The Inversion Equation

New Tax Regulations Have Changed the Formula for Success

By Rebecca McReynolds

New rules from by the Treasury Department and the Internal Revenue Service (IRS) governing corporate inversions have made it more difficult for some U.S. multinational corporations to shop around for lower a lower tax rate overseas. But lower taxes are just one factor to consider when weighing the benefits of merging a U.S. corporation with an international partner. To explain the complicated new regulations and explore the opportunities that still exist, three centers at Columbia University—the Millstein Center for Global Markets and Corporate Ownership; the Richman Center for Business, Law, and Public Policy; and the Charles Evans Gerber Transactional Studies Center—held a joint forum on the subject.

The discussion, “Inversions: Implications for Tax Planning, Tax Policy, and Corporate Governance,” sponsored Davis Polk & Wardwell LLP, invited experts from business and academia to weigh in on the new tax policies. The first panel, “The Tax Advantages of Inversions: Why are U.S. Companies Still Doing (Or Looking At) Inversion Transactions Even After The Treasure Response,” explained why inversions are still a very attractive option for many U.S. multinationals.

New Math

Even with the tighter restrictions that went into effect in September 2015, the tax motivations for inversions haven’t gone away, according to the panelists. They’re just more a little more difficult to reach. The bulk of the new regulations are designed to tighten up the so-called “60-but-not-80” rule, which was put into place in 2004 to prevent U.S. companies from abusing federal tax law by simply swapping stock with a smaller foreign company while keeping most of its operations and management in the United States.

Under the 60/80 rule, the U.S. will only recognize the new entity as a foreign business for tax purposes if the U.S. shareholders of the inverted company receive at least 60% (by vote and value) of the new foreign parent company stock, but less than 80% of the stock. The new regulations maintain that 60/80 rule, but they have raised the threshold on how companies can achieve that split.

For example, in the past, certain passive assets owned by the foreign company, such as cash, were taken into consideration when calculating the asset base of the acquiring company. The new rules say that if more than 50% of the total assets held by the foreign acquiring company are passive, those assets won’t be included in the calculation, which means that the numerator goes down in your calculation for the foreign target and the denominator goes up proportionally for the U.S. company, the panel explained.

Conversely, in the past U.S. companies could "skinny-down" their asset base to meet the 60/80 target by distributing cash or other property to shareholders before an inversion, thereby reducing the size of the U.S. company. Under the new rules, any distributions made within 36 months of the inversion date will be added back into the equation.

Even for companies that pass the new 60/80 ownership tests, though, other roadblocks have been erected to hamstring one of most common reasons U.S. corporations have for going through with an inversion: accessing cash trapped inside foreign subsidiaries. One popular method for freeing up that cash was to use "hopscotch" loans between the new foreign parent and the U.S. subsidiary. Another was to shift ownership of a pre-inversion controlled foreign corporation (CFC).

Under the new rules, if you make that loan to a foreign affiliate or to a foreign parent within 10 years after the inversion, the IRS will treat the transaction as if you'd made a distribution to the U.S. firm, subject to U.S. taxes. Similarly, if an inverted company tries to move assets out of a CFC by moving ownership of the CFC to the new foreign parent, the IRS will tax that, too.

With these new rules in place, the deals themselves don't necessarily change, but how they are valued by the market may be, the panelists cautioned. The rich premiums that corporations were willing to pay for some acquisitions will disappear as the tax advantages of a "60/80" inversion erode.

Still, these new rules won't affect "the vast majority of cross-border mergers," the panel said. "This very complicated set of rules was designed to stop the hemorrhage of deals in that range, which were substantial and significant, and I think would have continued in substantial numbers," one panelist said. "But it's a very short-term fix, as far as I'm concerned."

That's because the 2014 regulations only add another layer of Band-Aids to the current tax laws without addressing the broader issue: the fundamental structure of U.S. international tax policy, the panel noted. Longer term, the speakers urged regulators to rethink how the country views, and taxes, international business.

Rethinking U.S. Tax Policy

Inversions are a uniquely American phenomenon for two reasons. First, the U.S. has the highest corporate tax rate among developed countries. Second, the U.S. is one of the few countries that levies taxes on the worldwide income of its resident multinational corporations. Most of the country's trading partners use some form of territorial tax system instead, which exempts most active foreign-sourced income of their resident multinationals from domestic taxes.

Combined, these two policies put U.S. multinationals at a competitive disadvantage with their international counterparts, creating a strong incentive for U.S. companies to move their headquarters offshore. The forum's second panel, "The Lessons of Inversions for

Fundamental Tax Reform," provided direction on how U.S. tax policy could be revised to put its multinational corporations on more even footing.

Current U.S. policy, which one panelist described as more of a hybrid between territorial and worldwide systems, "induces a number of behavioral responses that distort business decisions and waste resources," because it provides incentives to invest capital in some locations instead of others based tax liability rather than the most efficient use of that capital.

Over the long term, those negative incentives will not only erode the U.S. tax base, they will continue to drive jobs and resources out of the country, another panelist argued. "Inversions are just the latest, most visible and most exotic manifestation of distortions to real activity caused by the U.S. tax system," he said. Tax laws that continue to redistribute U.S. wealth overseas effectively destabilize the U.S. job market. "We know job loss is more frequent the further you are from headquarters," the panelist said.

The challenge of trying to reshape something as unwieldy as the U.S. tax system, though, is that there are so many moving parts. Even labels such as "territorial" and "worldwide" aren't nearly as clear-cut as they may seem because every country applies its own set of rules to these overly broad terms. So instead of focusing on the semantics, panelists said that policymakers should focus on the incentives that the right tax policy can stimulate as much as on the revenue that it can generate.

For example, with an estimated $2 trillion or more parked offshore by U.S. multinationals, the focus should be on how to put that money to work in ways the benefit the U.S. economy. "It's more about having a tax system that actually promotes growth and opportunity in the country," one panelist noted. "Why should we have this lockout effect, which really communicates very powerfully, if unintentionally, to corporations that they're better off investing foreign earnings overseas instead of in the United States? It just doesn't make any sense."

Corporate Governance Concerns

Too often lost in the debate over business profits vs. government revenue is the influence that inversions have on corporate governance. Changing tax venues can have a profound impact on other equally important business considerations, from shareholder protections to access to capital markets. "Has the nature of the immediate tax grab given rise to a set of decisions that are actually value-reducing within these companies?" one panelist asked.

The third panel, "The Corporate Governance Implications of Inversion," laid out the broader issues that boards should consider before making the move, including:

> **Weakened shareholder protections:** As companies shop around for the best tax jurisdiction, they also need to consider how each country protects—or doesn't protect—shareholder rights. The United Kingdom, for example, has a binding say-on-pay requirement while Ireland doesn't. Also in the U.K., shareholders with

a 5% stake can call a special meeting, and directors can be removed without cause by a majority vote. Countries also differ on shareholder approval requirements, particularly around capital management issues such as paying dividends, offering share buybacks and issuing new shares. Of course, if a company continues to trade on U.S. exchanges it will also still to be subject to all Securities and Exchange Commission (SEC) rules, along with Sarbanes-Oxley regulations and any additional exchange requirements.

Access to capital markets: When a U.S. corporation immigrates to a new country, it will automatically drop out of certain indices. For example, you may no longer fit in the S&P 500 index, so the large capital flows that are committed to that benchmark by mutual funds and other managed accounts are no longer available. Similarly, you would no longer qualify for inclusion in a large-cap U.S. equities fund. "You may also have overlapping shareholders between the two companies resulting in concentration within various portfolios that will result in portfolio managers needing to sell down the combined company," one panelist warned.

Accounting standards: Depending on where the company ends up being domiciled, it may have to start reporting financials using International Financial Reporting Standards in addition to any SEC reporting standards if it's stock continues to trade on U.S. exchanges.

Board structure: Some countries, such as The Netherlands, require a 2-tiered board. Others don't allow the chief executive officer to chair the board of directors. The European Union requires that one-third of the board has to be made up of employees. "Talk about a very different philosophy between Anglo-American principles and continental European principles," one panelist said. "The UAW and the Steelworkers work like crazy to get one union rep on a board."

Director Liability: Some jurisdictions limit the scope of indemnity that companies can provide for their board members.

Takeover Regime: What happens if you are a target of a hostile takeover once the company moves to a new jurisdiction? Some countries, such as the U.K. and Ireland, impose strict rules on bidders, but they are offset by restrictions on how boards can defend themselves against such a move. For example, Ireland allows companies to swallow a "poison pill" as long as there are no bidders on the horizon at the time. "But in the U.K. there are real questions of fiduciary duty as to whether or not you can adopt a pill," one panelist noted. "When you're the director of a U.S. company, you're used to obviously U.S.-style governance and, at the critical moments in a company's life, [boards need to understand] what the legal regime is going to look like."

Corporate Citizenship

Finally, the panelists debated whether inversions are inconsistent with a firm's social responsibility to their home country. One panelist argued, "U.S.-based multinationals disproportionally benefit from expensive U.S.-provided benefits and thus have a social responsibility to avoid high-powered tax strategies to evade U.S. tax law." These benefits include the general regime of "Pax America," as well as targeted benefits for specific industries that enhance their profits worldwide. A clear example of this obligation, argued the panelist, can be found in the pharmaceutical industry, a major player in the inversion market over the past few years.

The argument was that such companies typically benefit from U.S. subsidies to biomedical research through support to universities, the National Institutes of Health and other types of research. At the same time, U.S. reimbursement rules under Medicare Part D and the Affordable Care Act limit the government's ability to negotiate drug prices, which also support the development of drugs that are sold worldwide. U.S. companies also benefit from intellectual property protection that has been a major U.S. trade-negotiation point, protecting foreign profits from erosion. "You might say that the multinationals that invert are simply free-riding," a panelist said. "They want the protection, just not to pay for it, which seems intellectually inconsistent with positions they've taken in other areas."

Other panelists disagreed with this position, focusing on the corporate governance dimension. One typical response was: Boards have a fiduciary obligation to shareholders not to pay unnecessary tax.

In Sum

The bottom line is that corporate governance and taxation are closely linked. Boards need to consider a wide menu of options and obligations before making such a potentially life-changing move. "As a company and a management, you've got to think about not only the positives and the candy of the tax benefits, but you've got to think about some of the negatives as well," the panel cautioned.