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Management Alert

U.S. Corporate Tax: The Time for Reform has Come

By John P. Napoli and Michael Rosenthal

As a result of the twin forces of globalization and technology, U.S. workers must now compete for jobs against workers around the world and U.S. companies must compete for domestic business with foreign companies headquartered around the world. Has the time come when the United States must also compete with other developed nations for corporations to be, or remain, headquartered in the United States? If recent investor activity is any guide, the answer is yes. Medtronic, the world's largest medical technology company, is the most recent company to follow a growing trend to enter into corporate transactions that allow it to move its corporate headquarters from the U.S. to Ireland and other low-tax jurisdictions. The response of many politicians in Washington has been to attack the specific tax rules that permit these transactions. However, others view the recent trend as simply the latest indication that the time has come to eliminate the competitive disadvantage faced by U.S. corporations. This can only be done by broadly reforming the U.S. corporate tax in order to encourage multinational corporations to remain headquartered within the U.S., create jobs in the U.S., and repatriate monies earned overseas back into the U.S.

Background - a Complex and Burdensome Corporate Tax System

At 35%, the United States currently has one of the highest corporate tax rates in the world.[1] Nominally, this tax rate is imposed on the worldwide income of all U.S. corporations. As a practical matter, however, U.S. tax is only imposed on the worldwide income earned directly (through foreign branches) of domestic corporations, or earned through subsidiaries that are treated as flow-through entities (either disregarded entities or partnerships). By contrast, income earned indirectly through corporate subsidiaries is subject to a much more complicated regime. Such income may or may not be subject to current U.S. taxation, depending on the type of income: generally, tax on "active" income earned through corporate subsidiaries operating overseas is deferred until the earnings are repatriated to the U.S. parent, while "passive" income earned by a controlled foreign corporation ("CFC") known as "subpart F income," is generally taxed immediately to the U.S. parent. (In each case, the United States allows a credit for foreign taxes paid on the income, subject to certain limitations and baskets.) Foreign income earned through a foreign corporation that doesn't qualify as a CFC may be subject to another set of complexity, the passive foreign investment company ("PFIC") rules, under which the U.S. shareholders of a foreign corporation that has a significant percentage of passive assets or passive income would recognize its share of the income of such corporation under one of three possible taxing regimes.

This overly-complex system of worldwide taxation and partial tax deferral combined with a high corporate tax rate results in inefficiencies and potential abuses. In particular, U.S.-based multinational companies are at a competitive disadvantage due to their high corporate tax rates taxed on worldwide income, creating a drag on the U.S. economy. This also encourages U.S.

[1] The combined federal and average state tax rate is 39.1% making the U.S. the highest corporate tax rate in the industrial world according to the OECD tax database.

companies to invest and create jobs overseas (through corporate subsidiaries) rather than in the United States, where such economic activity will be subject to 35% federal tax rate. In addition, the deferral regime incentivizes U.S. multinationals to keep foreign earnings outside the United States, rather than repatriating such earnings to invest domestically. Further, while the subpart F income rules generally require passive income to be recognized by the parent when earned, the complex rules are, in many cases, fairly easily manipulated through sophisticated tax planning to avoid such recognition. These rules can be further manipulated through several techniques that can be used to erode the U.S.-source income base of the domestic parent.

The Rise of Inversion Transactions and Code Section 7874

In recent years, many multinational companies have taken an even more extreme course of action in response to this overly-burdensome and complex tax system. These companies have engaged in "inversion transactions" - transactions whereby domestic parents of multinational groups restructure themselves to have a foreign corporate parent in low-tax jurisdictions to avoid being subject to United States taxation on its non-U.S. income. (There is a similar phenomenon occurring for individuals, with reports of a significant increase in expatriated U.S. citizens renouncing their U.S. citizenship to avoid being subject to U.S. taxation on their worldwide income.)

Inversion transactions are not entirely a new phenomenon. Section 7874 of the Internal Revenue Code of 1986, as amended (the "Code"), was added in 2004 to put a stop to these transactions. Under the rules of this section, if at least 80% of the new foreign corporation is held by the same shareholders who held the domestic corporation, the foreign corporation would be treated as a domestic corporation for all U.S. tax purposes. On the other hand, if the overlapping ownership between the domestic and the foreign corporations is between 60% and 80%, then the foreign corporation will be respected as foreign, but the inverted domestic entity must recognize for U.S. tax purposes any "inversion gain" (i.e., gains on the sale of the property of the inverted domestic company) that is recognized during the ten-year period after the inversion.

These rules, however, do not apply if the affiliated group has substantial business activities in the foreign country in which the new foreign parent is incorporated (when compared to the total business activities of the multinational group). Under relevant Treasury Regulations, to meet this test, the affiliated group must have at least 25% of its business activities in the relevant foreign jurisdiction.

Thus, under the current rules, if the overlapping ownership is less than 60% or 25% of the affiliated group's business activities are in the relevant foreign jurisdiction, there are no adverse tax consequences to an inversion transaction. Further, if overlapping ownership is less than 80%, while there are certain adverse tax consequences, they are generally considered manageable.

Recent Inversion Transactions and Proposed Legislative Responses

Despite these rules, inversion transactions have been on the rise. While the effect of the rules in section 7874 is that a single-entity reincorporation is no longer a viable option, many companies have been looking at mergers with foreign companies as inversion opportunities. There have been several high profile inversion transactions during 2013 and 2014. For instance, Endo Health Solution's acquisition of Montreal-based on Paladin Labs resulted in the former Endo's shareholders holding less than 80% of the total shares of the combined company. This allowed it to restructure under a new Irish holding company[2] without being treated as a domestic corporation under Section 7874. Through this inversion transaction, Endo was able to reduce its effective tax rate from 28 percent to 20 percent. Medtronic, which recently announced its move to Dublin, Ireland, is doing so for the same reasons - to reduce its overall global tax rate. A number of other companies have either effected an inversion or are considering doing so. According to some reports, about 50% of all inversion transactions of the past twenty-five years have occurred within the last few years.

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[2] Ireland's corporate rate is 12.5%.

In March 2014, President Obama's budget contained a proposal to tighten these inversion transaction rules, an initial indication that these transactions were again coming into the government's crosshairs. These proposals gained significant traction among Democratic legislators in Congress when Pfizer announced in late April that it was pursuing an inversion transaction through a merger with London-based AstraZeneca. (Pfizer's bid was ultimately rejected by AstraZeneca's board of directors.)

The most significant change to the inversion rules in the proposal going through Congress is that the ownership threshold for foreign corporations to be treated as domestic would be decreased to only 50% - meaning, in order for the foreign corporation to avoid being treated as a domestic corporation under section 7874, the former shareholders of the domestic corporation must hold 50% or less of the new foreign parent entity. This new threshold would make it significantly harder for large domestic companies to find foreign merger partners with whom they could employ a viable inversion transaction.

In addition, the proposed new rules would add an additional provision under which an inverted company will continue to be treated as a domestic entity (even if the old shareholders hold less than 50% of the new company) if the management and control remains in the United States and 25% of either the employees, assets, or sales of the merged company is in the United States.

The Democratic-backed proposal, as currently drafted, would impose these rules for a two-year period. This is designed to create a moratorium on such inversion transactions to allow Congress and the Treasury Department to more fully research the issue to determine the best approach to address the problem.

Broader Tax Reform

Republicans, however, believe that any such measures are merely treatments of the symptoms without addressing the more fundamental problems in the U.S. tax system. They argue that a full tax reform of the entire Internal Revenue Code - including lowering the corporate tax rate, simplifying the Code by removing special interest provisions, and moving towards a more territorial system of taxation (in which only U.S.-source income would be subject to United States tax) - would remove the impetus for domestic companies to engage in inversion transactions. According to this line of reasoning, reforms to the inversion transactions rules should only be done in conjunction with a broad tax reform initiative.

Such a broad tax reform could take the form of one of the numerous proposals issued over the past few years designed to move the United States to a more territorial tax system through a full or partial dividends received deduction. Other proposals such as the discussion draft proposals issued by the Senate Finance Committee in November 2013, would substantially revise the subpart F and PFIC rules. Rather than the current deferral rules, these proposals would reform the rules under a principle that all foreign income should be taxed immediately or not at all. Other, more radical tax reform proposals could include replacing the current system with a VAT or other type of non-income tax.

All these proposals are aimed at eliminating the complexity and unfairness inherent in the current system, while lightening the heavy tax burden of U.S. multinational corporations. However, while many of these proposals have a great amount of merit, the unfortunate reality is that any such broad tax reform would require a significant amount of bipartisan cooperation, which is sorely missing in the current political environment.

While the debate rages on in Washington, U.S. multinational companies are self-selecting out of the U.S. by seeking out foreign partners for inversion transactions. If anything, the debate itself is pushing more companies to do so before any legislation is enacted. While the proposed legislation contains a "threat" of a retroactive effective date of May 9, 2013, many companies are still rushing to try to consummate mergers under an assumption that any ultimately-passed legislation will have a prospective effective date. Getting in under the wire should therefore be a high priority for any company considering an inversion transaction.

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