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## **Offshore Drilling and Taxes**

### **Gulf Oil Spill Highlights Problems with the U.S. International Tax System**

The explosion of the Deepwater Horizon drilling rig has focused the world's attention on the environmental disaster in the Gulf of Mexico. It also reminds us of another disaster — the U.S. international tax system. Recent reports about the companies involved in the Gulf oil spill highlight some of the problems with the U.S.'s morass of international tax loopholes.

#### **Corporate Inversions**

U.S. multinational companies have avoided billions of dollars in U.S. taxes by moving their headquarters from the U.S. to offshore tax havens. Typically the restructuring is done by creating a new foreign corporation in a low-tax jurisdiction. The U.S. and foreign companies included in the multinational corporation become subsidiaries of the new foreign corporation which becomes the parent company. The multinational is no longer subject to U.S. taxes on its worldwide income, and can more easily shift its U.S. profits offshore.

Here's the rub: while the company moves its headquarters on paper, its operating headquarters continues to be in the U.S. So the company enjoys all of the advantages of being located in the U.S. without paying its fair share of taxes for those benefits. The U.S. military and law enforcement protect its physical assets, the courts enforce its contracts, and the federal and state governments provide critical infrastructure, an educated workforce, research, and a stable economic system with access to our country's rich marketplace.

Transocean, Ltd., the owner and operator of the Deepwater Horizon drilling rig has its real corporate headquarters in Houston, Texas. But the company "relocated" on paper from Texas to Delaware, then to the Cayman Islands in 1999, and finally to Switzerland in 2008. Transocean has saved an estimated \$2 billion in taxes because of its corporate inversion. Four other large oil service companies located in Texas have "relocated" their headquarters using this scheme.

The American Jobs Creation Act of 2004 included a provision to take away the tax benefits from these paper relocations. But it did nothing to stop the tax benefits from continuing to be available to companies that had already pretended to move.

Congressman Lloyd Doggett (D-TX) has introduced a bill that would tax these companies as U.S. companies from now on. The International Tax Competitiveness Act of 2010 would treat companies that are managed and controlled in the U.S. as U.S. corporations for tax purposes. The provision would not be retroactive — it would only change the tax treatment of profits after the effective date.

## **Transfer Pricing**

In general, transfer pricing is the way multinational corporations account for transfers of goods and services between their divisions or subsidiaries. Companies get to deduct the price they pay for goods or services they purchase in the course of business. The same is true when a company pays for a good or service transferred to it from one of its subsidiaries, except that there isn't a true "sale" or "price" because the transfer is internal to the corporate group. The "price" of the transfer is therefore easy to manipulate but it is nonetheless deductible by the company that pays it. So corporations have a lot of incentive to inflate the price of goods and services "sold" to a U.S. company or subsidiary from a subsidiary in a low-tax jurisdiction. The U.S. companies can thus claim large deductible expenses that reduce their U.S. taxable income. As a result, U.S. profits are shifted to subsidiaries in low-tax (or no-tax) jurisdictions.

Transocean is one of many companies that is in trouble with the IRS and tax authorities in other countries over the way it accounts for those transfers. Transocean's financial statements indicate a potential liability of \$1 billion in additional taxes related to its dubious transfer pricing methods.

One of the tax assessments in Norway, for example, relates to an oil rig that was being moved from a repair yard in Norway to a drilling site in the Norwegian sector of the North Sea. During the move, the rig was diverted into British waters for several hours and the ownership of the rig was transferred. Transocean claimed that the transaction was not subject to Norwegian tax because the transfer happened offshore.

Another of Transocean's outstanding tax disputes involves the transfer of "intangible" assets. Transfer pricing is a particularly thorny issue when intangible assets are involved. Multinational companies often transfer intangible assets, such as a patent, to a subsidiary in a low-tax jurisdiction which then charges its parent company large, tax-deductible royalties for the use of the patent in the U.S. or other country with a real tax system, thus shifting the income to the lower-tax country. Transocean's transfers relate to the creation of intangible assets for engineering services between subsidiaries.

## **Payroll Taxes**

In addition to aggressively reducing their income taxes, multinational companies also often avoid paying U.S. payroll taxes on their U.S. workers by employing them through an offshore subsidiary. The most infamous example is KBR (Kellogg, Brown, & Root), a former subsidiary of Halliburton (also working on the Deepwater Horizon rig), which paid U.S. civilian workers in Iraq through a Cayman Islands subsidiary and avoided over \$100 million in payroll taxes.

A 2008 tax bill "closed" the loophole, but only for companies providing services under contract with the U.S. government.

## **Fixing the U.S. International Tax System**

When problems with the U.S. tax system are explored, the discussion often turns to the need for a complete overhaul. Although that might be the preferable route, there is no reason to delay addressing the egregious abuses discussed above until (if ever) Congress has the time and political will to examine our entire international tax system.