SPECIAL REPORT

U.S. Treasury Issues Rules Curbing Tax Inversions

$150 Billion Pfizer-Allergan Deal Cancelled

International Tax Reform Needed – But What Kind?

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The business strategies of U.S. companies merging with offshore organizations to reduce taxes are under serious study. Meanwhile, new rules issued by the U.S. Treasury concerning tax inversions have taken debate over the issue to a new, angrier level.

This is certain to be a major political issue so the following background may be helpful.

The rules remove tax benefits for companies that undertake inversions, which led to the abrupt cancellation of the $150 billion Pfizer-Allergan merger. That provoked a vociferous reaction from other U.S. and foreign multinational companies.

The debate points up the need for serious international tax reform. The U.S. has the world's highest tax rate for business, at 35 percent. This has driven U.S. companies to pursue tax inversions as a means of remaining globally competitive. The new rules further limit international companies' ability to expand and create jobs outside their own countries.

Opposing parties in the tax reform debate agree that reform is necessary. However, they immediately differ on what path it should take. And, given the way in which the 2016 presidential election has claimed the public debate stage, do not expect tax reform action from Congress until 2017 or 2018.

What Are the New U.S. Treasury Rules?

The new Treasury rules are an escalation of those enacted last year, making it more difficult for corporations to transfer non-U.S. operations to a new foreign partner without paying U.S. taxes. Those rules also made it harder for companies to find a favorable foreign tax location for a merged entity.

The new rules make inversions less lucrative by eliminating a tax benefit for "abusive" inverters. After a merger, if the shareholders of the former U.S. company own at least 80 percent of the combined firm, the government treats the new combined business as subject to U.S. taxes, basically negating the inversion -- even if its address is abroad.

If shareholders of the former U.S. company own at least 60 percent, some restrictions apply, but the company is still considered foreign. That has led companies to keep their inversions below 60 percent -- and prompted the government to propose rules halting various techniques for doing so.

The rules would also deny benefits to foreign companies with U.S. operations by prohibiting a practice called earnings stripping. That entails a non-U.S. company loading up U.S. subsidiaries with debt from the head office, so they deduct the interest payments from their U.S. tax bills, gaining an advantage from the higher U.S. tax rate.

What About the Pfizer-Allergan Deal?

As noted, Pfizer and Allergan scrapped their $150 billion merger just 48 hours after announcement of the tougher Treasury rules.

The CEOs of Pfizer and Allergan, who vigorously opposed the previous round of U.S. anti-inversion rules, redoubled their criticism of the new ones. Pfizer Chief Executive Officer Ian Read, in a *Wall Street Journal* opinion piece, said that U.S.-based pharmaceutical companies "compete in a global marketplace at a real disadvantage. . . .While the Treasury's proposal is a shot at Pfizer and Allergan, this unilateral action will hurt other companies as well."

Allergan Chief Executive Brent Saunders called the new rules "arbitrary" and "capricious," adding: "The rules are focused on the wrong thing: Our government should be focused on making America competitive on a global stage, not building a wall locking companies into an uncompetitive tax situation."

Most recently, Mr. Read said Pfizer is considering an alternative strategy of breaking up the company as early as next year in order to reduce its U.S. taxes. "I think the government's willingness to act [on inversions] will make us think deeply about what the alternatives are to let part of this company possibly have a different tax jurisdiction," he said.

New Rules Fire Up Debate

There are few, if any, lukewarm opinions being expressed in the tax inversion debate.

Robert Holo, a tax partner at Simpson Thacher & Bartlett, LLP, termed the new rules "a significant escalation of the attack on inverted companies. Not only does it attack the ability to invert, but puts the single greatest advantage of doing so -- earnings stripping -- on the chopping block."

Nancy McLernon, President of the Organization for International Investment, which represents non-U.S. companies in the U.S., likewise attacked the portion of the rules designed to act against asset stripping: "Rather than using a scalpel to deal with this issue, they are using a machete."

Treasury Secretary Jack Lew naturally supported the measure: "After an inversion, many of these companies continue to take advantage of the benefits of being based in the United States -- including our rule of law, skilled workforce, infrastructure and research and development capabilities -- all while shifting a greater tax burden to other businesses and American families."

International Tax Reform -– What and When?

With the 2016 presidential election crowding out attention that could otherwise be devoted to international tax reform, no Congressional action is expected until 2017 or 2018.

One proposal, embraced by conservatives, is for a "territorial system" for international taxation. Under such a system, foreign income would be taxed only in the country where it is earned and would not be taxed by the United States. The idea would be to reduce the tax burden on American corporations and eliminate the disincentive to repatriate foreign profits. (Apple followers will recall that in 2013 the company borrowed $12 billion to help fund stock buybacks rather than bring home the $132 billion in cash it kept overseas and pay taxes on it.)

Another idea, proposed by President Obama, is for an "international minimum tax." Under his plan, all income of U.S. corporations would be immediately taxed, either by the U.S. or a foreign country, at a rate greater than or equal to the international minimum tax rate -- a rate as yet unspecified.

Senators Rob Portman-R, OH, and Chuck Schumer-D, NY have proposed a bipartisan framework for international tax reform that may gain broad support. House Speaker Paul D. Ryan and Kevin Brady, the chairman of the Ways and Means Committee, also back this approach.

Activist investor Carl Icahn, a strong supporter of the plan, described it this way: "We are one of the few countries in the world that asks our companies to pay a double tax on foreign earnings. The Schumer-Portman framework addresses this problem by allowing companies to repatriate all that stranded cash at a reduced rate of between 8 and 10 percent (or lower, depending on the foreign tax deduction).

"This tax on repatriated earnings would yield the United States huge incremental revenue," Mr. Icahn added, "an estimated $200 billion on the $2.6 trillion now kept overseas, and would allow companies to reinvest the nontaxed portion in the United States, creating thousands of jobs."

The Schumer-Portman framework also includes provisions that would stop "earnings stripping" -- as noted above, a way for non-U.S. companies to reduce U.S. taxes by building up deductions for U.S. debt payments.

What Companies Can Do

The new U.S. Treasury Department rules appear to block U.S. companies from entering into so-called inversions with foreign-domiciled companies in order to reduce U.S. taxes. Of course, these complex rules need to be reviewed carefully by a company's tax and legal experts.

Concerning the policy aspects of tax inversions, both U.S.-domiciled and non-U.S.- domiciled companies alike may want to consider taking a public position on this matter -- to get ahead of the debate and help facilitate a constructive resolution that will come, hopefully, next year or the year after.

These companies might also consider how to educate workers and customers about why a lower U.S. corporate tax rate would discourage companies from leaving the country and fuel the kind of investment and job growth that will benefit American workers, American businesses and the nation as a whole.