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Brief

Why Tax Inversions Continue to Be an Effective Global Tax Planning Strategy

Burger King, Pfizer, Medtronic, Chiquita, AbbVie, Mylan and Walgreens, among many other companies, have attracted considerable attention over their plans to (or in some cases the mere announcement that they were evaluating whether to) relocate overseas. Due to significant business opportunities offshore, inversions have become a popular strategy as merger and acquisition activity increases.

The United States' outdated tax system, which includes worldwide taxation of corporate income and a high corporate tax rate, arguably puts U.S.-based multinationals at a competitive disadvantage. The hype surrounding inversions could serve as the catalyst to encourage Congress to eventually take action on much-needed tax reform. In the near term, however, election-year politics, combined with disagreements about the appropriate policy response, have thwarted any congressional action.

With congressional action on tax reform before 2017 unlikely, the U.S. Treasury Department released Notice 2014-52 on September 22, 2014, which takes action to curb some of the tax benefits of inverting and limits certain structuring approaches to inverting. While the Treasury Notice likely will impact the economics of some pending and contemplated deals, it is just an incremental step toward slowing down inversions. The Notice does not (and cannot) address the core problem. Benefits of inverting remain and likely will continue to remain, absent congressional action to reform the way the U.S. taxes multinational businesses.

The Benefits of Tax Inversions

What is an inversion?

An inversion is a transaction that results in an existing U.S. company becoming a foreign company or becoming a subsidiary of a foreign parent. Historically, inversions involved U.S. companies redomiciling to tax havens. Since the enactment of anti-inversion legislation in 2004, however, inversions generally have involved a merger between a U.S.-based multinational and a foreign company, creating a new parent company located in a foreign jurisdiction. The transaction allows the U.S. company to become foreign-owned, even if all executives remain in the U.S.

Why do companies invert?

An inversion can lead to meaningful tax synergies, driving down the effective tax rate of the combined entity. By creating or combining to form a foreign parent, the companies reduce their tax liabilities. Some inversions result from a U.S.-based corporation purchasing a foreign competitor, often paying a premium reflective of the resulting inversion benefits. In other cases, U.S.-based companies are targeted by foreign-based corporations in a position to pay a premium reflective of the tax benefits that result from the U.S.-based target no longer being headquartered in the U.S.A.

How do the tax benefits of inversions manifest themselves?

Tax benefits are one among several "synergies" that can be identified in a cross-border merger. The tax synergy can be quantified and frequently becomes part of the acquisition currency for the transaction. Most of the inversion transactions to date have involved the payment of premiums to the foreign target shareholders, with the tax synergies contributing to the premium. The effective tax rate of inverted companies is considerably lower after the inversion, which provides shareholder value.

Where do companies generally go when they invert?

Companies frequently (but not exclusively) relocate to European jurisdictions such as Ireland, the Netherlands and the United Kingdom due to their territorial tax systems and competitive tax rates. Business drivers, such as the existence of plants and operations, can also help narrow the choice of jurisdiction.

Benefits

The U.S. has the highest effective corporate tax rate in the world. The ability of an inverted company to earn or shift income outside the U.S. tax net creates a benefit and is a driver for inverting. There are three basic tax benefits of inverting:

Territorial Corporate Tax and Reduced Rate: Most jurisdictions around the world have a territorial tax system under which income earned outside the parent company's jurisdiction is taxed in only limited circumstances. Inverted companies benefit from a territorial regime and typically grow their foreign operations out from under the U.S. worldwide tax net.

Access Trapped Cash: As a result of being outside the U.S. worldwide tax system, inverted companies can access cash trapped offshore without incurring significant tax and can deploy offshore cash more efficiently or distribute it to their shareholders. This access to cash trapped offshore can also have financial accounting benefits.

Earnings Stripping: Inverted companies can reduce the amount of income subject to tax in the U.S. by introducing debt into the U.S. companies, giving rise to interest deductions and reducing the effective tax rate paid on their U.S. income.

Costs

A number of tax considerations must be taken into account in connection with an inversion transaction:

If the historic shareholders of the U.S. entity take back 50 percent or more of the stock of the new foreign parent, the transaction may be taxable to the shareholders.

If the historic shareholders of the U.S. entity take back at least 60 percent and less than 80 percent of the stock of the new foreign parent and the company does not have substantial business activities in the foreign parent's jurisdiction, the utilization of certain tax attributes (such as losses and credits) is limited for 10 years, which could impact the ability to move foreign operations out from under the U.S.A. 15 percent excise tax on certain stock-based compensation of insiders also applies.

If the historic shareholders of the U.S. entity take back 80 percent or more of the stock of the new foreign parent and the company does not have substantial business activities in the jurisdiction of the foreign parent, the resulting foreign parent is treated as a U.S. company for tax purposes—in other words, the inversion fails.

Treasury's Efforts to Limit Tax Inversions

On September 22, 2014, Treasury released Notice 2014-52 to address certain tax benefits of inverting and structuring approaches. In particular, and as is relevant to several pending transactions, Treasury will issue regulations limiting an inverted company's ability to access trapped cash. The guidance will also tighten the existing anti-inversion rules to address specific transactions, making it more difficult in those situations to avoid "failing" the 60 percent and 80 percent thresholds. These new rules will apply to inversions completed on or after September 22, 2014—not retroactively to completed inversions.

Notably, the Notice does not provide specific rules dealing with earnings stripping, although it does state that Treasury is considering future guidance to address earnings stripping. Further, the Notice indicates that such guidance will apply prospectively except with respect to already-inverted companies, in which case, as for the rest of the Notice, the effective date would be September 22, 2014. This indicates that any future guidance may not be limited to inverted companies and may represent generally applicable rules addressing "base erosion and profit shifting."

How does the Notice affect repatriation and access to trapped cash?

Under the U.S. worldwide tax system, a U.S. parent company is not subject to current taxation on the active earnings of its controlled foreign subsidiaries ("controlled foreign corporations," or CFCs) but is subject to tax when the CFCs repatriate the earnings—this is referred to as "deferral." The U.S. tax serves as a disincentive to repatriate foreign earnings.

For inversions completed prior to the effective date of the Notice, after the U.S. group became owned by a new foreign parent, the cash and assets accumulated offshore by the CFCs could be accessed by the foreign parent and foreign sister companies under the foreign parent through loans or equity investments "hopscotching" the U.S. parent, joint venture investments or certain cross-chain sales. In addition, the new foreign parent could transfer assets to the CFCs in exchange for a sufficient interest to give the foreign parent control of the foreign subsidiary. Consequently, the foreign subsidiary would no longer be subject to the "anti-deferral" rules applicable to CFCs, meaning its U.S. parent could no longer be taxed on certain passive income of the CFCs.

The Notice provides several rules that limit the new foreign parent's ability to access the cash of the CFCs without incurring U.S. tax or its ability to avoid the application of the anti-deferral rules. The first and second rules would apply to an inverted U.S. company in which former shareholders own at least 60 percent but less than 80 percent of the new foreign parent. Under the first rule, a debt or stock investment by a CFC in the new foreign parent or a foreign sister company during the 10 years following the inversion would cause the inverted U.S. company to recognize a taxable constructive dividend up to the amount of the loan or equity investment.

Second, the Notice addresses specified "decontrolling" transactions, among others, involving CFCs of the inverted U.S. company. As an example of a decontrolling transaction, after an inversion, the new foreign parent could make a stock investment in a foreign subsidiary of the inverted domestic company such that the new foreign parent owned 50 percent or more of the stock of the foreign subsidiary. Absent the Notice, the foreign subsidiary would cease to constitute a CFC and would therefore cease to be subject to the anti-deferral rules, and the foreign subsidiary's cash could be accessed without triggering U.S. tax liability. Under the new rules, specified transactions occurring within 10 years following the inversion will be recast so that the foreign subsidiary will remain a CFC and will remain subject to anti-deferral rules.

Finally, the guidance precludes a specific method of accessing CFC cash through an intragroup sale of stock. Absent the new rules, if after an inversion the new foreign parent sold stock of the inverted U.S. company to one of its CFCs, the CFC could be treated as paying a dividend directly to the new foreign parent, and the constructive dividend would not be subject to U.S. tax. Under the new rules, the CFC will not be treated as paying a dividend to the new foreign parent, and the CFC's earnings will remain at the level of the CFC and subject to U.S. tax.

How does the Notice impact inversion structuring techniques?

The Notice also would tighten the existing anti-inversion rules, making it more difficult for the new foreign parent to avoid failing the 80 percent and 60 percent thresholds. Generally, under the existing rules, failing the 80 percent or 60 percent threshold can be avoided if the value of the foreign merger partner exceeds 20 percent or 40 percent, respectively, of the value of the new foreign parent after the inversion. Under the new rules, first, if 50 percent or more of the assets of the foreign merger partner are "passive" assets, such as cash or marketable securities, the value of the passive assets will not be taken into account in applying the 80 percent and 60 percent tests.

Second, extraordinary "skinny down" distributions by the inverting U.S. company made within the three years preceding the inversion will not be taken into account in determining the inverted company's value for purposes of applying the 80 percent and 60 percent tests. Such distributions also would not be taken into account for purposes of determining the taxability of any U.S. shareholders of the inverted U.S. company in connection with the inversion. Distributions for these purposes would not be limited to distributions that are treated as dividends and would include distributions of subsidiaries in spin-offs occurring within the three-year period. Finally, so-called spin versions, in which a part of a U.S. company is spun off in connection with an inversion, would be precluded.

Why Inversions Are Likely to Continue

Are there any benefits to inverting in light of the Notice?

The Notice will have a direct impact on certain aspects of inverting but is not sufficiently comprehensive to prevent inversion transactions from proceeding or to stop the trend, because meaningful benefits remain. First, many of the transactions that have occurred are pending or are being contemplated reflect a strategic business decision in which the inversion tax synergies are merely one consideration. In addition, not all inversion transactions are done to access trapped cash offshore, and even those strongly motivated thereby may have alternative financing or structuring options. The benefits of moving to a territorial tax system with a lower rate remain. In other words, an inverted company can still benefit from removing its future foreign growth from the U.S. worldwide tax system. In addition, the earnings-stripping benefits that allow a reduction in tax on U.S. earnings seemingly remain, although future regulatory action could limit earnings stripping and could apply retroactively.

What are the ancillary considerations that should be taken into account?

On the one hand, corporate boards have an obligation to deliver shareholder value. As a result, so long as the current U.S. tax system remains unchanged, inverting will be a consideration. On the other hand, public perception is a factor, especially for companies that have direct interaction with consumers or regularly contract with the government. The president of the U.S. has branded inverted companies as “corporate deserters” and unpatriotic. In short, both tax and nontax considerations must be weighed carefully.

Is corporate tax reform on the horizon?

Tax reform remains unlikely in the near term; however, legislative proposals have been introduced, largely in the Senate on the Democratic side, which would curb inversions and build walls to keep U.S. companies from moving overseas. These proposals have not been successful to date and are subject to political resistance among policymakers who intend to use inversions as a catalyst for needed fundamental tax reform.

Will inversions continue until tax reform is enacted?

Yes. Under current law, the Treasury Department is limited in its ability to fully address inversions. Congressional action is necessary for that, and the long-term solution is best addressed through comprehensive corporate tax reform. Tax reform takes time and, in the current political climate, is unlikely to occur before 2017.

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