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Alert
Tax

US Inversions

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What is an "inversion"?

An inversion is a process in which a corporate group changes the jurisdiction of its parent company by inserting a new company (incorporated in the new jurisdiction), above its existing parent company. Usually, the inversion is effected by the acquisition of a corporate group whose parent is based in one jurisdiction by a company which is based in another, whether by means of a share for share exchange, scheme of arrangement, or other mechanism.

Why are inversions attractive to US businesses?

An inversion can occur in any jurisdiction, and is not a concept exclusive to the US. However, inversions are particularly attractive to US businesses for the reasons set out in this note. Whilst a decision to relocate a parent company outside the US is likely to be influenced by various commercial reasons, the key factor is usually to ensure that earnings arising to the new combined group from future growth outside the US remain outside the US tax system.

Territorial vs Worldwide Systems

Most jurisdictions, including the UK, operate a *territorial* system of taxation which is based on the principle that taxes are charged in a given jurisdiction on profits generated in that jurisdiction. Under this system, if a parent company has subsidiaries in other jurisdictions, the profits of the subsidiaries earned in those other jurisdictions will generally not be subject to taxation in the parent's jurisdiction.

The US, on the other hand, operates a *worldwide* system of taxation. This means that a US company is subject to US tax on all its worldwide earnings, whether they are earned in the US or overseas. As a general rule, a US company's US tax liability on its non-US subsidiaries' non-US earnings is deferred until the earnings are "repatriated" back to the US. At the point of repatriation, the US company will incur a charge to corporate income tax, taking into account any available foreign tax credits (although it should be noted that the credit system is relatively complicated and burdensome). However, some non-US earnings do not qualify for deferral and may be charged immediately. Such earnings generally constitute "passive" (i.e., investment) income. In addition, a US company may incur a charge on earnings for financial accounting purposes in respect of any deferred tax liability relating to such earnings which have not been repatriated unless they are permanently reinvested offshore. Due to the complexity of the US foreign tax credit rules, US companies often structure their offshore arrangements to avoid both creating passive income subject to immediate US tax, and repatriating non-US earnings back to the US parent.

A worldwide taxation system usually results in a group's total tax bill in any given jurisdiction being set at the higher of the tax rate in the local jurisdiction and the tax rate in the parent's home jurisdiction. That tax bill can be reduced by moving the parent company of a multinational group from a worldwide taxation system into a territorial tax system with a comparatively low tax rate because then, once future profits are taxed in the various profit-making jurisdictions at the prevailing rates (whatever they may be), it is unlikely that there will be further taxes in respect of such profits at the parent level.

US Tax Rate

An inversion out of the US would not be worthwhile if the local tax rates in the underlying jurisdictions exceeded those applicable in the US. However, at around 40 per cent. on average, the combined US federal and state corporate income tax rate is the highest in the G20, and one of the highest in the world.

Why is the UK an attractive jurisdiction for inversions?

As mentioned above, the UK operates a t*erritorial* system of taxation. However, many other jurisdictions operate a similar system and it is other features of the UK tax regime which sets it apart, including:

- a corporation tax rate of 21 per cent. which will further fall to 20 per cent. in April 2015 (the lowest in the G7 and joint lowest in the G20);
- a relatively lenient "controlled foreign company" (CFC) regime which generally only applies to bring profits of non-UK subsidiaries into the UK tax net where they have been artificially diverted from the UK;
- no withholding tax on dividends paid by UK companies;
- exemption from corporation tax for most dividends received by UK companies;
- exemption from corporation tax on capital gains arising to corporate sellers on the disposal of subsidiaries in which they hold a "substantial shareholding";
- a low rate of corporation tax for profits arising from patents; and
- a comprehensive network of double tax treaties.

Why are inversions currently in the news?

Inversions have been attracting attention in the US for some time, but have only really hit the headlines in the UK as a result of the recent failed attempt by the US giant, Pfizer, to acquire AstraZeneca, Britain's second largest pharmaceutical company.

Other US inversions which have featured this year include Mylan Inc's unsuccessful pursuit of Sweden's Meda AB, the acquisition by Mallinckrodt plc of Questcor Pharmaceuticals, Inc, and Horizon Pharma Inc's purchase of Ireland's Vidara Therapeutics International Limited. In April, it was reported that the shareholders of Walgreens, the largest drug-store chain in the US, had pressed for an inversion, leading to press speculation that an acquisition of Alliance Boots (in which Walgreens already owns a stake) is on the cards. Inversions are not confined to the pharma industry: last year, Weil acted for Applied Materials in its USD 29bn merger with Tokyo Electron Ltd.

The recent run of inversions, and the potential loss of revenue for the IRS has caused a certain amount of outrage in Washington. On May 20 this year, in the wake of the Pfizer/AstraZeneca publicity, 14 Senate Democrats led by Carl Levin introduced draft legislation which seeks effectively to shut down inversions for two years. Under current law, an inversion is only effective for US tax purposes, if (broadly, among other things, and subject to certain exceptions) more than 20 per cent. of the equity in the new parent company is owned by shareholders who were not shareholders of the historic US parent company[1]. The draft bill seeks to raise that threshold to 50 per cent., and provides that a merged company will continue to be taxed in the US if it effectively remains, and either 25 per cent. of its employees or sales or assets are located, in the US. However, although the terms of the draft legislation echo sentiments which have originated from the Obama administration, political commentators have indicated that the lack of support among Republicans means that the draft legislation may well never be enacted.

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1 Note the US requirements are complex. Even if the 20 per cent. threshold is satisfied, there may still be adverse US tax consequences if less than 40 per cent. of the equity in the new parent company is owned by shareholders who were not shareholders of the historic US parent company. In addition, certain groups of new shareholders are disregarded for these purposes.

If you would like more information about the topics raised in this briefing, please speak to your regular contact at Weil or to any member of the Tax group:

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