Corporate Inversions: Potential Use of Executive Authority Pending Congressional Action

With Congressional action appearing unlikely, a number of lawmakers have urged the White House to use its executive authority to curb corporate inversions. The issue has been gaining traction over the past few weeks, and while the Administration has expressed a preference for Congress to address the issue, an Administration spokesman has indicated that nothing has been ruled out at this point. This article examines current events surrounding corporate inversions and a potential path that the Administration could take if it decides to act on its own.

Background on corporate inversions. In corporate inversions (also called "expatriation transactions"), a U.S. corporation becomes a wholly-owned subsidiary of a foreign corporation (through a merger into the foreign corporation's subsidiary) or transfers its assets to the foreign corporation. If the transaction is respected, U.S. tax can be avoided on foreign operations and distributions to the foreign parent, and there are opportunities to reduce income from U.S. operations by payments of fees, interest, and royalties to the foreign entity.

Current anti-inversion rules in the Code. Under Code Sec. 7874, which was added to the Code in 2004 to address an inversion-related loophole, a foreign corporation is treated as a U.S. corporation for all purposes of the Code where, under a plan or series of related transactions:

(1) The foreign corporation completes, after Mar. 4, 2003, the direct or indirect acquisition of substantially all the properties held directly or indirectly by a U.S. corporation;
(2) Shareholders of the U.S. corporation obtain 80% or more of the foreign corporation's stock (by vote or value) by reason of holding their U.S. shares; and
(3) The foreign corporation and corporations connected to it by a 50% chain of ownership (the "expanded affiliated group") don't have substantial business activities in the foreign corporation's country of incorporation or organization when compared to the total business activities of the group. (Code Sec. 7874(b); Code Sec. 7874(a)(2))

RIA observation: Put otherwise, in order to avoid being treated as a U.S. corporation under the above rules, the resulting entity must be more than 20% foreign-owned. Practically speaking, this means that the target foreign company must be at least 25% the size of the U.S. corporation.

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However, where the inversion transaction satisfies the above three tests, except that the domestic corporation's shareholders (or a domestic partnership's partners) obtain at least 60% but less than 80% of the foreign corporation's stock, the foreign corporation is a "surrogate foreign corporation" respected as a foreign corporation. (Code Sec. 7874(a)(2))

Inversions in the news. Corporate inversions became a mainstream news topic earlier this year, specifically with Pfizer's attempted takeover of AstraZeneca and U.S. medical device maker Medtronic's merger with Irish competitor Convidien. More recently, U.S. drug maker Abbvie announced its merger with Ireland-based drug maker Shire. There has also been talk that Walgreen, Inc., the American drugstore company, was planning a takeover of Alliance Boots (domiciled in Switzerland), but recent reports indicate that the plan won't involve Walgreens shifting its corporate citizenship abroad.

Earlier proposals. In his proposed fiscal year (FY) 2015 budget, the President proposed, for transactions completed after Dec. 31, 2014, broadening the definition of an inversion in Code Sec. 7874 by reducing the 80% test to a greater-than-50% test, and eliminating the 60% test altogether. The proposal would also add a special rule under which, regardless of the level of shareholder continuity, an inversion transaction will occur if the affiliated group that includes the foreign corporation has substantial business activities in the U.S. and the foreign corporation is primarily managed and controlled in the U.S.

When Pfizer was prominently featured in the news, Rep. Sander Levin (D-MI) and Sen. Carl Levin (D-MI), each with a number of co-sponsors, introduced companion legislation in the House and Senate, respectively, which would be effective for inversions completed after May 8, 2014. Similar to the President's proposal, the bills would reduce the current 80% threshold to a more-than-50% threshold, and the bills also contain provisions that would bar companies from shifting tax residence offshore if their management and control and significant business operations remain in the U.S. These bills have thus far failed to advance, with many key lawmakers instead calling for comprehensive corporate tax law reform to make the U.S. a more attractive place to do business.

Calls for action. Last month, Treasury Secretary Jacob Lew sent an identical letter to Rep. Levin, Rep. Dave Camp (R-MI), Sen. Ron Wyden (D-OR), and Sen. Orrin Hatch (R-UT), in which he described corporate inversions as "hollow[ing] out the U.S. corporate income tax base." He acknowledged the desirability of comprehensive business tax reform to "improve the investment climate" in the U.S., but stated that "[s]hort of undertaking a comprehensive reform of the business tax system, there are concrete

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steps" that can be taken in the meantime and that "we should prevent companies from effectively renouncing their citizenship to get out of paying taxes." He called on Congress to "enact legislation immediately-and make it retroactive to May 2014-to shut down this abuse of our tax system".

Shortly thereafter, in a July 24 Treasury blog post, Assistant Secretary for Tax Policy Mark Mazur wrote about the "quite common" practice of making tax provisions retroactive, referring to the above letter. He provided examples of provisions where "backdated implementation" was "important to ensure that companies do not take advantage of the lengthy legislative process to rush through transactions exploiting the loopholes they know they are about to lose".

In his weekly address on July 26, the President discussed inversions and stated that, while the best solution would be corporate tax reform, "stopping companies from renouncing their citizenship just to get out of paying their fair share of taxes is something that cannot wait." He referred to his earlier budget proposal to "clos[e] this unpatriotic loophole for good" and called for "an economic patriotism that says we rise or fall together."

On August 5, Senators Jack Reed (D-RI), Dick Durbin (D-IL), and Elizabeth Warren (D-MA) sent a letter to President Obama in which they stated that, while they "are working with our colleagues in Congress to pass legislation as soon as possible to eliminate tax breaks for inverted corporations," these efforts "should not preclude executive action to prevent corporate inversions." They urged the President to use his authority "to stand up for American companies which are proud to be part of our nation and reduce U.S. incentives for other corporations which would abandon their responsibilities to their country for a nod of approval from Wall Street."

On August 5, during a press briefing, White House Press Secretary Josh Earnest was questioned about whether the President would use executive action to stop corporate inversions. Although he declined to say with any certainty whether the President would take any unilateral action, he said that "it is our view that Congress should take the necessary step to address this loophole."
Reports indicate that the Treasury is actively exploring options that the Administration could take. Rep. Levin, in response, has said that "the discussion of possible administrative actions should not be an excuse for Congress to drag its feet."

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Possible avenue. According to a former Treasury official, one way that the Administration could unilaterally curb corporate inversions pending Congressional action would be to exercise its authority under Code Sec. 385, which authorizes IRS to prescribe regs to determine whether an interest in a corporation is debt or equity. Harvard professor Stephen Shay claims that, under that section, the Administration could limit the ability of inverted companies to take interest deductions in the U.S. or access their foreign cash without first paying U.S. taxes (i.e., the U.S. tax due upon "repatriating" foreign-earned income). According to Shay, by reclassifying debt as equity, a formerly deductible interest payment would be reclassified as a dividend for which no deduction may be claimed-resulting in a greater portion of income being taxable at U.S. corporate rates.

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