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Treasury Attempting to Slow the Inversion Craze

By Chloe Gouache, LL.M. Candidate 2015 | October 8, 2014

United States companies are required by U.S. tax rules to pay taxes on profits earned elsewhere. Consequently, companies that receive a significant portion of their income from foreign sources are taxed both abroad and in their country of incorporation. Those companies are likely to use an inversion to lower their taxes - a strategy by which a company reincorporates overseas through a merger with a foreign counterpart, enabling the company to relocate its headquarters to a tax-friendly country. "Inverted" corporations still pay taxes on profits earned in the United States, but the inversion makes it easier for them to bring cash from overseas into the country.

Lately, inversions have been highly criticized because they provide the framework for more complicated transactions that companies have been increasingly using to further reduce their U.S. tax burdens. For example, so-called "hopscotch" loans allow an inverted company to take advantage of an IRS loophole by having a foreign subsidiary lend money to the newly foreign parent, since such loans are not considered U.S. property and are therefore not taxed as a dividend. Another strategy is known as "de-controlling," where the new foreign parent of the inverted company buys enough stock of a foreign subsidiary from the former American parent to take control, granting the foreign parent access to the subsidiary's deferred earnings without ever paying U.S. taxes on them.

In recent months, several pharmaceutical companies have announced inversion deals that will allow them to move their headquarters to countries with lower corporate taxes. AbbVie, based near Chicago, announced in July the acquisition of its European rival, Shire, which will allow AbbVie to reincorporate in the U.K. in the largest inversion in U.S. history. Mylan also announced that it is acquiring Abbott Laboratories' specialty and generics business and that it will use the acquired assets to form a new parent company in the Netherlands.

However, the inversion craze may soon be slowing. On September 22, the Treasury Department announced a series of measures aimed to crack down on inversion deals. The new rules are intended to make inversions more difficult and less profitable.

The measures do not prohibit inversion deals. Rather, the primary objective is to prevent inverted companies from gaining access to their overseas profits without paying taxes in the United States. For example, hopscotch loans will now be treated as dividends, rendering them taxable in the U.S. Complicated transactions like internal loans or stock purchases and sales that companies use to reduce their tax burdens are also being short-circuited. In addition, the Treasury has made it "more difficult for U.S. entities to invert by strengthening the requirement that the former owners of the U.S. entity own less than 80 percent of the new combined entity."

The changes will affect inversion deals that were completed on or after September 22 and could include some pending deals such as AbbVie's or Mylan's. Mylan is likely to reconsider its plans since merging into an international spinoff of Abbot is a so-called "spinversion," which is now

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prohibited under the new Treasury rules. AbbVie's deal might be highly penalized by the new anti-hopscotch rule, since it expected to use those loans to help finance its inversion.

Some strong opponents of corporate inversions say the actions were far too limited to substantially reduce the practice and that the only way to effectively halt inversions is through congressional action. But is stopping inversions the real solution? As Stephen Shay, a professor at Harvard Law put it: "the objective is to stop transactions that aren't based on sound business objectives; it's to stop transactions that are aimed at avoiding U.S. taxes." Some inversions are effectuated for business reasons, and not simply tax avoidance.

The recent announcement of Burger King's acquisition of Tim Hortons garnered much criticism. However, critics may be misjudging the deal. As Steven Davidoff Solomon, professor of law at the University of California, Berkeley explained, it makes sense for Burger King to relocate to Canada, as it will be the biggest market for the newly combined company. Also, it is hard to blame the tax issue for driving this acquisition, as Burger King had the opportunity to relocate to the British Virgin Islands in 2006 but decided against the move. It seems that Canada would simply be the best place from which to run the business, and companies should have the right to make such business decisions.

The Treasury Department's new measures are making inversions substantially less attractive to companies seeking to escape U.S. taxation. This issue may show a need to overhaul the U.S. tax system, but as Solomon said: "even if we reform the tax code, companies will still move abroad – it will just be for business and not tax reasons." Perhaps deeper reform is needed, including broader measures to attract new businesses and investment to the United States.