PERSPECTIVE

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Inversions May Be Trending Now, But They're Not New

By Robert W. Wood

Inversions are not new. Yet in a short period of time they have undergone a rather startling metamorphosis. Once, they were interesting transactions 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 increasingly competing on a global stage. Nevertheless, almost out of the blue, these deals suddenly became one of the hottest trends in years that everyone was pursuing.

Then equally suddenly, inversions—and those perpetrating them—became pariahs. They carry hard to quantify negative press and investor relations backlashes. They even carry the possibility of a retroactive legislative fix that could still be imposed, even though that seems increasingly unlikely.

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

Tyco International, which would later become infamous over the scandal and 2005 criminal conviction of CEO Dennis Kozlowski (remember the $6,000 shower curtain), 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, Section 7874 of the tax code essentially requires inversions to involve more than 20% foreign ownership. One of several 2014 proposals to stem the inversion tide would up this 20% rule for inversions to a whopping 50%. That would make sure a foreign company would have to *really and truly* be the controlling buyer.

The 2004 provision is complex. Under Section 7874, a domestic company can be classified as a surrogate foreign company if the domestic company's shareholders own at least 60% of the inverted company after the transaction. If there is continuity of ownership between 60% and 80%, 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% or more, the surrogate foreign company will be treated as a domestic company for U.S. tax purposes. The idea of Section 7874 was to slap a 60% 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.

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

Like some other excise taxes, though, this may also not be a significant deterrent to the deals. The golden parachute payment excise tax comes to mind. Some companies will pay excises tax for their officers, grossing up their compensation.

A review of some notable 2014 inversion developments 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 Labs (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 Questor 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 Astra-Zeneca 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).
- Abb-Vie of the U.S. makes it first bid for Shire 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 Astra-Zeneca, is rejected again (May 16, 2014).
- Destination Maternity Corp. of the U.S. 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 U.S. (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 U.S. announces merger with Nabors Industries Ltd., the new company to be based in Bermuda (June 25, 2014)
- Auxilium Pharmaceuticals Inc. of the U.S. agrees to merge with Canadian based QLT Inc., the new parent to be based in Canada (June 26, 2014).
- Salix Pharmaceuticals Ltd. of the U.S. announces a combination with a Cosmo Pharmaceuticals SpA (Italy) subsidiary, the new company to be based in Ireland (July 8, 2014)

- After 3 prior offers, Abb-Vie finally succeeds with Shire, the latter announcing agreement under which Abb-Vie becoming based in Jersey (July 14, 2014).
- Mylan Laboratories Inc. of the U.S. announces purchase of Abbott Laboratories and move to Netherlands (July 14, 2014).
- Candy maker Lindt & Sprungli AG of Switzerland announces acquisition of Russell Stover Candies Inc. (July 14, 2014).

<u>Shareholders?</u>

In all of this, one group that it is often ignored is shareholders, who can face complex reporting and increased taxes from inversions. Shareholders in companies pursuing inversions are likely to owe capital-gains taxes if the deals occur. That is a surprise to many, and 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.

The reason may be to discourage the deals, though this fact clearly hasn't had that effect. The more technical reason is that the U.S. company is the one being acquired, so the ostensible owners, its shareholders, are viewed as selling out. In fact, of course, the U.S. firm's shareholders receive new shares to replace their old ones.

This is a taxable swap to the IRS. And tax bills when you don't receive cash are especially painful. The duration of the shareholder's holding period and the amount of the gain are big variables. But 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% capital gain tax and a 3.8% Obamacare tax, that's 23.8%.

One might even call that unpatriotic! Where inversions will go next is unclear. But it isn't only American investors and analysts that are watching.

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