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The World Turned Upside Down: Understanding Corporate Inversions

By J. Leonard Teti II

History tell us that, before leaving America after Lord Cornwallis's surrender to George Washington at Yorktown, the British fife and drum corps played "The World Turned Upside Down". The recent trend of so-called "inversion" transactions among US companies breathes new meaning into the song.

Inversions are frequently described as transactions in which US companies "leave" the United States, but this description is neither accurate nor useful. Rather, an "inverting" US company remains incorporated in the United States but becomes a subsidiary of a publicly traded foreign company. This article explains why inversions are attractive to US companies, explores the basic statutory and regulatory framework for them and discusses how some US lawmakers are seeking to stop them.

The Benefits of Inversions

The United States taxes US companies' income on a "worldwide" basis. "Worldwide" taxation means that US companies are taxed at the 35% US corporate tax rate not only on income they earn directly anywhere in the world but also on dividends received from non-US subsidiaries of profits earned abroad. US companies are allowed to credit taxes paid to another country in calculating the US tax due on repatriated foreign earnings.

Worldwide tax systems were once common among developed countries. But in the past few decades, many countries have changed their tax laws so that they tax companies on a "territorial" basis. This means that they generally tax companies only on profits earned in that country. The result is that, from a global tax perspective, many US companies find themselves disadvantaged by the US tax code compared to their foreign competitors. While a US company will always be taxed eventually at 35% on its worldwide income when dividends from non-US subsidiaries are repatriated, a foreign competitor will generally be taxed only at the lo-

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cal rates (usually well below 35% and sometimes zero) and only in the jurisdictions in which it earns income.

Inverting can change this adverse effect quickly and dramatically: at the time it announced its inversion in 2013, Actavis Inc. (now Actavis plc) stated publicly that its effective tax rate would decrease from 37% to 17% in just one year.

Moreover, because US companies are not taxed on their foreign earnings until they repatriate their earnings by paying dividends, they do not repatriate those earnings unless it is absolutely necessary. As a result, at least approximately $2 trillion of foreign earnings has accumulated in foreign subsidiaries of US companies over time.[1] Foreign parent companies in territorial regimes are able to deploy worldwide earnings without such tax concerns for repatriations.

Inversions provide three main benefits to US companies seeking to counteract the comparative disadvantages described above. First, they enable a multinational group to grow its non-US business outside of the United States without doing so under a US company. Because that growth is not owned directly or indirectly by a US company, it will never be subject to US tax.

Second, inversions enable the inverted US company to lower its US tax liability by "earnings stripping", that is, issuing debt to its new foreign parent (or to another foreign affiliate). Interest on this debt gives rise to a tax deduction in the United States (subject to certain existing limitations), producing a 35% after-tax benefit, which is reduced only to the extent the interest income is taxed in the foreign jurisdiction, assumedly at a much lower rate. Critics of inversions have pointed to this facilitation of "earnings stripping" as an especially pernicious feature of inversions because it represents a permanent erosion of the US tax base. However, "earnings stripping" is already available to existing foreign companies with US subsidiaries.

Third, inversions allow the inverted US company to access its foreign subsidiaries' "trapped" earnings (which have not yet been taxed in the US).

The transfer of these earnings (or the assets that gave rise to them) can be effected by way of a loan, sale or other transfer. While there may be certain costs (including tax "leakage" such as gain recognition or withholding taxes) to these "hopscotch" restructurings (so named because the "trapped" foreign earnings skip the US chain and are deployed by foreign affiliates), the long-term benefits of allowing those assets to grow in value outside of the US's worldwide corporate tax regime will often outweigh these upfront costs.

The Legal Framework and Calls for Reform

Before 2004, a US company could invert on its own by merging with a subsidiary of a new foreign company. In the merger, the US company's shareholders would receive shares of the foreign company in exchange for their US company shares. The result was that 100% of the US company's shareholders would become shareholders of the foreign subsidiary, and the foreign company would become the parent of the US company.

In 2004, however, US lawmakers enacted Section 7874 of the US tax code, which treats the new foreign company as a US company for US tax purposes if the new foreign company does not have "substantial business activities" in its jurisdiction of incorporation and if at least 80% of its shares are owned by former shareholders of the US company. Under the applicable Treasury Regulations, the "substantial business activities" test is very difficult for foreign companies to meet, and as a result, all inversions today keep the ownership of the US company's shareholders below 80%. This is generally achieved by having the US company be acquired in an all-stock transaction by a foreign company that is more than a quarter of the size of the US company. In that case, the US company's shareholders will own less than 80% of the combined company after the acquisition.

In the last two years many US companies have completed or announced inversions, and others have pursued

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inversions (often quite publicly, and sometimes at the insistence of activist shareholders) without engaging in one. The public debate on the issue has seen charged rhetoric on both sides, and President Obama himself has called companies pursuing inversions "unpatriotic" and "corporate deserters".

In May 2014, borrowing from the Obama administration's earlier budget proposal, several Democratic senators and representatives proposed legislation that would lower the ownership threshold from 80% to 50% for purposes of testing whether a US company has successfully inverted. This would require the foreign acquirer to be larger than the US target company for the inversion to succeed. And even if the 50% ownership threshold were met, the proposal would treat the foreign acquiring company as a US corporation if the group has substantial business activities in the United States and if it were managed and controlled in the United States. This is important because many US companies that have completed inversions retain the same executive officers that continue to be based in the United States. Most notable of all, the proposal would apply to inversions completed after 8 May 2014, even if announced before that date.

The Democratic proposal has not attracted widespread support in Congress. In recent weeks, law professors and others have argued for stricter limitations on earnings stripping, and the Treasury Secretary has indicated a willingness to consider broad regulatory approaches to combat inversions. On 14 August, Senator Schumer of New York announced a proposal to limit the benefits of earnings stripping, and there is a possibility of bipartisan agreement on limits on earnings stripping. Other proposals are undoubtedly on the way.

While the prospects for any form of legislation seem uncertain, and regulatory responses seem limited, the debate will certainly continue throughout the fall and into the future.

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1. Richard Rubin, Cash Abroad Rises $206 Billion as Apple to IBM Avoid Tax, BLOOMBERG (Mar. 12, 2014, 2:47 PM), http://www.bloomberg.com/news/2014-03-12/cash-abroad-rises-206-billion-as-apple-to-ibm-avoid-tax.html.

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