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AN ALERT FROM THE BDO RETAIL & CONSUMER PRODUCTS PRACTICE

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SUBJECT

WHAT DOES A CEO/CFO NEED TO KNOW ABOUT AN INVERSION TRANSACTION?

In an attempt to curtail their corporate income tax liabilities, a number of prominent multinational corporations, including a major retailer, have announced tentative plans to relocate their U.S. headquarters abroad. As a result, this practice, known as an "inversion transaction," has been thrust into the spotlight, prompting Congress, businesses and shareholders to reconsider the broader implications of this potential exodus of enterprise. Retail and consumer product companies should take note. Although relocating a corporation's headquarters may help reduce tax liabilities and compliance costs, the process is now subject to increased scrutiny from regulators and could introduce financial risks to businesses. As they continue to grow in number and size, it is critical that retail and consumer product companies better understand inversion transactions and how they can impact their business.

BACKGROUND

The United States (U.S.) is widely known to be one of the highest corporate income tax jurisdictions in the world. U.S. multinationals pay U.S. corporate income tax on their worldwide income at up to 35 percent (plus state and local taxes). Generally, U.S. tax on income earned by a foreign subsidiary is deferred until the foreign subsidiary makes a distribution to its U.S. owner. However, various anti-deferral provisions could also trigger U.S. corporate income tax even absent an actual repatriation if the foreign subsidiary earns certain types of passive income or engages in certain related party transactions. Although a foreign tax credit is generally available to alleviate the double taxation of foreign income in the U.S. and local country, the credit is, among other things, limited to foreign tax on the foreign income. Given that U.S. income tax rates are often higher than foreign rates, the actual and deemed repatriation of foreign income often results in additional tax paid in the U.S. and a higher worldwide effective tax rate for a U.S.-parented group. Moreover, a U.S. parent company is subject to extensive U.S. tax disclosure requirements (e.g., Forms 5471, 8865, 8858, 8621, 926 etc.) with respect to its foreign subsidiaries. To mitigate these costs and to eliminate the various tax and business disadvantages of having a U.S. parent company owning a multinational group, an increasing number of U.S. companies have moved the U.S. parent's tax residency to a more tax-efficient jurisdiction by engaging in so called "inversion" transactions.

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BDO has been a valued business advisor to retail and consumer product companies for 100 years. The firm works with a wide variety of retail clients, ranging from multinational Fortune 500 corporations to more entrepreneurial businesses, on myriad accounting, tax and other financial issues.

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What is an Inversion?

In an inversion, the U.S. parent corporation of a multinational group is replaced with a foreign parent. This could be effectuated in many different ways. For example, the U.S. parent can reincorporate in a foreign jurisdiction or merge into a foreign corporation or its U.S. or foreign subsidiary. If the U.S. parent is a surviving company in the merger, a further restructuring of the group is undertaken to transfer the former U.S. parent's foreign subsidiaries to the new foreign parent company. Most successful inversions are accomplished in connection with an acquisition of a foreign target (not related to the inverting U.S. group) whose value is more than 20 percent of the combined value of both groups. The resulting merged group has a foreign parent owned by former shareholders of the inverted U.S. group and the foreign target group. The recent inversion transactions are generally taxable to the U.S. shareholders of the U.S. parent.

What are the Benefits of an Inversion Transaction?

A foreign holding company structure can often better meet the needs for U.S. and non-U.S. shareholders to attract future investment. Once inverted, the multinational group can save taxes through the following main techniques:

- First, the group does not have to pay U.S. tax on income generated from non-U.S. operations. Avoiding U.S. tax and domiciling in a low tax foreign holding company jurisdiction can significantly reduce the group's worldwide effective tax rate.
- Second, the group is free to use cash generated overseas without paying high U.S. tax on repatriation of this cash up the chain to the foreign parent company. In contrast, in the U.S. holding company structure, the foreign cash needs to be kept abroad to avoid U.S. tax and complex planning is often needed to repatriate this cash in a tax-efficient manner and/or to avoid U.S. tax on phantom income under the various anti-deferral provisions.
- Third, additional savings may be achieved by reducing U.S. tax on U.S. income through inserting leverage into the U.S. company (now a subsidiary of a new foreign parent) or migrating its intellectual property abroad and making deductible payments of interest, royalties or management service fees to the new foreign parent or other foreign affiliates.
- Lastly, a foreign holding company structure could save money by reducing the U.S. tax compliance costs.

What Are the Potential Traps Created by an Inversion Transaction?

- Inversions could have immediate U.S. tax consequences, such as paying U.S. tax on the built-in gain inherent in a former U.S. parent's stock or assets. This tax could be imposed on both: the inverting U.S. company and its shareholders. However, the tax can be reduced or eliminated depending on the type of the transaction and the group's or shareholders' tax attributes (e.g., net operating losses, tax credits, high tax basis in stock/assets, low value etc.)
- Section 7874 (enacted in 2004) can treat the new foreign parent of the group as a U.S. corporation if the former shareholders of the inverted U.S. parent end up owning 80 percent or more of the new foreign parent and the group does not have substantial business activities in the country of the foreign parent's incorporation.
- If the former shareholders' continuity meets a 60 percent threshold (but is less than 80 percent), the foreign parent is respected as a foreign corporation, but the group's ability to use its U.S. tax attributes (such as losses and credits) may be limited and certain stock-based compensation held by certain corporate insiders (e.g., officers, directors, and 10 percent shareholders) and their families may be subject to an excise tax.
- An inversion can have reputational concerns as a result of a U.S. parent company's "renouncing its US corporate citizenship."
- There are proposals introduced in Congress to tighten the current anti-inversion rules to prevent U.S. companies from moving overseas. These proposals, if enacted in their current form, would apply retroactively.

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