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On Tax Inversions

Although tax inversions are currently a hot topic on Wall Street, they actually have been around for more than thirty years. A tax inversion occurs when a U.S. company forms or buys a foreign firm in a country with a lower tax rate and then shifts its tax domicile to the foreign country. Since the early 1980s, more than 50 inversions have taken place.

The term "inversion" refers to the fact that the company is basically turned upside down: by reincorporating in a foreign country, the larger U.S. business in effect becomes a subsidiary of the smaller offshore unit. An inversion also may be accomplished by "spinning off" a U.S.-based business to a foreign jurisdiction. Over the years, new tax rules have typically followed closely on the heels of an inversion, which are then followed by more inversions as companies adjust and find ways to work around the regulations.

The very first inversion took place in 1982 when the Texas oil and gas company McDermott International moved its tax base to Panama. In response, the Internal Revenue Service implemented a rule preventing U.S. companies from accumulating earnings in a foreign corporation and converting the earnings into dividends or capital gains which then would be taxed at lower rates.

The second inversion occurred in 1994 when Helen of Troy, a U.S. cosmetics company, formed a shell company in tax-haven Bermuda which then became the corporate parent. The IRS viewed the deal as structured solely to avoid taxation and ruled that Helen of Troy's U.S. shareholders should be liable for capital gains taxes. A short time later in 1996, the agency issued its first complete set of "anti-inversion guidance."

After this guidance was issued, the pace of inversions actually picked up. Fifteen took place between 1996 and 2001, including Loral Space & Communications, Tyco International, Transocean, Fruit of the Loom, Foster Wheeler and Ingersoll Rand. In 2002, Stanley Works was planning to relocate to Bermuda even though its roots in the U.S. date back to the mid-19th century. After a virulent "Made in America" backlash by the public, the company changed its mind and stayed put. It is now known as Stanley Black & Decker.

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Congress took note of the backlash and also was alarmed by the rising trend of inversions and the potential loss of tax revenue. It passed the first anti-inversion law in 2004. U.S. shareholders still were subject to taxes but so were the corporation, its officers, directors and significant shareholders. But the law provided for exemptions as well and the companies of course found ways to make effective use of them. Thirty-two inversions have taken place since 2004.

As the table below shows, so far this year 13 inversions have been announced with four completed and nine still pending. The companies include Burger King, which is buying the Canadian donut chain Tim Horton's, as well as banana grower Chiquita Brands, high-technology firm Applied Materials, medical device maker Medtronic, and pharmaceutical company AbbVie. Ireland and the United Kingdom top the destination list for 55% of the transactions while Canada, the Netherlands and a combination of Bermuda and the Cayman Islands each account for a 15% share. Ten years ago, Bermuda and the Cayman Islands were the most popular destinations.

Tax Inversions Announced in 2014

Company	Previous U.S. Headquarters	New Headquarters	Status	Top Executives Based in U.S.
Burger King	Florida	Canada	Pending	No
AbbVie	Illinois	Jersey	Pending	Yes
Mylan	Pennsylvania	Netherlands	Pending	Yes
Salix Pharmaceutical	North Carolina	Ireland	Pending	Yes
Auxilium Pharm.	Pennsylvania	Canada	Pending	Yes
Nabors *(hydraulic fracking unit)*	*(Spin-off)*	Bermuda	Pending	Yes
Medtronic	Minnesota	Ireland	Pending	Yes
Chiquita Brands	North Carolina	Ireland	Pending	No
Applied Materials	California	Netherlands	Pending	No
Horizon Pharm.	Illinois	Ireland	Completed	Yes
Theravance Biopharma	California	Caymen	Completed	Yes
Paragon Offshore	*(Spin-off)*	England	Completed	Yes
Endo Int'l	Pennsylvania	Ireland	Completed	Yes

Source: Bloomberg

One aspect of inversions which has garnered attention in the press and in Washington is the fact that most inverted firms maintain their executives and business operations in the U.S. Thus, the companies are seen as enjoying the benefits of operating in the U.S. without paying the corporate taxes that go towards maintaining those benefits.

From the companies' point of view, it can be argued that corporate leaders have a fiduciary responsibility to their shareholders and that those who arrange transactions that increase after-tax earnings are, in fact, doing their job. Also, the U.S. has the highest corporate tax rates in the developed world. The federal and state rates combined can be as high as 39% and even though few companies actually pay at such levels, the rates are about twice the average in Europe.

In a recent article for *The New York Times*, noted economist N. Gregory Mankiw pointed out that the U.S. has a form of corporate tax that differs from that of most other nations and which does not make much sense in the modern global economy: "A main feature of the modern multinational corporation is that it is, truly, multinational. It has employees, customers, and shareholders around the world. Its place of legal domicile is almost irrelevant. A good tax system would focus more on the economic fundamentals and less on the legal determination of a company's headquarters."

Mankiw continued: "Most nations recognize this principle by adopting a territorial corporate tax. They tax economic activity that occurs within their borders and exclude from taxation income earned abroad. (That foreign-source income, however, is usually taxed by the nation where it is earned.) Six of the Group of 7 nations have territorial tax systems."

He concluded: "The exception is the United States, which has a worldwide corporate tax. For companies incorporated in the United States, the tax is based on all income, regardless of where it is earned. Again, moving our tax code toward international norms would help slow corporate inversions."

While both sides of the aisle in Congress recognize that the U.S. corporate tax system needs an overhaul, it is unlikely to happen within the next few years and this perception may be one of the factors driving the current wave of inversions. Companies also may be "getting while the getting is good" before further restrictions are put in place.

In September, the U.S. Treasury Department announced new rules designed to make inversions less attractive. Now, it will be more difficult for companies to finance a transaction using their cash held overseas without having it taxed at U.S. rates. The standards to qualify a merger as an inversion also were tightened and the Treasury Department is considering additional measures.

The restriction on using offshore cash to fund a merger may be the most far-reaching of the new regulations. Many U.S. multinational companies have accumulated large cash balances overseas. If the cash were brought back to the United States, it would be subject to U.S. taxes, typically at a 35% rate. Using the cash to finance an inversion, which theoretically would also reap tax benefits going forward, is likely a more attractive alternative for many companies than bringing it back home with a hefty tax bite.

So far one company, Salix Pharmaceutical, has called off its inversion while another is planning on other financing arrangements to comply with the new rules. Medtronic, which plans to purchase Dublin-based Covidien, announced that instead of using cash from its foreign units as planned, it will borrow $16 billion to finance the deal.

Some investors have been angered by the fact that while U.S. shareholders will face capital gains taxes, a number of companies are "grossing up" their executives by giving them the funds to pay their tax obligations due to the inversion.

For example, Medtronic plans to give its executives the funds needed to pay the taxes they will realize on their stock-based compensation, options and restricted shares as well as the excise taxes and the taxes due on the excise tax subsidies. By some calculations, this could amount to a $60 million non-deductible expense. In a widely read article published over the summer, *Fortune Magazine* detailed Medtronic's plans as well as its explanation: "Medtronic has agreed to indemnify directors and executive officers for such excise tax because they should not be discouraged from taking actions that they believe are in the best interests of Medtronic and its shareholders."

Whether or not inversions are actually beneficial to shareholders in the long run is an open question. The financial research firm Reuters recently completed an analysis of the inversions that have taken place over the last thirty years. The study measured simple share price performance against the Standard & Poor's 500 Index with two benchmarks -- the date each company announced its deal and the date each deal was completed.

Of the 52 inversions completed since 1983, 19 companies, or a little more than a third, subsequently outperformed the S&P 500. An equal amount subsequently underperformed the Index. An additional 10 companies were bought by rivals, three went out of business and one reincorporated back in the United States.

The companies with the worst performances were the oilfield services and engineering firms. McDermott International, the first to invert, had the worst performance, lagging the S&P 500 by 85%. But six U.S. insurance firms used an inversion strategy and half of them have outperformed the Index while the rest were either acquired or went out of business. Most of the drug companies leading the current wave have outperformed the S&P 500 since announcing their deals.

Of course if the primary reason for inverting is to achieve lower tax rates, the underlying assumption is that the lower tax rates will stay low. As we go to press, Ireland has announced that it may close its corporate tax loopholes after pressure from other governments and the European Union amid slow economic growth. The most famous loophole is known as the "Double Irish," which allows royalty payments for intellectual property to be funneled from one Irish-registered subsidiary to another residing in a country with no corporate income taxes. It is often used in conjunction with the "Dutch Sandwich," a Netherlands-based structure that avoids certain taxes.

Clearly, analyzing the prospects of an inversion is complex and based on the specifics of the transaction as well as the company's fundamental characteristics. Evolving regulations and shifting tax rules make the analysis more difficult. As Reuters showed, shareholders in particular should note that inversions may or may not be a winning strategy over the long haul.

Finally, it is worthwhile to ponder the outcome of the first U.S. drug company to invert. In 1998, the biotechnology firm Xoma shifted its tax base to Bermuda. Thirteen years later, the company returned to the United States, stating it wanted to reduce its exposure to possibly adverse tax legislation and come back to a more familiar legal system.