Do Inversions Matter? How Should Inversion Transactions Affect Our Thinking About U.S. International Tax Reform

ABA SECTION OF TAXATION
MAY MEETING 2014

SUBCOMMITTEE ON TAX POLICY AND SIMPLIFICATION

Panel Participants

- Ronald Dabrowski, Special Counsel, Office of International Tax Counsel, Department of the Treasury
- Mihir Desai, Professor, Harvard Business School and Harvard Law School
- Jefferson Vanderwolk, Washington Council Ernst & Young
- Itai Grinberg, Georgetown Law, *Panel Moderator*

Outline

- Section 7874: Background and Current Law
- Economic Incentives and the Changing Shape of the Global Firm
- Administration's FY 2015 Budget Proposal
- Reflections on Policy Considerations

Tax Jurisdiction and Corporate Residence

Residence-based jurisdiction: tax the income of residents of the jurisdiction

…and nonresident citizens, in the case of the US

Source-based jurisdiction: tax the income arising in the jurisdiction, regardless of the taxpayer's residence

Corporate residence for tax purposes

- Place of incorporation (IRC sec. 7701(a)(4))
- Place of central management and control, or place of effective management, in many countries

Why does corporate tax residence matter?

- Worldwide taxation, in the US and a few other countries
- Applicability of CFC rules to resident parent corporations

Simple Inversion (mostly pre-§7874)

Before the exchange

Shareholders

USCo

- 35% tax
- Worldwide base

Subsidiaries

After the exchange

Same shareholders

ForeignCo

- Lower tax rate
- Narrower base

USCo

Subsidiaries

US Tax on Inversion, pre-2003

- *Shareholder-level tax* on gain from exchange of USCo stock for ForeignCo stock,

  unless:
  - Former USCo shareholders do not own more than 50% of ForeignCo after the exchange, and
  - ForeignCo is at least as valuable as USCo and has been in business abroad for at least 3 years, and
  - Any former USCo shareholder owning 5% or more of ForeignCo after the exchange agrees to pay US tax on a future sale of ForeignCo stock.

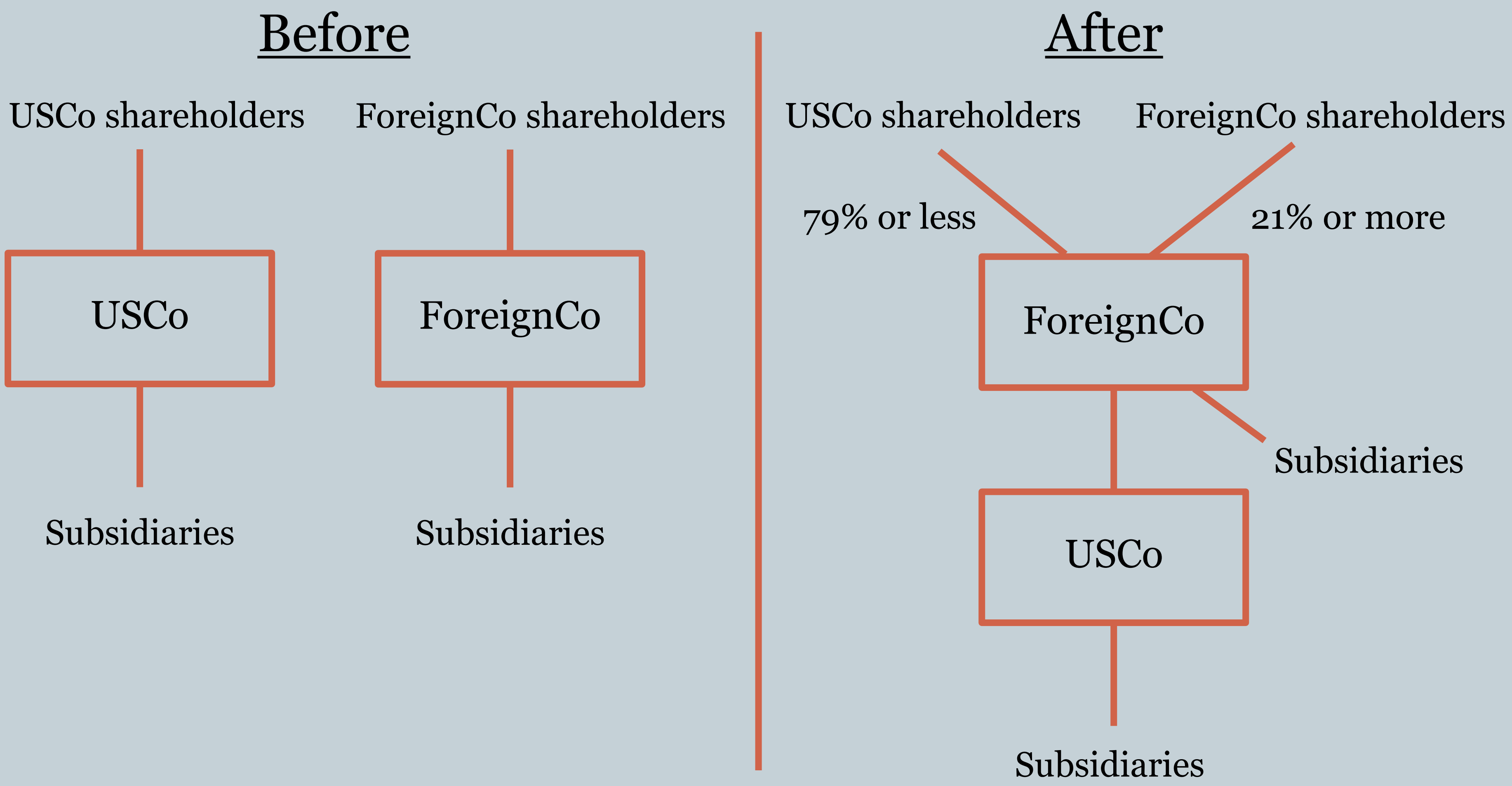
§7874 and Regulations: The 80% Test

- If:
  - ForeignCo acquires USCo, and
  - Former shareholders of USCo own 80% or more of ForeignCo after the acquisition by reason of having owned stock in USCo, and
  - The global group has less than 25% of its assets, employees, payroll, or income in ForeignCo's country of incorporation,
- Then ForeignCo will be treated as a domestic corporation for all purposes of the IRC.

§7874 and Regulations: The 60% Test

- If all of the conditions on the previous slide are met, except the former shareholders of USCo own 60% to 79.9% of ForeignCo by reason of having owned stock in USCo,
- Then USCo and its US affiliates lose the benefit of tax credits and net operating loss deductions with regard to income or gain from the transfer of stock or other properties during the 10-year period after the acquisition.
- ForeignCo is not treated as a domestic corporation.

Recent Transactions



Economic Considerations

- Recent Transactions
- Economic Incentives
- The Changing Shape of the Global Firm

Mergers/Inversions

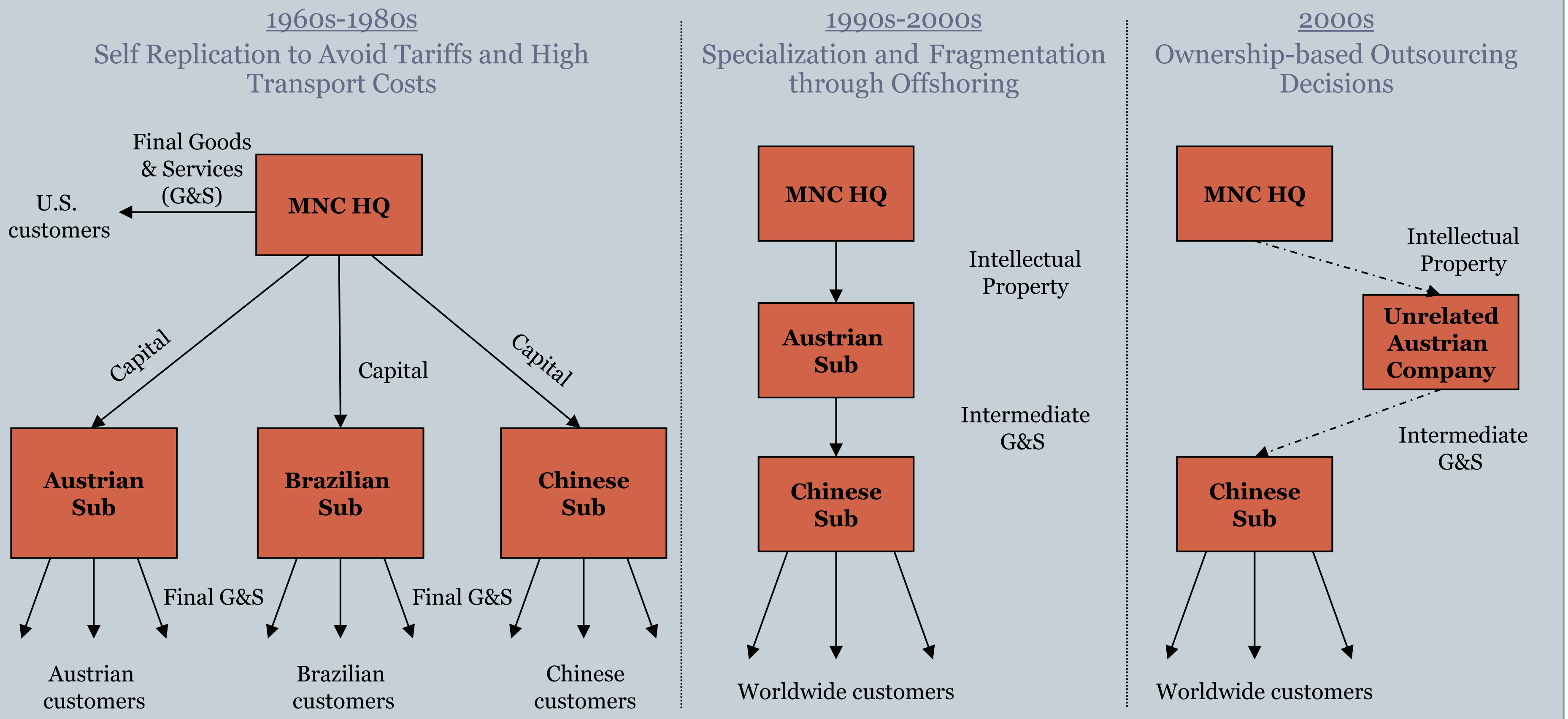
Date	Company 1	Company 2	Tax Domicile	Value	Quotes
Sep 2011	Jazz Pharmaceuticals (Ireland)	Azur Pharma (U.S.)	Ireland	all-stock deal	"Because the stock deal transferred more than 20 percent ownership of the combined company to foreign holders, Jazz was able to enact an "inversion" — relocating its corporate headquarters to Ireland and escaping the U.S. tax regime." -NYT
Mar 2012	Tyco International (Switzerland)	Pentair (U.S.)	Switzerland	$4.5 billion	"Citing Pentair and Tyco, the Star Tribune reported that being domiciled in Switzerland will give the merged company tax advantages: The new Pentair's estimated annualized tax rate globally will reportedly fall to 24 to 26 percent from the 29 percent Pentair is now paying." -TwinCities Business Magazine
May 2012	Eaton Corp (U.S.)	Cooper Industries (Ireland)	Ireland	$11.8 billion	"The deal brings tax and cash management benefits to the combined company of $160 million annually. On a conference call, Eaton management declined to be more specific, but the new Eaton PLC will be subject to the 12.5% corporate tax rate in Ireland, rather than the 35% rate in the U.S." -WSJ
Feb 2013	Liberty Global (U.S.)	Virgin Media (U.K.)	U.K.	$16 billion	"Liberty Global has said it is incorporating in the UK because it "more closely aligns our corporate function with our operations" – as most of its employees and operations will be in Europe, and the UK is its biggest market. Its tax rate will fall to 21 per cent. Analysts at Macquarie also note that Virgin Media has roughly 13bn pounds in unused capitalised allowances and expect the company will not have to pay cash taxes for several years." -FT
May 2013	Actavis (U.S.)	Warner Chilcott (Ireland)	Ireland	$5 billion	"Drugmaker Actavis (ACT) announced yesterday that it will buy rival Warner Chilcott PLC for $5 billion in stock and that, as part of the deal, it plans to reincorporate itself in tax-friendly Ireland, where Warner Chilcott (WCRX) is based. This despite the fact that the company's top executives, including CEO Paul Bisaro, will continue to live and work in New Jersey." -Fortune
Jul 2013	Omnicom (U.S.)	Publicis Groupe (France)	Netherlands	$35 billion	"In July, Omnicom, the large New York advertising group, agreed to merge with Publicis Groupe, its French rival, in a $35 billion deal. The new company will be based in the Netherlands, resulting in savings of about $80 million a year." -NYT
Jul 2013	Perrigo (U.S.)	Elan (Ireland)	Ireland	$8.6 billion	"The purchase allows Perrigo, based in Allegan, Michigan, to move its domicile to Ireland, where the corporate income-tax rate is 12.5 percent. […] The acquisition will result in more than $150 million of recurring after-tax annual operating expense and tax savings, the company said." -Bloomberg
Sep 2013	Applied Materials (U.S.)	Tokyo Electron (Japan)	Netherlands	$9.39.billion	"The merged company will save millions of dollars a year by moving — not to one side of the Pacific or the other, but by reincorporating in the Netherlands.[…]When Applied Materials announced its deal for Tokyo Electron, it said that its effective tax rate would drop to 17 percent from 22 percent as a result. For a company that had nearly $2 billion in profit in 2011, that amounts to savings of about $100 million a year." -NYT
Nov 2013	Endo Health Solutions (U.S.)	Paladin (Canada)	Ireland	$1.6 billion	"In Endo's case, moving to Ireland will lower the company's effective tax rate to 20 percent, from its current rate of 28 percent, leading to at least $50 million in annual tax savings. With time, those savings could grow, according to analysts." -NYT
Jan 2014	Fiat (Italy)	Chrysler (U.S.)	UK	$4.35 billion	"Fiat Chrysler Automobiles NV, the new holding company that will control the operations of Italy's Fiat and No. 3 U.S. auto maker Chrysler, will be based in the Netherlands, with a U.K. tax domicile and a New York stock listing." -WSJ
Mar 2014	Chiquita (U.S.)	Fyffes (Ireland)	Ireland	$1.07 billion	"By joining forces, the combined ChiquitaFyffes claims it will knock down operating costs by about $40 million a year. But the move also knocks down Chiquita's taxes, since it's hitching itself to a company domiciled in Dublin. Ireland isn't exactly a tax shelter, but it's close. Companies based there pay a 12.5% corporate tax rate compared with the (official) rate of up to 35% in the United States." - WSJ

Economic Incentives

- Rising gap between U.S. and ROW with respect to rates *and* tax systems leads to increased incentives.
- Consequences are non-trivial given what we know about headquarters activities and earnings stripping – Stanley (announcement effects) and Tyco. Governance implications may be important too.
- All of this is happening with the backdrop of a secular change in how corporations have become “decentered.”

The Changing Shape of the Global Firm

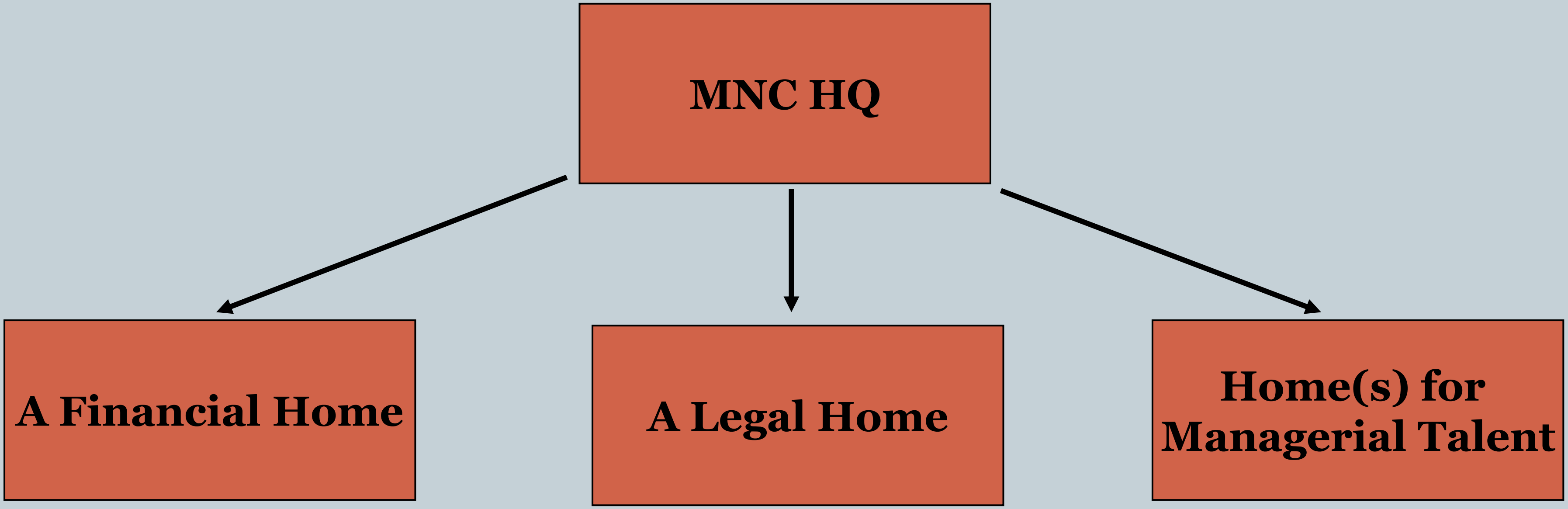
These changes can be best understood as a continuation to changes in the shape of the global firm. The last forty years have featured very different organizational responses to falling tariffs, transport costs, and contracting costs…



Reconceptualizing the Corporate Home

A traditional home can be unbundled into three critical functions that can then be relocated in response to global opportunities.

2000s and on
The Decentering of the Global Firm

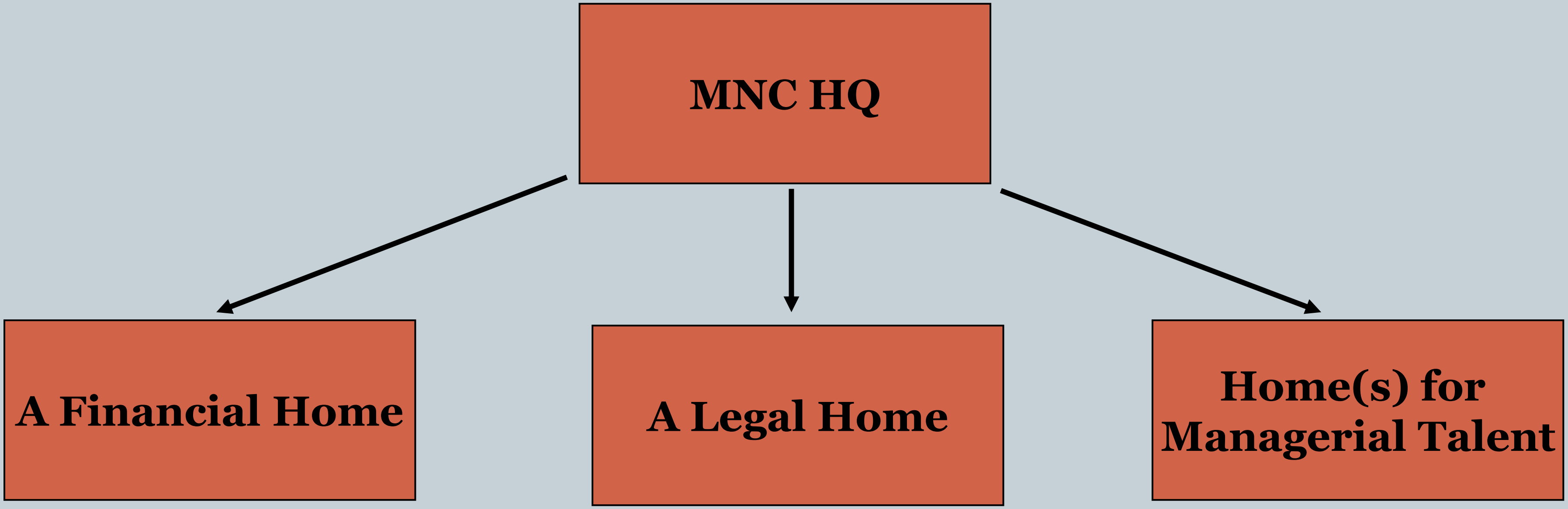


Consider Genpact – First Bermuda now Lux, NYSE listing, India talent with senior managers in Europe and Singapore

Reconceptualizing the Corporate Home

2000s and on

The Decentering of the Global Firm



First, what is giving rise to these changes? 1) Enhanced communication technologies, 2) Rising competition amongst countries, 3) Power of Talent, and 4) Emergence of global shareholder and lender base

Reconceptualizing the Corporate Home – Home(s) for Managerial Talent

MNC HQ

Home(s) for Managerial Talent

The most traditional and obvious function of HQ

Yet, this need no longer be unitary…CFOs, CIOs and COOs can be usefully located closest to key suppliers, labor pools, or travel hubs – e.g. Genpact

This home can change culture of company – Celanese

Consider Rio Tinto/Lend Lease – senior management spread across UK and Australia

Reconceptualizing the Corporate Home – A Financial Home

MNC HQ

A Financial Home

What functions does a financial home provide?

- Allows for recontracting around poor rules – ADRS
- Dictates incentive compensation arrangements – Alcon
- Capital raising and capital allocation – J. Hardie
- Can determine owners – Nestle
- Dictates firm value – News Corp and Boart Longyear

Reconceptualizing the Corporate Home – A Legal Home

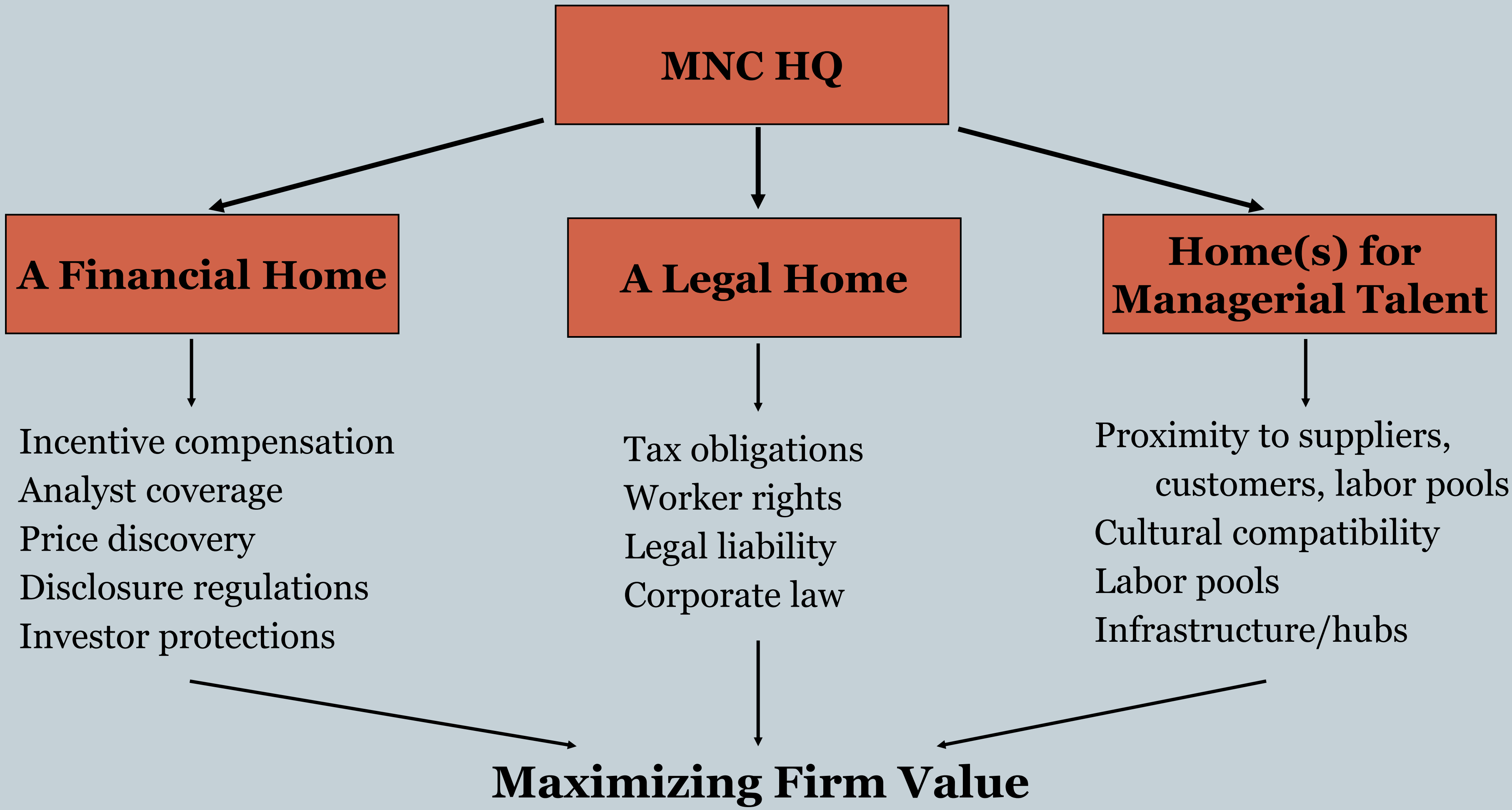
MNC HQ

A Legal Home

What functions does a legal home provide?

1. Legal homes create opportunities and obligations – e.g. corporate taxation and of investors
   - Stanley, BHP-Billiton, havens….
2. Rights of investors, workers and other stakeholders that can influence firm value
   - Celanese

Reconceptualizing the Corporate Home



FY 2015 Greenbook Proposal: *Limit the Ability of Domestic Entities to Expatriate*

- FY 2015 Greenbook proposal seeks to broaden the set of transactions to which section 7874 applies
- Under the proposal, foreign corporations would be taxed as domestic corporations if there is greater than 50% shareholder continuity after a transaction otherwise subject to section 7874 is completed.
  - The proposal would thereby eliminate the 60% - 80% category
- Regardless of the level of shareholder continuity, an inversion transaction would be deemed to occur if the EAG has substantial business activities in the U.S. and the foreign corporation is primarily managed and controlled in the U.S.
- Would broaden the circumstances in which acquisition of the assets of a domestic partnership constitutes an inversion for purposes of section 7874.

FY 2015 Greenbook Proposal:
Limit the Ability of Domestic Entities to Expatriate

"To limit the ability of domestic entities to expatriate, the proposal would broaden the definition of an inversion transaction by reducing the 80-percent test to a greater than 50-percent test, and eliminating the 60-percent test. The proposal would also add a special rule whereby, regardless of the level of shareholder continuity, an inversion transaction will occur if the affiliated group that includes the foreign corporation has substantial business activities in the United States and the foreign corporation is primarily managed and controlled in the United States. Finally, the proposal would amend section 7874 to provide that an inversion transaction can occur if there is an acquisition either of substantially all of the assets of a domestic partnership (regardless of whether such assets constitute a trade or business) or of substantially all of the assets of a trade or business of a domestic partnership."

U.S. DEP'T TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2015 REVENUE PROPOSALS 65 (2014)