Tax Inversions: Administrative and Legislative Responses

Dana S. Wood, Gregory J. Mastel

October 10, 2014

Tax inversions, mergers of U.S. companies with generally smaller foreign companies that result in a new company with headquarters overseas largely to take advantage of lower foreign tax rates, have occasionally taken place for more than three decades. In recent years, the pace at which these inversions have been announced has picked up markedly, particularly in the pharmaceuticals and medical device sector. A recent announcement of a possible merger between the U.S. company Burger King and a Canadian chain of coffee shops known as Tim Horton --- a rare inversion involving well–known consumer brands – has greatly raised public awareness of these transactions.

Political attention of these transactions has been rising for some time. Collectively, inversions could have a significant impact on U.S. tax revenues. The U.S. corporate tax rate is higher than that of most other developed countries so there has long been incentive to reorganize outside the United States, but there have been offsetting issues of adverse impact on brand names and the unwillingness to move important corporate operations outside the United States for a number of reasons. Add to this incentive, many U.S. companies have been deferring taxes on their overseas earnings and choosing to keep those earnings overseas.[1] This has led to as much as $2.1 trillion in earnings being parked overseas as deferred income.

There has been the hope – now fading in the eyes of many observers – that the U.S. would declare a “tax holiday” and allow this money to be brought back into the United States at a much reduced tax rate. The United States has declared such a tax holiday before, but despite intensive lobbying by much of corporate America political support for such a move appears limited. There has also been broad discussion of possible U.S. tax reform that would involve lowering the U.S. corporate tax rate in return for the elimination of many “loopholes” and tax credits. But in the last year concrete proposals by senior lawmakers to move in this direction have found it difficult to close enough loopholes in order to offset the cost of reducing the corporate rate from 35 percent to the stated goal of something like 25 percent.[2] Many of the “loopholes” also proved politically popular.

The outcome of the mid-term elections could affect the likelihood of a “tax holiday” or broader tax reform, but at this point both the outcome of the elections and the real chances for major tax legislation are uncertain. This uncertainty contributes to the desire of come companies to explore strategies such as tax inversions to reduce their tax liability and likely spurred some recent announcements.

Both ends of Pennsylvania Avenue reacted to the surge of inversions. Although legislative action is likely impossible this year and uncertain next year, several Members of Congress have circulated concepts to stop tax inversions and protect the flow of revenue to the U.S. Treasury.

The U.S. Treasury Department cannot by itself completely rewrite the underlying tax laws that make inversions possible, but it does have substantial room to impose new rules that make inversions much more difficult and make it harder for U.S. companies to avoid taxes on deferred foreign earnings. After several weeks of pointedly warning that it planned to act, on September 22nd in an announcement led by Treasury Secretary Jack Lew, Treasury outlined steps it plans to take to limit tax inversions. The broad concepts outlined on the 22nd are likely to be converted to specific rules shortly and additional steps may well be announced in the coming weeks.

Treasury Annoucement

Secretary Lew made a point to say that Treasury: 1) was not seeking to unravel transactions that had already closed, and 2) recognized that there was legitimate business value in many cross-border mergers and restructurings. But he also clearly – in both tone and proposed action – aimed to chill several high profile tax inversions that had been announced and were being contemplated. Several of the specific rule changes suggested seemed to directly respond to high profile transactions that were being considered.

Although the announcement was more a press release than a rule making, it did specifically target several widely used practices as tax abuses that Treasury planned to stop with future rule. The practices particularly targeted include:

1. Preventing inverted companies from accessing earnings of foreign subsidiaries through **"hopscotch loans."** Instead of paying foreign earnings back to the U.S. parent as taxable dividends or loan that would be taxed in the same way, some inverted companies would seek to loan the funds held by foreign subsidiaries to the newly created foreign parent avoiding U.S. taxes. Treasury proposes treating such a loan as a fully taxable loan to the former U.S. parent.

2. In some cases, inverted companies would seek for the new foreign lead company to purchase a controlling position in what are currently foreign subsidiaries of the U.S. partner in the transaction with the goal of avoiding U.S. taxes on the deferred earnings held by those subsidiaries. Treasury would treat this strategy – dubbed **"de-controlling"** – as an illegitimate effort to avoid U.S. taxes and continue apply U.S. taxes to deferred earnings.

3. In a similar vein, current foreign subsidiaries of U.S. partners in inversions would not be allowed to transfer earning or assets to the new foreign parent to avoid U.S. taxes. Such transactions would be taxed as transfers to the current U.S. parent.

4. In general, Treasury would also make it more difficult to carry out a tax inversion in several ways. Under Section 7874 of the U.S. tax code, inversions in which 80 percent or more of the assets are held by the U.S. entity inversions are disallowed. If the U.S. entity controls between 60 and 80 percent of the new combined entity, the inversion is subject to special scrutiny and some limitations.[3] To make it more difficult for an inverted company to meet these thresholds, Treasury proposes:

    A. **No Counting Passive Assets.** For purposes of Section 7874 transactions passive assets, such as cash and marketable securities, held by the foreign entity would not count to the total of assets held. Banks and financial service companies would be exempted from this rule.

    B. **No Skinny Down Dividends.** One often used way to meet these thresholds would be for the U.S. entity to grant extraordinary dividends to its shareholders, thus decreasing the size of the U.S. entity for purposes of Section 7874.

C. No Spinversions. The U.S. entity would not be allowed to transfer its assets to its current foreign subsidiaries and then spin off those subsidiaries to its public shareholders as separate corporate entities. These new entities are smaller and more likely to be able to merge with a new foreign parent and meet the 80 percent threshold. Treasury proposes taxing these new companies and as U.S. companies.

In the future, Treasury has indicated that it will flesh out rules to implement what it outlined on the 22nd. These rules are very important because, to this point, Treasury has only outlined some broad concepts. Specific rules on what is and what is not permissible will indicate the real impact of Treasury pronouncements and potentially define practices that are still permissible.

In addition, it is possible -- even likely -- that additional steps may be taken to further deter inversions. In particular, Treasury is reportedly preparing rules to prohibit **"earnings stripping"**, which is the practice of transferring debts and other obligations to foreign subsidiaries with the goal of offsetting earnings held by those subsidiaries and avoiding U.S. taxes. To date, however, no action has been taken on earnings stripping**.** A number of other ideas to deter tax inversions have also been mentioned ranging as far afield as altering Medicare reimbursement practices, but most concrete speculation has focused on earnings stripping.

Reaction

Much of the immediate political reaction was predictable. Democrats generally praised the Administration's actions, though many called for more. Many Republicans argued that the problems posed by tax inversions – assuming there were real, widespread problems – could only be dealt with through broad corporate tax reform on which the Administration had been perhaps lukewarm.

Editorial reaction was also mixed, though there was widespread consensus that some of the practices targeted by Treasury were tax loopholes that needed to be closed.

The most important reactions were probably those in the marketplace. Many of the companies that are in the process of high profile inversions transactions took an immediate stock price hit, though some have recovered. The participants in the three or four transactions that seem most specifically to be targeted by the Treasury announcements have generally tried to minimize the Treasury action and stated that they plan to continue with the planned transactions, while noting that they will need to study the specifics of Treasury proposals before completing deals.

Did Treasury Succeed?

This is as much a political question as a substantive one. By acting on a perceived problem while Congress appears paralyzed, the Administration likely scored some political points. Only the future will tell how lasting and important those points are.

It does seem clear though that the immediate goal of Treasury's announcement was to halt or at least slow the perceived stampede toward tax inversions. Of the handful of planned inversions that were already announced and planned, Treasury clearly has put a monkey wrench in plans no matter how much the companies involved may argue to the contrary. It is simply not possible to blindly stick with plans in light of Treasury's announced intention to find key elements of these planned mergers as illegitimate tax dodges. In the end, it may be that the companies involved are still able to restructure plans and proceed with planned tax inversions perhaps preparing years of litigation with U.S. tax authorities, but the risks and uncertainties for pursuing tax inversions have clearly been raised and that will eventually impact business planning. Perhaps more importantly, the pace of new planned inversion announcements seems to have slowed at least for now, but this is far from a scientific analysis and things could change.

Tax inversion deals and those that help structure and finance them have become a significant cottage industry that will not disappear overnight. Normally when Treasury and the IRS make announcements on tax rules they aim to increase certainty in the marketplace. In the case of these announcements on tax inversions, Treasury seems to have exactly the opposite goal – increasing business uncertainty in order to deter possible inversions. Only time will tell if this strategy will ultimately succeed or perhaps be replaced by permanent legislation. But for now Treasury has certainly succeeded in increasing the uncertainty around tax inversions and slow the pace of business planning More actions seems very likely, particularly if the pace of tax inversions were to again surge. Tax inversions are certain to be a topic of continued Treasury scrutiny and perhaps even legislation in 2015 and beyond.

---

[1] U.S. companies are taxed on their global earnings – with some adjustments – by the U.S. Treasury. Most countries only tax earnings from within their borders.

[2] The current U.S. federal tax rate on corporate profits is 35 percent. Some cite a higher rate that includes state taxes. The effective tax rate – the rate after deductions and credits are factored in – is much lower usually estimated between 19 and 24 percent, which is why there is frequent media attention to corporations that pay very low effective taxes on profits. But not all corporations can easily take advantages of various tax incentives to reduce their tax bill.

[3] Treasury has proposed a new 50 percent threshold, but that would require legislation and cannot be accomplished by regulation.