Inversion Excise Taxes

By Robert W. Wood • Wood LLP • San Francisco

When there is an excise tax payable under Code Sec. 4985, should the company reimburse the officers and directors? Medtronic, Inc. will pay $63 million so its executive officers and directors will not have to. The gross-up is expensive since the total excise tax is really only $23.25 million. The difference, of about $39.75 million, represents the add-on because Medtronic is picking up the tab.

Code Sec. 4985 imposes an excise tax on Code Sec. 16(a) officers and directors of an inverting corporation. The tax is 15 percent of the covered officer or director's stock-based compensation, including options, held from six months before to six months after the inversion. Grossing-up the Code Sec. 4985 excise tax is common.

Like Code Sec. 7874, Code Sec. 4985 dates to 2004. Congress knew that the taxes on an inversion would be triggered to shareholders. But the very people who are generally recommending the inversion in the first place—the officers and directors—can often avoid the taxes by holding options. The Code Sec. 4985 excise tax was designed so these persons, like more regular shareholders, would be hit with a 15-percent tax, the counterpart of the then-15-percent capital gain tax.

Notably, the tax applies only if gain (if any) on any stock in such corporation is recognized in whole or part by any shareholder. The excise tax is imposed on each "disqualified individual" of the inverting corporation, meaning officers, directors and 10-percent shareholders. The base of the tax is the value of the covered individual's "specified stock compensation."

Code Sec. 4985(e)(3) defines the term expansively to include all stock-based compensation. For stock options and other similar rights, including stock appreciation rights, Code Sec. 4985(b)(1)(A) defines value as the "fair value." For all other stock-based compensation, Code Sec. 4985(b)(1)(B) defines value as the "fair market value."

The Gross-Up

When the inverting corporation pays the tax on behalf of a disqualified individual, that payment of the excise tax would be included in the disqualified individual's taxable income. Moreover, Code Sec. 4985(f)(2)(A) provides that this payment "shall be treated as specified stock compensation." That means it too is subject to a 15-percent excise tax.

The result is inefficient, for each dollar paid by the corporation will reduce the disqualified individual's tax liability by considerably less. Medtronic's gross-up showcases that inefficiency. In rough terms, by grossing-up a disqualified individual's Code Sec. 4985 tax, an inverting corporation pays over two-and-one-half times the amount.

There are other excise taxes that serve as models, of course. Consider golden parachute payments and Code Sec. 280G. There, it is a 20-percent excise tax imposed on officers, shareholders and highly compensated individuals for excess parachute payments.

This golden parachute excise tax is routinely grossed-up. Presumably, Congress assumed the inversion tax would be routinely grossed-up too. After the example of excess parachute payments, Code Sec. 4985 itself expressly requires that third-party payments of the tax themselves be subject to the tax and be nondeductible.

If the golden parachute payment excise tax is any indication, the gross-up feature in inversions may become even more common. Statistics suggest that golden parachute payment excise tax gross-ups are now almost the norm. Compensation consultants lament the inefficiency of having companies pay millions of dollars to the IRS so executives can take home just a few hundred thousand dollars more in severance.

Yet this inefficiency does not seem to slow the gross-ups. With inversions, we can probably expect the same.