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In Spite of Treasury's New Regulations, Corporate Inversion Crisis Will Continue Without Congressional Action

The recent surge in corporate inversions — American corporations using mergers to pretend that they are foreign companies for tax purposes — has been curbed but not stopped by the Obama Administration. The Illinois-based pharmaceutical company AbbVie called off its planned acquisition of Shire to invert to the United Kingdom. But another corporation, Ohio-based Steris, announced this week it plans to acquire U.K.-based Synergy Health for that very purpose.

The Treasury Department's new regulations only address certain parts of the problem. Depending on a company's tax planning (and avoidance) strategies, some companies have altogether halted their plans while other corporations are unfazed.

Treasury has the power to enforce the law more effectively but not the power to fundamentally change it. For example, under current law, the company that results from a U.S.-foreign merger is taxed as an American company if it is 80 percent or more owned by shareholders of the American partner to the merger. President Obama and some members of Congress propose to change the law to lower that threshold from 80 percent to 50 percent. The administration cannot do this on its own, but the new regulations will prevent corporations from making parties to the merger appear larger or smaller to create the appearance that the 80 percent threshold is met.

Another aim of Treasury's regulations is blocking the tax avoidance opportunities that serve as a primary motivation for inversions. One relates to profits earned in the past (and booked offshore) while another relates to future profits that can be shifted offshore through earnings stripping. The Treasury announcement explains that the new regulations will address the former but only hints at future action to address the latter

This means that some corporations may still invert if their goal is earnings stripping. A simple example of this is an American company that is foreign-owned (which an inverted company is, technically) borrowing large amounts from its offshore parent company and deducting the interest payments to wipe out its U.S. income for tax purposes. Given that these companies are really acting as one company, this is really an accounting gimmick that moves money on paper to minimize U.S. taxes.

The new regulations will address the avoidance of taxes on profits already booked offshore. Many U.S. corporations are holding huge profits in their offshore subsidiaries and want to avoid paying the U.S. tax that is normally due if those profits are brought to the United States. Corporations that invert can use loans to route the money through the foreign company that ostensibly becomes the parent company after an inversion. The Treasury regulations would treat such a payment as a dividend and therefore taxable.

But even this problem will not be totally resolved by the new regulations. The new rule will apply only if a U.S.-foreign merger results in a company that is 60 percent or more owned by the shareholders of the American partner to the merger. This seems to mean that a merger could result in a company that is 55 percent owned by the shareholders of the American partner to the merger (basically meaning the Americans have not given up control) and can claim to be foreign for tax purposes, and the new regulation would have no effect. This may be another reason why some inversions continue.

One unpredictable factor is court challenges to the new regulations. Tax experts such as Stephen E. Shay, Victor Fleischer and others agree that the plain language of our tax law gives the administration the power to issue regulations to solve these problems. But litigation could create enough uncertainty to alter some corporate decisions and is another reason why congressional action would be the optimal solution.