PUBLICATION

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 v. 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 had been 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 to reinvest 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 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 are 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 carryforward 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 can result not only 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.

Many in Washington, in both political parties, say that corporate inversions highlight a need for comprehensive tax reform as the current U.S. tax system is fundamentally flawed in that it subjects taxpayers to worldwide taxation and has one of the highest marginal tax rates in the world. Although it is possible that corporate inversions could be the starting point to broader tax reform, it is unlikely any meaningful changes in law will occur until after the current election cycle.

Should you have any questions about or wish to otherwise discuss the topics addressed in this alert, please contact any one of the attorneys in the Firm's Tax Group.