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Stampeding for the Exits: Pharmaceutical Companies and the Recent Wave of Inversions

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Furthermore, although the U.S. imposes tax on a domestic corporation's worldwide income, the imposition of such tax is generally deferred until the corporation repatriates its active earnings from abroad. Many corporations, especially those in the pharmaceutical and technology industries, which often keep their intellectual property overseas, prefer to reinvest their earnings abroad indefinitely rather than repatriate and pay tax. Eventually, however, the amount of cash invested overseas builds up to such a level that shareholders force management to repatriate some of it to be distributed as a dividend. Apple's famous tiff with Greenlight Capital is a notable example of this phenomenon. Inverting is one way to free such trapped cash without incurring additional tax. In certain circumstances, following the inversion such cash can be distributed by the foreign subsidiaries to the new foreign parent without subjecting the funds to U.S. taxation (even though such cash was accumulated during the period in which the foreign subsidiaries were held by the prior U.S. parent). Finally, the inversion allows the combined corporate group to further reduce its effective U.S. tax with respect to future income earned in the group's remaining U.S. subsidiaries through the use of base-eroding payments from the U.S. subsidiaries to the foreign parent.

From a tax perspective the U.K. is a particularly attractive jurisdiction because of its extensive tax treaty network and lack of a dividend withholding tax on outbound dividends. It also has taxpayer-friendly rules relating to earnings earned outside the U.K. and the exploitation of intellectual property. There are non-tax reasons as well for choosing the U.K. or Ireland, such as their central location between the U.S. and Asia, highly skilled work force, common law legal system and membership in the European Union.

To be sure, certain hurdles must be cleared before the IRS respects an inversion. The first regulatory roadblock to inversions was set up in 1994 after Helen of Troy, a publicly traded U.S. cosmetics company, merged with the newly created U.S. subsidiary of a Bermuda company. The inversion prompted Treasury to amend the regulations under section 367(a) so that the transfer of stock of a domestic corporation by a U.S. person to a foreign corporation is taxable if the U.S. transferors own in aggregate 50% or more of either the total voting power or the total value of the stock of the transferee corporation immediately after the merger.

This outbound toll wasn't much of an obstacle though, and a wave of inversions by oil and gas companies such as Transocean, Noble and Nabors led to the enactment of section 7874 in 2004. Under section 7874, an expatriated U.S. corporation will still be treated as a domestic corporation if the historical shareholders of the U.S. corporation own at least 80% of the new foreign corporation post-merger and the new corporation does not have "substantial business activities" in its new tax home as compared to the total business activities of the expanded affiliated group. A corporation has "substantial business activities" in a foreign country when at least 25% of its employees, assets and income are located or derived from the relevant foreign country. Furthermore, although the IRS will respect an inversion where the historical shareholders own less than 80% of the new corporation, if historical shareholders own 60% or more of the new corporation post-merger then the new corporation may be subject to significant penalties such as the taxation of built-in asset gain and limitations on the use of its tax attributes.

President Obama's 2015 budget proposal and bills recently introduced in the House and Senate by Democratic lawmakers propose to tighten the requirements of section 7874. The proposals replace the 60% and 80% tests with a flat "greater than 50% test" such that the historical shareholders of the U.S. company may not own more than 49% of the new corporation after the merger if the inversion is to be respected by the IRS. The proposals also add a special rule that would ignore the inversion regardless of the level of ownership change if the company has substantial business activities in the United and is primarily managed and controlled from the United States after the merger.

In a letter to key lawmakers in the House and Senate, Jack Lew, the U.S. Secretary of the Treasury, called on Congress to "enact legislation immediately – and make it retroactive to May 2014 – to shut down" inversions. Retroactivity was also proposed when section 7874 was originally enacted, but ultimately section 7874 was only applied on a prospective basis.

Although it seems unlikely that the Democratic bills will actually be enacted, Republican lawmakers, specifically Senator Orrin Hatch, the ranking minority member on the Senate Finance Committee, recently expressed some willingness to enact some sort of reform to limit corporate inversions. It remains to be seen how far Republicans are willing to go.

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