CANADIAN TAX *Highlights*

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US Corporate Inversion Update

Numerous US legislative proposals have reacted to the perceived problems of US corporate inversions in which, generally, a parent USco becomes a Forco's subsidiary. (See "US Corporate Inversion Developments," *Canadian Tax Highlights*, September 2014.) Not content to wait for enacted legislation, the IRS and the US Treasury announced on September 23, 2014 the future issuance and details of more stringent regulations to reduce some of an inversion's tax advantages (Notice 2014-52). The notice appears to have had a chilling effect on at least two previously announced corporate inversions (Chiquita-Fyffes and AbbVie-Shire); other US corporations (Mylan and Medtronic) indicated that they will not stop their planned inversions. Many commentators noted that even non-legislative rule changes by the IRS and Treasury will not prevent the totality of tax advantages that can result from an inversion.

The inversion rules are exceedingly complex. The main rules are in Code sections 7874, 367, and 4985 and in several issuances of Treasury regulations and other guidance. (Interestingly, many of the sections targeted in the Treasury's September 23, 2014 notice modify perceived US tax loopholes in other Code sections that inverted companies sought to access.) Inversions are commonly seen as reducing US tax costs, but tax and non-tax costs can result. Under the inversion rules, adverse US tax consequences may result if USco is acquired by Forco and at least 60 percent of the Forco stock is owned by former USco shareholders (unless Forco has substantial business activities in its country of incorporation). The negative US tax consequences correspond to the extent to which Forco is owned by former USco shareholders: if 80 percent or more by votes or value is owned in Forco, it is subject to US taxation as a USco; if 60 percent but less than 80 percent of votes or value is owned, US tax applies to the inversion gain—the gain recognized when USco stock or property is transferred—without the benefit of otherwise applicable tax attributes to offset the gain, and corporate insiders face an excise tax on the gain realized on their exchange of compensatory US corporate ownership interests for Forco stock. (Those interests are compensation for their services rendered to USco.)

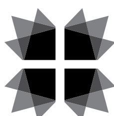
An inversion may create unpleasant tax consequences for the USco, its shareholders, and highly placed insiders. Treasury (and perhaps eventually Congress) is tightening the rules to prevent some tax advantages. But UScos will continue to pursue inversions because of the very high US corporate tax rate and a tax system that the United States applies worldwide. The US federal corporate tax rate reaches 34 percent at only US$75,000 in taxable income (the top rate is 35 percent); most corporations also pay state tax, which pushes the overall tax burden well into the 40-percent-plus range. In addition, USco's foreign subsidiaries face tax in the foreign countries in which they operate, and USco also faces US tax when it repatriates foreign profits to the United States. Moreover, a USco can sometimes avoid the inversion rules by not meeting the threshold of Forco being owned at least 60 percent by former USco shareholders (the new rules seek to curb perceived abuses that avoid the 60 percent threshold), or by being acquired by a Forco that has substantial business activities in its country of incorporation.

The negative press reports on corporate inversions rarely note the adverse US tax effects applicable to the US shareholders of expatriating companies. An inversion may save significant corporate tax dollars, and thus in the long run make a corporation more valuable to its shareholders; but an inversion may trigger an immediate US tax cost for a shareholder with unrealized gains. In addition, it appears that some companies that invert may cover the excise tax imposed on insiders, thus removing some of the inversion's corporate tax savings—savings that might otherwise inure to the benefit of ordinary shareholders—by providing a benefit to a select few.

The US federal government can deny federal contracts to expatriated companies: congressional appropriations bills have barred the award of federal government contracts to inverted companies. Although this potential disadvantage has not received much media attention, the loss of contracts was apparently not viewed as a reason to stop inversions in the past.

Interestingly, some companies invert, deliberately exceed the threshold of 80 percent ownership, and accept US taxation of the Forco parent as a USco. Although the structure does not prevent current US corporate tax, it does prevent the triggering of shareholder-level tax and insider excise tax. That strategy may be appealing for non-tax reasons, such as a desire to access foreign capital or to more effectively market a product to customers in a different part of the world.

The US press has said that inversions are unpatriotic. However, a corporation's goal is to maximize profits. If profits can be maximized by an inversion that reduces US



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corporate tax—even at a potential US tax cost to shareholders and insiders—inversions will continue regardless of whether the rules are tightened.

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