News or Noise: U.S. Companies Crossing the Pond—Problem or Opportunity?

By Chuck Gray, Partner

So far this year, 14 U.S. corporations have changed their domicile to foreign countries in a practice called “inversion,” which shifts the company’s tax base from the United States to another country. Currently, a sale involving a U.S. company for the purpose of relocating its headquarters for tax inversion requires the foreign company involved to own at least 20 percent of the U.S. company in order for the sale and relocation to be legal. Most of the inversions have occurred within the health care industry, and the favorite new destination is Ireland. This is because the United States has one of the highest combined corporate income tax rates in the world at 39.1%, while Ireland enjoys one of the lowest rates at 12.5%.

A Call for “Economic Patriotism”

In July, U.S. Treasury Secretary Jack Lew sent letters to members of Congress calling for a “new sense of economic patriotism” in which U.S.-based companies would no longer be allowed to do inversions merely to change their tax domicile. The Treasury Department has proposed new rules to increase the ownership threshold that the foreign entity must own to 50 percent. Meanwhile, a nonpartisan congressional research panel estimated that the U.S. tax base could gain as much as $20 billion in corporate tax revenue over the next 10 years if inversions were essentially halted.

Sen. Charles Schumer, D-N.Y., suggested recently during a special hearing that a new rule could target the interest expense deduction being claimed by inverted companies. Often, a corporation will lend one of its subsidiaries money from a different subsidiary, and receive a tax deduction. Also, the Senate Appropriations Committee has suggested legislation that would ban subsidiaries or joint ventures that are at least 10 percent owned by an inverted corporation from getting government contracts.
While other legislative issues may have more political capital to get done once Congress returns from its summer break in September, inversion transactions appear to have more momentum than originally expected.

**The Effect on Investments**

U.S. corporations have accumulated corporate cash outside U.S. borders, by some estimates, in excess of $2 trillion. According to Bloomberg, the number of takeovers by U.S. corporations of foreign companies in countries with corporate tax rates below 20% has doubled as a share of all overseas deals. So how may this inform our investment decisions?

Certainly, investment managers and hedge funds are attempting to identify potential target companies to invert. Since July 2013, the share prices of 23 Irish and U.K. health care companies have outperformed the S&P 500 index by approximately 60%. One of the reasons inversions have been clustered in sectors such as pharmaceuticals and biotechnology is that once one company in a group gains a tax advantage, competition ensues among its peers for growth and market share. Often, companies have an incentive to issue more debt and lever up their balance sheet to create the market capitalization thresholds to invert. This is yet another less reverenced catalyst for debt creation in sectors such as health care.

So what about the shareholders of these inverted companies? While the company benefits by a lower tax structure, the transaction usually triggers capital gains to be realized for the shareholders. Also, extra tax forms may need to be filed if the stock holdings exceed specified limits. This will come as a surprise to many shareholders when they receive their form 1099 the following year.

**An Interesting Debate**

Are the actions of these U.S. corporations choosing to invert unpatriotic? Or are these corporations not obligated to maximize the wealth of their shareholders? It will be an interesting debate, and we may see an escalation of inversions while the window exists.