The M&A Tax Report

SEPTEMBER 2014 VOLUME 23, NUMBER 2

The Monthly Review of Taxes, Trends & Techniques

Trending Now, Inversions and Hating Them

By Robert W. Wood • Wood LLP • San Francisco

Inversions are not new. Yet they have undergone a rather startling metamorphosis in just a short period of time. Once, they were considered clever transactions that some companies with the right facts, assets and international ambitions could pursue. A global enterprise that is not domiciled in the U.S. pays less U.S. tax on non-U.S. income, period.

Inversions reduce U.S. taxes on foreign income—not on U.S.-based income. That was and remains why they are attractive for companies competing on an increasingly global stage. But almost out of the blue, these deals suddenly became one of the hottest trends in years that everyone was pursuing.

Equally suddenly, inversions—and those perpetrating them—have become pariahs. They carry negative press and investor-relations backlashes. Their recent popularity has even spurred the possibility of a retroactive legislative fix, even though that seems unlikely.

The misinformation and invective surrounding them are hard to quantify. Although inversions probably commenced in the 1980s, there were few even through the 1990s. Some observers point to McDermott International's inversion into Panama in 1982, which was followed a dozen years later by the inversion into Bermuda of Helen of Troy Limited.

Tyco International, which would later become infamous over the scandal and 2005 criminal conviction of CEO Dennis Kozlowski, inverted into Bermuda in 1997. Other inversions followed, including Fruit of the Loom into the Cayman Islands in 1998, Ingersoll Rand into Bermuda in 2001 and Transocean into Switzerland in 2008. However, as the trend became something tax legislators thought was abusive, Congress finally acted to put the brakes on inversions in 2004.

Since 2004, Code Sec. 7874 requires inversions to involve more than 20-percent foreign ownership. One of several 2014 proposals to stem the inversion tide would increase this 20-percent rule for inversions to a whopping 50 percent. That would ensure that a foreign company would have to *really and truly* be the controlling buyer.

ALSO IN THIS ISSUE

The 2004 provision is complex. Under Code Sec. 7874, a domestic company can be classified as a surrogate foreign company if the domestic company's shareholders own at least 60 percent of the inverted company after the transaction. If there is continuity of ownership between 60 and 80 percent, the provisions restrict the inverted company's ability to use otherwise-available historical tax attributes to shelter any inversion gain.

On the other hand, if there is continuity of ownership of 80 percent or more, the surrogate foreign company will be treated as a domestic company for U.S. tax purposes. The idea of Code Sec. 7874 was to slap a 60-percent penalty on corporate-level gain on the inversion or on future transactions that would seek to escape from U.S. gain recognition. It appears that some companies are willing to pay the tax.

Still, the penalties for such a deal under existing law can go even further. Having 60-percent continuity of ownership (with the consequence of the surrogate foreign corporation being subject to Code Sec. 7874) can also trigger excise taxes to certain officers. Under Code Sec. 4985, there is an excise tax on their stock compensation.

Like some other excise taxes, though, this has proven to not be a significant deterrent to the deals. The golden parachute payment excise tax comes to mind. Some companies deem it important enough to pay excise taxes *for* their officers, grossing up their compensation.

A review of some notable 2014 inversion developments (compiled by Tax Analysts) may help explain some of the hysteria over them:

- Mallinckrodt (an Irish pharma company) announces an all cash acquisition of Cadence Pharmaceuticals to be based in Ireland (Feb. 11, 2014).
- Actavis PLC (another Irish pharma company) announces the stock and cash acquisition of Forest Laboratories (Feb. 18, 2014).
- U.S. electronics company Applied Materials, Inc. and Japanese Tokyo Electron Ltd. receive approval for proposed merger in which both will become Dutch companies (Feb. 24, 2014).
- U.S.-based Endo Health Solutions Inc. completes purchase of Paladin Labs Inc. with new Irish parent, Endo International PLC (Feb. 28, 2014).
- Chiquita Brands International Inc. and Fyffes PLC of Ireland agree to a merger with a new Irish parent (March 10, 2014).
- U.S.-based Horizon Pharma Inc. announces intent to acquire Vidara Therapeutics International Ltd of Ireland, with resulting parent company in Ireland (March 19, 2014).
- Mallinckrodt (the Irish pharma company) and Questcor Pharmaceuticals Inc. announce merger, with Mallinckrodt to be the survivor (April 7, 2014).
- Valeant Pharmaceuticals International of Canada opens a cash and stock bid for Allergan Inc. (April 22, 2014).
- Pfizer, Inc. makes offer for U.K.-based AstraZeneca worth $118 billion, but offer is rejected (April 28, 2014).
- Mylan Laboratories Inc., which has been bidding for Meda AB of Sweden, is rejected again (April 28, 2014).

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THE M&A TAX REPORT (ISSN 1085-3693) is published monthly by CCH, 4025 W. Peterson Ave., Chicago, Illinois 60646. Subscription inquiries should be directed to 4025 W. Peterson Ave., Chicago, IL 60646. Telephone: (800) 449-8114. Fax: (773) 866-3895. Email: cust_serv@cch.com.

- AbbVie Inc. of the United States makes it first bid for Shire PLC, which is rejected (May 2, 2014).
- Merck & Co., Inc. announces partial sale to Bayer AG (May 6, 2014).
- U.S.-based Mondelez International Inc. and D.E Master Blenders of the Netherlands announce combination with new Dutch headquarters (May 7, 2014).
- Pfizer keeps trying for U.K.-based AstraZeneca, is rejected again (May 16, 2014).
- Destination Maternity Corp. of the United States makes second unsuccessful pitch to Mothercare PLC of Britain for new U.K.-based combination (June 1, 2014).
- Medtronic announces intent to acquire Irish-based Covidien with new Irish parent (June 15, 2014).
- TE Connectivity Ltd. of Switzerland announces deal to acquire Measurement Specialties Inc. of the United States. (June 18, 2014).
- Walgreen Co. ceases inversion talks over completing its transaction with Alliance Boots GmbH (June 24, 2014).
- C&J Energy Services, Inc. of the United States announces merger with Nabors Industries Ltd., the new company to be based in Bermuda (June 25, 2014).
- Auxilium Pharmaceuticals Inc. of the United States agrees to merge with Canadian QLT Inc., the new parent to be based in Canada (June 26, 2014).
- Salix Pharmaceuticals, Ltd. of the United States announces a combination with a Cosmo Pharmaceuticals S.p.A. (Italy) subsidiary, the new company to be based in Ireland (July 8, 2014).
- After three prior offers, AbbVie finally succeeds with Shire, the latter announcing an agreement under which AbbVie will be based in Jersey (July 14, 2014).
- Mylan Laboratories Inc. of the United States announces purchase of Abbott Laboratories and move to Netherlands (July 14, 2014).
- Candy maker Lindt & Sprüngli AG of Switzerland announces acquisition of Russell Stover Candies, Inc. (July 14, 2014).

Shareholders?

One group that is often ignored is shareholders. Shareholders in companies pursuing inversions are likely to owe capital gains if the deals occur. That is a surprise to many, and it almost always seems unfair.

After all, in most stock deals, there is no tax at the shareholder level. In a taxable merger, there is almost always cash to pay the tax. Here, the shareholder is taxed, but unlike with other taxable mergers, they won't receive cash to pay their tax.

This is a taxable swap to the IRS. Tax bills when you do not receive cash are especially painful. The duration of the shareholder's holding period and the amount of the gain are key variables. The bigger the gain, the bigger the tax problem to the shareholder.

A long-term investor who bought stock for $10 that is now worth $100 may be very unhappy with the inversion deal if it means he or she will get shares in a new reformed company worth $100, no cash and a tax bill from the IRS on $90 of gain. With a 20-percent capital gain tax and a 3.8-percent Obamacare tax, that's 23.8 percent.