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Does Corporate Inversion Lead to Tax Savings?

By

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Advisor: Dr. Karen Pincus

**An Honors Thesis in partial fulfillment of the requirements for the degree of Bachelor of
Science in Business Administration in Accounting**

**Sam M. Walton College of Business
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Introduction

In August 2014, the unexpected announcement of Burger King's plan to move its corporate headquarters to Canada through their merger with Tim Horton's drew ire from not only members of Congress, but also the president himself. In a direct response to Burger King and other U.S. corporations who might be contemplating similar corporate inversions, the White House vowed to issue an executive order to curb companies from escaping taxes by taking up residence in a foreign nation. While the inversion controversy has been reported upon intermittently for many years, the recent activities of high-profile companies like Burger King and Pfizer has led to more press on this subject. So what is corporate inversion and why has it caused so much dissension?

A corporate inversion occurs when an American corporation acquires or merges with a foreign-domiciled company. As a result, the corporate structure of the American company becomes "inverted" by legally altering its place of incorporation. The foreign company becomes the legal parent company through the transaction, and shares of the former U.S. company are typically converted to shares of the newly formed entity. However, significant changes in operations rarely accompany corporate inversions (Seida & Wempe, 2004). The newly formed entity continues to function as it did pre-inversion, specifically the physical locations of its U.S. facilities, employees, and operations. In addition to the official change of address, there can be legal and regulatory ramifications. For example, an inverted U.S. firm listed on the New York Stock Exchange could choose to adhere to "International Financial Reporting Standards" (IFRS) instead of U.S. "Generally Accepted Accounting Principles" (GAAP).

In many instances, the foreign entity was incorporated in a nation that levies a corporate income tax at a low or nil rate, otherwise known as a tax haven. Furthermore, as noted in the

inversions of Weatherford International, Aon Corporation, and Cooper Industries the foreign company was initially registered and established as a subsidiary of the American company itself. This form of inversion is known as a “naked inversion” since it does not demand any major changes in control due to the prior associations of the two companies.¹

The primary motivation behind a corporate inversion is simple, to reduce a corporation’s tax burden. It is believed that corporate inversions lead to lower effective tax rates, improved cash flows, and overall higher earnings that gives American companies the competitive advantage to thrive in a globalized economy. On July 18, 2014, chief executive officer of Abbott Laboratories, Miles White, defended corporate inversions in an op-ed piece in the Wall Street Journal. He is quoted as saying, “In terms of global competitiveness, the U.S. and U.S. companies are at a substantial disadvantage to foreign companies. Taxes are a business cost. Our disproportionately higher tax rate puts foreign companies at a huge advantage competitively.” This rationale is shared among executives of American companies who have chosen to invert. The supposed improvement in financial performance through the result of inversions is congruent with the beliefs of profit-motivated organizations.

Another reality of corporate inversions is the relocation to nations who abide by a territorial tax system. This type of tax system only taxes income that is derived from the nation in which it is earned. However, the U.S. subjects its corporate residents to residential taxation. In this less common system, a corporation owes taxes on all worldwide income regardless of where the income is sourced. In theory, an American company is liable for U.S. tax on profits it claims were made offshore if it wants to repatriate the money back domestically. However, once a

¹ There has been legislation passed to prohibit this form of inversion, and is further discussed on page 4.

corporation reincorporates as foreign, the profits it claims were earned for tax purposes outside the U.S. become fully exempt from U.S. tax.

Even though a foreign corporation still owes U.S. tax on profits it reports were earned in the U.S., corporate inversions are often followed by the practice of “earnings-stripping”. The corporation makes its remaining U.S. profits appear to be earned in other countries in order to avoid paying U.S. taxes on them. For example, a corporation can do this by encumbering the American part of the company with debt owed to the foreign part of the company. The “interest payments” on the debt are tax deductible, officially reducing American profits, which are effectively shifted to the foreign part of the company. This method was popular for many years before the “Revenue Reconciliation Act” was passed in 1989. This bill led to the addition of Section 163(J) to the IRS Code in an effort to curb abusive earnings-stripping strategies. This section disallows the deduction of interest expense if the ratio of debt to equity of the corporation exceeds 1.5:1 (26 USC §163j).

Recently, a common method being used to employ earnings-stripping are royalty payments. Let’s say that the foreign segment of a corporation owns the rights to intellectual property such as a patent for a product. They will then grant the American part of the company the right to sell this patented product. In return, they will have pay an agreed upon amount for this right, otherwise known as a royalty. Royalty payments are an effective mechanism to reduce American taxable income since they’re classified as an expense. The foreign part of the company continues to receive all of the profits from this exploitation, meanwhile they shift their tax burden to lower taxed jurisdictions.

In 2004, Congress passed the “American Jobs Creation Act” which included legislation to crack down on inversions. Moreover, this bill annexed Section 7874 to the IRS Code. Section

7874 contains certain requirements in order for a U.S. corporation to reincorporate to a foreign tax jurisdiction. If the company fails to meet any of these requirements, it will be treated and deemed as a U.S. corporation for tax purposes. First, the foreign corporation must “substantially” acquire all of the properties of the U.S. corporation (26 USC §7874a). Second, after the acquisition, the former U.S. company’s shareholders cannot hold more than 80% of the new company (26 USC §7874a). However, if the former U.S. company’s shareholders own at least 60% but still less than 80% of the new company the inversion is subject to a certain stipulation. The government will recognize the legitimacy of the inversion, but the corporation is subject to a ten year penalty that taxes the entity on all “inversion gains”. Lastly, the U.S. company must have “substantial business activities” in the jurisdiction where it wishes to relocate (26 USC §7874a). In 2006, an addendum was added to Section 7874 defining substantial business activities. The newly formed company must have at least 10% of its employees, property, and income in the country where it relocates its corporate residence. This requirement was seen as the biggest obstacle for corporations who desired to invert. Especially, if the inversion destination was somewhere like the Cayman Islands or Bermuda. Nevertheless, many corporate inversions still were able to pass this business activity test. Consequently, this resulted in an amendment to the statute. In 2012, the activity requirement was increased to 25% in an effort to further curb inversions.

The number of corporate inversions has grown exponentially over the last decade mainly due to an antiquated tax code and partisanship in Congress. Since 1983, seventy-six corporate inversions have taken place, with 47 of those occurring in the last decade. Countries such as the Cayman Islands and Bermuda that do not tax corporate income were attractive destinations for inverting firms prior to anti-inversion legislation. In recent years, nations like the United

Kingdom have become popular due to the combination of favorable tax rates and the ability to meet the business activity test. The Joint Committee on Taxation estimates that corporate inversions could cause \$34 billion in lost tax revenue over the next ten years (Barthold, 2014). Politicians and economists alike have scrutinized this practice stating that many of these U.S. corporations who have inverted or plan to invert are heavily dependent upon America's infrastructure and property laws. Therefore it becomes easier to understand why this controversial practice has drawn condemnation, with President Obama even going as far as calling corporate inversions an "unpatriotic tax loophole" (Obama, 2014).

Corporations that choose to invert, argue that this action allows them to remain competitive due to the nature of U.S. corporate tax rates. The U.S. corporate income tax rate which is 35%, is considered one of the highest nominal tax rates in the developed world. However, a study done by the Citizens of Tax Justice (non-partisan research group) found that between 2008 and 2012 the average effective tax rate for U.S. corporations was 19.4% (McIntyre, 2014). With certain industries such as utilities paying an average effective tax rate of 2.9% (McIntyre, 2014). This is a far cry from the 35% tax rate listed in the corporate tax schedules. This raises the question; do U.S. companies really realize tax savings when they perform an inversion?

This thesis investigates the tax implications of U.S. companies that employ the practice of corporate inversion. I have selected eleven companies that have utilized this strategy, and have conducted research to determine if corporate inversion results in a tax savings when compared to a matched set of non-inversion companies. For my research, I will compare the tax liabilities of the selected companies both before and after the inversion has occurred.

Methodology

I investigated the financial ramifications of corporate inversions using a sample of eleven inversion firms and nine matched control firms (two matched firms were used more than once) as seen in Table 1 and 2 below. The matched control firms were chosen by three sets of criteria. First, the matched firm had to operate within the same industry of the inverted firm. To ensure this, both firms had to have identical four digit SIC codes. The “Standard Industrial Classification” (SIC) is a code used by U.S. government agencies to classify companies by industry and common characteristics. However, all three matched firms for Cooper Industries, Pentair Incorporated, and Eaton Corporation did not possess the same SIC code. These three firms operate in a myriad of segments within Diversified Industrials, making it difficult to locate a matched firm using the criteria described above. Therefore, I used Hoovers.com to select a matched firm that operates as a direct competitor and offers similar product lines. Second, the matched firm had to be within 20% of total revenue during the year of inversion, in comparison to the inverted firm. Third, the matched firm had to be incorporated and legally domiciled in the United States. In addition, the matched firms are aligned in time with the business of the respective inverted firm.

Table 1: Sample of Inverted Firms

Name of Firm	Year of Inversion	New Corporate Residence	SIC Code	Industry
Transocean Incorporated	1999	Cayman Islands	1381	Oil & Gas Drilling
Global Marine Incorporated	2001	Cayman Islands	1381	Oil & Gas Drilling

Weatherford International	2002	Bermuda	3533	Oil & Gas Machinery and Equipment
Noble Corporation	2002	Cayman Islands	1381	Oil & Gas Drilling
Nabors Industries	2002	Bermuda	1381	Oil & Gas Drilling
Ensco International	2009	United Kingdom	1381	Oil & Gas Drilling
White Mountains Insurance	1999	Bermuda	6331	Fire, Marine, and Casualty Insurance
Aon Corporation	2012	United Kingdom	6411	Insurance Brokerage & Services
Cooper Industries	2002	Bermuda	3670	Electronic Components & Accessories
Pentair Incorporated	2012	Switzerland	3550	Special Industry Machinery
Eaton Corporation	2012	Ireland	3590	Miscellaneous Industrial Machinery & Equipment

Table 2: Sample of Matched Control Firms

Name of Firm	Name of Matched Firm	SIC Code	Industry
Transocean Incorporated	Helmerich & Payne Incorporated	1381	Oil & Gas Drilling

Global Marine Incorporated	Pride International	1381	Oil & Gas Drilling
Weatherford International	FMC Technologies	3533	Oil & Gas Machinery and Equipment
Noble Corporation	Diamond Offshore Drilling	1381	Oil & Gas Drilling
Nabors Industries	Pride International	1381	Oil & Gas Drilling
Ensco International	Helmerich & Payne Incorporated	1381	Oil & Gas Drilling
White Mountains Insurance	HCC Insurance Holdings	6331	Fire, Marine, and Casualty Insurance
Aon Corporation	Marsh & McLennan Companies	6411	Insurance Brokerage & Services
Cooper Industries	Danaher Corporation	3823	Industrial Instruments for Measurement & Display
Pentair Incorporated	Flowserve Corporation	3561	Pumps & Pumping Equipment
Eaton Corporation	Illinois Tool Works	3560	Industrial Machinery & Equipment

This thesis examines whether a corporate inversion results in a reduction of the effective tax rate. To test this, I took into consideration the firm's pretax income, income tax provision, and effective tax rate over a five year period. Furthermore, I sorted total revenue and pretax income for each sample firm by domestic and foreign to see if there was any evidence of earnings stripping post-inversion. The "inversion period" is defined as two years prior to the inversion (Years 1 & 2), the year of inversion (Year 3), and two years following the inversion (Years 4 & 5). The firm's pretax income and income tax provision are both listed in the

consolidated statement of income found on form 10-K. This form is an annual filing required by the U.S. Securities and Exchange Commission for public corporations. The tax provision is the sum of both current and deferred income tax expenses. A deferred tax expense represents the portion of the income tax expense that will be paid in future years. The deferred portion is included because it is a bona fide expense and provides an accurate reflection of the total tax burden.

As noted in the introduction, following many corporate inversions is the practice of earnings stripping. In theory, this practice works in conjunction with a corporate inversion because it results in the lowering of American pretax income. In turn, this should result in the reduction of the effective tax rate. There are a myriad of methods in which earnings-stripping can be employed. Admittedly, by only analyzing the information provided in the firm's 10-K, I cannot be absolutely certain of the exact method used to execute this practice. However, I can conclude whether or not this practice was utilized by separating pretax income into U.S. and foreign. I selected one firm per industry who I believed engaged in this practice, and calculated U.S. and foreign pretax income as a percentage of total pretax income during the five year period. I then compared the percentage of pretax income derived from the U.S. two years prior to the inversion and two years following the inversion.

The effective tax rate is calculated by dividing the income tax provision by pretax income. I calculated the effective tax rate over the five period for my sample of inverted and matched firms. Moreover, I first compared the effective tax rates in the years following the inversion to the years prior to the inversion to see if there were any material differences. Next, I compared the effective tax rates of the inverted firms to their respective matched firms. The purpose of this was examine the tax burden of an U.S. domiciled corporation similar in size and

operations in comparison to the inverted company. For further comparison, I calculated the average effective tax rate by industry for the inverted and matched firms over the five year period. I excluded any tax benefits (negative effective tax rates) from the calculation since it significantly skews the average, and in all instances the benefit resulted from non-recurring events unrelated to the inversion.

Oil & Gas Results

The effective tax rates for the six sample firms who operate in the Oil & Gas industry is noted in Table 3 below. Using the data in Table 3, the average effective tax rate in the two years following the inversion decreased by 9.5% in comparison to the average rates of years one through three.

Table 3: Effective Tax Rates for Inverted Oil & Gas Companies

	Pre-Inversion		Inversion Year	Post-Inversion	
	Year 1	Year 2	Year 3	Year 4	Year 5
Transocean Incorporated	10.9%	8.7%	-19.0%	25.4%	23.8% ²
Global Marine Incorporated	22.4%	26.7%	38.4%	11.1%	11.2%
Weatherford International	46.2%	36.3%	44.3%	26.0%	21.5%
Noble Corporation	26.8%	24.6%	13.9%	11.0%	9.7%

² Transocean was the only firm in all of my samples in which the ETR increased post-inversion. This could be in part that a material amount of income was earned in higher taxed jurisdictions following the inversion compared to the pre-inversion period. However, I cannot be certain since their 10-K's did not provide a breakdown of sales or pretax income by region.

Nabors Industries	40.2%	35.9%	13.7%	-10.7%	9.9%
Enco International	20.9%	17.3%	18.6%	14.9%	17.8%
Average ETR³	27.9%	24.9%	25.8%	17.7%	15.7%

Meanwhile, Table 4 below, contains the effective tax rates for the four matched firms who throughout the five year period are legally domiciled in the U.S.

Table 4: Effective Tax Rates for Matched Oil & Gas Companies

	Year 1	Year 2	Year 3	Year 4	Year 5
Helmerich & Payne Incorporated ⁴	35.7%	37.2%	39.6%	42.2%	39.6%
Pride International ⁵	29.4%	31.6%	31.8%	30.0%	26.3%
FMC Technologies	25.1%	38.0%	29.0%	29.1%	26.6%
Diamond Offshore Drilling	34.8%	34.9%	35.0%	10.7%	-105.0%
Pride International ⁶	31.6%	31.8%	30.0%	26.3%	62.8%

³ Excluded Transocean Year 3 and Nabors Year 4 in the calculation of the average effective tax rate since both companies incurred a tax benefit and neither tax benefit can be attributed to the inversion.

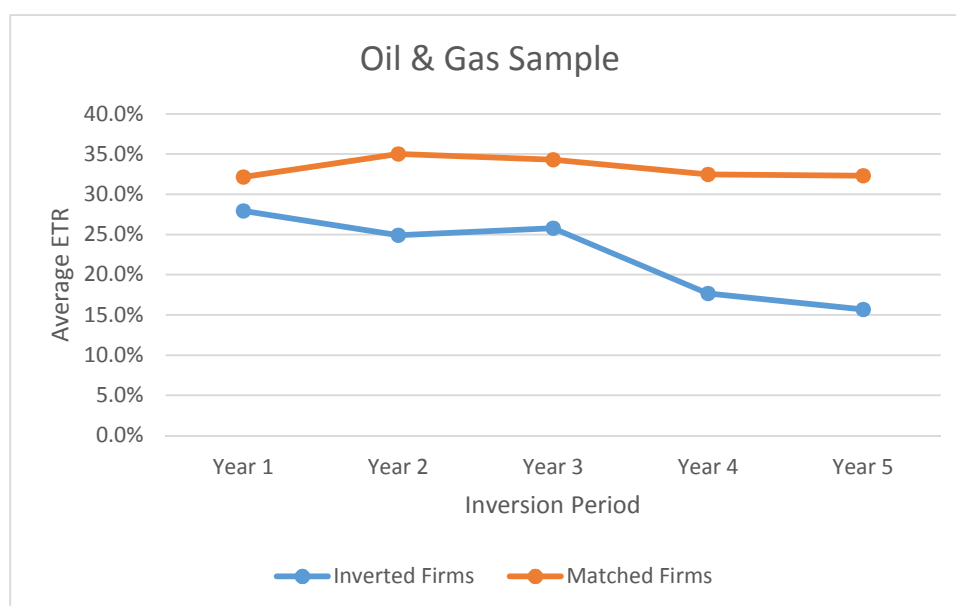
⁴ For the period between 1997-2001

⁵ For the period between 1999-2003

⁶ For the period between 2000-2004

Helmerich & Payne Incorporated ⁷	36.4%	36.5%	40.4%	34.7%	36.7%
Average ETR⁸	32.2%	35.0%	34.3%	32.5%	32.3%

As evidenced by the data above and the graph below, the six inverted firms on average benefited from the inversion especially in comparison to their respective matches.



The decline in effective tax rates can also be attributed to the practice of earnings stripping, which typically follows an inversion. As I said in the introduction, a corporate inversion is just an official change of address and has minimal impact on operations. This should result in the reorganized company still reporting a significant amount of income earned in the U.S. following the inversion, which would essentially nullify the purpose of inverting since a

⁷ For the period between 2007-2011

⁸ Excluded Diamond Offshore Year 4 and Year 5 since there were pretax losses both years. Excluded Pride International Year 5 (62.8%) due to non-recurring debt refinancing charges reducing income without a proportional reduction to income taxes.

substantial portion of income would still be taxed at the same rates prior to redomestication.

Table 5 below, provides the percentage of reported sales and pretax income by U.S. and foreign operations for Nabors Industries.

Table 5: Percentage of Sales and Pretax Income for Nabors Industries

	Sales by Region		Pretax Income by Region	
	United States	Rest of the World	United States	Rest of the World ⁹
2000	79.5%	20.5%	65.8%	34.2%
2001	84.0%	16.0%	83.3%	16.7%
2002 ¹⁰	68.4%	31.6%	-20.0% ¹¹	120.0%
2003	61.0%	39.0%	-110.2% ¹²	210.2%
2004	62.8%	37.2%	7.7%	92.3%

As you can see, U.S. sales accounted for at least 50% of total sales each year during the five year period. However as noted in Table 3, Nabors' effective tax rate notably decreased following their inversion in 2002. Logically, this means that Nabors had to engage in some form of earnings stripping to lower U.S. pretax income and shift those same earnings through inter-company means to a lower taxed jurisdiction. In 2004, Nabors' foreign operations accounted for only 37.2% of total sales as illustrated in Table 5. However, foreign operations accounted for a staggering 92.3% of total pretax income during that same year. This resulted in an effective tax rate of 9.9% in 2004.

⁹ Nabors' 10-K's did not provide a country by country breakdown of foreign pretax income. Nevertheless, the assumption can be made that these foreign nations tax at a significantly lower rate.

¹⁰ The inversion occurred in 2002. The two years prior and subsequent represent the pre and post-inversion periods respectively.

¹¹ Reported a U.S. Pretax Loss of \$28,157,000. However, reported total Pretax Income of \$140,774,000.

¹² Reported a U.S. Pretax Loss of \$192,405,000. However, reported total Pretax Income of \$174,623,000.

Insurance Results

The effective tax rates for the two sample firms that operate in the Insurance industry are noted in Table 6 below. Using the data in Table 6, the average effective tax rate in the two years following the inversion, decreased by 13.0% in comparison to the average rates of years one through three.

Table 6: Effective Tax Rates for Inverted Insurance Companies

	Pre-Inversion		Inversion Year	Post-Inversion	
	Year 1	Year 2	Year 3	Year 4	Year 5
White					
Mountains	39.4%	36.8%	32.9%	12.0%	41.3%
Insurance					
Aon					
Corporation	28.3%	27.3%	26.1%	25.4%	18.9%
Average ETR¹³	33.8%	32.0%	29.5%	18.7%	18.9%

Meanwhile, Table 7 below, contains the effective tax rates for the two matched firms that throughout the five year period stayed legally domiciled in the U.S.

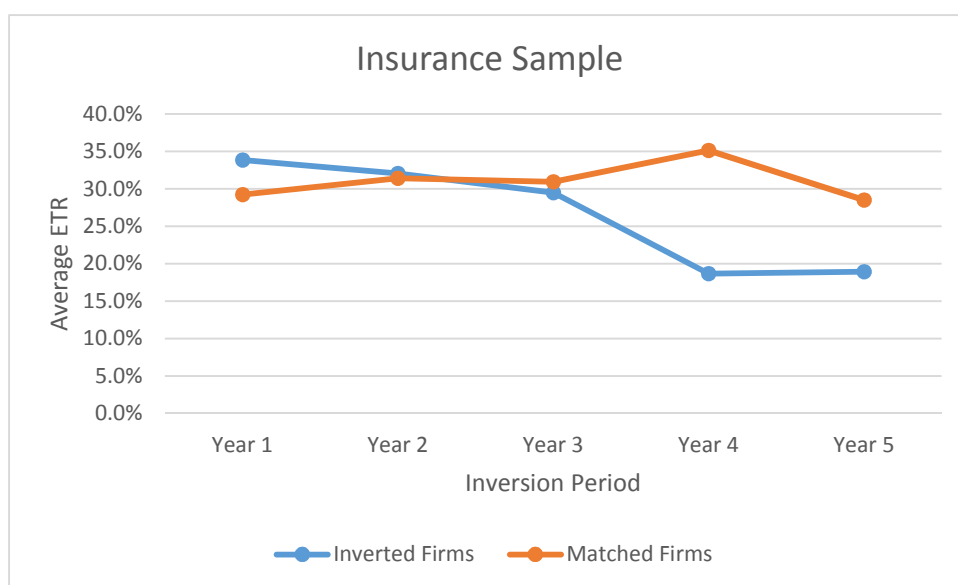
Table 7: Effective Tax Rates for Matched Insurance Companies

	Year 1	Year 2	Year 3	Year 4	Year 5
HCC Insurance					
Holdings	31.9%	32.8%	32.8%	40.2%	50.0%

¹³ Excluded White Mountains Year 5 due to a pretax loss of \$422,000,000 and tax benefit of \$174,300,000 which stemmed from the effects of deferred credit amortization, unrelated to the inversion.

Marsh &					
McLennan	26.5%	30.1%	29.0%	30.1%	28.5%
Companies					
Average ETR¹⁴	29.2%	31.4%	30.9%	35.1%	28.5%

As evidenced by the data above and the graph below, the two inverted firms on average benefited from the inversion especially in comparison to their respective matches.



I selected Aon Corporation from my sample, to analyze whether there seemed to be any evidence of earnings stripping following their inversion in 2012. Table 8, provides a percentage of reported sales and pretax income by U.S. and foreign operations for the sample firm.

¹⁴ Excluded HCC Insurance Year 5 because the abnormally high effective tax rate was the result of a non-recurring goodwill impairment charge related to their exit from the worker's compensation service line of business. The impairment was not tax deductible.

Table 8: Percentage of Sales and Pretax Income for Aon Corporation

	Sales by Region		Pretax Income by Region	
	United States	Rest of the World	United States	Rest of the World
2010	39.9%	60.1%	2.0%	98.0%
2011	45.5%	54.5%	21.7%	78.3%
2012 ¹⁵	46.3%	53.7%	34.0%	66.0%
2013	47.2%	52.8%	22.7%	77.3%
2014	48.4%	51.6%	-3.1% ¹⁶	103.1%

As you can see, U.S. sales remained relatively constant throughout the five year period, with a slight marginal increase the two years following the inversion. However as noted in Table 6, Aon’s effective tax rate notably decreased following their inversion in 2012. Sensibly, this means that Aon had to utilize some form of earnings stripping to lower U.S. pretax income and shift those same earnings through inter-company means to a lower taxed jurisdiction. Aon’s 10-K’s did provide information segmenting foreign pretax income between the “United Kingdom” and “other nations”. U.K. pretax income on average during the five year period accounted for 25% of foreign pretax income. Furthermore, the average corporate tax rate for the U.K. between 2010 and 2014 was 24.4%. This leads me to believe that Aon certainly could have benefitted from shifting pretax earnings from the U.S. to domiciles like the U.K. and as a result reduce their tax liability.

¹⁵ The inversion occurred in 2012. The two years prior and subsequent represent the pre and post-inversion periods respectively.

¹⁶ Reported a U.S. pretax loss of \$55,000,000. However, reported total pretax income of \$1,765,000,000.

In 2014, Aon’s foreign operations accounted for 51.6% of total sales. Yet, foreign operations accounted for an astounding 103.1% of total pretax income during that same year. This resulted in an effective tax rate of 18.9% in 2014. As evidenced in the years prior to the inversion, Aon probably had already been employing some form of earnings stripping.

Diversified Industrials Results

The effective tax rates for the three sample firms who operate in the Diversified Industrials industry is noted in Table 9 below. Using the data in Table 9, the average effective tax rate in the two years following the inversion, decreased by 5.9% in comparison to the average rates of years one through three.

Table 9: Effective Tax Rates for Inverted Diversified Industrials Companies

	Pre-Inversion		Inversion Year	Post-Inversion	
	Year 1	Year 2	Year 3	Year 4	Year 5
Cooper Industries	35.0%	32.1%	23.7%	20.8%	20.7%
Pentair Incorporated	32.4%	29.6%	43.1%	25.3%	22.6%
Eaton Corporation	9.6%	12.9%	2.5%	0.6%	-2.4%
Average ETR¹⁷	25.6%	24.9%	23.1%	15.6%	21.7%

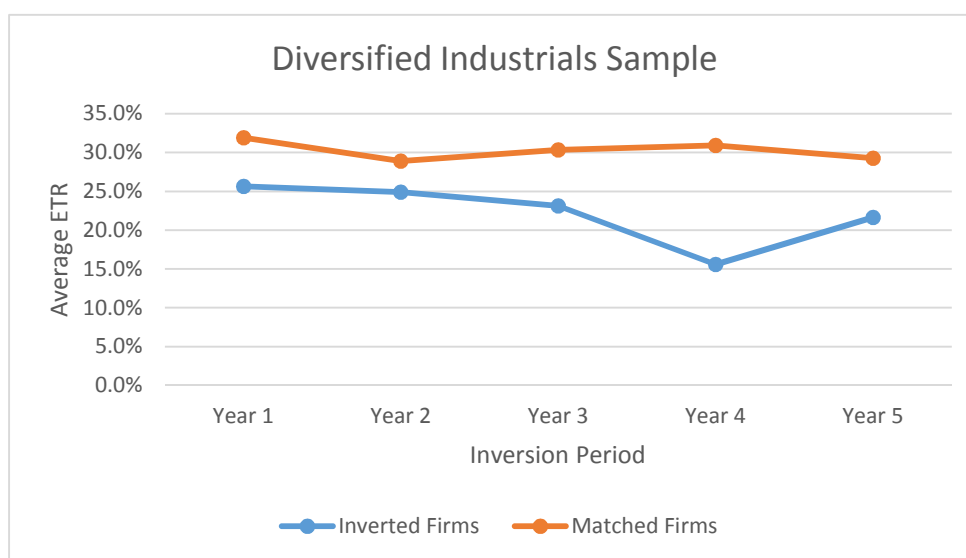
Meanwhile, Table 10 below, contains the effective tax rates for the three matched firms who throughout the five year period are legally domiciled in the U.S.

¹⁷ Excluded Eaton Year 5 due to a tax benefit \$42,000,000 mostly attributable to the Meritor and Triumph litigation settlements and related legal costs. This realization was a non-recurring event and unrelated to the inversion.

Table 10: Effective Tax Rates for Matched Diversified Industrials Companies

	Year 1	Year 2	Year 3	Year 4	Year 5
Danaher Corporation	38.0%	37.5%	34.0%	32.6%	29.5%
Flowserve Corporation	26.7%	27.0%	26.3%	29.5%	28.4%
Illinois Tool Works	31.0%	22.2%	30.8%	30.5%	30.0%
Average ETR	31.9%	28.9%	30.3%	30.9%	29.3%

As evidenced by the data above and the graph below, the three inverted firms on average benefited from the inversion especially in comparison to their respective matches.



I selected Cooper Industries to see whether there seemed to be any evidence of earnings stripping following their inversion in 2002. Table 11 below, provides a percentage of reported sales and pretax income by U.S. and foreign operations for the sample firm.

Table 11: Percentage of Sales and Pretax Income for Cooper Industries

	Sales by Region		Pretax Income by Region	
	United States	Rest of the World	United States	Rest of the World ¹⁸
2000	78.5%	21.5%	78.9%	21.1%
2001	77.0%	23.0%	67.0%	33.0%
2002¹⁹	76.3%	23.7%	29.1%	70.9%
2003	73.5%	26.5%	16.2%	83.8%
2004	73.1%	26.9%	16.6%	83.4%

As you can see, U.S. sales remained relatively constant throughout the five year period. The U.S. accounted for nearly three-fourths of total sales reported during this period. However as noted in Table 9, Cooper's effective tax rate notably decreased following their inversion in 2002. Understandably, this means that Cooper's had to utilize some form of earnings stripping to lower U.S. pretax income and shift those same earnings through inter-company means to a lower taxed jurisdiction. In 2004, Cooper's foreign operations accounted for 26.9% of total sales. Nevertheless, foreign operations accounted for a materially different 83.4% of total pretax income during that same year. This resulted in an effective tax rate of 20.7% in 2004.

Conclusion

Predicated on the results of my study, I am able to come to two primary conclusions. First, as a result of a corporate inversion, the inverting firm is able to significantly reduce their

¹⁸ Cooper's 10-K's did not provide a country by country breakdown of foreign pretax income. Still, the assumption can be made that these foreign nations tax at a significantly lower rate.

¹⁹ The inversion occurred in 2002. The two years prior and subsequent represent the pre and post-inversion periods respectively.

effective tax rate. Based on my sample of eleven inverting firms, the effective tax rate on average decreased by 9.5% during the post-inversion period. Second, I observed that a substantial portion of the reduction in the effective tax rates, was likely the result of the practice of earnings stripping. By reducing U.S. pretax income and shifting them to foreign entities domiciled in favorable tax jurisdictions, it enables inverting firms to minimize their U.S. tax burden. Nabors Industries and Aon Corporation, two sample firms I cite as likely employing earnings stripping, reported U.S. pretax losses in the two years following the inversion. Cooper Industries, the third sample firm I cited, experienced a 71% decrease in U.S. pretax income following their inversion. There were no underlying phenomenon's that affected domestic and foreign profitability for all three firms. Therefore, the sudden reduction in U.S. pretax income most likely is attributable to earnings stripping. In conclusion, the findings of my research support the belief that a firm can materially reduce their tax burden as a result of a corporate inversion.

Potential Future Research

Potential future research could focus on applying more sophisticated statistical analysis when comparing the pre and post-inversion periods for effective tax rates, pretax incomes, and revenue shares. Furthermore, statistical methods could be applied to discover the exact method of earnings stripping. For example, by noting significant year to year changes in intercompany debt or unusual royalty payments, one might be able to confidently assume the utilization of this practice. Additionally, if one were able to calculate by how much U.S. pretax income was reduced, you could calculate the effective tax rate without the application of earnings stripping. Lastly, since my samples were all publicly traded entities, one could measure if there were any substantial changes in share price as a result of the inversion.

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