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Perspective

All You Wanted To Know About Corporate Inversions

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Inversions have moved the corporate tax rate issue to the front-burner

Summary

The opportunity for US companies to “side-step” US taxes and reduce tax rates via inversion deals has reached a crescendo. The deals, mostly in pharmaceutical but also in medical device – most notably, Medtronic’s announced acquisition of Ireland’s Covidien – have been based on two trends: a rebounding appetite for transformative mergers and acquisitions; and fear that the opportunity to use the “cross-border” tax strategy may soon disappear.

As more firms take jobs – and tax revenues – overseas, inversions have also placed complex corporate tax rates and international competitiveness on the front-burner for the first time in many years.

The optimal way to address the “inversion situation” will be through comprehensive tax reform that lowers the corporate tax rate, closes loopholes, and simplifies the tax system.

What Is An Inversion?

It occurs when a US company acquires a foreign target and adopts its lower tax rate – or establishes a holding company in a country with a low tax rate.

Inversion deals can reduce corporate tax bills by hundreds of millions of dollars, primarily by “shielding” money earned in other countries from the US Treasury. Effective tax rates for many companies can drop to percentages in the teens – or lower – from the high to mid-twenties.

Are Inversion Deals Being Considered By Healthcare Companies?

Although many companies across corporate America are considering inversion strategies (three of the top accounting firms are supposedly working with over 250 companies about potential relocation to the UK alone), inversions have been strongest in the pharmaceutical and medical device sectors – especially for companies who generate substantial sales overseas that would be taxed at high US tax rates if brought home. Examples include:

- AbbVie's proposed takeover of Shire PLC for $54 billion, and establishment of its tax headquarters in the UK, will effectively reduce the Company's tax rate to 13% by 2016 from the current 22%,
- Mylan Inc.'s agreement to acquire assets from Abbott Laboratories in a $5.3 billion deal that will create a new Netherlands-based holding company, and
- Medtronic's proposed acquisition of Ireland's Covidien PLC for $42.9 billion
- Stryker's "early stage evaluation" of Smith & Nephew may have been at least partially driven by inversion considerations

Tax lawyers are suggesting that "if you're considering an M&A transaction, you're absolutely thinking about whether it's doable as an inversion……..it's just too good of an opportunity to waste".

What's Driving Inversions?

In large measure, the "inversion momentum" is being driven by business unhappiness with the US tax system – which many corporations view as out-of-date and uncompetitive.

At 35% – and 40% on average including state levels – the US corporate tax rate is the highest in the developed world – double the average in Europe and more than triple the 12.5% rate in Ireland. The US is also one of the few developed nations that still seek to tax firms on a worldwide basis regardless of where in the world revenue is earned. US multinationals pay taxes twice – first to the foreign country in which they do business and then to the US after they repatriate their profits. As a comparison, most other countries tax only domestic profits.

Special federal rules allow US firms to avoid US tax on their foreign earnings, as long as they maintain the money offshore. The perverse result has been that companies "park" much of their overseas earnings in tax havens – but can not make use of it in the US to do such things as make investments or pay dividends. Recent estimates peg the total currently held abroad at $2 trillion.

Are Inversions New?

No, inversion deals have been around since the 1980's, but were used less frequently. About 50 US companies, desiring a lower overseas tax base, inverted over the last decade by reincorporating primarily in Bermuda or the Cayman Islands.
However, recent rules have made that type of tax strategy virtually impossible. The latest rules – in 2012 – left foreign takeovers as the only clear path to securing a new, lower tax domicile.

That said, 19 inversion deals were completed since the start of 2013 – and 14 deals have occurred already in 2014.

What Is the Case for Inversions?

The Chairman and CEO of Abbott Laboratories proposes the following:

- Inversions are legal. They are permitted under the tax code – which actually specifies the terms and conditions under which they can be done.
- Inversions don't change a company's tax rate. A company pays the same tax rate in the US after inversion as it does before inverting. A company also pays the same tax rates in foreign domiciles before and after inversions.
- Inversions do not relieve any pre-existing tax burden. It does not reduce the tax that any company would ultimately have to pay on past earnings overseas that have been deferred under the US tax system.
- The tax law today views overseas earnings that have not been repatriated as part of the US tax system, regardless of whether a company has inverted. Those past foreign earnings, if repatriated to the US, are still subject to full US taxation.

The Abbott CEO opines that what does change after inversion is a company's access to its future foreign earnings generated outside the US tax system. Those future earnings may be used for any capital allocation purpose the company may have, including investment in the US – without the additional US repatriation tax.

Foreign taxes will have already been paid on those profits earned outside the US. It is the additional repatriation tax, imposed by the high corporate tax rate in the US, that is not paid after inversion.

Abbott's CEO also offers the following:

- In terms of global competitiveness, the US – and US companies – are at a substantial disadvantage to foreign companies. Taxes are a business cost. US companies' disproportionately higher tax rate puts foreign companies at a huge advantage competitively – and their lower tax burden amounts to a subsidy that encourages them to acquire American companies.

In addition, lower tax rates can translate into higher earnings – that in turn attract investors. Many executives feel they have a “fiduciary duty to their shareholders and can’t cede a permanent tax advantage to their global competitors”.

What Is the Case against Inversions?

A professor of law at the University of Southern California, proposes the following:

If allowed to continue, inversions will gut the US domestic corporate tax base, because making a foreign company the parent of a US firm opens up new tax avoidance possibilities.

- Inversions enable inverted firms to shed their domestic US corporate tax liability. They also allow companies to use existing offshore cash to fund US investments, which typically can’t be done without paying US tax.
- Once a company inverts, it’s gone – corporate tax reform will not be able to undo the damage done to the US tax base.
- When companies argue that inversions are a reasonable response to an anti-competitive US corporate tax system, it’s simply not true. Taking AbbVie as an example, the company reported a global effective tax rate for 2013 of 22.6% – a roughly one-third discount off the statutory rate of 35% – largely as a result of its low-taxed foreign earnings. What’s at stake for US firms is not international competitiveness, but rather their ability to improve their stock prices through dividends and buy-backs funded by low-taxed foreign cash.
- Inverting damages the domestic tax base and allow key players (those with international operations) to excuse themselves from the debate, while domestic firms are left holding the bag.

According to researchers at the Joint Commission on Taxation, the US Treasury stands to lose close to $20 billion from corporate tax inversions over a decade, The estimate is based on previous inversions in which US companies make overseas acquisitions to gain tax advantages. The figure does not take into account current inversion deals in-progress.

Are Inversions becoming Controversial?

Absolutely. Lawmakers are worried that the growing appeal of lower tax rates will spark a wave of such moves in the next few years.

In July, the US Treasury Secretary sent a letter to Congress calling on lawmakers to stop US corporations from merging with foreign corporations and locating the parent company abroad to reduce their taxes. He also asked Congress to make the new law to combat such inversions retroactive to May. The Treasury Secretary independently requested that companies considering inversions to demonstrate “a new sense of economic patriotism”.

How Have Lawmakers Responded?

Not surprisingly, lawmakers remain divided. Some favor "closing the exit doors" for almost all firms seeking to leave by imposing a higher threshold of foreign ownership (50% vs. 20% currently) or depriving inverted firms of government contracts or other benefits. But others argue that a temporary fix may actually have unintended consequences – like hurting US companies by making them more vulnerable to a take over.

The Wall Street Journal reports that a longer-term solution favored by many lawmakers – a re-write of the US corporate tax rules – is "already dead for this year, and likely faces long odds next year."

According to a former senior US Treasury Department official, the President could act without congressional approval to reduce the key incentives which allow US corporations to complete tax inversions. Supposedly, the President can invoke a 1969 tax law to bypass congressional gridlock and restrict foreign tax-domiciled US companies from using inter-company loans and interest deductions to reduce their US tax bills.

Inversion has already become a 2014 mid-term election issue as both parties seek to win over voters. Democrats will likely argue that when corporations avoid taxes, middle-class taxes increase. Republicans are likely to counter that argument by saying jobs will be at risk by limiting US companies' access to their overseas profits, weakening them financially and leaving them vulnerable to a foreign takeover.

How Have Companies Reacted?

More recently, companies have voiced concern about the bad publicity that could result when politicians criticized inversion deals. But as more and more inversions have occurred, it has become less likely that specific companies would be singled out.

As an example, pharmaceutical giant Pfizer remains interested in completing its highly desired tax inversion – despite AstraZeneca's rejection of its $106 billion takeover bid in May. Pfizer's CEO is lobbying in Washington for an overhaul of tax rules which he says put US companies at a disadvantage, and predicts that reforms will likely take years to play out. The CEO confirmed that Pfizer is now "aggressively" pursuing acquisition options and a tax inversion is likely to be a part of a future deal.

What Are Deal-Makers Advising Their Clients?

Deal-makers have cautioned clients that the uncertainty in Washington DC – and increasing inversion publicity – may cool merger activity. They stressed that deals struck now should be done with great care – including allowing buyers to walk away without paying a break-up fee, should the tax advantage be removed (Note: Medtronic included such language in its proposed deal to acquire Covidien).

Other bankers are advising clients to give selling shareholders more stock than the 20% in the combined company that is currently required for tax benefits – in an effort to get ahead of any stricter requirements.

Interestingly, the prospect of congressional action may actually accelerate the pace of inversions, as companies seek to "stay ahead" of any changes in the law.

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