Corporate inversions: How US shareholders may be adversely affected

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Due to a rapid rise in the number of transactions and the resulting potential losses for the US Department of Treasury, corporate inversions are a current hot topic in Washington. The US corporations which enter into these transactions defend their actions, at least in part, by highlighting their fiduciary duty to shareholders to maximize profits, which can be achieved through incorporating in a lower tax jurisdiction. However some US shareholders may be subject to a taxable capital gain due to such transactions which, in some cases, they may not even be aware are taking place.

A corporate inversion occurs when a US multinational corporation combines with a foreign corporation which then becomes the 'parent corporation' of the US corporation. For US corporate tax purposes, the result is that the multinational company is no longer subject to US taxation on its worldwide income. Instead, the corporation is only subject to US tax on its US earnings. Since the US has one of the highest corporate tax rates in the world at 35% (compared with, for example, Ireland with a 12.5% tax rate) the potential tax savings may be worth the current political backlash.

Regardless of one's political thoughts, the question for US shareholders in these firms is whether they will reap the financial benefits of a company's expatriation. The answer is surprisingly unclear. In the short term, many shareholders may experience a sudden tax hit because the US Tax Code treats corporate inversions as taxable events. This means that a US shareholder is treated as having sold his or her stock in the company which often results in a taxable capital gain. Unlike a typical capital gains transaction, however, tax is imposed at the shareholder level even though no cash is received and the shareholder is merely exchanging his current stock for shares in the new foreign parent corporation. Additionally, as many US shareholders hold stock through mutual funds, they may not appreciate that they are holding shares in an inverting corporation (and are therefore facing a potential capital gains charge) until they receive their investor's annual report at year end. With careful tax planning, there are ways to prevent a capital gains tax charge, though US shareholders should take action before the inversion is completed. A US shareholder may offset capital gains with capital losses, gift the stock away to an individual in a lower tax bracket as part of the US shareholder's lifetime gift planning, or donate the shares to a public charity for a deduction equal to the fair-market value of the shares.

In the long term, however, corporations expect higher earnings per share and greater dividend distribution – benefits that many multinational corporations believe justify the current tax hit some US shareholders may take. However, if you are facing a potential capital gains charge on a stock transaction, Withers can advise you on your capital loss position, and help structure tax-efficient donations to charity or tax-efficient gifts as part of your lifetime planning.