Anti-inversion legislation and US taxation

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The 2016 US presidential election year has included a significant amount of discussion about international taxation. The volume of the discussion can be attributed to the fact that it is being voiced on multiple fronts in different proposals by the US presidential candidates, the US Congress, President Obama and the US Treasury, and echoed in still different forms by other nations, the Organization for Economic Cooperation and Development ('OECD') and [the European Union Commission]. The plethora of proposals and agendas is enough to confuse even the most astute Chief Financial Officers, Tax Directors and General Counsel. This article aims to put the attacks on inversions in their historical context thereby enabling the reader to better predict what might come next.

The US taxation scheme

From the early days of US taxation, the US government decided to tax its corporations (' USCo') on a worldwide basis, regardless of the location of USCo and its subsidiaries (the 'Worldwide Scheme'). This Worldwide Scheme is in contrast to the tax schemes of the vast majority of other countries, who tax their resident corporations only on the income earned in their respective territories (the 'Territorial Scheme'). For a grossly oversimplified example, consider a USCo with a Dutch subsidiary, both earning $100 million (ignoring for a moment how the income was earned), the US would tax $200 million. If one were to flip the structure, a Dutch parent company with a USCo subsidiary, and assuming the same income, the Dutch taxing authority would tax only $100 million, and the US would tax the other $100 million. Essentially, this would be the result in 'pure' Worldwide and Territorial Schemes. However, from the very beginning, the US never had a 'pure' Worldwide Scheme, because it has allowed for foreign tax credits ('FTCs'), which attempt to avoid taxing the same income twice and, along the way, has further chipped away at the purity, most significantly, perhaps, in the 1960's, when the US decided that only active foreign business operations would be allowed deferral (currently taxing passive income regardless of whether the income is repatriated back to the US as, for example, a dividend).

The US Worldwide Scheme, in its pure form and placed in a modern context, presumes that companies so desperately want to be headquartered in the US that they will succumb to not only global taxation, but one of the highest statutory rates on Earth. However, whether this may or may not have been true in the past, it seems less likely that it is the case today. First, it is likely that companies locate in the US in large part because of the decidedly un-pure Worldwide Scheme, relying on FTC, deferral, interest deductions and treaty benefits (collectively 'Tax Benefits') to get to an ETR that is more competitive with non-US companies. Secondly, USCo's are constantly lobbying for more Tax Benefits and arguing that the Worldwide Scheme is anti-competitive. Thirdly, many USCo's are fleeing the US for tax reasons. Why would they do so if the Worldwide Scheme was acceptable? It seems obvious that USCo's are less and less willing to live with the Worldwide Scheme, even in its impure form. Further, the push for further Tax Benefits requires thousands of pages of law, regulations and guidance, so the 'catch-22' for USCo and the US government is that usually additional Tax Benefits necessitate additional compliance time and cost, resulting in a less efficient system. Moreover, the additional Tax Benefits beget more complexity which often leads to disparate treatment for companies and a sense of inequality that leads some to characterize the Tax Benefits as 'loopholes.' However, this characterization fails to take into account the evolution of the US tax laws.

The inversion scenario

The current debate on inversions (US companies moving their tax situs for various tax purposes outside the US) is a perfect example of how politicians manipulate a set of facts and rules to suit their agenda. To some, an inversion is just another example of USCo legitimately attempting to level the playing field. Those people argue that US companies cannot compete with their foreign competitors because those competitors have a much lower effective tax rate ('ETR'). To others, inversions are another example of unpatriotic corporate greed.

Theoretically, if you could get these two groups to agree on the question of 'what is the fair amount of tax?', then the debate should boil down to merely the administration of the tax. Both sides seem to admit that the statutory rate is too high and anti-competitive. President Obama and the US Treasury issued The President's Framework for Business Tax Reform: An Update (April 2016) ('Framework') which references an average ETR for US corporations of 23% and claims that, as such, the anti-competitive argument of the inversion companies is hollow while, at the same time, suggesting a new reduced statutory rate of 28%. So for President Obama the fair rate is not 35% or 18%, but something in the middle.

If USCo did an inversion to lower its ETR from 35% to 28%, would President Obama object? Absent a complete re-write of the Internal Revenue Code ('Code'), we will have to live with the historic incentives (Tax Benefits) that exist in the Code. That means, if one starts at 28%, some will be able to get to an ETR below that figure. Piecemeal changes to the Code to attempt to hand-pick the winners and losers is both inefficient and unjust. We are a land of rules and when smart people play by the rules to gain an advantage it is decidedly un-American to stigmatize and punish those USCo's.

The historic perspective of the inversion

As the global reach of multinational companies has extended over the past 30 years, US corporations have looked to inversion transactions as a way to lower their worldwide ETR and thereby stave off global competition from foreign companies that enjoy lower ETRs. By one count, approximately 50 inversions occurred since 1982 and over 20 since 2012. [12] In 2003, Congress enacted rules to combat these inversion transactions (the '2003 Rules'). Most recently, there have been two Notices issued (Notice 2014-52 and Notice 2015-79 (the 'Notices')) as well as new temporary regulations that attempt to combat the recent appetite for US companies to invert (the 'New Regs'). In addition to the New Regs, the Framework looks to discourage inversions by addressing the overall US tax system. Finally, on the same day the New Regs were issued, the Treasury Department issued proposed regulations under Section 385 (the 'New 385 Regs') that attack certain aspects of inversion planning and, subsequently, legislators continue to proffer legislation aimed at making it prohibitively expensive to invert.

Inversion transactions:

A typical inversion involves a transaction whereby a US corporate parent of a multinational company (' USP') becomes the subsidiary of a smaller non-US company ('FAC'), typically located in a low-tax jurisdiction such as Ireland or the Netherlands.
These USPs may have various non-tax motivations when undertaking an inversion transaction. However, because it is almost inevitable that the US will have a corporate rate of tax higher than most other jurisdictions in the world, the USP's ETR will be reduced as a result of the transaction.

The effect of the 2003 rules:

The 2003 Rules reduce the benefits of certain inversions by either treating the foreign corporation that acquires substantially all the assets of a domestic corporation (or in the case of a domestic partnership, substantially all the properties constituting the trade or business of the domestic partnership) ('FAC') as a USCo and taxes it fully according to the US Worldwide Scheme (the '80% Rule'), or alternatively taxes the inverted company over a 10-year period on certain of the built-in gains of the business (the '60% Rule'). Neither of these rules applies if the FAC has 'substantial business activities' in the foreign jurisdiction ('Substantial Business Test').

The perceived abuse:

The Notices and New Regs are in response to the Treasury Department's frustration that the 2003 Rules allowed too much deferral for USCo's and the Notices and New Regs take aim at those USCo's whose former shareholders ended up with over 60% of the FAC. The Treasury views these transactions as facilitating the erosion of the US tax base without a substantial change in business operations.[3] However, the 2003 Rules were not enough to dissuade companies from inverting.

Examples are the Eaton/Cooper merger, whereby Eaton Corporation (a US company) acquired Cooper Industries (an Irish company) and redomiciled to Ireland, and also the Perrigo/Elan merger, whereby Perrigo (a US pharmaceutical company) acquired Elan Corporation, plc, (an Irish drug company), and reincorporated in Ireland. In both of these cases the inversion rules applied but no inversion gain was recognized.[4]

Another recent example is Allergan Plc which had been a US company before it inverted to Ireland in an acquisition by Actavis Plc and has since acquired a number of smaller pharmaceutical companies. Allergan would likely be considered a so-called 'serial inverter' by the IRS in that one inversion has enabled the company to undertake other US acquisitions because, with each acquisition, it grows the value of the FAC for the purposes of testing future acquisition ownership percentage values.

Another perceived abuse is the so-called 'stuffing transaction'. This transaction involves the artificial inflation of the value of the FAC by stuffing assets into the FAC prior to the inversion so as to stay below the 80% threshold. This can be easily accomplished using passive assets and is consequently ripe for abuse. Another recent example is the potential acquisition of Tyco (Ireland) by Johnson Controls (US) announced in early 2016 whereby Johnson Controls would merge with Tyco and move its headquarters to Ireland. Under the terms of the 'merger', Johnson Controls shareholders will receive a 56% equity stake in the new combined entity and thus not be subject to the inversion rules of Section 7874. However, in its S-4 regulatory filing, Johnson Controls spent significant time addressing the Inversion Notices, proposed regulations and announcements by members of congress and how each of those could significantly change the rules and application of the inversion test with possible retroactive effect and how such changes could materially alter the potential tax benefits of the proposed transaction (including future spin-offs and restructurings of the new combined group).

Similarly, Terex Corporation (US) announced, in August 2015, its intention to merge with Konecranes Oyj (Finland). However, the recent changes to the inversion rules as outlined above have thrown a significant wrench into the merger's works. In Terex's SEC filing 10-Q on April 27, 2016, the company announced that upon review of the new rules, almost all of the $35 million in financial and tax synergies with respect to the merger will be wiped out. Specifically, the 10-Q highlighted the restriction to re-domicile any place but Finland and the potential imposition of the New 385 Regs as reasons for the elimination of the $35 million in tax savings from the merger. As a result, Terex is now entertaining a new cash offer to purchase 100% of Terex shares by a Chinese company.

The new regs:

On April 4, 2016, the IRS and Treasury issued the New Regs as both the fulfillment of their intentions as described in the Notices and as yet another attempt to restrict both the occurrence and benefit of inversions. The New Regs incorporate the rules in the Notices (with certain modifications) and provide new rules that both expand the scope of transactions and entities that will be subject to Section 7874 and inhibit the ability of an inverted company to escape the US tax net.

The most significant new rule that was not addressed in the Notices is aimed at so-called 'serial inverters' and specifically aimed at multiple domestic entity acquisitions. Specifically, the new rule would exclude from the denominator of the ownership fraction test the stock of the FAC attributable to prior domestic entity acquisitions made in the previous 36 months. Absent such a rule, each time a foreign corporation acquired a US target it would increase their size and by definition enable acquisition of other US targets thereby potentially decreasing the likelihood that either the 80% Rule or the 60% Rule would apply. This 'serial inverter' rule expands the current rule of Treas. Reg. 1.7874-2(e) 'the combination rule' which targets multiple acquisitions of domestic targets but only applies if the acquisitions were pursuant to a plan. One example is Allergan as discussed above, who had been in talks to purchase Pfizer recently. Those merger talks were discontinued after the New Regs were issued with many feeling that the timing and rules were aimed at stopping the merger.

The New Regs hold true to the announcements in the Notices in that for all provisions that were in the Notices the effective dates are the date of the Notices. For all new rules and changes to rules in the Notices, the effective date is April 4, 2016.

The new 385 regs:

Also on April 4, 2016, the IRS and Treasury issued the New 385 Regs. As discussed above, the intention to issue guidance under Section 385 had been discussed in the Notices. Additionally, the timing of the announcement, i.e. in conjunction with the New Regs, shows an intention for the New 385 Rules to be another tool by which the government wishes to prevent inversions and their associated benefits. However, despite the seeming interrelationship between the two sets of rules, the New 385 Regs have far reaching consequences beyond the inversion context and may significantly inhibit multinational companies (whether US or foreign based) from using the routine financial transaction to run their businesses. Specifically, the New 385 Regs: (i) authorize the IRS to treat certain related-party interests in a corporation as part debt and part equity; (ii) establish documentation requirements for related-party debt; and (iii) treat as equity certain related-party interests that would otherwise be treated as debt. The third category, which includes distributions of debt instruments by corporations to their related corporate shareholders, may negatively impact cash management functions of multinational corporations, as well as have other adverse results.

As a threshold matter, the New 385 Regs would generally be limited to indebtedness between members of an ‘expanded group’ defined by reference to Section 1504(a) with several expansions. The expansions include, but are not limited to, attribution rules under Section 304©(3) as well as including affiliations held through partnerships. The New 385 Regs do not apply to transactions between members of a US consolidated group. The preamble to the New 385 Regs state that the documentation requirements of Prop. Reg. 1.385-2 is intended to apply only to ‘large taxpayer groups’ i.e. where an entity in the expanded group is publicly traded, has assets of over $100 million, or has revenues of at least $50 million. Therefore, an analysis must be done as to whether these rules apply before any debt transaction is undertaken.

Conclusion

The Notices, New Regs and New 385 Regs are massively complicated and overly broad. Collectively, they represent further efforts by the Administration and the US Treasury to carve back the Tax Benefits designed to lessen the blow of the Worldwide Scheme. Many argue that the US should join the UK in abandoning the Worldwide Scheme, and move to a Territorial Scheme. One may wonder if such a move would be a sign of weakness by the US, especially in the face of multi-hundred million dollar settlements by US companies, such as Apple in Italy, Starbucks in the UK and likely Google in France (the investigation is ongoing at the time of print).

It does seem likely that the overwhelming complexity of the US tax system is likely to cause there to be a very significant overhaul of the US tax system in the next two to five years. One can only hope that the result will be an efficient, competitive and just tax system.

Footnotes

[1] Bloomberg QuickTake, Tax Inversion, *How US Companies Buy Tax Breaks* by Zachary R. Mider and Jesse Drucker, updated April 6, 2016.

[2] These figures do not include private company acquisitions.

[3] S. Rep. No. 192, 108th Cong, 1st Sess., at 142 (2003).

[4] In both cases, no inversion gain was recognized. See Eaton Corporation Limited, 2012 Form S-4 Registration Statement and Perrigo Company Limited, 2013 Form S-4 Registration Statement