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Practice Spotlight: Corporate Inversions and Related Transactions

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The past several months have seen a flurry of business activity by and between U.S.-based corporations and foreign competitors. Mergers have been announced between foreign and domestic pharmaceutical companies, drug retailers and fast food restaurants. While multi-billion dollar mergers of iconic brands would generally tend to draw media attention, these transactions have drawn a particular amount of publicity due to their characterization as vehicles for corporate inversions. Broadly speaking, a typical corporate inversion involves a U.S. corporation merging with a foreign entity in a manner that results in the foreign company becoming the parent of the U.S. entity, regardless of whether the U.S. entity's management actually changes or its headquarters is physically relocated. While there are undoubtedly many non-tax reasons for the companies to enter into merger transactions, the tax savings aspect of inversions has drawn the attention (and the ire) of politicians and the media.

U.S. Tax Structure versus Other Developed Nations

In order to more fully understand the tax benefits of corporate inversions, it is important to first understand the current U.S. tax structure. The U.S. maintains a worldwide system of taxation that subjects all of a U.S. corporation's income to U.S. taxation, notwithstanding that some income was earned overseas. Income earned in a foreign subsidiary is not taxed immediately, however, but is generally taxed when that income is distributed to the U.S. parent corporation. Therefore U.S. corporations often keep foreign earnings in foreign subsidiaries, rather than reinvest it in the U.S. It is worth noting that the U.S. is the only developed country with such a tax system, a fact that has likely led many corporate taxpayers to consider inversions.

Post-Inversion Transactions

U.S. domiciled corporations that participate in corporate inversion transactions generally realize benefits via two types of transactions pejoratively referred to as "hopscotching" and "earnings stripping." Hopscotching transactions involve earnings of a foreign subsidiary of the U.S. corporation. By avoiding the repatriation of these earnings, U.S. corporations are able to escape U.S. taxation. However, once the U.S. taxpayer/parent and the foreign subsidiary both become subsidiaries of another foreign corporation (the foreign inversion partner), the foreign subsidiary can pass its untaxed earnings to the foreign parent which will then "loan" the untaxed earnings to the former U.S. parent. Since loan proceeds are not subject to taxation, the foreign earnings are not taxed in the U.S.

The ability to more fully utilize what are referred to as "earnings stripping transactions" is another likely reason behind some recent inversions. These transactions generally involve the U.S. corporation, in its new subsidiary position, repaying a loan, including those from outside investors that may have been used to fund the inversion, to the foreign parent. Although the repayment of loan principal is not deductible, the deduction of interest payments means that income otherwise subject to a U.S. marginal tax rate of 35 percent is instead only subject to the lower tax rate in the jurisdiction of the foreign parent.

The increase in merger and acquisition activity that could result in corporate inversions has resulted in concern from both sides of the aisle. Some members of Congress have called for increased oversight from the Internal Revenue Service (IRS) and stated that the IRS should be given the authority to review most commonly used earnings stripping transactions (some of which are already subject to intense IRS scrutiny). More recently, Senators Charles Schumer of New York and Richard Durbin of Illinois introduced the "Corporate Inverters Earnings Stripping Reform Act." Key points from the legislation include (i) a reduction in the permitted net interest expense to 25 percent or less of the subsidiary's adjusted taxable income (as opposed to 50 percent), (ii) a repeal of the interest expense deduction carry forward that would effectively limit the taxpayer's ability to use the deduction in future years, and (iii) the imposition of a requirement that the remaining U.S. subsidiary obtain annual approval from the IRS on the terms of any related party transactions during the ten-year period following an inversion. The Obama administration has also stated its intent to address "inversion loopholes."

These corporate inversions and related transactions not only can result in tax reductions at the federal level but also have the potential to impact taxes at the state level, since many states compute corporate taxable income based upon federal taxable income.

Corporate and Transactional Considerations

In addition to the tax considerations facing U.S. corporations that contemplate inversion transactions, there are a number of corporate and transactional considerations the board and senior management of U.S. corporations must also consider. Initially, the board must consider the corporate law requirements of the new country of domicile, including where board meetings must be held, if senior management will need to migrate to the new country and if the tenets of director liability under the laws of the new jurisdiction are comparable to U.S. federal securities law and state corporate law. In addition, given the regulatory uncertainties surrounding inversion transactions, the board and senior management must determine if the economics, synergies and growth opportunities of a proposed inversion transaction would survive an adverse change in law or regulation. Finally, the board and senior management must determine the appropriate amount, structure and timing for any break-up fees in a proposed transaction. Several recent inversion deals have terminated since the regulatory changes were recently proposed by the Treasury. Some of these deals involved multi-billion dollar fees that were payable to the target companies as a result of the break-up. Other deals had exceptions to the break-up fees specifically conditioned on changes to the laws and regulations affecting corporate inversions.

Many political leaders, in both political parties, say that corporate inversions highlight a need for comprehensive tax reform. U.S. companies taking advantage of inversions stand to gain significant benefits, but risk being declared unpatriotic. As Washington weighs the costs and benefits of increasing the penalties on inversions and enacting proposed measures to prevent companies from leaving the U.S., expect inversions to remain a hot topic in 2015.

If you are interested in learning more about tax inversions, please contact a member of our Tax Group.