July 21, 2014

The Inversion Craze: Will Today's Routine Tax Planning Be Retroactively Outlawed?

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Alongside the more typical summer fare, such as coverage of the best beach reading and the latest action movie blockbuster, this summer the media have been abuzz with seemingly daily reports on the latest so-called "inversion" transactions shifting a U.S.-based multinational corporation's tax residence offshore. Recently announced transactions include the Medtronic acquisition of Irish-listed Covidien (which itself had previously inverted); Mylan's acquisition of the Abbott Laboratories non-U.S. specialty and branded generics businesses for $5.3 billion in stock; and AbbVie's $54 billion acquisition of Shire, a London-listed, Jersey incorporated, Irish tax resident corporation. Other transactions remain in the planning stages (Walgreens-Boots), and the largest such transaction proposed to date (Pfizer's $100 billion-plus bid for UK-based AstraZeneca) has been shelved, at least temporarily, but remains very much in the media and political spotlight.

The pace at which inversion transactions are being announced shows no sign of slowing, and could even accelerate further if companies begin to make use of a variant which has been referred to as a "spinversion."[1] A spinversion would allow a larger conglomerate to spin-off one line of business to its shareholders using a separate entity that would then move offshore via a merger with a non-U.S. partner. Because this type of transaction would involve only one business line rather than the whole company, it could make inversion a possibility for companies for which a whole-company transaction would not be commercially viable (either because of sheer size or commercial constraints).

All of this activity is occurring notwithstanding recently proposed legislation (discussed below) intended to put a stop to the exodus of U.S. companies to foreign jurisdictions that are considered to be more tax-favorable than the U.S. While these transactions undoubtedly are motivated by strategic and competitive factors, there is no mistaking that tax savings also are a key driver of these deals: The Pfizer-AstraZeneca combination was estimated to reduce taxes by at least $1 billion per year post-closing, and the New York Times described the AbbVie-Shire transaction as "For $53 Billion, Tax Savings."[2]

Apparently spurred into action by the Pfizer-AstraZeneca proposal, in May Democrats in both houses of Congress introduced legislation that would tighten the existing anti-inversion rules. Significantly, the proposed changes would apply to transactions completed after May 8, 2014, a threat of retroactivity clearly intended (at least) to halt inversion activity immediately and give Congress time to reach a consensus on a longer term legislative solution to the overall inversion problem.

To provide some context to evaluate the new proposal, this alert will first briefly describe how and why inversions have been accomplished in the recent past, then discuss the key proposed changes to the existing rules and the options available to multinationals in the face of considerable legislative uncertainty.

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[1] For recent coverage of "spinversions," *see* Brooke Sutherland, "Conglomerates Could Escape U.S. Taxes Through 'Spinversions'", Bloomberg BNA Daily Tax Report at 134 DTR G-4 (July 10, 2014).
[2] New York Times, July 18, 2014, p. A1

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INVERSIONS BACKGROUND

In very simple terms, an inversion involves redomiciling a U.S. corporation into a foreign jurisdiction, so that a multinational group of corporations becomes controlled by a foreign parent rather than a U.S. parent. The revised group structure creates the opportunity to pursue three key tax benefits:

- First, while a U.S. corporation is taxed on its worldwide income, the inversion generally permits the group to limit future U.S. taxation to U.S. earnings only. This benefit is amplified by the relatively high corporate tax rates in the U.S., particularly when compared to the headline rates in the countries (such as the UK) into which U.S. companies typically invert, and the fact that these countries often have incentive regimes applicable to certain types of income (such as from patents) that may be quite beneficial.

- Second, while in many cases a U.S. corporation pays U.S. tax upon a repatriation of earnings from its foreign subsidiaries or the use of those earnings to acquire U.S. assets, the new foreign parent generally will be able to use the group's future non-U.S. earnings to acquire U.S. businesses or to pay dividends to shareholders without paying U.S. tax on those earnings.

- Third, within limits, following the inversion the group can engage in certain base erosion techniques, such as the payment by the U.S. and other operating companies of deductible royalties or interest to lower-taxed group members.

Legislation has been enacted in varying forms over the past few decades in an effort to stem the tide of corporations exiting the United States. As a result, under current law inversion is not without its U.S. tax costs; most inversion transactions are taxable to U.S. shareholders, and the usual post-inversion restructuring typically results in an additional significant U.S. corporate tax cost. However, the current inversion calculus is that the future tax savings are simply worth the cost. Thus, by all accounts, existing legislation has failed to achieve its goals and corporations continue to find it worthwhile to reorganize so that they are no longer "U.S. multinationals" but merely "multinationals" with substantial U.S. operations, often with their headquarters and significant operations remaining in the United States after they have expatriated.

Historically there were a greater number of ways to achieve this end result, but today for virtually all companies there is only one viable option: to merge with a non-U.S. company in a transaction in which the shareholders of the offshore merger partner receive more than 20% of the shares in the combined offshore entity (which may be the merger partner itself or a third party jurisdiction holding company). Failure to exceed this 20% threshold will result in the combined corporation, although it is organized under foreign corporate law, being treated as a U.S. corporation for U.S. tax purposes. For this reason, virtually all inversion transactions satisfy this greater-than-20% share ownership test.

PROPOSED CHANGES

Many members of Congress have concluded that existing law provides insufficient barriers to corporate migration and that it must be significantly changed. The Obama administration has taken a similar position, most recently and adamantly in the form of a letter this week from Treasury Secretary Jacob Lew to Congressional leaders from both parties. However, there is a lively debate as to whether any change to the anti-inversion regime should be enacted on its own, or only as part of overall corporate (or corporate and individual) tax reform. Legislators in the first camp have introduced bills in both houses of Congress that would tighten the existing rules in two key respects:

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- First, the stock ownership threshold would be reduced, so that treatment of the combined offshore entity as a U.S. corporation for U.S. tax purposes would apply whenever the former shareholders of the U.S. corporation own more than 50% of the foreign entity following the inversion.
- Second, regardless of the degree of shareholder continuity, U.S. tax residence would continue to apply if, following the transaction, management and control of the group that includes the former U.S. parent occurs primarily in the United States and the group has significant business activities in the United States. For this purpose, "significant U.S. business activities" would be deemed to exist if at least 25% of any of the group's (i) employees (by headcount or compensation), (ii) assets or (iii) income were in the United States. This change would be a radical departure from historic U.S. law that generally has looked solely to place of incorporation in determining tax residency.

The bill as introduced in the Senate would allow the changes to expire after two years, a feature intended to spur Congress to enact comprehensive corporate tax reform within that time frame and thereby also address the inversion issue.

PRACTICAL IMPLICATIONS

Particularly given the climate in the present Congress, it is difficult to predict with any certainty whether or when the proposals described above (or any other possible relevant legislation) might be enacted and, if ultimately enacted, whether they will apply retroactively as proposed. There appears to be a growing consensus among members of both political parties that legislative action is needed to stem the tide of U.S. corporations exiting the U.S. However, at present there is no agreement on whether inversions are best addressed through punitive measures, such as the pending bills, or through fundamental corporate tax reform that presumably would attempt to induce multinationals to remain in the U.S. through enactment of a more benign international tax regime.

The possibility of the current legislation being enacted does not seem to be having a significant chilling effect on public transactions. None of them has featured the delivery of over 50% of the combined corporation's stock to the shareholders of the non-U.S. merger partner. Therefore, all of the transactions on their face would appear to be taxable under the current proposals, given the retroactive effective date. One could conclude from this that the parties involved may well be of the view that either the legislation will not be passed, or that if it is passed, the current retroactive effective date will not be included. Alternatively, there may be a "nothing ventured, nothing gained" mentality at work here: If the group was U.S. before the transaction, and in the worst case under the proposed legislation will be taxed as U.S. afterward, there may be no compelling reason not to pursue the foreign target through an inversion structure if the acquisition makes good business sense.

U.S. multinationals (particularly in the pharmaceutical and, to a lesser extent, technology industries) continue to seek to expatriate from the United States in order to reduce their current tax burden and to be able to access offshore cash more easily. This is despite the current U.S. tax costs incurred at the shareholder level, on the merger itself, and at the corporate level in connection with the usual post-inversion restructuring of subsidiaries and operations. Anecdotal evidence suggests that despite the upfront costs, the companies involved believe that self-help via inversions will ultimately yield more beneficial results (and certainly quicker results) than those that may eventually come with major tax reform.

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Companies in other industries, particularly those with a direct U.S. consumer base or with substantial U.S. government contracts or with rights to receive reimbursements from the U.S. government for various types of payments, may find an inversion much more difficult to accomplish.[3] For example, it has been suggested that these considerations may be viewed as significant impediments to an offshore move in the Walgreens-Boots merger, although expatriation continues to be explored in that transaction given the significant tax savings that would be expected to be achieved.

TAKEAWAYS

Any company contemplating a move offshore will need to vigorously examine the pros and cons involved, including the possibility that adverse legislation could be passed with a retroactive effective date. Furthermore, the costs that already exist under present law are not insignificant and must be factored into the overall calculus. Last, and certainly not least, the ability to expatriate depends upon finding a suitable merger partner and the ability to deliver more than 20% of the shares in the combined entity to the merger partner's shareholders.

Amidst all of the current buzz about inversion transactions, it is important to bear in mind that these are significant, and in many cases very substantial, third party business combinations featuring all of the hurdles that typically accompany such a global union: Challenging negotiations regarding the future management, direction and geographical presence of the combined entity; the need for regulatory approvals from the various countries involved, each of which might have its own, potentially adverse, interest in where and how the combined business operates; and, not least, the challenge of successfully integrating the two businesses following the transaction. Within the past six months, at least one announced inversion transaction (Omnicom-Publicis) collapsed, apparently under the weight of these considerations, and at least one other (Pfizer-AstraZeneca) seemed unable to gain traction for similar reasons. Given these commercial realities and the possibility that the intended tax savings could be limited or eliminated by the effect of retroactive or even prospective legislation, in the current climate a potential inversion transaction should only be pursued if the strategic and other non-tax reasons for the combination are sufficiently compelling to justify the combination even in the absence of the anticipated tax savings.

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[3] Even if a company in this position successfully abandons its U.S. tax residency through an inversion transaction, the non-tax costs of the change might prove prohibitive. In particular, there appears to be increasing willingness in Congress to prohibit companies that migrate overseas from benefiting from government contracts. In recent months, appropriations bills relating to transportation and energy programs, among others, have featured bans on contracts with inverted companies incorporated in the Cayman Islands and Bermuda, and a more recent defense appropriations bill would have an even broader geographic reach.

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