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"Unpatriotic Tax Traitors or Rational Tax Avoiders? Corporate Inversions in the Oil Field Services Industry"

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ABSTRACT

Recently, a substantial amount of press coverage, corporate watchdog activity, and congressional debate has been devoted to the issue of existing major US corporations establishing their parent company as an offshore entity for the purpose of obtaining tax advantages. These are basically "paper" relocations since the bricks, mortar and personnel of the company seem essentially unchanged. However, these "paper" relocations could have significant impacts on US taxes.

In an attempt to avoid paying US taxes on foreign earnings, several US corporations have utilized a method of reorganization that is known as a "corporate inversion." There are several methods of accomplishing an inversion. However, all the methods have one common goal: to establish a new ***foreign-*** *based entity to be the parent company, with the other existing multinational companies (including the former US parent entity) now becoming subsidiaries or part(s) of this foreign parent.*

This paper explores the basic tax, legal, and financial aspects of corporate inversions in general. Furthermore, since there have been several corporate inversions in the oil and gas field services industry, this industry is examined for insights into the corporate inversion trend.

INTRODUCTION

A fair amount of press coverage and public debate has recently been devoted to the issue of major US corporations who are seeking to re-establish their corporate address, at least for tax purposes, in some strange offshore or remote location (Boise and Koenig, 2002). Even more amazing, the bricks and mortar of the business are still at the old address, the company personnel are still there, but suddenly this company is considered a non-US company. What is taking place and why?

While it may be whimsical to think that perhaps the chairman or president of the company simply wants to have a tax deduction for traveling to a nice offshore site, there are substantial economic/tax reasons why a company may wish, barring political issues, to establish an offshore presence. A filing cabinet and post office box in a foreign tax haven such as Bermuda or the Cayman Islands are, theoretically, all that are needed to accomplish one of these restructurings. But, the result of these transactions can be dramatic. The tax savings can be enormous. For instance, earlier this year Stanley Works considered "moving" to Bermuda. Stanley's primary motivation was the belief that they would save \$30 million per year in US taxes. Ingersoll-Rand is paying Bermuda approximately \$28,000 a year to "move" there, but expects to save \$40 million in US taxes (Johnston, 2002). To understand the increased interest in these non-US based companies, we must review the basics of the Internal Revenue Code as it applies to these and other companies.

TAXATION BACKGROUND

In general, the Internal Revenue Code demands an individual taxpayer report income from all sources derived. Similarly, a US corporation is taxed on its worldwide income, although it is allowed credits for any taxes it may pay to a foreign government. This credit is allowed to avoid double or even triple taxation of the foreign based income. However, a US parent-controlled foreign subsidiary's income is not taxed to the US parent company if such subsidiary's funds do not return to the parent company in the form of dividends, unless otherwise included as a result of sections 951-964 of the Internal Revenue Code. Thus, if the company can successfully keep the overall company's foreign sourced income, or even a part of it, from being considered earned by a US based corporation, it is possible to avoid a significant amount of income taxes on that income, ranging from 15-35% (New York State Bar Association Tax Section, 2002).

A "simple" way for a multinational company to avoid having foreign-sourced income taxed in the US is to alter its corporate parent from a US-based company to that of a foreign-based parent company, thereby establishing a "break" between the foreign-based income and the US-based company (Avi-Yonah, 2002). Thus, only US-based income, centered on the old US corporation (now usually a subsidiary) is now solely taxed by the US. Happily for the new entity, the same foreign income that was previously exposed to US taxation now falls outside of the tax code web since it is "captured" outside the US (and probably will not flow back to the US). Furthermore, if the proper foreign jurisdiction is selected, there may be very low or even no taxes due on the income "earned" in the foreign jurisdiction.

Of course, with these restructurings there are tax implications to the shareholders. If any dividends are paid to the US shareholders from this now "foreign corporation", a withholding tax may apply, ranging from approximately 30% to a much lower level, depending on applicable tax treaties. As this is a significant restructuring of the overall corporate organization, it is expected that such restructuring may have their own potential tax costs, as well (New York State Bar Association Tax Section, 2002).

CORPORATE INVERSION METHODS

The most common method used for this reorganization is what is known as a corporate "inversion," possibly accompanied by some ancillary activities. The inversion technique, whichever method is used, has one common goal: to establish a new ***foreign***-based entity to act as the parent company, with the other existing multinational companies (including the former US parent entity) now becoming subsidiaries or part(s) of this foreign parent (U.S. Treasury, 2002).

While numerous permutations of the various methods are evident, there appear to be three predominant types of inversion methods to provide for the foreign reincorporation and transfer of corporate power.

1. The first method is via the actual physical reincorporation of the US parent into the foreign jurisdiction via a merger of the US (former parent) company ***into*** the newly established foreign parent company. The existing US shareholders receive shares in the newly formed foreign corporation. The new parent holds the corporate entity previously held by the old parent. This is commonly known as the ***asset transaction*** method.
2. The second method is whereby the new foreign parent company obtains the stock of the existing US parent company, with the old US company surviving and becoming a ***subsidiary*** of the new parent. The US company shareholders exchange their stock for the new stock of the new parent company, and as a result the new parent holds all of the stock of the US company. This is known as the ***stock transaction*** method.
3. The final main method is known as a ***"drop down" transaction*** (which is a combination of the prior two methods previously described) whereby the old US parent transfers its assets to the new foreign parent, and then some, but not all, of those assets are contributed by the new parent into a new US subsidiary of the foreign parent. The transfer of the assets to the new US subsidiary is similar in result to the stock transaction method shown above. The result of where the parent directly holds the remainder of the assets of the old US-based company is similar to the result of the asset transaction method shown above (U.S. Treasury, 2002).

These methods have various tax effects, as expected. However, with recent stock market and overall economic woes of late, the impact is not as great as it would have been in the past, primarily because of the reduction in the fair market value of the underlying assets and/or stock. As a result, even more planning and activity in this regard has been "inspired" by the economic climate.

While generally reorganizations are designed to be a tax free event, certain other elements, particularly IRC §367, impact the results. IRC § 367 basically imposes a tax on otherwise tax-free events under §368 on outward bound transfers of assets or stock. However, the effectiveness of § 367 has been raised (New York State Bar Association Tax Section, 2002).

As a result, for the *asset* transaction method, the company's gain is computed based on the FMV of the assets versus the company's basis in those assets, but no loss is allowed. The shareholders are treated as having exchanged stock for stock, and receive the same basis in the new stock as the old stock. For the *stock* transaction, the gain recognized, if any, is the difference between the shareholders basis versus the FMV of the stock exchanged, but no loss is recognized. The *drop- down* technique combines those two results, generally taxing the excess of the FMV versus the basis of the assets is taxable to the new corporation for the assets retained in the new foreign company, while the assets placed into the US subsidiary are treated as a stock transaction, where the gain is reported by the shareholders as the excess of FMV versus their basis but the old US parent is not required to report the gain at the corporate level (U.S. Treasury, 2002).

The result of these transactions after the inversion, sometimes called post inversion, is dramatic. The tax savings on the company operations, particularly based on the current economic climate of FMV of assets and stocks, usually more than offsets the costs of the changeover/inversion and any tax cost resulting from the corporate change (Joint Committee on Taxation, 2002).

US operations continue owing "traditional" taxes on US based income. Dividends from the US-company to the foreign parent may be subject to a 30% withholding requirement, dependant upon the tax treaty in place, but it appears such amount is generally approximately five percent (U.S. Treasury, 2002).

As a result of the inversion, foreign operations income is now ***eliminated*** from US corporate taxation, but similarly foreign income tax credits are now reduced or eliminated. Nonetheless, as a result of the restructuring, the process of restructuring has apparently saved a significant amount of tax money for the organization. Generally US shareholders will not have any practical resulting difference in their treatment of dividend income, but a corporate shareholder will no longer be able to enjoy the dividends received deduction (ranging from 70 -100%).

It is noteworthy that the IRS has issued several new regulations that require corporate inversions to be reported to the service and shareholders. Reg. § 1.6043-4T implements the required disclosures via Form 8866 and other related regulations invoke penalties if not followed. Of course, the regulations do not attempt to prohibit companies from organizing offshore, rather these regulations concentrate on the reporting of such activities not unlike a tax shelter reporting mechanism.

THE HISTORY AND RECENT POLITICAL IMPLICATIONS OF CORPORATE INVERSIONS

Although there has been a great deal of discussion lately about companies undertaking an inversion to avoid paying US taxes on the income of their foreign subsidiaries (Boise and Koenig, 2002). The actual number of companies that have completed an inversion is relatively small. Over the past decade, there have only been at approximately 25 firms that have successfully completed an inversion in the past decade (Weisman, 2002). These firms have been in a number of different industries and the inversions have occurred over several years. The stated purpose of these inversions is to reduce taxes (New York State Bar Association Tax Section, 2002). This implies that US-based companies are paying higher taxes than foreign-based companies. Furthermore, it is implied that by moving off-shore the company will reduce its taxes. These assumptions are generally accepted as fact (New York State Bar Association Tax Section, 2002; U.S. Treasury, 2002).

Corporate inversion activity is not new. It has been going on for a number of years. Taylor (2000) provides a good history of corporate inversions in this country. However, in light of the terrorist attacks of September 11, 2001, many people see this activity as, at the best, unpatriotic, and at the worst as downright treason. Consequently, both state and federal officials have devoted a great deal of time and effort to studying the corporate inversion tactics, often with the intention of either stopping these inversions or making them very difficult or costly to achieve (Collier, 2002; Francis, 2002; McIntyre, 2002; Wall Street Journal, 2002).

EXAMINING INVERSIONS IN THE OIL FIELD SERVICE INDUSTRY

Given the political and financial implications of corporate inversions, it is important to investigate these transactions to get a better understanding of whether these inverting firms are unpatriotic tax traitors or just rational tax-avoiders. Because of the small number of firms that have completed inversions, it is impossible to perform any meaningful statistical tests of firms that have been inverted and the benefits that were derived from these inversions. However, it is possible to at least undertake a preliminary examination of some of the firms that have undertaken a corporate inversion. Of the recent inversions, several have occurred in the oil field services industry. Therefore, this paper focuses on corporate inversions in the oil field services industry.

This paper examines companies in four SIC codes that are in the oil field services and equipment industry. Companies in SIC codes 1380 (Oil and Gas Field Services), 1381 (Drilling Oil and Gas Wells), 1382 (Oil and Gas Field Exploratory Services), 1389 (Oil and Gas Field Services, NEC), and 3533 (Oil and Gas Field Machinery and Equipment) were examined to gain some insight into the corporate inversion phenomena. Financial information about these companies was gathered using COMPUSTAT. Using this information, the effective tax rates of the companies were determined by taking the companies' reported income tax expense and dividing by the pretax net income (Income Tax Expense / Pretax Net Income). This effective tax rate includes all of the taxes that a company pays including federal, foreign, state, and other taxes. Consequently, this effective tax rate is a measure of the total taxes faced by the firm. This is not the same as the US corporate tax rate.

There was only one inversion in this industry before 2002. However, there were several inversions in 2002 in this industry. Therefore, each of these inversions is examined.

TRANSOCEAN INCORPORATED

Transocean Incorporated is a company in the offshore drilling business. In 1999, Transocean undertook an inversion that resulted in the Houston-based firm becoming a Cayman Island headquartered company. Table 1 shows the effective tax rate of Transocean Incorporated versus the effective tax rate of other US and foreign-based companies for the two years before and the two years after Transocean completed its inversion.

TABLE 1: EFFECTIVE TAX RATES OF TRANSOCEAN INCORPORATED VERSUS OTHER FIRMS.

	Two Years Before Inversion			**Two Years After Inversion**	
	1997	**1998**		**2000**	**2001**
US COMPANIES	35.31%	44.02%		48.12%	38.58%
	n = 65	n = 64		n = 58	n = 54
TRANSOCEAN INC	31.51%	29.50%		25.41%	23.77%
FOREIGN COMPANIES	19.77%	23.25%		26.90%	46.16%*
	n = 15	n = 14		n = 12	n = 10

* Foreign company tax rate in 2001 is influenced by SCHLUMBERGER LTD which is the largest of the foreign-based companies as ranked by net sales.

From this table, there are two apparent conclusions that can be drawn. First, it appears that in general, the effective tax rate for US-based companies is higher than the effective tax rate of foreign-based companies. Second, the effective tax rate for Transocean was higher in the two years before the inversion than it was in the two years after the inversion. This is consistent with the expectation of Stanley Works' Vice President for Investor Relations Gerard J. Gould who expected Stanley's worldwide tax rate to drop from 32 percent to 23 to 25 percent after an inversion (Johnston, 2002).

Table 1 tends to support the contention that US-based companies pay more taxes than do foreign-based firms (at least in this industry). Furthermore, Table 1 also supports the practice of moving off-shore to lower a firm's taxes. Transocean's effective tax rate decreased in the years after reincorporating as compared to the years before the company "moved."

INVERSION ACTIVITY IN THE OIL FIELD SERVICES INDUSTRY IN 2002

There are four companies in the Oil Field Services industry that inverted or discussed inverting in 2002. Nabors Industries, a Houston based drilling company, reincorporated from Delaware to Bermuda (Nabors, 2002). Noble Drilling Corporation, a Sugarland Texas based drilling company, reincorporated from Delaware to the Cayman Islands (Noble, 2002). Weatherford International, a Houston based provider of services to the drilling industry, reincorporated from Delaware to Bermuda (Weatherford, 2002). Veritas DGC, Houston based company offering geophysical services to the oil and gas industry, was in the process of a reincorporation as part of a merger with a Norwegian company that would have seen Veritas DGC's place of incorporation move from Delaware to the Cayman Islands (Veritas DGC, 2002a). However, Veritas DGC's board of directors called off the merger (Veritas DGC, 2002b).

These four companies are examined in Table 2. Because these inversions are so recent, it is impossible to look at the effective tax rates of these companies after the inversion. However, Table 2 shows the effective tax rates of these companies versus both US and foreign-based companies in the years 1997 to 2001.

TABLE 2: COMPARISON OF EFFECTIVE TAX RATES FOR COMPANIES THAT INVERTED IN 2002 VERSUS OTHER FIRMS.

	1997	**1998**	**1999**	**2000**	**2001**
US COMPANIES	35.57%	43.85%	49.18%	47.58%	40.16%
	N = 62	n = 61	N = 59	N = 54	n = 50
NABORS INDUSTRIES LTD	37.06%	37.50%	39.28%	40.24%	35.87%
NOBLE CORP	30.51%	29.83%	24.29%	26.85%	24.60%
VERITAS DGC INC	19.44%	33.82%	32.04%	42.88%	41.43%
WEATHERFORD INTL LTD	34.95%	34.76%	29.87%	153.56%	36.34%
FOREIGN COMPANIES	19.77%	23.25%	23.20%	26.74%	42.69%*
	N = 15	n = 14	N = 13	N = 13	n = 11

* Foreign company tax rate in 2001 is influenced by SCHLUMBERGER LTD which is the largest of the foreign based companies as ranked by net sales.

Table 2 shows that the US-based companies, in general, had higher effective tax rates than did the foreign-based companies. It is interesting to note that although Nabors Industries, Noble Corporation, Veritas DGC, and Weatherford International all had higher effective tax rates than their foreign-based competitors, these firms in general had lower effective tax rates than did their US based competitors. This same pattern also holds for Transocean (see Table 1).

SUMMARY, CONCLUSIONS, AND IMPLICATIONS

The process of companies relocating their corporate headquarters for taxes purposes through the use of corporate inversions is not a complete new activity. However, these transactions have recently come under the microscope because of political considerations. This paper has briefly reviewed the processes of corporate inversions and has attempted to examine the evidence related to some of these transactions.

There are a number of limitations associated with this paper. Only one industry was examined. There are very few firms that have actually completed a corporate inversion. Very little time has pasted since these companies have completed their inversion. Therefore, this paper serves an exploratory analysis of the inversion phenomena instead of definitive study.

From the limited evidence that is available, it does appear that these US-based companies can reduce their effective tax rates by undergoing a corporate inversion. For instance, Transocean International's effective tax rate declined in the two years after undergoing an inversion when compared to the two years before the inversion (see Table 1).

An interesting point to note is that all of these firms already had lower effective tax rates than did their US-based competitors. Both Table 1 and Table 2 show that although the companies that inverted had higher effective tax rates than their foreign competitors; these inverting firms also had lower effective tax rates than the other US-based companies. This may imply that the firms that underwent a corporate inversion were already utilizing effective tax reducing strategies. Therefore, it is possible that inversions are used mainly by "aggressive" tax avoiding companies. In which case, given the small number of companies engaging in these inversions, all the concern about these inversions may be an overreaction.

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