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### Profit Shifting and Manipulation

Byron Dela Rosa

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# Profit Shifting & Manipulation

A Capstone Project Submitted in Partial Fulfillment of the  
Requirements of the Renée Crown University Honors Program at  
Syracuse University

## Byron Delarosa

Candidate for Bachelor of Science in Accounting  
and Renée Crown University Honors  
May 2016

Honors Capstone Project in Accounting (Signatures on physical copy)

Capstone Project Advisor: \_\_\_\_\_  
Advisor's Name and Title

Capstone Project Reader: \_\_\_\_\_  
Reader's Name and Title

Honors Director: \_\_\_\_\_  
Stephen Kuusisto, Director

## **Abstract**

As of late, many U.S. firms have made their way overseas in ways many feel are unethical. U.S. multinationals have taken note of the unimaginable domestic corporate income tax rate the United States has set for these U.S. corporations. Similar to an individual paycheck you may receive, you must pay a portion to the U.S. government in taxes. And even more similarly, you wish that you did not have to pay it either. U.S. multinationals have the same mindset, as they have found ways to avoid the corporate income tax through foreign activity strategies.

Using scholarly research papers and well-renown media coverage, I was able to discover the methods used to avoid the 35% corporate income companies must pay on U.S. sourced income. Several sources have mentioned similar results about the techniques used to avoid taxes, which makes me believe that the results I have found in my paper are valid and trustworthy.

## **Executive Summary**

The topic I have chosen for my honors capstone is profit shifting and manipulation. This topic is quite controversial, as many people believe that this is a form of tax evasion, which is completely illegal. By analyzing the methods used to profit shift and the inversions that happened in recent years, I was able to obtain a better understanding of how the whole tax avoidance structure and strategies operate. To many, understanding how companies avoid paying taxes on a significant amount of their net income may be difficult. These big corporations can legally move their income from one country with high corporate income taxes to another jurisdiction with low corporate tax. The reasoning behind profit shifting is due to the staggering U.S. corporate tax rate of 35%. This means that firms must pay 35% of their generated income to the U.S. government for operating within their boundaries. A jurisdiction is an area with its own

tax rules and regulations. Many firms have started finding ways to avoid this immense taxation, as it can severely hurt the operations of their company by paying such high taxes.

The methods they use to make such transactions happen may be difficult to follow, but through the use of expatriations, corporate inversions and intracompany transactions, these firms are allowed to save on a good portion on taxes. These multinationals just need to make sure that they follow all tax codes in their respective jurisdiction their subsidiary firm resides in. For example, many tax jurisdictions have tax law on transfer pricing, or the pricing companies charge inter-company units for goods and services. Before tax regulations became popular, many multinational firms took advantage of the lax behavior of tax officials and make their transfer pricing very low to transfer over money efficiently and cost-effectively. Another method that is becoming more popular as companies see other companies use it is corporate inversions. Inversions occur when a U.S. company becomes a subsidiary to a preexisting foreign corporation. By classifying themselves as a subsidiary to this foreign parent corporation, these U.S. multinationals can capitalize on several benefits such as operational flexibility and easier access to foreign markets. But the primary reason behind their subsidiary treatment is to make it easier to avoid the domestic corporate income tax. Some big names that have inverted in recent years are Pfizer, Eaton, and Medtronic.

With the increasing amount of inversions happening to U.S. corporations, there has been severe backlash received by government officials and the public. Their main reasoning behind their disapproval is that they want to have American companies keep their operations domestic because the United States is losing major bargaining power in the global economy. Furthermore, many companies within the same industry as firms who have inverted are finding it extremely hard to compete with these large firms who have the capital and resources to invert and

ultimately save substantial amounts in taxes. The money saved through inverting is then put towards making their large corporations even stronger within their industry.

However, without the proper research many misconceptions can arise. Many believe that the U.S. employment rates decline to corporate inversions because many jobs are lost to operations overseas. Also corporate stockholders in these U.S. multinationals must claim a capital gain on all dividends paid out to them by the U.S. parent company, which makes it not worth holding ownership in the company. Both statements are false, as jobs are not lost because operations are still held domestically even though there are registered as a foreign subsidiary and stock prices have historically been on the rise since companies invert.

According to Standard & Poor (S&P), credit ratings can be severely affected due to corporate inversions. Some credit risks that the S&P noticed ever since companies began to invert was that multinationals had more leverage on future acquisitions due to the tax savings, easier access to foreign cash and assets, stricter regulations are set in place for the immense amount of inversions planned to occur over the next few decades and the potential for future backlash by the government and media. These risks can alter the credit ratings the S&P gives to financial instruments and it will continue to occur as long as companies continue to invert.

Expatriation is another strategy U.S. use to obtain that corporate tax edge on its competition. By shifting ownership on all foreign assets and business activity into a foreign tax haven, these firms are allowed to skip out on the U.S. domestic income tax law. Incentives for expatriating are that the IRS cannot legally tax any foreign income generated by these U.S. multinationals and that firms have increased flexibility when deciding where to allocate their taxable assets.

Whatever method companies decide to use, the tax savings can be used to revamp their corporate structure or to strengthen their preexisting competitive advantages. This will make them stronger within their industry, as well as enhance their foreign presence overseas. Although they may receive negative tension towards government officials and media, it does not seem that these U.S. multinationals will stop with their foreign activity.

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## **Introduction**

Every country across the world conducts business transactions, which therefore means each falls under a given tax jurisdiction. Each country's individual government is responsible for determining the value of taxation for their country. Having varying rates in different countries can cause concepts such as double taxation or no taxation for a given entity. Double taxation is the idea where a tax is levied on certain income by two different tax jurisdictions due to the nature of the income. However, reductions and tax credits can be issued to reduce the amount of income that is taxed.

Multinational companies take advantage of these differing tax jurisdictions through something called profit shifting. Profit shifting is an idea where companies operating in foreign countries can swap profit from operations in one country to a tax haven country. A tax haven is a country or area where income taxed is placed at a lower rate. Companies opt to profit shift to avoid large tax rates and retain more of their earnings. How this works though is that each company that operates internationally will have branches in different countries. For example, a multinational company such as Nike may operate in countries such as Spain and Germany. Their Spain and Germany subsidiaries may fall under the different tax jurisdictions but are considered related legal entities of Nike as a whole.

To many, tax avoidance sounds like an illegal practice, however it is actually completely legal for multinational companies to perform profit shifting. Jurisdictions create rules, however, that entities must follow in order to profit shift. These rules usually deal with intra-company royalties and transfer pricing ([www.economist.com](http://www.economist.com)). Transfer pricing deals with setting the price for goods and services between controlled entities and their parent company. The goal of transfer pricing is that they must equate the price a parent company would charge to an everyday



customer. Multinational companies in the past have taken advantage of transfer pricing to abuse profit shifting and lead to tax avoidance. By charging unfair transfer prices to different divisions, corporations can lower profits for entities in high levying tax areas and raise profits in countries that issue no income taxes. These scenarios will be described and analyzed further in this paper. However, to highlight the importance of this topic, some notable companies that I will be investigating are Microsoft and Google (Drucker).

### **Effects of Tax Avoidance Strategies**

The reason why American based companies choose to escape to tax havens across the world is because the top corporate statutory tax rate in the United States is at a staggering 35%. To explain how the U.S. tax rate would work, let's say you are a U.S. corporation and you just made \$100 on a recent sale of goods to a U.S. customer. The U.S. government will take 35% of that \$100, in taxes equating to \$35. This would leave you with only \$65 from the sale of your product. Luckily, the use of tax credits is created to avoid double taxation on any foreign earned income. If you made the same sale to a foreign customer while operating overseas on Europe where their corporate tax rate is 10%, as a U.S. domiciled firm you would pay \$10 (10% of \$100) to the European government but only would have to pay \$25 to the U.S. government with the use of a tax credit (Desai & Hines, 5).

Tax havens are countries that set their corporate income tax at a low or zero percent rate and lack the exchange of information or transparency, which makes it very favorable for multinationals. This section will demonstrate the effects of profit shifting and other tax avoidance schemes on the current tax havens in the world. Some popular tax havens include the Cayman Islands, Bermuda, and the Bahamas, which all have a zero-percent tax rate. As of 2014,

Bermuda was home for \$94 billion in profits from multinational companies while the country's gross domestic product (GDP) was only at \$6 billion (www.economist.com). Investors of these multinational companies are fond of profit sharing, as it ultimately increases the bottom lines of the company and earns investors higher dividend payouts.

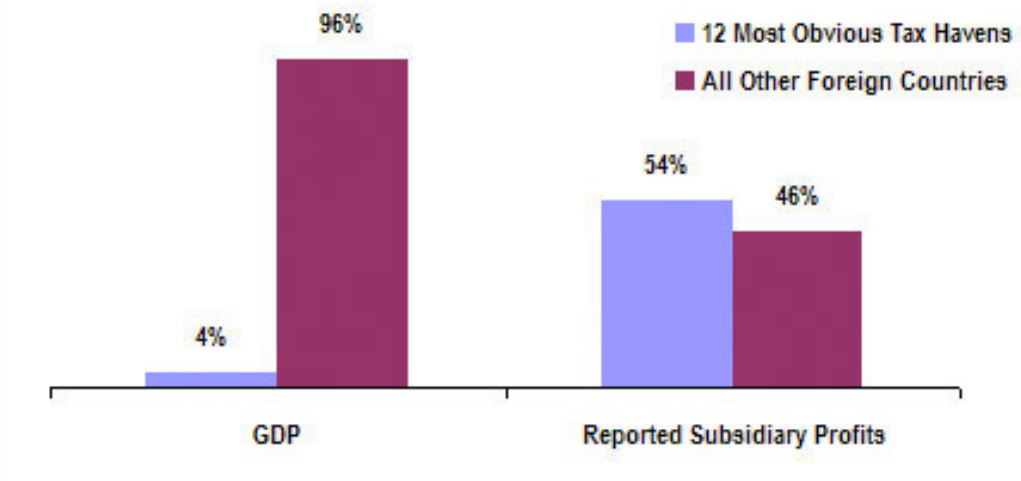
Figure 1: Top Viable Tax Havens for Multinational Companies (dollars in billions)

	Reported Profits of US-Controlled Subsidiaries	Gross Domestic Product	Subsidiary Profits as % of GDP	Foreign Income Taxes Paid by Subs*	Foreign Taxes Paid by Subs/ Profits of Subs
Bermuda	\$ 94	\$ 6	1643%	\$ 7	8%
Cayman Islands	51	3	1600%	10	19%
British Virgin Islands	10	1	1102%	0	5%
Bahamas	10	8	123%	1	11%
Luxembourg	55	52	106%	2	4%
Ireland	87	208	42%	3	3%
Netherlands Antilles	1	4	25%	0	11%
Netherlands	127	772	16%	10	8%
Cyprus	3	23	13%	0	2%
Barbados	0	4	10%	0	19%
Singapore	20	217	9%	1	5%
Switzerland	47	551	9%	3	6%
<b>Total for Dozen Most Obvious Tax Havens</b>	<b>\$ 505</b>	<b>\$ 1,849</b>	<b>27%</b>	<b>\$ 37</b>	<b>7%</b>
<b>Total for All Other Countries in IRS Data</b>	<b>\$ 424</b>	<b>\$ 42,363</b>	<b>1%</b>	<b>\$ 74</b>	<b>17%</b>

Although this graph depicts twelve popular tax havens for corporations to utilize in 2010, these locations still stand as the most useable options for companies. Some key metrics to take from this chart are the reported profits of US-Controlled Subsidiaries and Gross Domestic Product. For several countries, there are significant amounts of profits coming into the country, while the GDP is a fraction of that amount. What is also shocking is the amount of foreign income taxes paid by each subsidiary in each of these countries listed. For example, in the British Virgin Islands \$10 billion of profits were sent there, however less than a billion was taken out due to foreign taxes, which avoided most income tax expense (www.rt.com). Furthermore, on

average only 7% of foreign profit exported to these countries was considered taxable. These multinational companies have used the tactic called repatriation, which allows companies to avoid paying any United States taxes until they have repatriated, or returned the earnings, to the US.

Figure 2: Popular Tax Havens vs. Other Foreign Countries



To further demonstrate the significance of profit shifting, Figure 2 depicts how much profit is going into these low-tax countries and other foreign countries and how much of the world GDP they account for. Over 50% of reported subsidiary profits are sent into these tax havens, while only accounting for 4% of the world’s GDP (www.rt.com).

### **The Organization for Economic Co-operation and Development**

With profit shifting becoming more of a controversial topic for the IRS and foreign governments, an authoritative figure was thought to be ideal to watch over multinational actions. This section will describe the governing body that was created for this reason. To help monitor profit shifting by multinational companies, the Organization for Economic Co-operation and

Development was created in 1961. The OECD consists of 34 countries ([www.oecd.org](http://www.oecd.org)). Figure 3 lists each country with current membership. The OECD has produced a template outlining rules for negotiations regarding tax rules and cooperation. Furthermore, they have been the body to resolve any unsafe tax practices geared toward tax havens. FATCA is the Foreign Account Tax Compliance Act, which requires certain countries to automatically share tax information for reporting reasons ([www.treasury.org](http://www.treasury.org)). From this organization, the rise of FATCA started to come about. This will increase the tax transparency between countries allowing for a more accurate free-flow of information to occur. Congress established this act to obtain information from any U.S. taxpayers that hold a significant interest in foreign accounts. By 2018, 93 more countries will be forced to comply and reveal any tax information that is asked of them ([www.treasury.org](http://www.treasury.org)). The countries that follow FATCA will fall under either a Model I or Model II agreement with the United States based on agreed terms between the two governments.

Figure 3. List of Countries with Current Membership in OECD.

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## CURRENT MEMBERSHIP

- |                                  |                           |                               |                                   |
|----------------------------------|---------------------------|-------------------------------|-----------------------------------|
| > <a href="#">Australia</a>      | > <a href="#">France</a>  | > <a href="#">Japan</a>       | > <a href="#">Slovak Republic</a> |
| > <a href="#">Austria</a>        | > <a href="#">Germany</a> | > <a href="#">Korea</a>       | > <a href="#">Slovenia</a>        |
| > <a href="#">Belgium</a>        | > <a href="#">Greece</a>  | > <a href="#">Luxembourg</a>  | > <a href="#">Spain</a>           |
| > <a href="#">Canada</a>         | > <a href="#">Hungary</a> | > <a href="#">Mexico</a>      | > <a href="#">Sweden</a>          |
| > <a href="#">Chile</a>          | > <a href="#">Iceland</a> | > <a href="#">Netherlands</a> | > <a href="#">Switzerland</a>     |
| > <a href="#">Czech Republic</a> | > <a href="#">Ireland</a> | > <a href="#">New Zealand</a> | > <a href="#">Turkey</a>          |
| > <a href="#">Denmark</a>        | > <a href="#">Israel</a>  | > <a href="#">Norway</a>      | > <a href="#">United Kingdom</a>  |
| > <a href="#">Estonia</a>        | > <a href="#">Italy</a>   | > <a href="#">Poland</a>      | > <a href="#">United States</a>   |
| > <a href="#">Finland</a>        |                           | > <a href="#">Portugal</a>    |                                   |

## Base Erosion and Profit Shifting

One distinct method that is used by corporations to decrease tax and increase their profitability is called Base Erosion and Profit Shifting (BEPS). BEPS is a tax strategy multinational entities use to capitalize on any gaps in tax laws to maximize profitability and minimize losses. These companies send profits to countries with low tax rates, however these tax havens are not benefiting from the value added from the business transactions that are generating the profits. The OECD has claimed that almost as much as \$240 billion a year of corporate income tax revenue is lost (Drucker). In order to mitigate the use of BEPS by corporations, the OECD and G20 countries, along with 80 participating developing countries, have come together to create the BEPS Package that not only outlines fifteen key areas of tax law avoidance that need to be addressed but also supplies them with domestic and international tools to stop BEPS ([www.oecd.org](http://www.oecd.org)). These fifteen actions are depicted in Figure 4. To see frequently asked questions on the BEPS Package or more specifically each action addressed, please visit <http://www.oecd.org/ctp/beeps-frequentlyaskedquestions.htm#Action1>.

Figure 4. 15 Action Plans Addressed in the BEPS Package.

- 
- » Action 1: Addressing the Tax Challenges of the **Digital Economy**
  - » Action 2: Neutralising the Effects of **Hybrid Mismatch Arrangements**
  - » Action 3: Designing Effective **Controlled Foreign Company Rules**
  - » Action 4: Limiting Base Erosion Involving **Interest Deductions** and Other Financial Payments
  - » Action 5: Countering **Harmful Tax Practices** More Effectively, Taking into Account Transparency and Substance
  - » Action 6: Preventing the Granting of **Treaty Benefits** in Inappropriate Circumstances
  - » Action 7: Preventing the Artificial Avoidance of **Permanent Establishment Status**
  - » Actions 8-10: Aligning **Transfer Pricing** Outcomes with Value Creation
  - » Action 11: **Measuring** and Monitoring BEPS
  - » Action 12: Mandatory **Disclosure Rules**
  - » Action 13: Guidance on **Transfer Pricing Documentation** and Country-by-Country Reporting
  - » Action 14: Making **Dispute Resolution** Mechanisms More Effective
  - » Action 15: Developing a **Multilateral Instrument** to Modify Bilateral Tax Treaties

With the implementation of the BEPS Package, all participating countries can now understand the necessary steps to take when multinationals use BEPS by using the newly admitted framework. Monitoring where business transactions are made and value is created will help tax haven countries determine the appropriate taxation to impose on generated profits. By participating in the BEPS Project, developing countries will now be further supported by the OECD and G20 countries as they continue to strengthen their tax laws ([www.oecd.org](http://www.oecd.org)).

### **Microsoft vs. IRS**

The technological giant, Microsoft, has been put under the limelight after recently going against the IRS in court regarding profit shifting. Although headquartered in Redmond, Washington, Microsoft does not send profits to this location to be collected and counted. After making sales on their technology, the revenue is all sent to Microsoft's sales subsidiary that is stationed in Nevada (Day). Over the years, Microsoft has done well to set up subsidiaries worldwide. They have taken advantage of these foreign tax havens having created subsidiaries in Bermuda, Singapore, Ireland, and Puerto Rico. The international path of Microsoft profits starts in Puerto Rico, after being sent over from Nevada. From Puerto Rico, it is sent to a subsidiary in Bermuda, which has a zero corporate income tax. A tactic described earlier, intracompany deals were heavily used by Microsoft in the early 2000s. Microsoft sent technological software and coding to their subsidiaries across the world. As of today, over \$108 billion in profits are currently being held overseas in Microsoft subsidiaries (Day). Figure 5 illustrates this metric in graph form. The chart also states how much in taxes Microsoft would owe if they decided to keep profits in the United States, which is \$34.5 billion (Day).

Figure 5. Microsoft's Overseas Holdings in International Subsidiaries



It may seem as Microsoft has successfully figured out an effective way to profit shift while complying with tax law. However, in November 2015, after facing the IRS in tax court, the judge demanded Microsoft to comply with the requests of the IRS by sending requested documents and conducting interviews with the IRS. It seems the IRS did not favor Microsoft's early 2000s tax schemes when Microsoft executives were unwilling to adhere to IRS demands (Day).

An issue the IRS had with Microsoft's tax strategy was with their operations in Puerto Rico. Microsoft's subsidiary in Puerto Rico, Microsoft Operations Puerto Rico, LLC (MOPR), was created for two reasons. Since they have the right to manufacture Microsoft technology and software, MOPR would create these goods and send them back into the United States to resell to retail customers ([www.copetax.com](http://www.copetax.com)). Next, Microsoft does what many other multinational firms do by sending a hefty portion of their gross revenue over to MOPR to ensure that it will only be taxed between 1-2% ([www.copetax.com](http://www.copetax.com)). This rate is significantly less than the tax rate in the

United States, which is 35%. Although MOPR is considered a controlled foreign corporation managed by Microsoft, it was determined that MOPR was taking advantage of its own low tax jurisdiction for any in-house manufacturing that was happening in Puerto Rico. The IRS has been attempting to use regulations regarding cost-sharing that were released in 2009 to reallocate any revenue generated in Puerto Rico back to the United States to be taxed there. The results of this are still unknown, as the IRS is still currently fighting this case against Microsoft.

### **Google's Use of the Profit Shifting Techniques**

Similarly to Microsoft and their profit shifting antics, Google has caught fire by the IRS in recent years due to their silent transfer pricing profit-shifting techniques. Since 2011, the IRS has been after Google Inc. for their tax avoidance strategies by auditing the technological empire (Drucker). It was claimed that Google has unfairly valued its foreign software and intellectual properties and has called for cooperation with the IRS. This is not the first transfer pricing case that the IRS has dealt with, as transfer-pricing controversies are quite common for companies that send intangibles, such as intellectual property and software, to their foreign subsidiaries (Drucker). The IRS has been closely monitoring the acquisitions Google has been making in the past few years, as Google must comply with the numerous agreements they had to make with the IRS regarding shifting profits into subsidiaries owned by their newly acquired companies.

Google capitalizes on the various loopholes in international tax law to avoid domestic corporate taxation and save about 15% on taxes for several years straight. The way Google approaches this is called the "Double Irish with a Dutch Sandwich" (Duhigg). Google uses several step procedures. It requires a US parent company, such as Google, to own three offshore subsidiaries, with two of them incorporated in Ireland and one in the Netherlands (Duhigg &



Kocieniewski). Next, Google will license their software or intellectual property to one of their Irish subsidiaries. The difference between this Irish subsidiary and the other is that the subsidiary receiving the licensing agreement is incorporated in Ireland but is a tax resident of Bermuda because management operations are there. This will play a significant role later with Bermuda offering a zero corporate income tax. This Irish subsidiary will then sublicense the original intellectual property rights to a Dutch subsidiary, who will then sublicense it again to the other Irish Operations Company (Irish OpCo) (Duhigg & Kocieniewski). This Irish OpCo will then begin to generate foreign business revenue for the US Parent Company. After a year of operations, the generated revenue begins to streamline to Google. Due to the international tax laws regarding royalties and net income, very little tax is imposed on the revenue. Google was notorious for this strategy, as it was determined that their effective tax rates between 2010 and 2014 are approximately 19%, while the corporate tax rate in the United States is 35% (Duhigg & Kocieniewski).

Due to the magnitude of profit shifting that Google has created, there has been a new law established by the Australian government to counteract the amount of money being generated in their country but are being sent to tax havens with zero corporate income tax (Herber). In 2014, Google paid roughly \$12 million in taxes to the Australian government on their generated \$59 million in profit (Khadem). The calculated tax amount is much under the 30% rate Australia holds for corporate income tax (Khadem). The intent of the law is to keep the original domestic tax rate at 30% but will yield penalty tax of 100% if any multinational company gets caught for unauthorized profit shifting in Australia. The Treasurer of the Australian Government, Joe Hockey, has implemented this rule as of May 2015 (Cooper).

## Corporate Inversions

To assist in understanding how profit shifting works, the idea of inversions needs to be explained. Inversions are when a U.S parent corporation creates themselves as a subsidiary to a new foreign parent corporation (Skadden, 3). Many inversions take place because corporations believe that a new company structure allows for increased operational flexibility, better cash management, and enhanced access to international capital markets (Sheppard, 554). However, the main reason inversions occur is due to the tax savings companies benefit from. For example, any profits that are sent to the parent company as dividends to shareholders are exempt from any U.S. taxation because the transaction is considered between two foreign companies. Intercompany payments such as interest payments or royalties are used to help companies escape U.S. taxation even further.

The long-term benefits are, however, initially offset by tax consequences. For stockholders holding stock in the foreign company, they must recognize gains on the difference between the prices of stock once swapped. Therefore, gains generate tax liabilities for stockholders. Although perfectly legal, companies' ethical behaviors about using corporate inversions are what many find skeptical. Usually, this is controlled internally, or within company control, which would be considered a self-inversion. Two examples of self-inversions would be Aon, the British-stationed multinational company that offers financial advice, risk management, and corporate strategy, and Ensc0, who provide services and products in the engineering field (Skadden, 3). If, however, a business decides to become a subsidiary of a new foreign parent corporation that is not under control of its own management, then it is considered a combination migration transaction. Some examples of combination migration transactions include the medical

inversion of Medtronic and Covidien and the inversion of electrical equipment manufacturers of Cooper and Eaton (Skadden, 3).

Corporate inversions started as early as 1982 and have started to gain worldwide attention by the International Revenue Service (IRS). The IRS is the United States Government agency that is responsible for enforcing tax laws and ensures collection of taxes. The inversion strategy provides companies with four main benefits for their operations. The first being an outlet for foreign expansion if a company decides to globalize and venture into new existing markets. Next, having a foreign parent corporation will allow for easier access to any offshore cash that is stashed in their financial books. This will be helpful just in case the parent company is in need of readily available and liquid assets. Furthermore, another reason inversion is favorable is because a parent company will be able to have more control of foreign operations and be easier to enhance any facet of the business. Finally, for the reason that will be discussed heavily in this analysis, it allows parent corporations to avoid an immense amount of corporate domestic income tax.

After seeing how much U.S. companies abused profit shifting and inversions, the IRS had a call to action in the mid-1990s to counteract this strategic movement. The first act they announced were Treasury Regulations that forced any U.S. stockholder of a parent company that utilized self-inversions to recognize any gains, and not losses, when exchanging US parent stocks (Skadden, 6). The reasoning behind this was that it creates taxation on any exchange of stocks that normally would not be deemed taxable. As this is still currently enacted, it primarily focused on parent corporations that own any more than 50% of new foreign parent corporation stocks (Skadden, 6). However, this regulation did not stop these U.S. companies from inverting because the taxes that they escaped would exceed the amount that had to be paid out. Therefore,

as long as these multinationals followed the regulations that were set forth for corporate inversion, then they would continue to reap the tax benefits.

The U.S. Government then noticed how the regulations set forth by the IRS did not prove as effective as planned. With that being said, the Government created a new tax code that took a different direction than the IRS approach. Instead of taxing shareholders for their portions of the parent companies income, it targeted the new foreign parent corporations' income. What Code Section 7874 of the Internal Revenue Code was created to do was to treat any new foreign parent corporations as a domestic entity for tax purposes, however only if certain conditions were not met (Skadden, 8). The three required conditions are that the foreign companies must acquire a significant amount of the assets owned by the parent corporation. Second, shareholders before the inversion must own greater than 80% of the new foreign parent company. And third, there is not a significant amount of foreign operations being completed in the foreign company. Any condition not followed will incur an extra tax on any untaxed value stock-based compensation earned by officers and directors (Skadden, 8). After debate over the consequences of not complying to the conditions set forth in section 7874, it was determined that the consequences given to U.S. companies will depend on the size of both their domestic operations and their foreign operations (Skadden, 8).

Although there are punishments created for those companies who do not comply with the regulations, inversions still seem like a viable option for most companies looking to not only strengthen their foreign presence but also avoid domestic income taxes. With the multitude of ways to avoid U.S. taxes, companies have many options to find out which method may be best suited for their operations. Given that companies continue to perform the inversion strategies demonstrates the power these companies possess by holding foreign property and assets. It is

certain that corporations will continue these strategies to make their firms more dominant compared to its competition.

### *Effects of Corporate Inversions*

There are many effects from a company's decision to invert. One main effect is the backlash received by government, media and the public. The controversy that arises due to inverting can force companies to get into trouble with the U.S. government. Many companies view inverting as the safer option instead of fighting back against the government. Furthermore, many believe that these corporate inversions are economically weakening the United States (Sheppard, 557). Since the United States is suffering through the recession and the abundant international controversies that we face, many are beginning to doubt management at these large corporations who decide to set aside their domestic operations to avoid taxation. These corporate inversions have begun to lead to boycotts by public on products and services of those companies who claim to be foreign-domiciled.

One underlying effect corporate inversions have on competition is that it is forcing many U.S. companies to consider inverting to stay competitive in their industry. Those companies that invert see a large tax savings amount, which will be used to lower their prices of their goods and services or higher dividend payouts to shareholders to ultimately make them more profitable (Sheppard, 562). Those non-inverted companies will be at a disadvantage when trying to gain reputation and customer loyalty. Many smaller companies that do not have the resources to shift operations abroad will find themselves in an even deeper hole when trying to compete against the giants in their respective industry.

### *Common Misconceptions*

It is claimed that corporate inversions hinder U.S. employment growth (Sheppard, 559). Since companies are beginning to create a larger global presence, a higher percentage of operations are conducted overseas. With that being said, the larger presence is taking away from jobs domestically. However, this claim has been claimed to be false because although the headquarters is deemed to be in a foreign country, a small portion of companies operations have to physically be abroad. With the savings companies receive from their tax expense, more money can be spent towards creating new jobs domestically and/or raise the wages for preexisting jobs.

Already discussed previously, corporate inversions can economically hurt corporate stockholders because they must claim all capital gains when exchanging their domestic stocks to foreign stocks (Sheppard, 560). Similar to the previous claim, this claim about stockholders is invalid as well. The first reason that makes this claim invalid is that shareholders and corporate officers have a mutual interest in seeing the company become very profitable (Sheppard, 560). The following reason is because in order for a corporate inversion to become effective, the parent corporation must obtain stockholder approval. Corporations must follow all laws outlined by the Securities and Exchange Commission (SEC) and outline all terms and agreements of the inversion to its stockholders. More often than not, shareholders have had a positive outlook on inversions, as many times these votes are passed unanimously. And the final reason that makes this invalid is that management will only decide to invert if they believe that the benefits to shareholders outweigh the cost of inverting (Sheppard, 560). Management will only decide to invert if they see that the savings that they receive on their taxable income is higher than the capital gains that stockholders must pay. Based on past inversions, after publicly announcing an inversion for a company, the stock price for the parent company tends to rise significantly (Sheppard, 561).

One main criticism that large corporations receive from inverting is the lack of patriotism. With companies sending their operations abroad, the public feels that the United States is losing the commercial battle of goods and services. Especially with what the United States has gone through economically and socially in the past decade, the public feels corporations need to stay more domestic. Again, another misconception people make of corporate inversions. Up to today, there have been less than 50 multinational companies to invert their operations. In addition, corporate inversions may be in the best interest for a company's stockholders. Due to the legality of inverting, if a company sees that inverting will increase profitability then it is only fair that the company exercises its rights of making the best financially sound business decision (Sheppard, 562).

Another thought that the public has about corporate inversions is that it makes the United States tax system look weak. With the multitude of strategies utilized by companies to avoid paying taxes on generated income, it is claimed that the tax system is "voluntary." (Sheppard, 565) The lack of confidence in the United States tax system has upset many individual taxpayers, as they feel they have to pay a larger portion of the U.S. government budget. Public outrage is believed to take a turn for the worst, as these rebellious taxpayers are beginning to consider not complying with the laws and regulations set forth by the U.S. tax system. It is only a matter of time for significant economic problems to ensue due to the controversy arising from the U.S. tax system. Even the U.S. Treasury Department understands this issue and believes an immediate response must be taken in order to revive confidence in the U.S. tax system (Sheppard, 565).

*Seida Research*

In a study conducted on twelve inversions that happened over time, Seida et al. (2004) were able to analyze each company's financial statements to uncover four main points. These points include examining if the inversions reduced the company's effective tax rates (ETR), analyzing the duty of earnings stripping in ETR reductions, quantifying the tax reduction and earnings improvement created from earnings stripping and reevaluating the valuation consequences of inversion (Seida, 806). ETR is the effective tax rate, which indicates the percentage amount of taxes each individual company has to pay on their earnings. What makes the findings in this research so significant are that the authors were able to compare the financial statements pre-inversion with the post-inversion numbers. One of the big findings from their research is that mean pre-inversion ETR for companies was 30.01 percent, while post-inversion ETR equated to a staggering 20.44 percent (Seida, 806). The 11.57 percentage change between the pre- and post-inversion firms is related to the shifting of profits into the foreign headquarters to avoid any sort of domestic income taxation.

Companies also have ways of avoiding domestic tax on their U.S. earned income. The strategy that is used to avoid U.S. tax is called earnings stripping. How earnings stripping works is that a former U.S. domiciled company that is now a foreign subsidiary participates in intracompany transactions where the firm incurs an immense amount of intracompany expenses (Seida, 809). Some ways to transfer expense payments can be made through intercompany debt or making the other party pay for the use of intangible assets. It was determined that many companies that were contemplating or conducting inversions have used earnings stripping for tax saving purposes. What is significant about this is that the savings came primarily from savings from U.S. taxes on U.S. earnings rather than U.S. taxes on foreign earnings. This idea is



important later when the idea of repatriation is discussed. The results found from this study help explain the significance of inversions to companies today.

## **Pfizer – Allergan Merger Talks**

For those unfamiliar with Pfizer, Inc., it is an American global pharmaceutical company stationed in New York City. Lead by CEO Ian Read, Pfizer has worked to develop and create medicines and vaccines for a variety of medical sciences. As of November 22, 2015, Pfizer has been in the works of a \$150 billion acquisition of Allergan PLC (Rockoff). Previously known as Actavis until their branding initiative was implemented in February 2015, Allergan has similar responsibilities as Pfizer. They are a global pharmaceutical company that develops, manufactures and sells pharmaceuticals and over the counter medicines.

Early talks of this merger have entered news recently in the Wall Street Journal. This acquisition will create the largest drug manufacturer by sales. The terms of the deal were determined as 11.3 Pfizer shares per 1 Allergan share (Rockoff). It was said that a small cash component was also detailed in the terms of the contract, however the amount is unknown until the agreement is accepted and announced. At first glance, this seems like a normal merger and acquisition for two well-known corporations. What many do not understand is that this may be one of the biggest inversions to date. As previously explained, inversions are when a company reincorporates themselves overseas to reduce taxation on income. Allergan is headquartered in Dublin, Ireland, which as mentioned previously is a favorable country for companies to shift profits into (Rockoff). To solidify that Pfizer can take advantage of the lower tax rate, they will form this merger as a reverse merger. This means that Allergan will be buying the New York City-based Pfizer. Pfizer CEO Ian Read will be in command of the merged corporation with

Allergan CEO Brent Saunders acting as his second in command. However, in recent news this merger has been called off due to increased regulations to stop corporate inversions.

This merger has many benefits for both parties of the contract. Now that their resources are combined they will have a very large research & development (R&D) budget and sales. Both parties having top-selling products such as Pfizer's Prevnar pneumonia vaccine and Allergan's anti-wrinkle treatment Botox that will generate large amounts of revenue for the merged company. Their products will be able to cover a range of diseases from cancer to Alzheimer's to eye health. In financial year 2014, Pfizer had roughly \$50 billion in revenue and Allergan had \$13 billion (Rockoff). The full effect of the merger may take up to eight to nine months after both sides can agree on the terms. It is said by people dealing with the merger contract that once the merger officially occurs, the entities will work as two businesses. One would work with patent-protected products, while the other would work on products that have lost their protection from patents (Rockoff).

Now with operations being mandated in Dublin, Ireland, Pfizer escapes their 25% US corporate income tax and thrives in their approximately 15% rate that Allergan possessed (Rockoff). Pfizer has attempted this inversion plan with a London-based pharmaceutical company named AstraZenca PLC, however was unable to make this merge happen. Without the AstraZenca merger completion, Pfizer still has a bright future, as they work alongside Allergan. Although they have been receiving tremendous backlash from the public and media, Pfizer continues to offer their services to their customers.

## **Transocean Offshore Inversion**

Back in the early 1990s, Transocean Ltd., the Swiss-based offshore drilling contractors, began its inversion movement to avoid vast amounts of taxation on their generated income. Starting as an American-based company, it moved its operations to the Cayman Islands. After a few years, they decided to move all efforts into the Swiss headquarters they are currently stationed in. The shift from the Cayman Islands to Switzerland was due to the incoming pressure from higher authority on the amount of activity occurring in the Cayman Islands (Newquist). However, in 1999 Transocean entered into a contract with British Petroleum (BP) to work on the Deepwater Horizon project in the Gulf of Mexico. The contract terms were that BP would pay Transocean \$500,000 a day to drill the well (Newquist). This was Transocean's first attempt to avoid paying fees, as the Deepwater mission hit a roadblock. On April 20, 2010, the Deepwater Horizon project suffered an explosion, which led to a gigantic offshore oil spill, along with 11 killed and 16 injured (Koplow). By leveraging the Limitation of Liability Act of 1851, Transocean tried to avoid liability payments saying that the act protected them from any damages during the contract (Koplow).

During the same year as the contract, Transocean performed an inversion, which put them ahead of the trend and avoided many of the code changes that took place in the early 2000s. Writer Martin Sullivan further discusses the idea of inversion in *The Tax Analysts' Tax Notes*, "Top executives, key personnel, and all significant business operations in the United States before the transaction remain in the United States." (Newquist) Further in his article, he explains how before Transocean entered into the inversion, they had an effective income tax rate of 31.6%, but after the inversion they held a tax rate of 16.9%. Over the past decade, Transocean has saved approximately \$1.8 billion in taxes (Koplow).

## **Combination Migration Transactions**

### *Eaton Corporation & Cooper Industries Plc*

Eaton Corporation is a U.S.-based global technology leader who engages in power management solutions that allow for more effective, reliable, safe and sustainable operation of several power sources ([www.eaton.com](http://www.eaton.com)). On May 21, 2012, Eaton's top management decided to purchase and acquire Cooper Industries Plc, a U.S. manufacturer of electrical products that distribute and control electricity, provide circuit protection, and support electronic and telecommunications ([www.eaton.com](http://www.eaton.com)). After the acquisition was made, it was decided that their headquarters for the combined business would be located in Ireland, Cooper's previous headquarter residence. The duo came out with an estimate on tax savings due to the inversion of approximately \$160 million by fiscal year 2016 ([www.eaton.com](http://www.eaton.com)). The combined corporation was set to be named Eaton Global Corporation Plc, with Eaton shareholders holding roughly 73% of the combined company. The transaction was marked as an \$11.8 billion transaction. Although it seems like a big price to pay to make this inversion happen, both parties have seen several benefits to help their sides prosper. Two outcomes of the tax avoidance that the combined business saw was that the tax credits they received for both research and development and foreign taxes paid. In 2011, Eaton earned approximately \$6.4 billion in profits due to this inversion, by the time it came to taxation on profits, Eaton avoided the tax because it remained a foreign entity headquartered in Ireland. It was determined that 49% of their 2011 sales were domestic, which rattled Congress on their operations ([www.eaton.com](http://www.eaton.com)). Due to the profitability made overseas, Eaton will strategically plan on borrowing money domestically, in order to fund major foreign projects to earn more revenue.

### *Medtronic Plc & Covidien Ltd.*

Another example of a combination migration transaction is between the two corporations Medtronic Plc and Covidien Ltd. Medtronic is U.S. headquartered and the world's largest medical technologies company that is transforming healthcare by working closely with their clients ([www.medtronic.com](http://www.medtronic.com)). Covidien was an Irish-based company that manufactured global health care products, medical devices and supplies ([www.covidien.com](http://www.covidien.com)). This transaction of Medtronic acquiring Covidien was set at \$49.9 billion, which was held in June 2014. This migration strategy has created one of the largest companies in medical industry with market capitalization at around \$125 billion (Skadden, 7). The combined company has still kept its roots for both parties, as they manufacture basic medical tools to high-precision tools needed for more complex surgeries. The takeover of the Irish-headquartered company has seen Medtronic drop its effective tax rate by a few points. Chief Executive Officer of Medtronic, Omar Ishrak, has claimed that this purchase will not only save on their taxes but also provide the liquidity to pay off any debt needed to be paid off to its creditors (Cortez, 2). He further mentioned how this acquisition will help provide greater coverage and higher reimbursements for the products they make because the quality of their products will be much higher due to research and development and quality control. Finally, Covidien will help Medtronic negotiate and form deals with hospital administration because more Medtronic products will be demanded in these hospitals nationwide (Cortez, 2).

Obviously, U.S. Government did not let this one go unnoticed. After the Minneapolis-ran and Ireland-domiciled Medtronic borrowed \$16 million domestically to continue to fund the acquisition, U.S. Treasury did not allow Medtronic to hold those funds overseas without paying taxes on it. Within the first six month of the deal, Medtronic stock rose 25%, which made shareholders very happy with the purchase of Covidien. Continually, once the deal went through,

the combined corporation had 40,000 employees and combined cost savings of \$850 million (Cortez, 2). Top management then released that job cuts will be necessary due to the massive influx of workers.

## **Inversions Affect Credit Ratings**

Up to this point of the paper, it is evident that companies use inversions to lower their tax burden on both domestic and foreign earnings. However, inversions have an underlying issue that may not be readily apparent. While inverting, the impact on credit ratings are significant and the larger the inversion deal the larger the influence on credit ratings is. Standard & Poor is the financial services company that commonly releases credit ratings on financial instruments.

The credit risks that are involved with the inversion strategy are as follows:

1. Attraction of tax inversion savings leads to more assertive financial policies, such as higher leverage to fund their acquisitions. (S&P)
2. Simple access to any stored foreign cash, which will lead to more assertive share buybacks and dividend payments. This may weaken liquidity and raise any adjusted leverage metrics. (S&P, 2)
3. Large inversions will limit a company's financial ability to manage any future strategic acquisitions to revamp their product portfolio. (S&P, 2)
4. With more U.S. domiciled firms moving their tax obligations overseas, stricter legislations are being implemented to limit the activity of these inversions. The U.S. Government has been in talks to fully eliminate the use of inversions for tax saving purposes, as they believe the strategy is getting too out of hand. (S&P, 2)

5. The potential for any public, political, media, and customer backlash when an inversion is created. (S&P, 2)

When determining the impact of an inversion, Standard & Poor analyzes several factors, including strategic and management fit, cash flow and liquidity, and product, market, and geographic diversification. (S&P, 3) According to Standard & Poor, inversions should be looked at for whether it is beneficial to a company's internal and external operations and not just for tax purposes. The influx of inversions in the past few decades have shifted towards that mindset where companies will only invert if they see a significant amount of savings looming. Many companies have come out to speak about their inversion deals stating that many of these deals are enhancing their internal operations while revamping their product development and research and development. They also mention how their merger deals have been strategic based more so than tax driven. In 2013, the average EU corporate tax rate was set at 23%, while in the United States the corporate tax, including the state tax that is required by companies, averaged around 39.1% (S&P, 6).

#### *Why Invert?*

Standard and Poor has determined several reasons why this new popular inversion movement has occurred in corporate America. The first reason is because the U.S. tax system is heavily against the repatriation of foreign-held income. This topic will be discussed later in a future section. The next reason is that multinational companies are easily becoming aware of the backlash from government on the use of inversions, therefore their window of opportunity to invert is slowly closing. They feel that they need to invert as soon as possible before they lose on the chance to become domiciled in a foreign tax haven (S&P, 6). Furthermore, any inversion

merger deal that has occurred in the past few years has seen a tremendous stock price rise. This rise allows companies to fuel their foreign operations since they have their shareholders and investors back up their decisions. A vital reason for the use of inversions according to S&P is that the money that companies save from inverting can be also used to fuel foreign operations, which will increase share buybacks and higher dividend payouts (S&P, 6). Finally, the negative connotation that the U.S. tax system has on U.S. corporations has made top management in these big firms stay away from any U.S. taxes.

## **Expatriation and Incentives Involved**

Expatriation is the method where companies send ownership of all foreign assets and foreign business activity to a foreign tax haven, ultimately escaping most U.S. taxes on the foreign income generated (Desai & Hines, 8) Before a company sends ownership over to the tax haven controller, the way the U.S. government taxes them are through the dividend payments that are required to be paid out to shareholders in the United States. Tax law further states that expatriation should be required for recognition of capital gains; therefore taxpayers are allowed to claim capital gain tax liabilities on any unrecognized gains (Desai & Hines, 8). What determines the effect of capital gain is based on the type of structure of this expatriation. It could either be a taxable stock transfer or asset transaction. In a taxable stock transfer, the foreign operating corporation swaps its foreign shares into shares of the U.S. domiciled company. Shareholders are now able to recognize a capital gain on the difference between the fair market value of the shares and tax basis. This also allows shareholders to be partial owners of the foreign domiciled company (Desai & Hines, 9). In an asset transaction, the foreign domiciled company obtains assets from the U.S. parent company. This causes taxes on capital gains of the difference between the fair market value of the asset and its basis.



### *Incentives to expatriate*

Corporations that choose to expatriate are still exposed to U.S. taxation on their U.S. income. This is because the American subsidiary that was created under the new corporate structure is taxed as a U.S. domiciled firm (Desai & Hines, 10). Therefore, there are three main incentives that are associated with expatriation. The expatriation incentives are focused on three ideas:

1. The tax consequence that arises from no longer being subject to rules arising from the U.S. treatment of foreign source income (Desai & Hines, 10).
2. The tax consequences that arise from triggering capital gains at the firm level or shareholder level (Desai & Hines, 10).
3. The tax consequences that arise from enhanced opportunities to relocate profits worldwide in a tax-advantaged way after an expatriation (Desai & Hines, 10).

Many companies choose to expatriate due to the first incentive. The reason is because the U.S. tax system holds high repatriation taxes and many companies spend time and effort finding ways to avoid paying them. By expatriation, companies bypass paying any amount for repatriation because they keep their money overseas. The money saved from avoiding repatriation can be spent on restructuring and enhancing foreign operations. By transferring ownership of foreign assets away from U.S. hands, many corporations are capable of fully benefitting from the tax shields associated with interest payments (Desai & Hines, 10). The third incentive is quite popular for expatriating firms because shareholders view that the increase in flexibility of the allocation of taxable profits is a gain to the firm. Many companies face foreign tax credits and repatriation taxes when trying to return money back domestically. However, this increased flexibility temporarily removes any barriers for companies to shift profits. This causes

corporations to be more aggressive when structuring their foreign operations because they have an easier time sending profits to their subsidiaries. The U.S. tax law has created regulations to limit the amount sent through subsidiaries but the use of debt contracts with parent companies find it easier for companies to reduce their domestic taxation. The act of utilizing these debt contracts is called interest stripping (Desai & Hines, 11). How interest-stripping works is that parent companies finance their ownership in the American subsidiaries with debt, which generates interest deductions against U.S. taxable income (Desai & Hines, 11). Therefore, any interest income is untaxed or slightly taxed by the tax haven, as well as not taxed by the U.S. because ownership of the interest is not held domestically.

## **Closing Remarks**

This paper analyzes how multinational corporations use various multilevel tactics to avoid a large portion of taxation on their annual profits. Giant well-renowned entities, such as Microsoft and Google, have been using these legal tax avoidance schemes for decades now by utilizing loopholes in international tax laws. Headquartering subsidiaries in tax havens capitalizes on their low to zero corporate income taxes and lack of information transparency. The net effect of profit shifting can lead multinationals to save up to an outstanding 30% on their overall taxation on profits generated through business activities. The Organization of Economic and Co-operation and Development was created to help monitor tax avoidance strategies and along with the help of G20 countries, the BEPS Package was instated to help further the monitoring.

Tax laws over the past years have strengthened in foreign countries but many suggest that tighter and stricter laws need to be enforced to slow down or stop tax evasion. The IRS has tried

to hunt down those multinationals that have attempted to exploit the international tax law loopholes. However, from past experiences, it seems that multinationals have the resources and capabilities to continue to avoid taxation on their earnings.

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