CONSIDERING CORPORATE INVERSIONS

Andrew Short*

The United States taxes U.S. corporations on their worldwide income, at one of the highest corporate tax rates in the world. It is understandable that U.S. corporations with offshore operations strive for the advantages of the lower tax rates available to competitors in offshore jurisdictions where these corporations operate. Current U.S. tax law provides U.S. multinationals with a limited ability to structure offshore operations using foreign corporate subsidiaries to defer tax on active earnings so long as those earnings are reinvested offshore and not repatriated to the United States. U.S. multinationals spend significant time and incur significant expense trying to maximize the benefit of deferral. Deferral is only temporary, and ultimately the profits are taxed in the United States upon repatriation.

However there are limits. It is often desirable from a corporate perspective for U.S. multinationals to operate in different regions of the world through different corporate chains. Existing planning opportunities make it difficult to transfer funds from one chain to another without incurring U.S. taxes. Deferral requires demonstrable business activity. The contemporary technologically advanced business model is not always consistent with the traditional notions of an active business enterprise and some offshore operations may fall short of the statutory activity requirement. Deferral also requires the foreign subsidiary to maintain employees in the offshore jurisdiction, comply with frequently onerous employment laws, and become subject to media criticism for moving jobs overseas.

Established U.S. multinationals must consider whether a corporate inversion, consisting of the expatriation of the domestic parent offshore and reestablishment in a lower tax jurisdiction, is an appropriate solution. The corporate inversion provides a clear path for the corporate group to pay taxes at a lower effective rate, and minimizes the U.S. tax planning associated with circulating profits.

* Partner, Paul Hastings LLP. All views expressed herein are solely those of the author.
within a corporate group. Planning for “permanent” deferral through foreign subsidiaries is difficult whereas permanent exclusion is a fundamental benefit of corporate inversions. Subject to some limits, the inverted U.S. corporation can reduce taxable income by creating deductible interest and royalty payments, and transfer pricing techniques can be used to allocate profit attributable to “headquarters operations” offshore.

The incentive to expatriate also applies to owners of less well-established U.S. businesses. The United States provides start-up businesses with access to capital through angel investors and venture capitalists. The United States provides a stable legal system in which to operate. Perhaps most importantly the United States provides a pool of talent to develop the business successfully. Entrepreneurs initially may not consider the ultimate tax ramifications of establishing operations in the United States rather than offshore. Many soon realize that building a business through investing after-tax profits based on a 35% rate (or 39.5% for non-incorporated businesses) is substantially more difficult than building one based on after tax proceeds at the lower rates available in offshore jurisdictions. Although it may not be feasible for an entrepreneur to initially establish offshore operations, once the entrepreneur has gained some footing, and the tax bill becomes too high, thoughts of inversion arise.

Congress has made inverting more difficult by introducing Section 367, which limits tax-free reorganizations with foreign corporations, and Section 7874, which either requires inverted entities to pay U.S. taxes on a specified portion of their overall gain, or, if substantial U.S. ownership remains, treats inverted entities as U.S. corporations. Nonetheless U.S. businesses have continued to invert. There are methods to avoid the statutory restrictions and penalties for inversions, including by acquiring an existing business. Moreover, especially for the newer businesses, the tax costs of the existing penalty may not be prohibitive if inversion is considered before there is substantial untaxed appreciation.

Successful inversions move revenues and the associated tax revenue, as well as the jobs that are particularly scarce in today’s economy, offshore. Significant time and effort is devoted to tax planning for the business which takes away resources that could be used to grow the business itself. Business acquisitions may be undertaken more for tax purposes than for business purposes. Finally,
the overall conversation in the media and business groups about the competitiveness of the U.S. tax system leads the global community to wonder if the United States is a good business environment.

One way to reverse the incentive is to adopt a territorial system of taxation. Under a territorial system, U.S. tax is imposed only on earnings from U.S. operations. Many major world economies tax based on the territorial tax system to facilitate the global flow of capital. Adopting a territorial system will allow domestic firms to repatriate their profits tax-free and return to a level playing field with their foreign competition. In turn, there will be less of an incentive for U.S. multinationals to change their tax residency and corporate inversions would no longer be a significant problem in the United States.