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New regulations likely to slow 'inversion' deal activity

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Background

Over the past several years the frequency and notoriety of so-called 'inversion' transactions have increased dramatically. An inversion typically involves a US company merging with an overseas company, with the US company becoming a wholly owned subsidiary of the non-US parent. Many companies have used the inversion structure in recent years, with notable deals including Argonaut-PXRE (reincorporating in Bermuda), Alkermes-Elan Drug (reincorporating in Ireland) and Liberty Global-Virgin Media (reincorporating in the United Kingdom).

The proliferation of this structure reflects an oddity of US tax law: unlike in the corporate tax systems of most developed nations, US taxes on corporate profits are not limited to US-based earnings, but also include earnings abroad that are repatriated. This not only makes effective corporate rates much higher for US-based companies, but also prevents many US-based companies from bringing foreign earnings into the United States, thereby reducing the potential for investment and shareholder returns. As a result, US companies that reincorporate abroad often choose to do so in a country:

- with a corporate tax rate that is lower than the US rate;
- with a territorial tax system (ie, one that does not tax income from a foreign source); and
- that has entered into an income tax treaty with the United States.

The economic advantage is undeniable: reincorporating in Bermuda generally yields a corporate tax rate of 0%, in Ireland approximately 12.5% and in the United Kingdom approximately 21%. These rates represent a significant reduction from the 35% marginal federal corporate tax rate faced by many companies in the United States.

New rules

Although inversion transactions are designed specifically to conform to US tax laws and regulations, inversions have come under increasing attack by politicians and the press, which typically deride the deals as 'unpatriotic' attempts to shirk taxes. After months of rhetorical attack on inversions by the Obama administration, on September 22 2014 the Department of the Treasury and the Internal Revenue Service (IRS) issued a notice of new regulations "to reduce the tax benefits of—and when possible, stop—corporate tax inversions". Critics have noted that these rules were issued within months of statements by administration officials that, in the absence of additional legislation, they lacked the power to limit inversions by regulation. Regardless, the rules have led to the termination of at least one deal – the $54 billion merger of Shire and AbbVie.

The new Treasury and IRS rules are designed to limit key advantages of inversions in four specific ways:

- prevention of 'hopscotch' loans;
- tightened restrictions on inverted companies' tax-free access to a foreign subsidiary's earnings;
- disallowance of tax-free cash and property transfer between a foreign subsidiary and its new parent; and
- stronger requirements that the former owners of the inverted company own less than 80% of the new combined entity.

Hopscotch loans allow inverted companies tax-efficient access to a foreign subsidiary's earnings (ie, the cash trapped offshore). However, the new regulations prevent this tax treatment by considering loans of inverted companies as dividends that are taxable in the United States. The new tax treatment is the same as if the foreign subsidiary had made a loan to the inverted company before the inversion

took place.

Previously, inverted companies could restructure a foreign subsidiary in a way that allowed the inverted company tax-free access to the subsidiary's earnings. However, the new regulations restrict post-inversion transfers of a US target's controlled foreign corporation shares, as well as those corporation's assets. This rule change will make it more difficult to access overseas cash tax free. Treasury notes that the new regulations will expand the reach of existing IRS rules to prevent inverted companies from transferring cash or property tax-free from a controlled foreign corporation to the new parent. This change means that inverted companies will no longer be able to repatriate cash or property tax-free by bypassing the US inverted company.

The new rules also tighten the restriction that the former owners of the inverted company own less than 80% of the new combined entity, making it more difficult for a US company to invert. Passive assets, including cash or marketable securities, that were not part of the foreign entity's daily business functions previously counted towards this 80%; however, the new regulations disregard much of these assets from the calculation. The new rules also prevent US companies from reducing their pre-inversion size by making extraordinary dividends to meet the 80% threshold.

Notably, the new regulations did not address transfer pricing or earnings stripping, other practices which can reduce the amount of taxes owed by US companies.

Comment

The new regulations will likely draw a challenge in the courts. However, until their fate is decided, the new regulations are expected to reverse the upward trend in corporate inversions in recent years.

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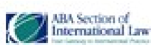

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