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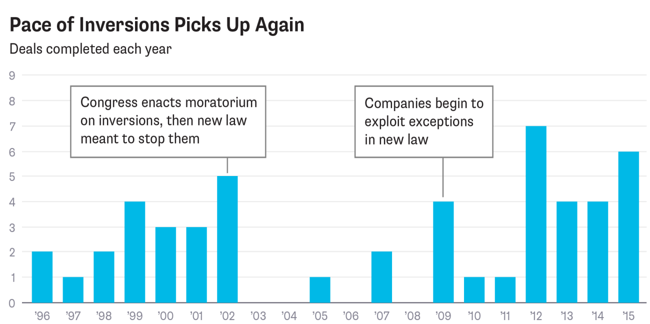
May 2nd, 2016

The ever-present loophole: An In-depth analysis of the constant battle between corporations and congress to keep companies in the United States

On April 5th, 2016, Pfizer decided to walk away from the biggest pharmaceutical deal in M&A history. Pfizer, being a historically aggressive acquirer, intended to use this merger, to drop its tax rate to about 17 or 18 percent after the deal, from 25 percent: creating over $1 billion in annual cost savings.[1] These cost savings, however, might not be realized, as treasury regulation was recently put in place to make it harder for companies to move their tax addresses out of the U.S. and then shift profits to low-tax countries using a maneuver known as earning stripping. While uncertainty continues to circle the future of this mega-deal, the bigger issue remains regarding whether official legislation will be implemented to combat companies wanting to exercise tax-evading maneuvers. While talk has begun to emerge from current presidential candidates, much gridlock across party-lines still remains, regarding proper remedies. With that, the purpose of this article is to detail the emergence of inversions, the impact this new legislation will have, and future expectations.



While companies have been utilizing inversions since the early 80s, it was not until 1994 in response to El Paso, Texas company, Helen of Troy's attempt to utilize a Bermuda-based subsidiary to benefit from lower tax rates that the Treasury Department, under the

[1] http://www.investingengine.com/pfizer-allergan-call-off-deal-amid-us-tax-crackdown/

authority of Section 367 of the tax code, wrote regulations that imposed a shareholder-level tax on inversions.[2] While a step forward, the new tax code had little impact on inversions from ’96-’02 as deals began to increase annually. It was not until the anti-inversion bill finally became law in 2003, temporarily halting inversion activity. This law, however, lost strength quickly, as the law allowed companies to still adopt the foreign address of a merger partner as long as the partner was at least one-fourth the size of the U.S. firm. Utilizing this loophole, from ’09-present day, a new wave of inversion deals has risen, driven primarily by pharmaceutical companies.[3] While built on a short sample size, the graph implies cyclicality, as there are multiple cases of tax codes have first endured treasury changes, followed by more impactful legislation. While the pattern seems clear, understanding the Treasury Department’s changes offer clarity of what’s to come.

While the U.S. Department of the Treasury and the IRS have considered proposing new regulation, the magnitude of the Pfizer-Allergan deal applied significant pressure to expedite the process. In the treasury’s announcement, actions will be concentrated on solving three key issues:

- **Restrict foreign companies**[4] from acquiring numerous American companies to push its size and value outside of the section 7874 threshold, making all parties immune to the tax code’s existing curbs on inversions.
- **Address earnings stripping**[5] (avoiding taxes by paying excessive amounts of interest)
    - Targeting transactions that generate large interest deductions by simply increasing debt while not financing new domestic investment.

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2 http://www.taxanalysts.com/www/features.nsf/Features/F817995A255AFD2485257CF900427B06?OpenDocument

3 http://www.wsj.com/articles/race-to-cut-taxes-fuels-urge-to-merge-1405381053

4 https://www.treasury.gov/press-center/press-releases/Pages/jl0405.aspx

5 Ibid

- Allowing the IRS on audit to divide a purported debt instrument into part debt and part equity
- Facilitating improved due diligence and compliance by requiring certain large corporations to do up-front due diligence and documentation with respect to the characterization of related-party financial instruments as debt.
- Limit companies from partaking in multiple inversions within a 36-month timeframe.[6]

This regulation change is significant in that it focuses the pressing issue of earning stripping, a topic Treasury Secretary Jacob Lew has hinted at including in future anti-inversion regulation since 2014[7]. This, in addition to imposing a waiting period between inversions, has been a driving force in halting the Pfizer-Allergan deal altogether. These changes though will however likely serve as a temporary hindrance for companies as an opposition is already mounting to challenge the legislation and exploit loopholes. Even the Obama administration, which has taken several steps to discourage inversions in recent years, says Congress ultimately must step into this fight. This statement segues directly to what will determine future possibilities of inversions: government legislation.[8]

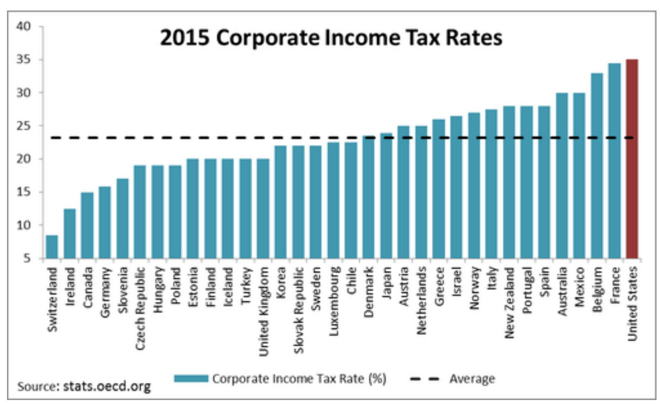
It is no secret that the US legislative branch has experienced significant gridlock, especially surround corporate tax structures. While both sides seem in favor of fighting inversions, methods have varied across party lines.

- **Democrats** have taken a moderate approach in pushing to continue reforming the current tax code to remove loopholes from companies and build off of treasury

[6] http://www.sltrib.com/home/3743783-155/pfizer-is-scrambling-to-save-the
[7] http://ww2.cfo.com/tax/2014/09/earnings-stripping/
[8] http://www.wsj.com/articles/u-s-treasury-unveils-new-steps-to-limit-tax-inversions-1459803636

regulation reform. Hilary Clinton, in particular, has introduced a plan to call on Congress to prevent "inversions" and end transactions like the Pfizer-Allergan deal. This includes imposing a commonsense 50% threshold for foreign company shareholder ownership after a merger before an American company can give up its U.S. identity, and an "exit tax" to ensure multinational companies that change their identity pay a fair share of the U.S. taxes they owe on earnings stashed overseas. If Congress has not acted to address inversions and related loopholes, Hillary is also calling for Treasury to use its full legal authority to prevent inversions and restrict the tax loopholes they allow, including cracking down on "earnings stripping," one of the key benefits of inversions.[9]

- **Republicans** have taken a more fatalistic approach to the problem, arguing that, in a free-market system, you can't stop capital from flowing to the place where it will get the best after-tax return. That's why Republican hopefuls have proposed corporate tax reform plans that would lower the statutory rate from today's world leading 35%. Trump argues for a 15% rate. But others, including Mike Huckabee and Ted Cruz, have proposed eliminating the corporate tax altogether.[10]



[9] https://www.hillaryclinton.com/briefing/factsheets/2015/12/08/ending-inversions-and-investing-in-america/
[10] http://fortune.com/2015/11/25/why-republicans-democrats-tax-plans-inversion-problem/

In comparing the two sides, it is without question that both sides are fully against allowing inversions, however finding common ground on how to address companies leaving the United States has driven this gridlock. While Democrats have brought various proposals, Republicans have stayed firm in “sitting on their hands” until the 2016 election. With that, this issue is sure to remain a pressing issue for both sides and it will be interesting to see what is to come in the upcoming year and what will happen with the impending Pfizer-Allergan deal.