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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Assessing Retroactive Inversion Legislation And Its Risks

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Jason Halper

The increasing use of corporate inversions, whereby a company via merger achieves 20 percent or more new ownership, claims non-U.S. residence, and is then permitted to adopt that country's lower corporate tax structure and take advantage of tax base reduction techniques, has been the subject of intense media commentary and political attention. That is perhaps not surprising given the numbers: there was approximately one inversion in 2010, four in each of 2011 and 2012, six in 2013 and 16 signed or consummated this year to date — or more than in all other years combined. And, the threat of anti-inversion legislation appears only to be hastening the pace at which companies are contemplating such transactions.

The political outcry has come from the president, who called inversions "wrong,"[1] the Treasury secretary, members of Congress and others. On Aug. 5, three senators urged executive action to curtail corporate inversions motivated by tax considerations. In a letter to President Barack Obama, Senate Assistant Majority Leader Richard Durbin, D-Ill., and Sens. Jack Reed, D-R.I., and Elizabeth Warren, D-Mass., members of the Banking Committee, advocated that the president use executive authority to reduce or eliminate tax breaks for companies that adopt foreign citizenship to avoid paying U.S. taxes.

The senators' concerns echoed those of Treasury Secretary Jack Lew, who in a letter to Congress requested legislation stopping U.S. corporations "from effectively renouncing their citizenship to get out of paying taxes" by enacting legislation that would substantially limit tax inversions retroactive to May 2014.[2] The Treasury Department's assistant secretary for tax policy, Mark Mazur, argued that there was precedent for retroactive legislation: "Congress has frequently imposed retroactive effective dates for provisions that shut down egregious tax loopholes. In these cases, backdated implementation is often important to ensure that companies do not take advantage of the lengthy legislative process to rush through transactions exploiting the loopholes they know they are about to lose."[3]

These developments confront companies that have executed agreements to undertake inversions, or are planning to do so, with significant uncertainty. This article explores a number of relevant unsettled issues, including whether Congress can legally pass legislation that applies retroactively to invalidate the tax advantages of inversions at the 20 percent-or-more new ownership level; whether the president via executive order or the Treasury Department through its rulemaking authority can enact rules without Congress to the same effect; and in either case, if the rules change, how companies that have signed agreements to invert will be impacted.

Statutory Background

In 2004, Congress enacted Section 7874 of the Internal Revenue Code (the "Code") to address perceived abuses associated with inversion transactions. Section 7874 applies to a transaction if:

- a foreign corporation completes the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation;[4]

- after the acquisition at least 60 percent of the stock of the foreign corporation (by vote or value) is held by former shareholders of the domestic corporation; and[5]

- the expanded affiliated group that includes the foreign corporation does not have "substantial business activities" in the foreign country in which the foreign corporation is created or organized when compared to the total business activities of the expanded affiliated group.[6]

The 60 percent threshold results in the foreign corporation being treated as a "foreign surrogate corporation," such that it is not permitted to use deductions to offset gain or income from the inversion transaction. If following the transaction, former shareholders of the domestic corporation own 80 percent or more of the foreign corporation, the foreign corporation instead is treated as a domestic corporation for U.S. federal income tax purposes.[7]

Potential for New Regulatory and Statutory Proposals

In contemplating the potential for new legislative or regulatory action, it is worth recalling that the Treasury Department has shown a willingness to use its regulatory authority under Section 7874 to limit the use of inversion transactions.[8] For instance, in 2012, Treasury limited the "substantial business activities" exception to application of Section 7874. Where the "expanded affiliate group" — the post-inversion combined company — can show that it has "substantial business activities" in the foreign jurisdiction, Section 7874 will not apply.

The IRS and Treasury issued temporary regulations raising the bar for application of the substantial business activities exception by requiring the expanded affiliated group to show, among other things, that at least 25 percent of its employees, assets and income are located in or derived from the foreign country.[9] These regulations replaced 2009 regulations that were based on a less mechanical "facts and circumstances" approach.[10]

Likewise, earlier this year, the Treasury Department issued regulations that had the effect of excluding from the calculation of stock owned by former shareholders of the domestic corporation certain additional stock of the foreign acquiring corporation that was issued for cash (in addition to both stock issued in a public offering or a private placement related to the transaction, which was already excluded). This had the effect of increasing the likelihood of crossing the 80 percent threshold.[11]

Although the form and content of any new regulatory action remains to be seen, if it occurs at all, commentators have suggested as possibilities issuing regulations under both the earnings stripping and Section 956 rules.[12] Much of the benefit from an inversion comes from tax base reduction techniques. “Earnings stripping” refers to when a corporation reduces its taxable income by taking deductions for interest paid to a foreign affiliate. Congress enacted Code Section 163(j) to address such transactions, which significantly limits the amount of permissible interest expense deductions.

New regulations could further limit the availability or amount of such deductions for inverted companies.[13] To accomplish this, one proposal would involve treating as equity the debt of expatriated corporations that has been issued to foreign members of the expanded affiliated group. Similarly, another benefit of an inversion derives from the ability of the inverted U.S. company to no longer be subject to the repatriation rules of Section 956. A second proposal would result in a foreign subsidiary’s profits treated as having been repatriated by the inverted U.S. company when the subsidiary makes investments in U.S. property even though it is no longer the parent of the subsidiary.

A more significant development having the potential to fundamentally alter the ability to achieve tax advantages in connection with inversions is legislation working its way through Congress. Sen. Carl Levin introduced such legislation, the Stop Corporate Inversions Tax Act of 2014 (SCIA), while a comparable bill was introduced in the House of Representatives by Rep. Sandy Levin, Carl Levin’s brother. The proposed legislation would broaden the scope of Section 7874 by implicating transactions in which there has been a change in control of 50 percent or less of the domestic corporation’s stock ownership. In addition, the proposals would apply to any inversion transaction, regardless of the change in control, if management and control of the merged company remains in the U.S. and either 25 percent of its employees, sales or assets are located in the U.S.[14]

The proposed legislation would be retroactive to May 8, 2014, and extend to May 2016 for the purpose of giving Congress time to reach a long-term solution. The SCIA is substantially similar to a comparable provision in the Obama administration’s fiscal 2015 budget. Given the relatively low chances of any legislation passing prior to the November mid-term elections, passage of the SCIA sometime in 2015 could mean it would be retroactive for a period covering approximately one year or more.

The Legality of Applying Retroactively Tax Legislation Aimed At Inversions

The question of whether anti-inversion legislation can legally be applied retroactively, while obviously not settled, ultimately turns on whether it would pass constitutional muster.[15] Retroactive tax legislation traditionally has been challenged as violation of the due process clause. Such challenges can be based on the length of retroactivity, a lack of notice, or both. Assuming that any legislation here retroactively applied to May 2014, however, a due process attack appears unlikely to succeed even if legislation is not passed until in or around the spring or summer of next year.

With respect to length of retroactivity, in Nichols v. Coolidge, 274 U.S. 531 (1927), the U.S. Supreme Court invalidated a retroactive estate tax reaching back approximately 12 years under the Fifth Amendment's takings clause, noting that "the arbitrary, whimsical and burdensome character of the challenged tax is plain enough." Id. at 713. Since Nichols, however, courts have generally rejected arguments that a retroactive tax constitutes a due process violation. See, e.g., Quarty v. U.S., 170 F.3d 961, 963 (9th Cir. 1999) ("Levying of taxes does not constitute a Fifth Amendment taking unless the taxation is so 'arbitrary as to constrain to the conclusion that it was not the exertion of taxation, but a confiscation of property'") (quoting Brushaber v. Union Pac. R.R. Co., 240 U.S. 1, 24–25 (1916)).

More recently, the Supreme Court has rejected challenges to retroactive taxes where the period of retroactivity is roughly one year or less. In United States v. Carlton, 512 U.S. 26, 33 (1994), for example, the court upheld a 14-month retrospective application of an estate tax amendment, holding that, unlike Nichols, the "period of retroactive effect is limited." Id. at 34.[16] In an oft-cited concurring opinion, Justice Sandra Day O'Connor expanded upon the court's concern about the length of the retroactivity: "A period of retroactivity longer than the year preceding the legislative session in which the law was enacted would raise, in my view, serious constitutional questions." Id. at 38.

Since Carlton, lower courts also generally have rejected due process challenges to retroactive tax legislation where the retroactivity period is less than a year. See, e.g., Furlong v. Commissioner of Internal Revenue, 36 F.3d 25 (7th Cir. 1994) (relying on Carlton to find that a retroactive tax application of less than one month was "quite limited" and thus did not offend due process); Quarty v. U.S., 170 F.3d 961 (9th Cir. 1999) (upholding a tax statute's "eight-month period of retroactivity" based on "judicial deference to periods of retroactivity in tax legislation 'confined to short and limited periods'").

Although the court has never held a "one-year rule" to be a bright-line test, under Carlton, retroactive application to May 2014 would be unremarkable, provided the legislation passes within the next year. And several post-Carlton decisions have sustained retroactive tax application beyond the one-year period identified by Justice O'Connor. See, e.g., Montana Rail Link Inc. v. U.S., 76 F.3d 991, 995 (9th Cir. 1996) (upholding a six-year retroactive application of a tax statute because it was "supported by a legitimate legislative purpose furthered by rational means").

Nonetheless, given the sheer number and market value of the transactions potentially impacted by retroactive application of such legislation, a substantial delay in passing the law coupled with it remaining retroactive to May 2014 could provide a basis for a colorable due process claim. As Justice O'Connor explained in Carlton, "[t]he governmental interest in revising the tax laws must at some point give way to the taxpayer's interest in finality and repose." Carlton, 512 U.S. at 37-38. Therefore, the more time that passes without congressional action, the greater the odds of success on a constitutional challenge to the law that ultimately is enacted.

Mounting a due process challenge based on lack of notice also seems unlikely to succeed. See, e.g., Carlton, 512 U.S. at 34 ("we do not consider [plaintiff's] lack of notice to be dispositive"); Quarty, 170 F.3d at 971 ("Notice considerations, therefore, neither suggest any reason to amend our due process holding"); Davon Inc. v. Shalala, 75 F.3d 1114, 1127 (7th Cir. 1996) ("[plaintiffs] offer no authority, and we have uncovered none, that timely notice is a due process requirement for retroactive economic legislation"). In any event, here, Lew, seemingly aware of the legal implications, wrote in his letter to Congress that the ongoing debate has already "put companies on notice that any transaction that takes place after early May 2014 will not have the desired effect of lowering future U.S. tax liabilities."

The Uncertainty Surrounding Anti-Inversion Legislation or Regulation Presents Risks For Companies Contemplating Inversion Transactions

The impact of retroactive legislation is quite different depending on whether the companies in question already have consummated an inversion transaction or, alternatively, signed agreements to undertake but have not yet closed the deal.

As discussed in more detail below, while certain of the agreements governing inversions condition an obligation to close on there being no change in the applicable tax law, such a provision typically does not survive closing. There is no mechanism for unwinding a completed deal notwithstanding an unfavorable change in the tax laws. In that circumstance, presumably the only recourse for the merged companies (other than simply accepting the consequences of being taxed as a domestic corporation), presumably would be to attempt to satisfy the applicable ownership thresholds in the new legislation through another transaction.

For transactions that have not yet closed at the time applicable legislation is enacted, the situation is different. As noted, certain agreements contain as a closing condition that there is no change in the relevant law as supported by a nationally recognized counsel opinion. (Earlier transactions would typically just condition the transaction on an opinion regarding the application of Section 7874.) For example, U.S.-based Medtronic announced in June[17] that it intended to acquire Ireland-based Covidien, a deal that would include changing Medtronic's tax domicile to Ireland. According to Medtronic's U.S. Securities and Exchange Commission filing:

there shall have been no change in applicable law (whether or not yet effective) with respect to Section 7874 (or any other U.S. Tax Law), or official interpretation thereof as set forth in published guidance by the IRS (whether or not yet effective), and there shall have been no bill that would implement such a change which has been passed in identical or substantially identical form by both the House of Representatives and the Senate and for which the time period for the President to sign or veto such bill has not yet elapsed, in each case, that, once effective, would cause Holdco to be treated as a United States domestic corporation for United States federal income tax purposes.[18]

Similar provisions exist in several, but by no means all, of the agreements governing inversion transactions that were consummated or signed this year.

Closing Conditions in Response to Tax Legislation

Date(2014)	*Transaction*	*Closing condition related to change in tax law?*
Feb. 17	Activas/Forst	None
Feb. 24	Applied Materials & Tokyo Electron to jointly invert to Netherlands	None
Feb. 28	Endo/Palladin	None
Mar. 10	Chiquita Brands/Fyffes PLC	None
Mar. 19	Horizon/Vidara	None
Apr. 7	Mallinckrodt/Questcor	None
May 7	Mondolez/D.E. Master Blenders	None
June 15	Medtronic/Coviden	Acquisition is subject to a condition that there shall have been no change in applicable law (whether or not such change in law is yet effective) with respect to Section 7874 of the U.S. Internal Revenue Code of 1986 , as amended (or any other U.S. tax law), or official interpretation thereof as set forth in published guidance by the IRS (other than news releases) (whether or not such change in official interpretation is yet effective), and there having been no bill that would implement such a change that has been passed in identical (or substantially identical such that a conference committee is not required prior to submission of such legislation for the president's approval or veto) form by both the United States House of Representatives and the United States Senate and for which the time period for the president of the United States to sign or veto such bill has not yet elapsed, in each case, that, once effective, in the opinion of nationally recognized U.S. tax counsel, would cause Holdco to be treated as a United States domestic corporation for United States federal income tax purposes.
June 18	TE Connectivity/Measurement Specialties	None

June 26	Auxilium/QLT	Auxilium's obligation to close the merger is subject to closing condition that on or before Oct. 31, 2014, there shall have been no change in applicable law (whether or not such change in law is yet effective) with respect to Section 7874 of the Code (or any other U.S. tax law) or official interpretation thereof as set forth in published guidance by the IRS (other than news releases) (whether or not such change in official interpretation is yet effective), and there shall have been no bills that would implement such a change passed by the United States House of Representatives and the United States Senate and for which the time period for the president of the United States to sign or veto such bills has not yet elapsed, in each case, that, once effective, in the opinion of nationally recognized U.S. tax counsel, would cause QLT to be treated as a United States domestic corporation for U.S. federal income tax purposes.
July 8	Cosmo/Salix	Salix's obligation to consummate the merger is subject to there having been no (1) change in law or official interpretation thereof (whether or not such change in law or official interpretation is yet effective) with respect to section 7874 of the Internal Revenue Code of 1986, as amended or (2) passage of any bill that would implement such change in substantially identical form by both the United States House of Representatives and the United States Senate, that, in either case, in the opinion of Cadwalader Wickersham and Taft LLP, could be expected to increase the risk that Cosmo Tech would be treated as a U.S. domestic corporation for U.S. federal tax purposes immediately after the effective time of the merger.
July 14	AbbeVie/Shire	No change in law condition, but if AbbVie, the U.S. acquiror, backs out of the deal, it is obligated to pay $1.6 billion.[20]
July 14	Mylan/Abbott	Each of Mylan's and Abbott 's respective obligations to consummate the transaction is subject to a condition that there shall have been no change in applicable law (whether or not such change in law is yet effective) with respect to Section 7874 (or any other U.S. tax law), or certain official interpretations thereof, that will, in the opinion of nationally recognized U.S. tax counsel, cause

		New Mylan to be treated as a U.S. domestic corporation for U.S. federal income tax purposes, and there shall have been no bill that would implement such a change that has been passed in identical (or substantially identical such that a conference committee is not required prior to submission of such legislation for the president of the United States' approval or veto) form by both the United States House of Representatives and the United States Senate and for which the time period for the president of the United States to sign or veto such bill has not yet elapsed.
Aug. 26	Burger King/Tim Hortons	None

Where merger parties have signed an agreement but not consummated an inversion transaction, the passage of applicable legislation could trigger their ability to terminate the deal due to failure of a closing condition. In that event, each party typically walks away from the deal while incurring its own costs, although in some circumstances the parties may allocate the tax risk differently. There typically are no breakup fees or other financial impact imposed on one party in that circumstance.

On the other hand, in situations where there is no such closing condition, the parties' options in the event of a change in tax law are more limited. In that situation, the parties might be able to mutually agree to terminate the deal or perhaps one party could seek another nontax basis to argue that it has no obligation to close (although the odds of such a tactic being viewed by a merger counterparty or a court as a pretext intended to end run merger agreement obligations as a result of the tax law change appear, in the absence of countervailing evidence, relatively high).

Even where it exists in the agreement, however — and certainly where it does not — companies need to proceed cautiously in terminating a merger agreement based on or following a change in tax laws.

First, obtaining the tax benefits associated with an inversion requires that the merging companies have a nontax purpose for the deal.[20] Terminating based solely on or following a change in law could lead to regulatory inquiries and shareholder litigation based on the accuracy of any disclosure previously made regarding the purpose of the deal. In other words, if the sole reason for termination is not obtaining anticipated tax benefits, regulators or shareholders could allege that there was inaccurate disclosure regarding other reasons for and benefits expected to be derived from the transaction. Corporations should take care in drafting disclosure to take into account these possibilities, including by making comprehensive risk disclosure about the import of a change in law regarding inversions notwithstanding other reasons to pursue the transaction.

Second, like with any extraordinary transaction, an inversion could have a significant impact on the affected companies' employees, operations, vendors and customers. The uncertainty inherent in an inversion transaction in the current environment could unsettle efforts to integrate the companies, retain key customers and employees, and assure the market regarding the companies' prospects going forward. Corporations need clear communications to key constituencies regarding plans in the event of a change in the law governing inversions, including articulating contingency plans should the deal not close.

—By Jason Halper, Peter Connors, David Keenan and Carrie Lebigre, Orrick Herrington & Sutcliffe LLP

Jason Halper, based in New York, is a partner in Orrick's securities litigation and regulatory enforcement practice group and serves as co-head of the firm's financial institutions litigation practice.

Peter Connors is a partner in Orrick's tax practice group in New York.

David Keenan is a managing associate in Orrick's securities litigation and regulatory enforcement practice group in Seattle.

Carrie Lebigre is an associate in the firm's litigation practice in New York.

[1] John D. McKinnon & Siobhan Hughes, Obama Urges Quick Action to Stop 'Inversions,' Wall St. J., July 24, 2014, http://online.wsj.com/articles/obama-to-urge-quick-action-on-inversions-1406220197

[2] Letter from Jacob J. Lew, U.S. Sec'y of Treasury to Senators, Dave Camp, Orrin Hatch, Sander Levin and Ron Wyden (July 15, 2014) available at http://online.wsj.com/public/resources/documents/Treasuryletter071514.pdf (last accessed Aug. 18, 2014).

[3] Mark J. Mazur, Retroactive Tax Provisions, a "Quite Common" Practice, Treasury Notes (Jul. 24, 2014), http://www.treasury.gov/connect/blog/pages/retroactive-tax-provisions.aspx

[4] Section 7874(a)(2)(B)(i).

[5] Section 7874(a)(2)(B)(ii).

[6] Section 7874(a)(2)(B)(iii).

[7] Under Section 7874(c)(2), certain stock of the foreign corporation is not taken into account in determining ownership under Section 7874(a)(2)(B)(ii): (a) stock of the foreign corporation held by

members of the expanded affiliated group that includes the foreign corporation, and (b) stock of the foreign corporation sold in a public offering related to the acquisition described in Section 7874(a)(2)(B)(i).

[8] See, e.g., Code Section 7874(g) (the Secretary shall issue regulations necessary to implement this section); id. § 7874(c)(6) (the Secretary shall prescribe such regulations as may be appropriate to determine whether a corporation is a surrogate foreign corporation).

[9] Treas. Reg. §1. 7874-3T(b).

[10] Treas. Reg. §1. 7874-2T(g) (2009).

[11] Treas. Reg. § 1.7874-4T(i)(7)(i).

[12] Shay, "Mr. Secretary, Take the Tax Juice Out of Corporate Expatriations" appearing in 2014 TNT 144-10 (July 28, 2014).

[13] Stop Corporate Earnings Stripping Act of 2014 (Discussion Draft) S. ___ , 133th Congress, Tax Reform Act of 2014 (Discussion Draft), H.R. ___ 113th Congress §3704 (2014);

[14] S.2360, sec. 2, 113th Cong. (2014); H.R.4679 sec. 2, 113th Cong. (2014).

[15] Nor would the Constitution's ex post facto clause apply because that clause refers to criminal penalties. See e.g. Doe v. Miller, 405 F.3d 700, 718 (8th Cir. 2005) (the ex post facto clause prohibits "enacting laws that increase punishment for criminal acts after they have been committed"); E. Enters. v. Apfel, 524 U.S. 498, 538 (1998) ("Since [1798], this Court has considered the Ex Post Facto Clause to apply only in the criminal context") (Thomas, J., concurring). Presumably, the ex post facto clause would not apply to retroactive tax legislation unless the legislation is so onerous that it loses its character as a tax and instead becomes a penalty. It would be difficult to characterize the retroactive application of the SCIA to certain inversions as so onerous as to become a mere penalty in tax clothing.

[16] Carlton explained that retroactive taxes, like other retroactive economic legislation, should be examined under rational basis review. Id. at 30-31 ("Provided that the retroactive application of a statute is supported by a legitimate legislative purpose furthered by rational means, judgments about the wisdom of such legislation remain within the exclusive province of the legislative and executive branches").

[17] Medtronic Inc., Medtronic to Acquire Covidien for $42.9 Billion in Cash and Stock (June 15, 2014), http://newsroom.medtronic.com/phoenix.zhtml?p=irol-newsArticle&c=251324&ID=1939883.

[18] Medtronic Inc., Form 8-K (June 16, 2014), http://www.sec.gov/Archives/edgar/data/64670/000119312514237236/d742021d8k.htm.

[19] David Gelles & Mark Scott, AbbVie Clinches $54 Billion Deal for Shire in a Move to Reduce Taxes, DealB%k, N.Y. Times, July 18, 2014, http://dealbook.nytimes.com/2014/07/18/abbvie-reaches-deal-to-buy-european-drug-maker-shire/

[20] 26 U.S.C. § 7701(o)