhance their competitive standing and increase shareholder value. They further indicate that government officials did not raise concerns at the time these companies reincorporated offshore, and that applying a state contracting ban on companies that reincorporated before the effective date of this bill does not follow current federal contracting standards.

CalSTRS and other public pension funds, along with institutional investors, labor organizations and state treasurers around the country, have launched the “Come Back to America” campaign to educate corporate, financial and government decision makers about the negative effects of corporate expatriation and the benefits of reincorporation in the U.S. As investors, the group believes investments in foreign-based American corporations are best protected by relocating those companies back on American soil.

CalSTRS staff believes that most of the expatriate companies targeted in the Come Back to America Campaign have failed to credibly quantify the amount of tax savings they think they generate by moving offshore. However, by locating offshore to reduce their tax burden, these

expatriate corporations have likely increased the tax burden of domestic corporations whose securities are held by the Teachers' Retirement Fund (TRF), and individual CalSTRS members.

In addition, CalSTRS' staff indicates they cannot adequately compare the corporate governance of expatriate companies against CalSTRS' other holdings in U.S.-domiciled corporations. Given that many of the rating agencies have now included corporate governance criteria as a part of their rankings, a company's expatriate status may hinder its capital-raising activities, and faced with the loss of hundreds of millions of dollars worth of government contracts, substantial new tax liabilities, the tax-haven benefit becomes questionable.

At the present time, CalSTRS does not contract with any expatriate corporations. While SB 640 would require the System to modify its current procurement process to allow potential vendors to certify that they do not meet the definition of an expatriate corporation and are eligible to enter into agreements, CalSTRS staff indicates these changes would be minor. The certification requirement proposed by this bill does not allow the System to identify ineligible corporations early in the contracting process, however, staff time and System resources should not be adversely affected.

FISCAL IMPACT

Program Costs– Possible lower investment returns to the TRF from expatriate companies affected by the loss of revenue from government contracts.

Administrative Costs– Unknown, but likely minor and absorbable costs to include notice of certification procedures and the additional provision in bid proposals and contracts.

BOARD POSITION

Support. If SB 640 and other efforts to encourage expatriate companies to reincorporate in the U.S., or provide equivalent shareholder protections prove successful, it will be easier for CalSTRS to compare corporate governance practices and the underlying investments themselves.