Tax Inversion

ISSUE

The client would like to complete a tax inversion by acquiring a foreign company in Switzerland and moving the domicile of the combined company overseas in order to significantly reduce the company's corporate income tax burden and seeks our recommendation.

FACTS

- The client is a US corporation subject to income tax in the US at a 21% rate
- The client is seeking to acquire a Swiss-domiciled company
- The client believes the Swiss corporate income tax rate is 5%
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IDENTIFY SOURCES
(although this is generally not included in a good form tax research memorandum, it is included as required in the grading rubric for the assignment)

In order to identify the primary sources of tax law related to tax inversions, I conducted a search in Checkpoint querying "Inversions". Based on that search I identified the relevant IRC section related to inversions is IRC Section 7874. I also identified secondary sources that help me better understand the implications of IRC Section 7874.

Corporate Expatriation, Inversions and Mergers: Tax Issues (Updated March 12, 2019, Congressional Research Service R43568, Retrieved from: https://crsreports.congress.gov

Checkpoint Catalyst Library International (U.S. Income Tax), 2112 Inversions.

Tax Policy Center (n.d.) *What are inversions, and how will TCJA affect them?* Tax Policy Center Briefing Book. Retrieved from: https://www.taxpolicycenter.org/briefing-book/what-are-inversions-and-how-will-tcja-affect-them

PWC (2013) *Tax strategy and corporate reputation: ~~a tax issue~~, a business issue.* PricewaterhouseCoopers, 2013. Retrieved from: https://www.pwc.com/gx/en/tax/publications/assets/pwc-tax-strategy-and-corporate-reputation-a-tax-issue-a-business-issue.pdf

Geoffrey Smith & Claire Groden *Pfizer, Allergan Confirm $160 Billion Merger Deal,* Fortune (Nov. 23, 2015, 8:00 AM). Fortune. Retrieved from: http://fortune.com/2015/11/23/pfizer-allergan-merger

Chris Daniels (2014, August 28) *Corporations walk a tightrope on tax-inversions comms*. Retrieved from: https://www.prweek.com/article/1309894/corporations-walk-tightrope-tax-inversion-comms

Kevin Drawbaugh and Olivia Oran (2014, August 6). *Walgreen retreats from plan to move tax domicile abroad*. Reuters. Retrieved from: https://www.reuters.com/article/us-walgreen-alliance-boots/walgreen-retreats-from-plan-to-move-tax-domicile-abroad-idUSKBN0G526820140806

RELEVANT LAW

IRC Section 7874 provides rules relating to expatriated entities and their foreign parents
IRC Section 7874(a)(1) imposes tax on inversion gain of expatriated entities
IRC Section 7874(a)(2) defines an expatriated entity
IRC Section 7874(b) defines when an inverted corporation is taxed as a domestic corporation
IRC Section 7874(d) provides definitions of relevant terms in Section 7874, including "inversion gain"

Other relevant law based on secondary sources:

Switzerland levies a direct federal corporate income tax at a flat rate of 8.5% on profit after tax. Since the income tax is deductible, the net effective tax rate on pre-tax income is approximately 7.83%. In addition to the federal tax, each Swiss canton has its own tax laws with tax rates ranging from 11.9% to 21.6%, (PricewaterhouseCoopers (2021, January 6) *Tax Summaries - Switzerland Corporate – Taxes on corporate income.* https://taxsummaries.pwc.com/switzerland/corporate/taxes-on-corporate-income)

ANALYSIS

A tax inversion is a transaction where a foreign corporation:

- Acquires substantially all of the properties held directly or indirectly by a US corporation (IRC Sec 7874(a)(2)(B)(i). Treasury Regulations refer to this as a "domestic entity acquisition". (Reg. § 1.7874-12(a)(5), and

- After the acquisition, at least 60% of the stock (for a 60% inversion) or 80% of the stock (for an 80% inversion) of the foreign corporation is held by former shareholders of the domestic corporation. IRC § 7874(a)(2)(B)(ii) and IRC § 7874(b), and

- The "expanded affiliated group" (EAG) doesn't have substantial business activities in the foreign country. The EAG will be considered to have substantial business activities in the foreign country if at least 25% of the number of group employees, at least 25% of the employee compensation, at least 25% of the value of the group's assets, and at least 25% of the group income is derived in the foreign country. The foreign corporation must also be a tax resident in the foreign country. Reg. § 1.7874-3(b)(1).

A transaction that satisfies these three tests for a 60% inversion is referred to as an inversion transaction. Reg. § 1.7874-12(a)(15). The foreign acquiring corporation is considered a "surrogate foreign corporation" (IRC § 7874(a)(2)(B)) and the acquired domestic company is defined as an "expatriated entity" IRC § 7874(a)(2)(A)(i).

In a 60% conversion, the surrogate foreign corporation's classification as a foreign corporation is respected, but the expatriated domestic corporation must recognize income at least equal to the "inversion gain" over the 10-year period following the acquisition. IRC Section 7874(a). IRC Section 7874(d)(2) defines an inversion gain as the income or gain recognized by reason of the direct or indirect transfer of stock or other property by the expatriated entity, and any income received or accrued by reason of a license of any property by the expatriated entity.

Pursuant to IRC Section 7874(b), if 80% or more of the stock of an acquiring foreign corporation is received by the shareholders of the domestic target company, the foreign corporation will be taxed in the US as a domestic corporation. As a result, the foreign acquiring corporation is subject to US tax on its worldwide income.

CONCLUSION

In order to successfully complete the inversion transaction, the client will need to ensure at least one of the three tests that define an inversion transaction is not met. For example, the business might be structured to have at least 25% of the combined group's employees, compensation, assets and income derived in Switzerland. Alternatively, the transaction should be structured such that the shareholders of the US company own less than 60% of the foreign acquiring company after the transaction is completed.

If neither of those situations is possible, the transaction should be structured such that less than 80% of the foreign acquiring company's stock is owned by the US shareholders after the transaction is completed. Although this likely will result in some US tax liability, the IRS will recognize the foreign status of the company.

The client should also be aware that the tax benefit of a successful inversion may not be as significant as it believed. Switzerland's combined federal and cantonal tax rate ranges from 19.7% to 29.4%, depending on the canton where the business is located. The US combined federal and state corporate tax rates can generally do not exceed 28.9%.

Lastly, the client should be aware of other non-tax implications of the inversion transaction. PricewaterhouseCoopers' 16th Annual Global CEO Survey indicates that CEOs recognize that governments, the public and the media are questioning whether their companies are paying their "fair share" of tax. (PWC, 2013 p. 8). A number of companies who have completed or considered inversions transactions have also been negatively scrutinized potentially causing at least temporary reputational damage (Daniels, 2014).

Based on the limited tax savings, if any, that would result from a successful inversion and in light of the potential reputational damage that might be incurred, I do not believe an inversion transaction is advisable.

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CLIENT CORRESPONDANCE

DATE: March 1, 2021
SUBJECT: Tax Inversion, US to Switzerland

You expressed an interest in a potential tax inversion to Switzerland, given that country's 5% corporate tax rate. We do not commend this transaction.

First, the effective tax rate in Switzerland is not significantly less than the US combined federal and state tax rate. Corporations doing business in Switzerland are subject to an 8.5% federal income tax as well as income taxes imposed by the canton in which the business activities are incurred. The current tax rates in the various Swiss cantons range from 11.9% to 21.6%. This results in an effective combined Swiss tax rate of 19.7% to 29.4%. The US combined federal and state effective corporate income tax, assuming a state tax rate as high as 10% is 21% to 28.9%.

Second, the Internal Revenue Code will reduce and potentially eliminate the benefit of the corporate inversion if three tests are met:

- If the Swiss company acquires substantially all of the properties held directly or indirectly by your US corporation

- After the acquisition, at least 60% of the stock of the Swiss corporation is held by the former shareholders of your US corporation, and

- The resultant combined business doesn't have substantial business activities in Switzerland. In order to have substantial business activities in the foreign country, you will need to have at least 25% the total number of employees, at least 25% of the total employee compensation, at least 25% of the value of the combined group's assets, and at least 25% of the combined group's income derived in Switzerland. The foreign corporation must also be a tax resident of Switzerland.

You would need to structure the transaction very carefully to ensure that at least one of these tests is not met.

Lastly, you should also be aware of the potential reputational risk of such a transaction. Inversion transactions have been scrutinized by the public, the media and customers of companies that have announced their intention to do so. For example, it is believed Walgreen Co cancelled its 2014 plan to move its tax domicile overseas due to the complexity and heightened political sensitivities of the transaction. Two other larger inversions also were curtailed (Pfizer and Omnicom Group) that year.