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ECONOMIC ANALYSIS

Oil Drillers Gain Billions From 'Immoral' Tax Break

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Deepwater drilling can lead to monumental disaster. That our business and government experts did not fully comprehend that is a sure sign that our vital domestic oil and gas industry is broken. The catastrophe in the Gulf of Mexico has exposed how too much cost cutting and too little oversight can be a lethal combination. (See, for example, "Feds Let BP Avoid Filing Blowout Plan for Gulf Rig," *The Seattle Times*, May 5, 2010.)

There is something else not working well in the gulf: the tax system. No, we are not talking about those cash-only Cajun-country fishermen who never pay income tax and now lack records needed to receive compensation ("The Fishermen and the Tax Man," *Los Angeles Times*, May 30, 2010). We are talking about the two largest offshore drilling companies in the world, Transocean and Noble Corp., that are in reality headquartered in the Houston area but moved their legal domiciles first to the Cayman Islands and then to Switzerland to avoid U.S. tax. Calculations shown below indicate that those maneuvers have reduced their tax bills by more than $2 billion.

Transocean owned and operated the floating, dynamically positioned rig that exploded on April 20, leading to a loss of 11 lives and spilling hundreds of thousands of gallons of crude oil into the Gulf of Mexico.

The transaction in which a corporation changes its legal domicile from the United States to a foreign jurisdiction is referred to as an inversion or a corporate expatriation. These tax-motivated restructurings occur with little or no real change in day-to-day business operations. Top executives, key personnel, and all significant business operations in the United States before the transaction remain in the United States.

In general, a U.S. multinational is liable for U.S. tax on income from its worldwide operations. By inverting, a multinational is no longer subject to U.S. tax on income from its foreign operations. In addition, the transactions often are accompanied by planning techniques that strip income out of the United States. (See New York State Bar Association Tax Section report on outbound inversion transactions, *Tax Notes*, June 3, 2002, p. 1456, *Doc 2002-13085*, or *2002 TNT 105-34*.) Yet another tax benefit from inverting is that foreign stockholders (as well as U.S. tax evaders posing as foreign shareholders) are no longer subject to U.S. withholding tax on dividends paid from a foreign corporation.

Outrageous Shenanigans

Congress took the tax benefits out of standard inversion transactions when it enacted the American Jobs Creation Act of 2004, which added section 7874 to the code. The provision applies to inversion transactions completed on or after March 4, 2003. (Earlier versions of the legislation applied to transactions completed after September 11, 2001, and after March 20, 2002.)

During the long debate before enactment, inversions were defended by some conservatives who saw the transactions as a rational business move necessary to minimize taxes in the face of international competition. But mostly inversions were criticized and condemned. In April 2002 then-Senate Finance Committee ranking minority member Chuck Grassley, R-Iowa, stated: "These expatriations aren't illegal. But they're sure immoral."

> ***'These expatriations aren't illegal. But they're sure immoral,' Grassley said.***

A May 2002 report from the Bush Treasury Department concluded that "careful attention should be focused on ensuring that an inversion transaction, or any other transaction resulting in a new foreign parent, cannot be used to reduce inappropriately the U.S. tax on income from U.S. operations" ("Corporate Inversion Transactions: Tax Policy Implications," Department of the Treasury, *Doc 2002-12218*, *2002 TNT 98-49*). And in June 2002, then-House Ways and Means Committee ranking minority member Charles B. Rangel, D-N.Y., said: "We should listen to the people rather than big corporate contributors to Republican fundraisers, and stop permanently these companies from unfairly avoiding paying their fair share."

The general public widely considered corporate expatriation unpatriotic — an especially damning criticism after the September 11, 2001, terrorist

Effective Tax Rates Before and After Inversion Transactions by Four Oil Service Corporations (in millions of dollars)								
Transocean (Delaware)	**1994**	**1995**	**1996**	**1997**	**1998**			**Total**
Before-tax income	$20	$75	$122	$207	$487			$911
Income tax expense	$8	$28	$44	$65	$144			$288
Preinversion average effective tax rate								**31.6%**
Transocean (Cayman, Switzerland)	**2000-2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**Total**
Before-tax income	-$1,967	$240	$803	$1,607	$3,374	$4,772	$3,924	$12,753
Income tax expense	$3	$91	$87	$222	$253	$743	$754	$2,153
Postinversion average effective tax rate								**16.9%**
Tax saving from rate reduction on postinversion profits								**$1,882**
Noble (Delaware)	**1997**	**1998**	**1999**	**2000**	**2001**			**Total**
Before-tax income	$380	$231	$125	$226	$350			$1,312
Income tax expense	$116	$69	$30	$61	$86			$362
Preinversion average effective tax rate								**27.6%**
Noble (Cayman, Switzerland)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**Total**
Before-tax income	$187	$162	$364	$921	$1,489	$1,912	$2,016	$7,051
Income tax expense	$21	$16	$67	$189	$283	$351	$337	$1,265
Postinversion average effective tax rate								**17.9%**
Tax saving from rate reduction on postinversion profits								**$678**
Nabors (Delaware)	**1997**	**1998**	**1999**	**2000**	**2001**			**Total**
Before-tax income	$209	$200	$46	$227	$542			$1,224
Income tax expense	$73	$75	$18	$91	$194			$452
Preinversion average effective tax rate								**36.9%**
Nabors (Bermuda)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**Total**
Before-tax income	$175	$336	$857	$1,428	$1,032	$686	-$235	$4,278
Income tax expense	-$18	$33	$219	$435	$201	$206	-$149	$928
Postinversion average effective tax rate								**21.7%**
Tax saving from rate reduction on postinversion profits								**$652**
Weatherford (Delaware)	**1997**	**1998**	**1999**	**2000**	**2001**			**Total**
Before-tax income	$198	-$6	$28	$71	$339			$630
Income tax expense	$68	-$5	$8	$33	$123			$227
Preinversion average effective tax rate								**36.1%**
Weatherford (Bermuda, Switzerland)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**Total**
Before-tax income	$200	$431	$632	$1,239	$1,444	$1,690	$299	$5,935
Income tax expense	$52	$93	$161	$321	$323	$250	$20	$1,219
Postinversion average effective tax rate								**20.5%**
Tax saving from rate reduction on postinversion profits								**$923**

Source: All data are from company annual Forms 10-K filed with the SEC. When forms from different years show different figures, the figure from the latest form was used. In this table, Transocean data for the years 2000 through 2003 were combined to save space.

attacks. In the mainstream media, there were repeated references to these companies as "Benedict Arnold corporations." An editorial in *The New York Times* on May 13, 2002, commented: "Even in the best of times, it is outrageous for companies to engage in offshore shenanigans to avoid paying their fair share of taxes."

An unusually large concentration of inversion transactions have been conducted by companies in the oil services industry. In addition to Transocean and Noble, U.S.-based oil service companies that have inverted include Nabors Industries (headquartered in Houston), the nation's largest onshore drilling company, and Weatherford International (25 miles west of Fort Worth in Weatherford, Texas), a provider of a wide range of advanced oil field services. And in 2001 Houston-based Global Santa Fe Corp. was restructured as a Cayman Islands

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corporation and existed in that form until it was merged with Transocean in November 2007.

That's a total of five oil service companies — all operating out of Texas — that have inverted. Before Congress shut the door on inversions, about two dozen large corporations inverted (Jim Seida and William Wempe, ''Effective Tax Rate Changes and Earnings Stripping Following Corporate Inversion,'' *National Tax Journal*, Dec. 2004). So while the entire oil and gas extraction industry accounted for less than 1.5 percent of GDP (according to 2008 Commerce Department data), the oil services industry accounted for about one-fifth of all corporate inversions.

Offshore Drillers Go Offshore

Transocean completed the reorganization that changed its place of incorporation from Delaware to the Cayman Islands on May 14, 1999. In comments to shareholders before the reorganization, Transocean's management stated: ''Our expectation is that we will, over time, achieve a reduction of 10 to 20 percentage points in our effective rate.'' The table shows that prediction was correct. Transocean's effective tax rate before 1999 was 31.6 percent and after 1999 was 16.9 percent — a 14.8 percentage point reduction. If the preinversion tax rate of 31.6 percent had prevailed, Transocean would have incurred $1.88 billion of additional tax expense on the $12.8 billion of profits earned from 2002 through 2009.

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In December 2008 Transocean changed the place of incorporation of its parent holding company from the Cayman Islands to Switzerland. In a proxy statement mailed to shareholders the day after the 2008 presidential election, the company explained that it believed the move would ''substantially lower our tax risk related to possible tax legislation changes.'' As reported by the *Houston Business Journal* (July 24, 2009), the move from island tax havens to Switzerland by Transocean and other Houston-area corporations was a reaction to a possible crackdown on offshore avoidance by the incoming Obama administration.

Noble Drilling, a Delaware corporation, completed its restructuring to Noble Corp. of the Cayman Islands on April 30, 2002. In a proxy statement, it explained to shareholders that the move was caused by competitive pressures and ''inequitable treatment'' under U.S. tax law: ''The parent companies of certain of our competitors, including our two largest competitors [Transocean and Global Santa Fe], are incorporated in the Cayman Islands and other non-U.S. countries that impose either no tax or tax at rates substantially less than the United States.'' The table shows that Noble's effective tax rate before 2002 was 27.6 percent and after 2002 was 17.9 percent — a 9.7 percentage point reduction. If the preinversion tax rate of 27.6 percent had prevailed, Noble would have incurred $678 million of additional tax expense on the $7.1 billion of profits earned from 2002 through 2009. On March 26, 2009, Noble Corp. moved its legal residence from the Cayman Islands to Switzerland.

On June 24, 2002, Nabors Industries changed its place of incorporation from Delaware to Bermuda. In its 2002 annual report, Nabors estimated that this restructuring lowered its effective corporate tax rate by 9 percentage points in 2002. The table shows that Nabors's effective tax rate before 2002 was 36.9 percent and after 2002 was 21.7 percent — a 15.2 percentage point reduction. If the preinversion tax rate of 36.9 percent had prevailed, Nabors would have incurred $652 million of additional tax expense on the $4.3 billion of profits earned from 2002 through 2009.

On June 26, 2002, Weatherford International Inc. of Delaware became Weatherford International Ltd. of Bermuda. At the time, energy industry analysts estimated that the inversion could lower Weatherford's effective tax rate by one-third (*Houston Business Journal*, May 3, 2002). The table shows that Weatherford's effective tax rate before 2002 was 36.1 percent and after 2002 was 20.5 percent — a 15.6 percentage point reduction. If the preinversion tax rate of 36.1 percent had prevailed, Weatherford would have incurred $923 million of additional tax expense on the $5.9 billion of profits earned from 2002 through 2009. On February 26, 2009, Weatherford moved its legal residence from Bermuda to Switzerland.

Effective Date Lobbying

Of all the legislation proposed to combat corporate inversions in the early 2000s, the most important by far was the Reversing the Expatriation of Profits Offshore Act introduced by Finance Committee Chair Max Baucus, D-Mont., and Grassley on April 11, 2002. Its provisions would have applied to inversion transactions occurring after March 20, 2002. Noble, Nabors, and Weatherford completed their inversions after that date.

These companies were keenly aware of the problem and reported it to their shareholders as a major risk to their business. For example, Nabors's 2002 annual Form 10-K put it this way:

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> Because we cannot predict whether legislation ultimately will be adopted, no assurances can be given that the tax benefits associated with our reorganization ultimately will accrue to the benefit of the company and its shareholders.
>
> During 2002 the Senate Finance Committee approved legislation that, for United States federal tax purposes, would treat a corporation such as Nabors that reorganizes in a foreign jurisdiction as a domestic corporation and, thus, such foreign corporation would be subject to United States federal income tax. Substantially similar legislation was introduced during 2002 by the Chairman of the House Committee on Ways and Means. The proposed legislation did not pass during the 2002 session of Congress but is expected to be reintroduced during 2003 and may have a retroactive effective date for transactions completed after March 20, 2002.

But it turns out Nabors need not have worried. The provision that eventually became law moved the effective date forward about one year, leaving Nabors, Noble, and Weatherford unscathed. The Joint Committee on Taxation estimated that the original Baucus-Grassley legislation would raise $2.1 billion over 10 years. The revised version raised only $830 million over 10 years.

In January 2007 the Finance Committee needed revenue to offset the cost of a package of small-business tax incentives. Also, many members of Congress wanted to punish Nabors because it sought an extension of its special exception to the Jones Act that allows only U.S. companies to ship goods between U.S. ports and to and from oil rigs. Citing the fact that companies were given notice at the time that the legislation could be effective for transactions completed as early as March 2002, the Finance Committee passed a rollback of the inversion provisions of section 7874 to that date. The JCT estimated that that change — catching Noble and Weatherford as well as Nabors — would raise $1.2 billion.

But a funny thing happened before the provision came up for consideration in the House. According to a report in *The New York Times* (''The Congressman, the Donor and the Tax Break,'' Nov. 24, 2008), Nabors CEO Eugene M. Isenberg and tax lobbyist Kenneth Kies met with Rangel on February 12, 2007, the same day the Ways and Means Committee was considering the Senate inversion proposal. Citing his opposition in general to retroactive tax hikes, Rangel opposed the Senate provision. Isenberg subsequently pledged $1 million for the Charles B. Rangel Center at City College of New York. ''What is clear is that Mr. Rangel played a pivotal role in preserving the tax shelter for Nabors and the other companies in 2007,'' the *Times* reported.

Both Rangel and Isenberg hotly disputed that there was any link between Isenberg's contribution to the Rangel Center and Rangel's opposition to the Finance Committee provision that Isenberg sought to kill. Nevertheless, the Rangel-Isenberg relationship is often cited as one of a series of factors leading to Rangel's resignation as chair of the Ways and Means Committee in March 2010.

Ball in Obama's Court

In a recent speech at Carnegie Mellon University, President Obama spoke of ''rolling back billions of dollars of tax breaks to oil companies so we can prioritize investments in clean energy research and development.'' Most likely he was referring to his budget proposals to cut industry tax benefits, including percentage depletion, the domestic manufacturing deduction (as it applies to the oil and gas industry), and expensing of intangible drilling costs. Obama's list of tax increases on the oil industry does not include any reduction in the billions of dollars of inversion tax benefits enjoyed by some of the largest oil service companies.

One simple way of curtailing tax benefits of corporate expatriation would be to change the effective date for application of section 7874. That was the action taken by the Finance Committee in 2007. In March 2002 Sen. Paul Wellstone introduced anti-inversion legislation (S. 2050) that would apply to all inverted companies regardless of the date the inversion transaction took place.

> ***Under the Doggett proposal, foreign corporations managed and controlled in the United States would be treated as domestic corporations for tax purposes.***

Another method would be to adopt the approach taken in the International Tax Competitiveness Act of 2010 (H.R. 5328, *Doc 2010-11125*, *2010 TNT 97-15*) introduced by Ways and Means member Lloyd Doggett, D-Texas, on May 18 and in the Stop Tax Haven Abuse Act introduced by Sen. Carl Levin, D-Mich., chair of the Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations, on March 2, 2009. Under U.S. law, the residence of a corporation is determined by its legal domicile. Under the proposed legislation, foreign corporations managed and controlled in the

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United States would be treated as domestic corporations for tax purposes. In effect, Doggett and Levin are proposing that the United States adopt the ''management and control test'' for determining corporate residency that most of the rest of the world already uses. These bills have a broader scope than pure anti-inversion measures because they apply not only to existing entities that expatriate, but also to businesses (like hedge funds) that actually conduct most of their business in the United States but have always been legally domiciled outside the United States, usually in tax havens.

Using either method, eliminating future tax benefits for expatriate corporations in the oil industry would be consistent with the president's goals of tilting tax benefits away from fossil fuels and of raising revenue by suppressing aggressive tax avoidance by U.S. multinationals using shell companies in tax havens. ■

NEWS ANALYSIS

Living With GAAR Lite?

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Following codification of the economic substance doctrine earlier this year, practitioners and government officials have debated just how extensively the new statutory provision applies the common-law test to tax planning.

Taxpayers and their lawyers worry that traditional areas of tax planning might be subject to challenge based on less-than-clear definitions of what constitutes a transaction, what expenses feed into a profit calculus, and the new attendant strict liability penalty. They are trying to put the burden on the IRS to clearly delineate areas where planners can continue working without the threat of dispute.

That raises an important question for the government: Can the IRS, if it so desires, treat economic substance codification as implementation of a general antiavoidance rule?

> ***Can the IRS, if it so desires, treat economic substance codification as implementation of a GAAR?***

Some foreign legal observers are calling section 7701(o), the statute now containing economic substance codification, the United States' first statutory GAAR. In ''The U.S. GAAR,'' an article written by John Prebble of the Victoria University of Wellington in New Zealand and published on TaxProf Blog on May 25, the author notes that just as a standard GAAR gives a revenue administrator authority to void a transaction and impose tax on the reconstructed transaction instead, ''the economic substance doctrine tells the Commissioner to disregard the parties' legal transactions and instead to tax the economic substance that lies behind those transactions.''

Many government officials have spent the past couple of months claiming that codification has not changed the underlying common-law tests that courts apply when it is determined that economic substance is relevant. But as Prebble points out, that view ignores the reality that the statute, apart from requiring a conjunctive test, has added new elements inconsistent with a strict adoption of prior judicial case law. Requiring analysis of a transaction based on the relative benefits, including regulatory authority for guidance on the treatment of foreign taxes for such purposes, seems to squarely place the statute in a less-demanding GAAR form.

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