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Corporate Inversions: New Challenges, New Opportunities

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Abstract

With a wave of recent tax inversion and corporate reorganization discussions, corporate tax strategy has begun to move to the forefront of media, public and Congressional attention. These high-profile inversion strategies have gained momentum and achieved heightened attention, becoming a matter of public policy matter in 2014. While corporate international tax strategies have existed since the dawn of the U.S. federal income tax, inversions in their current form have been active only since the 1980s. Using three predominate inversion cases as a lens; this research intends to fill a gap in the existing literature relating to corporate inversions. By combining existing case law, tax legislation, and Treasury regulations, this paper develops a framework for supporting strategic global tax initiatives. The conclusions and recommendations reached are generalizable and appropriate for use in developing best practice solutions.

Keywords: Tax inversions, Debt recharacterization, Inversion cases, corporate reorganizations

I. Introduction

The corporate inversion, also called tax inversion, is a tax-planning technique that arose out of a distinctive feature of the United States income tax law. That feature is that worldwide income of U.S. corporations is subject to U.S. income tax regardless of where earned.

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While the vast majority of countries, including the other G-7 nations, have territorial systems that only tax their respective domestic income, the U.S. stands virtually alone in its insistence on taxing income earned beyond its borders. (Matheson, 2013) Under Subpart F of the Internal Revenue Code (the "Code"), Code secs. 951-965, this income includes the income of foreign corporations controlled by domestic corporations. Although there are different forms that the corporate inversion can take, the common format is a merger between a domestic and foreign corporation that would be tax-free as a corporate reorganization as defined in Code sec. 368, where the foreign corporation ended up as the parent of the domestic corporation. Because the U.S. Corporation is a subsidiary of foreign parent, rather than the other way around, the foreign-earned income of that parent would not be subject to U.S. income taxes. The corporate inversion then, did nothing to do reduce the U.S. taxation of income earned domestically, but would eliminate U.S. taxation on foreign-earned income.

Once this relationship was established to keep the foreign parent's foreign-earned income free from U.S. taxes, additional savings would be sought by "earnings stripping." This would mean reducing the taxable income of the domestic subsidiary, typically through interest payments to the foreign parent. The U.S. has the third-highest corporate tax rate in the world. (Tax Foundation, 2015). So, the benefit of this technique would be to move income from a higher-taxed jurisdiction to a lower-taxed one. The current administration long considered this opportunity to save U.S. taxes an unwarranted loophole in need of being closed. (White House, April 18, 2016) Although no comprehensive approach has been taken to address corporate inversions, separate statutes and regulations have put limitations on the ability to take advantage of corporate inversions as originally used, most recently final and temporary regulations published October 21, 2016 (Internal Revenue Service Final, Temporary Rules) that limit the availability of interest payments used for earnings stripping by recharacterizing certain debt as equity.

1. Background

The seminal case in establishing the basic viability of the corporate inversion was Bhada v. Commissioner, 892 F.2d 39 (6th Cir. 1989). This case confirmed the tax treatment sought by the taxpayers in a corporate inversion involving McDermott, Inc., a global engineering company specializing in complex offshore oil and gas construction.

At the time of its inversion, McDermott was incorporated in Delaware and based in New Orleans. Its wholly owned subsidiary and I.R.C. § 957 controlled foreign corporation McDermott International Inc. ("MII") was based in Panama and served as the holding company for McDermott's foreign operations.

The McDermott Case

In October 1982, McDermott executed its historic inversion by offering an exchange of its own common stock for cash and common stock of MII. MII effectively purchased its parent, using its own stock as the currency. In doing so, McDermott "inverted" into its own Panamanian subsidiary, making MII the new parent. At the time, inversions were unknown and far from a public policy issue and McDermott were not subtle in its official reasoning for the reorganization.

In its offering prospectus to shareholders for the MII shares, management stated outright, "The principal purpose of the reorganization is to enable the McDermott Group to retain, reinvest and redeploy earnings from operations outside the United States without subjecting such earnings to United States income tax." McDermott's inversion was challenged by the Service in Bhada v. Commissioner but ultimately prevailed, and MII continues to operate under this structure to this day. For another decade, the inversion landscape remained quiet. Then in 2002, a swarm of corporations performed "naked" inversions via a similar procedure to Helen of Troy, with alterations. The "naked" distinction is to denote that the inversions were not completed via merger with an external corporation, but were simply an internal reorganization seemingly for tax reasons.

The Valeant Case

In September of 2010, U.S.-based Valeant Pharmaceuticals Inc. engaged Canadian pharmaceutical company Biovail Corporation in a merger, with the intent to relocate Valeant to Canada. At the time, Valeant was roughly twice the size of Biovail as measured by market capitalization, making certain the legacy Valeant shareholders would own more than fifty percent of the merged entity and therefore realize built-in gains under Sec. 367(a) and Reg. 1.367(a)-3(c).

Since shareholders of both corporations had to approve the merger and Valeant had significant built-in gains, this cost would have put the transaction in jeopardy. To sidestep this roadblock, Valeant devised a clever scheme: prior to the merger, Valeant took on debt to pay an enormous special dividend to its shareholders—$16.77 per Valeant share, against a then-stock price of $26.35. The special dividend served two purposes. One, it dramatically reduced the market value of Valeant; enough such that subsequent to the merger, legacy Valeant shareholders owned a 49.5% continued interest in the combined entity; just under the fifty percent threshold for realizing gains.

While Reg. 1.367(a)-3(c) contains rules against inflating the value of the foreign corporation to achieve the same result, it provides no reciprocal rule against reducing the U.S. Corporation's value. Second, it effectively served as backdoor cash consideration for the acquisition, as the dividend formally qualified as a distribution under Sec. 301 and not as consideration paid for Valeant stock in the merger. This allowed the formal consideration for the merger to be entirely for stock at a pre-determined exchange ratio, qualifying as a nontaxable reorganization under Sec. 368(a). While the merger heavily indebted Valeant, it nonetheless succeeded in avoiding the influences of Sec. 367(a) and Sec. 7874(a) and (b), and despite Biovail being the larger acquirer, the merged entity changed its name to Valeant Pharmaceuticals International, Inc. shortly after.

Aided by the tax advantages of its new Canadian residency, Valeant has since reorganized their main operating subsidiaries in Barbados and Switzerland, which hold its intellectual property and generate the vast majority of its income. Due to net operating losses and other deferred tax assets, and a GAAP loss of pre-tax income in 2011, Valeant's effective tax rate is not calculable with certainty. However, some media outlets and investment banking analyst reports have estimated tax rates of between 4.8 and 6.4%, which is roughly confirmed by Valeant's 2011 cash flows from operations of $676 million and income tax expense (before tax asset benefits) of $40 million (5.8%).

Under the leadership of CEO Michael Pearson, who has a reputation as a clever dealmaker, and somewhat aided by its tax advantages, Valeant has subsequently pursued an aggressive acquisition strategy, and its stock price has appreciated incredibly since the 2010 inversion.

The Phillip Morris Case

Philip Morris International Inc. (PMI) has ideal circumstances for an international taxation and inversion case study. While PMI is incorporated in Virginia, its revenues and income are generated entirely outside of the U.S. Representing an extreme in terms of its proportional international domestic income, PMI arguably stood to gain from a tax inversion transaction under current tax law. As a major operator in a heavily taxed industry, PMI is an enormous contributor to treasury departments worldwide. In 2014, PMI paid an astounding $50.3 billion in excise taxes, dwarfing its U.S. federal income tax expense of $3.1 billion, and realized a 29.1% effective income tax rate. This rate does not include deferred tax liabilities on approximately $23 billion in retained earnings held in foreign subsidiaries.[i] Given the modern advent of Sections 367 and 7874, PMI's options for an inversion are limited, particularly considering the built-in gains tax imposed by Sec. 367. The consolidated nature of the tobacco industry also limits prospective merger partners for executing a Valeant-like inversion.

As part of a rebranding to highlight that its business portfolio had grown beyond tobacco, the company renamed itself Altria Group, Inc. at the holding company level in 2003. To maximize shareholder value, Altria pivoted towards separating its U.S. and non-U.S. tobacco business, and de-diversifying to remove the assets weighing down the high return on capital of its core tobacco business. In 2007, Altria spun off Kraft Foods (which itself included General Foods) and one year later, spun off Philip Morris International to its shareholders in Sec. 355(a) tax-free stock distributions, retaining only the U.S. tobacco assets and a minority holding in SABMiller.

Government Reactions

The leading alteration was to establish legal "tax residency" in the obscure Caribbean island nation of Barbados, despite that the corporations had formally reincorporated in Bermuda, the Cayman Islands, and other well-known tax havens. The use of Barbados for tax residency was to capitalize on the then-unnoticed U.S.-Barbados tax treaty enacted between the two countries in 1984.

The Barbados treaty allowed corporate residents to claim benefits for reduced U.S. withholding tax rates by virtue of being publicly traded, even if the company's shares were traded on a U.S. stock exchange and the company had no more economic presence in Barbados than a mailbox. It also allowed some U.S. source income to be obfuscated through the use of deductible interest on inter-company debt, royalties on intellectual property and the subtle manipulation of transfer pricing. Bermuda's rise as a reinsurance hub also allowed for more cash flow transfers via insurance premiums to move offshore, where such payments are not only deductible, but are not U.S. source income to the parent of the reinsurer entity.

Until this point, the U.S. Government's most effective backstop against inversions was the toll charge of gain recognition posed by Reg. 1.367(a)-3(c). But as this 2002 wave painfully showed, shareholder-level taxation is not always a significant friction cost. The substantial price declines in U.S. stock markets following the Dot-Com Bubble in 2000-2002 greatly depressed the built-in gains of the time. Also, directors and management could lessen this tax burden for themselves by holding stock-based compensation such as stock options, instead of actual shares. This provided a motivation even if it penalized minority shareholders. For the naked inverters, the discounted present value of expected recurrent tax savings overwhelmed the one-time toll charge.

The U.S. Government responded to this flood of inversions in austere fashion. First, the Treasury negotiated a protocol amending the Barbados treaty to eliminate the benefits claimed by recent inverters, which Congress approved in 2004. Then Congress promulgated I.R.C. § 7874, which remains the most comprehensive statutory attack on inversions to date.

The most relevant conditions of Sec. 7874 direct the Service to treat a new foreign parent to a U.S. corporation as a U.S. corporation for tax purposes, unless either the legacy U.S. corporation shareholders own less than eighty percent of new parent, or the new parent demonstrates it has a substantial business presence in its new incorporated jurisdiction. The Treasury later provided guidance on the substantial business presence doctrine in 2006, which outlined both a "facts and circumstances" test, and a safe harbor test to determine if the new foreign domicile is legitimate.

Despite these measures taken, which appear comprehensive, corporate inversions continued. In the decade following the Barbados protocol, most of the corporations that once claimed Barbados tax residency moved again in 2008-2009 to Switzerland and Ireland to take advantage of those countries' U.S. tax treaties (US Barbados, 1984). Having successfully inverted already, and without further protocols to amend the other treaties, these inversions continue unchecked to this day. Others attempted naked inversions claiming to meet the safe harbor test and avoid Sec. 7874's influence. The Treasury then patched that loophole in 2009 by removing the safe harbor exception. Once done, Sec. 7874 effectively killed the naked inversion, leaving inversions only possible via merger.

2. Recharacterizion of Debt as Equity

While it is still possible to create a successful tax inversion, there are still limits to the benefit. One of the limitations can be seen in recent tax regulations designed to curb the ability of inverted corporations to do earnings stripping by making deductible interest payments from the domestic subsidiary to the foreign parent. Code sec. 385, enacted in 1969, authorized the Treasury Department "…to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness (or as in part stock and in part indebtedness)." One of the main effects of a recharacterization of debt as equity would be to deny the deductibility of payments made as interest, as these would be recharacterized as non-deductible dividends.

Other effects would be that payments purported to be repayment of principal could be recharacterized as taxable dividends, and there may need to be an adjustment to calculations based on stock ownership, such as rules related to net operating loss limitations. After publishing proposed regulations under sec. 385 on April 8, 2016, the Treasury Department published final, temporary rules on October 21, 2016. The main thrust of the final, temporary rules is that certain debt instruments issued after April 4, 2016 would be recharacterized as equity (Sec. 1.385-3 of the Final, Temporary Rules, at page 72960ff) where there are entities in an "expanded group." An expanded group is the same as an affiliated group under Code sec. 1504(a), with three modifications: First, an expanded group includes both foreign and tax-exempt corporations. It also includes corporations held through controlled partnerships.

Second, Code sec. 304(c)(3) attribution rules apply when determining related entities. The third modification states that corporations would be treated as a member of an expanded group if 80 percent of the vote or value is owned by expanded group members similar to Code sec. 1504(a)(2) 80- Percent Voting and Value Test.

Under Reg. sec. 1.385-3, a debt instrument will be recharacterized as equity if the debt instrument is issued by a member of an expanded group to another member of the group, called an expanded group instrument or "EGI," in any of the following transactions:

1. A distribution, such as a dividend under Code sec. 301 or a redemption under Code sec. 302;
2. An exchange for expanded group stock, such as debt received in a Code sec. 304 exchange or a triangular reorganization; or
3. An asset reorganization where a shareholder of a member of the expanded group receives the debt instrument in exchange for stock.

A debt instrument will also be so recharacterized if issued to fund any such transaction. (Sec. 1.385-3 of the Final, Temporary Rules, at page 72960ff). It should be noted, however, the Final Regulations are more limited in their impact than the regulations as originally proposed. The first update is that S corporations, as well as non-controlled regulated investment companies known as "RICs" and real estate investment trusts known as "REITs" are excluded from an expanded group.

The second update prevents brother-sister groups with non-corporate ownership to be treated as expanded groups. The prevention is a result of the determination by the "indirect" ownership that is now created by the modified attribution rules that do not integrate a downward attribution. In addition, expanded groups must include a domestic corporation. The rules at this time would not apply to transactions between two foreign corporations, even if both are members of an expanded group with a domestic corporation. Although the authorization in Code sec. 385 that was given to the Treasury Department to create rules for recharacterizing debt as equity had only a few false starts until 2016, this does not mean that there have been no rules applicable to the subject. Case law going back years, up to the present, has created a body of rules related to the recharacterization of debt as equity.

In the case of Dixie Dairies Corp. v. Commissioner, 74 T.C. 476, 493 (1980), the Tax Court summarized the factors cited in prior cases to include: …the names given to the certificates evidencing the indebtedness; presence or absence of a fixed maturity date; source of payments; right to enforce payments; participation in management as a result of the advances; status of the advances in relation to regular corporate creditors; intent of the parties; identity of interest between creditor and stockholder; "thinness" of capital structure in relation to debt; ability of corporation to obtain credit from outside sources; use to which advances were put; failure of debtor to repay; and risk involved in making advances. The continued viability of these factors is confirmed in the new rules, which state that "…whether an interest in a corporation is treated for purposes of the Internal Revenue Code as stock or indebtedness (or as in part stock and in part indebtedness) is determined based on common law, including the factors prescribed under such common law." (Sec. 1-385-1(b) of Internal Revenue Service Final, Temporary Rules).

The regulations also provide for extensive documentation requirements, but these are only effective for debt instruments issued on or after January 1, 2018. (Sec. 1.385-2 of the Final, Temporary Rules, at page 72952ff). The documentation supporting the expanded group instrument (referred to as "EGI") must show that there is an obligation to pay a sum certain, that the creditor has all the rights of a creditor to enforce payment, that at the time the instrument was executed there was a reasonable expectation that the obligation would be met (including the value of collateral securing non-recourse obligations).

In short, the documentation requirements, although extensive, do not appear to create any new substantive standards that did not already exist under prior case law. The first $50 million of indebtedness is exempt from the new regulations. It is not clear whether they would also be exempt from the common law rules, although this might be a practical effect. Two things stand out as takeaways from this recent regulatory activity: First, the common-law criteria are still valid, and in the case of a corporate inversion the Internal Revenue Service now has elaborate documentation rules to assist it in applying those rules. Second, where there is indebtedness from a U.S. corporation to a related foreign corporation, it will be recast as equity, but only if the indebtedness arose from a reorganization-type transaction that did not actually increase the business operations of the foreign corporation.

4. Conclusion

U.S. corporations are continuing to undertake corporate inversions to foreign domiciles for the purposes of unlocking significant tax savings to the corporations and their respective shareholders and thus eroding the U.S. corporate tax base. Inversion transactions have occurred since their dawn in the early 1980s despite repeated tax code legislation to prohibit them. The recent high-profile proposals have spawned public discussion for more comprehensive reform.

Based on the principles advanced in the above cases, it can conclude that inversions are still possible in limited forms. The most effective appears to be via merger with a foreign business whereby the legacy U.S. shareholders own less than eighty percent of the merged entity. This may not avoid gain recognition under Sec. 367(a) and Reg. 1.367(a)-3(c) as Valeant case illustrates, but avoids the far harsher punishment of being treated as a U.S. corporation for tax purposes under Sec. 7874(a). This has led tax critics to claim that Sec. 7874 is not particularly effective at curbing inversions, as a merger with a modestly sized foreign company could avoid its influence.

The 2016 rules were intended to close what the current administration perceived as an unwarranted loophole available through corporate inversions. But ultimately, they addressed only the very narrow issue of earnings stripping, more narrowly that of interest deductions, and more narrowly still only the interest deductions that arose from corporate distributions and restructuring that wasn't part of corporate expansion. This is no different that prior laws and regulations which placed limits on, and made special rules applicable to, corporate inversions, but did not in any way invalidate the underlying tax rationale.

Thus, the promised closing of the corporate inversion loophole is something that is yet to happen. The opportunity for the benefits from corporate inversions still remain, they are however subject to the costs and limitations that have developed over the years.

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