INVERSIONS: THE AMERICAN EXPERIENCE

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Background

The American experience with corporate inversions has been one of iteration, that has seen periodic waves of expatriation activity followed by (sometimes swift) legislative and regulatory changes designed to curtail these transactions, only to be followed by yet another wave of new types of expatriation transactions, as the market reacts to the shifting legal landscape. The legal framework governing these transactions has both evolved in response to transactions occurring in the marketplace, and played a role in shaping subsequent generations of inversion transactions. We are currently witnessing one of these waves, involving combination transactions with smaller foreign merger partners, which have become the dominant form of inversion transaction today, largely as a result of changes made in June 2012 to the substantial business activities test under section 7874.

Despite each new legal and regulatory regime of increasingly strict rules discouraging inversions, the appetite of U.S. multinationals to be organized under a foreign-parented structure remains unabated, and that should not be surprising. In contrast to foreign competitors organized in countries with territorial tax systems, and who can effectively base-erode their U.S. operations without significant limitation, U.S.-based multinationals are at a significant disadvantage. Until Congress addresses the fundamental structure of the U.S. system of taxing international income and the systemic biases that favor such foreign-parented structures, we should expect such transactions to continue.

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Foreign Mergers as the Dominant Form of Inversion Today

The foreign merger has emerged as the dominant form of inversion transaction today, not so much by design, as by default. Any cross-border combination transaction effected today must navigate the rules of both section 367(a) and section 7874. Although similar in their aims, the focus of these two provisions is somewhat different, and in their consequences, dramatically so. On a certain level, both of these regimes could be viewed as essentially effecting a purposive test, attempting to ascertain whether the subject transaction is being undertaken for business reasons that dictate the chosen structure or jurisdiction of reincorporation, or instead reflect a tax motivation.

Regulations under section 367(a) permit a transaction to be tax-free to U.S. shareholders of the U.S. company only where, among other requirements, they receive no more than 50% of the foreign company stock and the foreign company is at least equal, or greater, in value. This regime could be seen as setting up a presumption that the natural form of business combination transaction involves the larger company acquiring the smaller one, and the decision to depart from that form implies a tax motive. However, as was seen in the inversions that occurred in the early part of the last decade, shareholder-level taxation was seldom an impediment, due to the large degree of institutional shareholding, and existing market conditions.

Recognizing that shareholder taxation was not stemming the tide of inversions, in 2004 Congress acted, this time focusing squarely on single-company inversions into jurisdictions where the corporate group lacked substantial business activity. Under section 7874(b), where there is the requisite 80% or greater continuity by former shareholders of the U.S. company and the group does not conduct substantial business activities in its jurisdiction of organization, the foreign parent company is treated as a domestic corporation. Like the 367(a) regulations, this regime too can be seen as essentially a purposive test, drawing a distinction between inversions (defined at the 80% continuity threshold) into jurisdictions where there are substantial business activities (presumptively for business reasons) and those where there are not substantial business activities (presumptively tax motivated).
For several years following the enactment of section 7874, and two sets of Temporary Treasury Regulations, the focus of the inversion transactions was on satisfying the substantial business activities test. Inversions that formerly had been undertaken into jurisdictions such as Bermuda and the Cayman Islands were now replaced by inversions into jurisdictions such as the Netherlands and the United Kingdom, which not coincidentally around the same time had substantially revised its domestic tax laws to become a far more attractive holding company jurisdiction. The government response came in June of 2012, in the form of a new set of Temporary Regulations that render the substantial business activities exception unavailable for all but a few companies with a strong concentration of activities in a single foreign country.

In the wake of these recent changes the foreign merger transaction has emerged, involving business combinations between U.S. companies and generally smaller (but more than 25% of the size of the U.S. company) foreign companies, sometimes under a holding company formed in a third, more attractive jurisdiction. Because these transactions rely on the shareholders of the U.S. company receiving less than 80% of the stock of the foreign parent and not on the presence of substantial business activities, U.S. companies once again are afforded their choice of jurisdiction. This type of foreign merger transaction sets up a curious paradigm, where "foreignness" itself becomes a valuable attribute that commands a premium in the marketplace, and raises interesting questions in the context of a transaction that relies on the shareholders of the foreign company receiving more than 20% of the stock.

Conclusion

That inversions of one sort or another continue, despite repeated attempts to quash them, only highlights the benefits of a foreign-parented structure. The approach to-date, by focusing on curtailing the ability of U.S. companies to invert, instead of the underlying features of the U.S. tax system that disadvantage U.S.-based multinationals relative to their foreign-parented competitors, has only led to new, and different forms of inversions. Fundamentally, the decision of where to incorporate is driven by the same considerations, whether that decision is exercised in the context of starting a business,
determining which company will be the acquirer in a cross-border business combination, or in a standalone inversion. Until the fundamental structure of the U.S. system of taxing international income is addressed, that decision will favor foreign-parented structures, and experience has shown that such transactions are likely to continue despite ever-restrictive anti-inversion regimes.