Transocean and the History of Tax Inversions

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ABSTRACT: The first tax inversion in 1983 was followed by small waves of subsequent inversion activity, including two inversions completed by Transocean. Significant media and political attention focused on transactions made by U.S. multinational corporations that were primarily designed to reduce U.S. corporate income taxes. As a result, the U.S. government took several actions to limit inversion activity. The Tax Cuts and Jobs Act of 2017 (TCJA) significantly lowered U.S. corporate tax rates and one expected impact of TCJA is a reduction of inversion activity. Students use the Transocean inversions to understand the reasons why companies complete a tax inversion and how the U.S. tax code affects inversion activity. Students also learn about the structure of inversion transactions and how they have changed over time as the U.S. government attempted to limit them. Students also assess the tax and economic impacts of inversion transactions to evaluate tax policy.

Keywords: tax inversion; Transocean; tax cuts; Jobs Act of 2017.

I. THE CASE

Inversion transactions have increasingly been in the news and the subject of political debate in recent years. In a tax inversion transaction, a U.S. company reorganizes its structure so that the parent of a group of companies is a foreign corporation, rather than a U.S. corporation (Marpelles and Gravelle 2014), to take advantage of lower corporate tax rates in many jurisdictions. Although a comparatively small number of inversion transactions have been completed, the increasing size and frequency of these transactions has made inversions a political target.1

In one of the early examples of an inversion to reduce a U.S. multinational company’s tax rate, Transocean, Ltd., in 1999, moved its place of incorporation from the United States (U.S.) to the Grand Cayman Islands.2 Several other companies in the oil field services industry quickly followed with their own inversions. These early inversions were usually so-called “naked inversions” that were paper transactions that did not involve any change in operations and were accomplished by creating a corporate parent in a tax haven, usually Bermuda or the Grand Cayman Islands.

As a result of legislative proposals to penalize firms that were headquartered in tax havens such as Bermuda or the Grand Cayman Islands (Sullivan 2007), each of the companies that were involved in the early inversions subsequently moved their corporate headquarters to Europe, usually Switzerland or Ireland (Webber 2011). Although these European countries have a corporate income tax, the rates in these countries were still much lower than in the U.S., and they offered stable tax systems and...
were considered less likely to cooperate with the U.S. in closing tax loopholes. Transocean was the first company to make this move, and relocated to Switzerland in 2008. However, unlike the paper incorporation in the Grand Cayman Islands, Transocean indicated that they would relocate 14 officers and support staff to Geneva, Switzerland. It is estimated that Transocean reduced its taxes by $2 billion in the first ten years following its initial inversion (Donmoyer 2010).

II. U.S. CORPORATE TAXATION IN THE UNITED STATES

The primary reason for an inversion is to lower a multinational corporation’s tax rate by incorporating in a foreign location that has favorable tax rates. The foreign location also normally has a territorial tax system and only taxes earnings generated in that country, unlike the U.S. system, which taxed all income regardless of source. This created additional opportunities to shift income from high tax locales to lower tax jurisdictions.

Congress enacted the Tax Cuts and Jobs Act of 2017 (U.S. House of Representatives 2017) in December 2017. Among the provisions to the Act are a reduction in the top corporate tax rate to 21 percent and a change to a territorial system of tax. As a result, incentives to engage in tax inversions should be substantially reduced.

Comparison of U.S. Corporate Tax Rates with Inversion Locations

As illustrated in Table 1, prior to passage of the Tax Cuts and Jobs Act of 2017 the top corporate statutory tax rate in the United States was 39 percent, which was higher than the top rate in most countries. The average worldwide tax rate in 2017 was 24 percent. Popular tax havens such as the Grand Cayman Islands, Bermuda, and the Bahamas have no corporate income tax. Seida and Wempe (2004) found the average post-inversion effective tax rate was 20.44 percent for a sample of 12 inversion firms compared to an average rate of 32.01 percent pre-inversion.

Territorial versus Global Tax System

Prior to passage of the Tax Cuts and Jobs Act of 2017, the United States had a worldwide or global tax system in which all income of a U.S. corporation was subject to taxation in the United States, regardless of whether the income was earned in the U.S. or another country. Many other countries use a territorial system in which income from foreign sources is generally exempt from tax. Both tax systems attempt to avoid double taxation of income. While the territorial system exempts foreign-sourced income from taxation, the global system includes tax credits for income taxes paid in other countries.

For example, if a U.S. company sells goods to a customer in Ireland, the company is subject to U.S. income tax on the profits from the sale. Any U.S. tax is reduced by tax credits for any tax that is paid in Ireland. While the tax credits eliminate double taxation, the global tax system also ensures that the U.S. taxpayer will not pay a combined tax to the two countries that is lower than what the tax would have been if the income were exclusively taxed by the U.S. That is, the company is effectively taxed in the U.S. on the difference between the U.S. income tax rate and the Ireland tax rate on the income earned in Ireland. However, tax on foreign-sourced income is generally not payable until the earnings are repatriated to the U.S.

The credit for foreign taxes paid does not address the fact that high U.S. corporate tax rates made the U.S. a relatively unattractive location for a multinational corporation. Lower global tax rates also make U.S. corporations attractive targets for acquisition by foreign companies, and foreign acquisitions of U.S. companies reached record levels in 2016. Of the 500 largest companies measured by revenue, 218 were U.S. companies in 1986, but this number decreased to 128 U.S. companies in 2016 (Carter and Christian 2016).

Earnings Stripping

An inversion allows a multinational corporation to avoid U.S. tax on foreign-sourced income that would have been taxed under the U.S. global tax system. However, U.S.-based earnings are still subject to U.S. corporate income tax. Additional tax savings can be achieved by shifting income from the U.S. to the lower-taxed foreign jurisdiction through a process known as “earnings-stripping.” This shifting of income is often done not only through the use of intercompany debt, but also can be done through other methods such as transfer pricing and royalty payments. Seida and Wempe (2004) examine the change in pre-tax foreign earnings for a sample of 12 inversion firms and conclude that much of the tax savings arising from an inversion is due to the avoidance of U.S. tax on U.S. earnings through such income-stripping techniques. U.S. Department of the Treasury regulations issued following a proposed merger between Pfizer and Allergan significantly limited the ability to use intercompany debt to reduce U.S. income taxes (Rubin 2016).

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3 In addition to the UAE, only Puerto Rico, a U.S. territory, and Comoros (not included in Table 1) had higher corporate tax rates than the United States. Following passage of the Tax Cuts and Jobs Act of 2017, the top corporate tax rate in the U.S. is now 21 percent.
TABLE 1
Selected Corporate Income Tax Rates
2017

<table>
<thead>
<tr>
<th>Country</th>
<th>Top Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Tax Havens</strong></td>
<td></td>
</tr>
<tr>
<td>Bahamas</td>
<td>0%</td>
</tr>
<tr>
<td>Bahrain</td>
<td>0%</td>
</tr>
<tr>
<td>Bermuda</td>
<td>0%</td>
</tr>
<tr>
<td>Grand Cayman Islands</td>
<td>0%</td>
</tr>
<tr>
<td>Guernsey</td>
<td>0%</td>
</tr>
<tr>
<td>Isle of Man</td>
<td>0%</td>
</tr>
<tr>
<td><strong>Selected Lowest Marginal Corporate Tax Rates</strong></td>
<td></td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>7.5%</td>
</tr>
<tr>
<td>Montenegro</td>
<td>9.0%</td>
</tr>
<tr>
<td>Bosnia and Herzegovina</td>
<td>10.0%</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>10.0%</td>
</tr>
<tr>
<td>Gibraltar</td>
<td>10.0%</td>
</tr>
<tr>
<td>Macedonia, The Former Yugoslav Republic of</td>
<td>10.0%</td>
</tr>
<tr>
<td>Paraguay</td>
<td>10.0%</td>
</tr>
<tr>
<td>Qatar</td>
<td>10.0%</td>
</tr>
<tr>
<td>Macao</td>
<td>12.0%</td>
</tr>
<tr>
<td>Ireland</td>
<td>12.5%</td>
</tr>
<tr>
<td>Liechtenstein</td>
<td>12.5%</td>
</tr>
<tr>
<td><strong>Highest Marginal Corporate Tax Rates</strong></td>
<td></td>
</tr>
<tr>
<td>United Arab Emirates</td>
<td>55.0%</td>
</tr>
<tr>
<td>United States—before 2018</td>
<td>39.0%</td>
</tr>
<tr>
<td>Argentina</td>
<td>35.0%</td>
</tr>
<tr>
<td>Congo, The Democratic Republic of the</td>
<td>35.0%</td>
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<tr>
<td>Malta</td>
<td>35.0%</td>
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<tr>
<td>Sudan</td>
<td>35.0%</td>
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<tr>
<td>Zambia</td>
<td>35.0%</td>
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<tr>
<td>France</td>
<td>33.3%</td>
</tr>
<tr>
<td>Japan</td>
<td>30.9%</td>
</tr>
<tr>
<td>Germany</td>
<td>29.8%</td>
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<tr>
<td>Canada</td>
<td>26.5%</td>
</tr>
<tr>
<td>Italy</td>
<td>24.0%</td>
</tr>
<tr>
<td>Russia</td>
<td>20.0%</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>19.0%</td>
</tr>
<tr>
<td><strong>Average Worldwide Tax Rate</strong></td>
<td>24.0%</td>
</tr>
</tbody>
</table>

**Tax Deferral on Permanently Reinvested Foreign Earnings**

U.S. Generally Accepted Accounting Principles (GAAP) generally require firms to record all incremental U.S. income tax and foreign withholding taxes on foreign earnings as if the earnings are repatriated in the current period. Even if the foreign earnings are not repatriated, the firm still records the additional taxes as a deferred tax expense. Accounting Principles Board (APB) Opinion No. 23 (ASC 740-30-25-17) provides an exception to this treatment by allowing firms to avoid recognizing a deferred tax expense on their financial statements if they designate the earnings as permanently reinvested. Thus, a tax expense is only reported when the multinational repatriates the earnings or no longer considers the earnings permanently reinvested.

Statement of Financial Accounting Standards (SFAS) No. 109, Accounting for Income Taxes, requires firms to disclose material amounts of permanently reinvested earnings and report the deferred taxes related to those earnings if they can be estimated (ASC 740-30-50-2). A multinational must also recognize income tax expense for U.S. taxes on foreign subsidiary earnings when it no longer considers earnings to be permanently reinvested. Thus, repatriating low-tax foreign earnings designated as permanently reinvested requires the firm to pay U.S. taxes and record a tax expense that decreases book income.
Krull (2004) finds evidence consistent with firms using the “permanently reinvested” designation due to tax and investment incentives to reinvest the earnings in foreign subsidiaries.

It is estimated that U.S. multinationals had $2.5 trillion in earnings accumulated overseas as of 2016 (Furner, Moore, and Morrow 2017), reducing the amount available for investment and employment opportunities in the U.S. Deferral of the U.S. portion of the tax on foreign earnings designated as permanently reinvested decreases companies’ effective tax rate reported under GAAP, thus increasing reported income. This positively influences stock prices and returns to shareholders, as well as executive compensation agreements (Furner et al. 2017).

III. WHAT IS A TAX INVERSION?

The tax treatment of foreign corporations provided an incentive for a U.S.-based corporation that had significant foreign income to alter its structure and emerge as a foreign corporation through an inversion. In an inversion, an entity domiciled in another country takes over a company that is established in the U.S. Following an inversion, the former shareholders of the U.S. corporation emerge as shareholders in the acquiring foreign corporation, and the legal location of the entity is now in the foreign nation that has lower tax rates. Although the legal location of the entity has changed, the operational structure and related locations where business is conducted usually remain essentially unchanged.

Foreign corporations, which are not “effectively connected” with a U.S. trade or business, are able to escape U.S. income tax on income that is not sourced to the U.S. As a result, an inversion transaction creates a new foreign entity that is not “effectively connected” to the United States, so when goods are sold from the foreign company to non-U.S. customers, there is no tax owed to the United States.

As an example, assume Simon Corporation is a U.S.-based company and pays an effective U.S. income tax rate of 30 percent. Humphrey Corporation is an Irish corporation in the same lines of business as Simon but is taxed at a 10 percent rate. If Simon and Humphrey complete an inversion, Simon would combine with Humphrey, typically either through an exchange of stock or assets, and operate exclusively as Humphrey. When business is conducted through Humphrey, income is sourced in Ireland, and avoids U.S. taxation.

When properly structured, inversions are legal transactions. However, critics argue that inversions result in significant loss of tax revenue to the U.S. federal government during a time of large budget deficits. Proponents argue that inversions are a response to high U.S. corporate tax rates.

Types of Tax Inversions

Although tax inversions by a U.S. corporation can take several forms, the primary forms are a stock inversion and an asset inversion, and some transactions are a combination of the two approaches. Regardless of inversion type, the result is a business that has moved its headquarters from the U.S. to a lower-taxed nation, but with little change in operations. However, inversions also involve tax consequences that need to be considered in structuring the transaction.

Asset Inversion

An asset inversion involves the transfer of assets from the U.S. parent company into the newly established parent corporation in exchange for stock in the foreign company. The existing U.S. shareholders receive shares in the new foreign parent. The event is a taxable event to the corporation. The taxable gain to the corporation is the excess of fair value of the assets over the U.S. corporation’s cost basis in those assets.

Stock Inversion

In a stock inversion, a new foreign parent company acquires the stock of the existing U.S. parent company, which becomes a subsidiary of the new parent. As an illustration, Figure 1 presents the structure of a stock inversion. The U.S. company shareholders exchange their stock for the stock of the new foreign parent. In contrast to an asset inversion, which is a taxable event to the corporation, a stock inversion is a taxable event to the shareholder. The gain recognized by shareholders is the difference between their basis and the fair market value of the stock exchanged. This potential negative impact on shareholders is diminished if the stock price is depressed or significant amounts of stock are held by non-taxable entities.

As this discussion illustrates, an inversion can have significant tax consequences on shareholders. When shares of stock are sold by the U.S.-based entity at the time the transaction closes, there may be a capital gains tax assessed on shareholders due to anti-inversion provisions that are governed under IRC Section 367 and known as a “toll charge.” At the time of the inversion, the stock of many entities had a depressed value, and structuring an inversion at the specific point in time when the stock is low minimizes this “toll charge” assessed to shareholders. Under IRC Section 7874, an inverted company will continue to be taxed
as a U.S. domestic entity if 80 percent or more of the company’s stock is held by the same shareholders before and after the inversion.

After a proposed inversion involving a $160 billion merger between Pfizer and Allergan, then-President Barack Obama called inversions “one of the most insidious tax loopholes out there.” He further noted that “the problem isn’t that companies are engaging in illegal activity, but what is legal in the first place” (Rockoff, Hoffman, and Rubin 2016). In April 2016, in an effort to crack down on “serial inverters,” the U.S. Treasury Department issued a temporary regulation and proposed regulation that would disregard the last three years of U.S. acquisitions when determining a foreign company’s size for purposes of meeting the 80-percent rule.

Allergan had been involved in a $25 billion takeover of Forest Laboratories in 2014 and a $66 billion combination with Actavis in 2015. Excluding those shares from Allergan’s market capitalization would make it too small to be Pfizer’s inversion partner and qualify for favorable tax treatment (Rockoff et al. 2016). The day after the proposed regulations were announced, Pfizer and Allergan announced that they were calling off the merger. However, the regulation was ruled invalid in Federal Court because the Treasury failed to follow the requirement for notice and comment on the regulations required under the Administrative Procedures Act (Chorvat 2017).

**History of Inversions**

The first known inversion occurred in 1983 when McDermott International—an engineering and construction company that was, at that time, incorporated in Delaware with headquarters in Louisiana—moved its tax residence to Panama (CBO 2017). The company argued that the ability to reinvest earnings without subjecting the earnings to U.S. tax would allow the company to compete more effectively with foreign competitors. The next inversion did not occur until more than ten years later in 1994, when Helen of Troy inverted to Bermuda. The long period between inversions may have reflected negative publicity and a failed lawsuit by the IRS against McDermott International (Hwang 2015).

The first wave of concentrated inversion activity came between 1999 and 2002, including the Transocean inversion. Politicians and others were critical of these tax inversions because of their potential negative impact on the U.S. tax base, and because they seemed unpatriotic during the period immediately following the September 11, 2001 terrorist attacks.

In response, in 2003 the U.S. Congress passed Internal Revenue Code (IRC) Section 7874 to restrict corporate inversions. IRC Section 7874 indicated that the U.S. would tax an inverted entity as a domestic corporation if the same shareholders held 80 percent or more of the firm’s stock before and after the inversion (Webber 2011). Although IRC Section 7874 did not prohibit inversions, it did slow the practice by effectively preventing paper inversions in tax havens such as Bermuda and the Grand Cayman Islands.

Inversion activity slowed in 2003, and there were no inversions in 2004 because the American Jobs Creation Act of 2004 placed new restrictions, which were retroactive to 2003, on the ability of U.S. companies to invert. However, because of high U.S. corporate tax rates and a global tax system that taxed U.S. companies on all income regardless of where earned, companies...
continued to pursue allowed inversion transactions through merger or an inversion with a foreign subsidiary with substantial business activities. As a result, in 2016 the U.S. Department of the Treasury issued proposed regulations to limit some of the potential benefits of a tax inversion.

In addition to the restrictions on serial inverter, the proposed 2016 regulations significantly changed earnings-stripping rules. Prior to the proposed regulations, after an inversion transaction occurred, a U.S. firm could borrow from its foreign parent and reap the benefit of deductible interest payments. This earnings-stripping process moved taxable income from the U.S. to the foreign parent, which had a much lower tax rate. In contrast, if the U.S. firm was the parent corporation, it could not benefit in the same way. Internal Revenue Code Subpart F requires that income U.S. companies receive from controlled foreign corporations is taxable income as earned.

IV. THE TRANSOCEAN INVERSIONS

Initial 1999 Inversion in the Grand Cayman Islands

Transocean was the first of five oil field services companies to complete an inversion when it relocated its corporate headquarters from the U.S. to the Grand Cayman Islands in 1999. The transaction was essentially a paper transaction, with no changes in business operations. The transaction involved both asset and stock transfers, with taxation at the corporate and shareholder level (Cloyd, Mills, and Weaver 2003). Transocean cut its global tax rate from 31.6 percent in 1999 to 16.9 percent in 2009 and saved over $2 billion in taxes in the decade following its inversion (Donmoyer 2010).

Move to Switzerland in 2008

The five oil field services companies that were among the earliest inverters moved their corporate headquarters to either Bermuda or the Grand Cayman Islands. However, due to concerns about proposed legislation that might increase their potential tax obligations, most of these companies moved again, either to Ireland or Switzerland (Webber 2011). Transocean was once again a first mover when it relocated to Switzerland in 2008. Because most European Union countries have “real seat” rules that require a business presence to determine a corporation’s tax home, Transocean indicated it would move its corporate offices to Switzerland.

In its preliminary proxy statement describing the move, Transocean noted that Switzerland has a developed and stable tax regime, with many tax treaties throughout the world. In contrast, the Grand Cayman Islands had no tax treaties and no system of taxation. Switzerland was friendlier to corporations and less willing to be cooperative in closing U.S. tax loopholes due to a pending crackdown by the Obama Administration on companies that used inversions (Sullivan 2008). In essence, while the move to the Grand Cayman Islands was primarily to reduce taxes, the move to Switzerland, where there is a corporate income tax, was primarily to reduce tax risk.

A Move Back to the United States in 2014 . . . Without the Taxes

In 2014, Transocean took action to partially move back to the U.S., but without tax liability on profits earned. In July 2014, under pressure from activist investor Carl Icahn, a spin-off of Transocean filed an initial public offering with the Securities and Exchange Commission to form a new entity as a Master Limited Partnership (MLP). Common within the oil and gas industry, an MLP is a publicly traded partnership that generates at least 90 percent of its income from what is referred to as a “qualifying source.” Qualifying sources are those that are related to the production, processing, and distribution of oil.

An MLP is treated as a pass-through entity at both the federal and state levels. As such, income from the MLP passes through to the owners, in which a significant stake is a spin-off overseas in a tax-free foreign nation. The benefit of the MLP is continued significant tax savings and easy access to U.S. markets to raise capital.

The parent Transocean entity retained a 49 percent ownership interest in the Transocean MLP, with the remaining 51 percent ownership interest held by the public. The public ownership added significant capital to the structure of the firm, which was used to create new drilling rigs that will continue to generate income sheltered from tax at the corporate level. However, Transocean reacquired the shares in the MLP in 2016, indicating that the change would simplify administration (Pulsinelli 2016).

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4 The definition of a qualifying source is defined under IRC Section 7704. Proposed regulations limit the definition of what is considered a qualifying source.
V. CONCLUSION

Transocean has a history of being an aggressive innovator in saving taxes, as illustrated by its initial move to the Grand Cayman Islands in 1999, its subsequent move to Switzerland in 2008, and its creation of a Master Limited Partnership subsidiary in 2014. Table 2 provides an overview of the taxes paid by Transocean during each of these periods.

The Tax Cuts and Jobs Act of 2017 significantly reduced the U.S. corporate tax rate, but it is uncertain whether the lower rate will be permanent and whether this will eliminate inversion activity. Although there have only been around 60 inversions, it is unclear if any of these companies will reestablish headquarters in the U.S. due to the lower tax rate.

VI. CASE REQUIREMENTS

1. Tax inversions have occurred infrequently over the past 30 years. Describe a tax inversion and the factors that impact a company’s decision to complete a tax inversion.

2. The earliest inversions were usually in tax haven countries. The companies subsequently relocated their headquarters to Europe. Why did these companies decide to move headquarters to European countries?

3. Most recent inversions either meet a substantial activities test or are accomplished through mergers. What companies are the most likely targets for these types of inversions?

4. A primary benefit of an inversion is avoiding U.S. tax on foreign-source income. How do multinational companies also use inversions to reduce U.S. tax on U.S.-source income?

5. Using the information in Table 2, calculate Transocean’s effective tax rate for each of the four years (1998, 2000, 2009, 2015). Estimate the dollar amount of the annual reduction in taxes for the initial move to the Grand Cayman Islands.

6. The Congressional Budget Office (2017) reports that 60 inversion transactions have occurred. The CBO estimates that the average annual reduction in U.S. tax expense for these companies is $65 million. What is the amount of total annual revenue loss to the U.S. government? What is the amount of total annual revenue loss to the U.S. government as a percentage of total corporate taxes (search for the total corporate taxes in the CBO report or other online source)?

7. The U.S. recently reduced the top statutory corporate tax rate from 35 percent to 21 percent. In addition, the U.S. changed from a global to a territorial tax system for multinational corporations. Evaluate the likely effects of these tax law changes on inversion activities.

8. Should companies be allowed to enter into inversions? Consider the perspective of shareholders and the U.S. Treasury in developing your response. Do you believe the changes in U.S. tax law to lower corporate taxes will eliminate inversion activity permanently?

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