AMERI-CAN TAX TALK NEWSLETTER

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TAX INVERSIONS: BURGERS & COFFEE

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Tax inversions have been front and center in the news recently, hitting close to the homes of many Canadians with the December 2014 transaction between Burger King and Tim Hortons. The attention has provided an opportunity to discuss corporate taxation, specifically tax inversions, in Canada, the United States and around the world.

The US has one of the highest corporate tax rates among OECD countries and arguably some of the most punitive corporate tax laws. According to a recent KPMG study of corporate taxation amongst ten countries, Canadian corporations have, on average, a 46% lower tax cost than a US corporation.

In comparison, individual tax rates in the US have been much lower on average than many other parts of the world in past decades. Further, there is common and legitimate tax planning that would allow many businesses, large and small, to avail themselves of the individual tax rates and more favorable “non-corporate” tax rules, while still having many of the benefits of a corporate tax structure. Inequity exists for those that choose to use a pure corporate structure, primarily public companies or multinational companies who are not permitted to use the other planning techniques that domestic shareholders can practice to avoid the punitive corporate rules and rates.

The fundamental issue that most people have with the US corporate tax system, and what differentiates it from most of the rest of the world, is that it has a lack of integration between the entity and the shareholders (and sometimes within its own corporate structure) – so it can be a true double (or triple, quadruple…) tax system. Furthermore, the corporation pays tax on its worldwide income. This is true of most corporations worldwide, and in particular Canada, however for foreign subsidiaries of US corporations that would presumably pay tax in those foreign countries, the dividend is fully taxable when the money is repatriated to the US corporation by a dividend.

Using a basic example, a US individual incorporates a new corporation and contributes $100 in capital. This is a regular corporation and the individual makes no election to be taxed at the individual rates and does not engage in special tax planning. The corporation earns $100,000 the first year. There are graduated rates for corporations but they are relatively small and there is a phase-out, so a flat rate of between 34% and 35% would apply to many corporations.

For ease of our example, the tax rate will be 35% and the corporation would pay $35,000 in tax, leaving $65,100 in the corporation. The individual cannot take out the original $100 until he takes out the first

$65,000, and any amount he takes out in dividends would be taxable on his personal return, in what used to be his regular tax rate but was reduced in 2004 to what his capital gains rate is (currently a maximum of 20%). So, if he were to take out the $65,000, he may be subject to an additional tax of up to $13,000. This is not considering any applicable state taxation at either the corporate or personal levels.

Now if this corporation had a subsidiary that had earnings of $100,000 and paid tax of $35,000, the dividends paid to the parent corporation would be included in income as well and taxed at 35% (there is no reduction in rate on dividends or capital gains for corporations). There is a deduction available for dividends received from domestic (US) subsidiaries that have been held for 45 days of 70%, 80% or 100% of the amount of dividend, depending on the ownership percentage of the subsidiary. It is obvious that there is the potential for multiple taxation on the same income, particularly for foreign subsidiaries. In addition, there are rules for including passive income from foreign subsidiaries in the domestic income of the parent corporation, which further complicates the issue of multiple taxation.

One solution may be to restructure the company from having the parent company in the US and the subsidiary company in foreign countries, to having the parent company in the foreign country and the subsidiary company in the US. This would likely have no effect on the actual operations of the companies, many of which actually have their head offices and operations in the United States anyway.

Two different kinds of inversions generally take place. With a stock inversion, the shareholder exchanges their shares of the US parent for shares of the new foreign parent. This can be accomplished under Section 351, 354 or 368(a)(1)(B). The other method is by transferring all of the assets of the corporation to a new foreign corporation in exchange for shares of stock in a Section 368(a)(2)(D) or 368(a)(2)(E) reorganization.

This is a foreign reorganization, so Section 367 must be considered. Section 367(a)(1) provides that a gain (but not a loss) may result from the shareholders exchanging shares from the former US parent for the stock in the new foreign parent. This gain is based on the difference between the fair market value of the foreign corporation shares received and the basis of the domestic corporation's shares that are exchanged. It is triggered when more than 50% of votes or value of the foreign corporation are owned by the US shareholders (transferors) immediately after the transaction. There may be other sections such as Section 311(b) and 1248 which may also cause gains, and these need to be considered and planned for as well.

Despite the restrictions of Section 367, there is an exception which could make the inversion possible. The Regulations state that if the transferee foreign corporation was engaged in a business outside of the US for 36 months prior to the transfer, there was no intention to dispose of or discontinue the business, and the fair market value of the foreign corporation was at the time of the transfer at least equal to the fair market value of the domestic corporation, then there is the possibility that any gains imposed by Section 367 do not apply.

Since Congress realized that corporations continued to find ways to complete tax inversions, in 2004 they imposed Section 7874, purportedly to prevent the sort of transaction that would qualify under existing rules.

The first case where Section 7874 applies is if:

(1) A US corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity in a transaction completed after 3/4/2003.

(2) The former shareholders of the US corporation hold (by reason of holding stock in the US corporation) 80% or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction.

(3) The foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50%, does not have substantial business activities in the entity's country of incorporation, compared to the total worldwide business activities of the expanded affiliated group. Further regulations state “substantial” to be 25%.

Should those conditions occur, the foreign entity would be considered a domestic entity for US tax purposes, in which case, Section 367 wouldn’t apply.

There are also rules in §7874 that deal with the situation where at least 60% but less than 80% of the votes or value of stock is acquired in the foreign corporation. There will be an income inclusion for 10 years based on a calculation.

What is interesting is that there were a number of significant tax inversions between 2004 and 2014 (including the announcement of the Burger King/Tim Hortons deal) despite the implications of Section 7874. Congress may have not anticipated that merging an existing foreign business with a US company and having substantial business with the foreign company would work around Section 7874 and possibly 367.

Secretary of the Treasury Jack Lew has been adamant in asking Congress (through the press) to effect legislation to stop tax inversions. For the Treasury Department’s part, they issued Notice 2014-52 on September 23, 2014 which outlined their intent on changing the regulations under Sections 7874 and 367 for all transactions completed after September 22, 2014.

The Treasury’s intent was to minimize the ability to access cash in the new foreign parent and to better control the rules in Section 7874 to treat more inverted companies as US domestic companies.

Some of the highlights of the proposed regulations are as follows:

There is a technique commonly called a “spinversion,” alluded to above, where the US company contributes stock or assets to a foreign subsidiary and that entity spins off that foreign subsidiary to its shareholders, which may be exempt from Section 7874. The new regulations would have Section 7874 apply to this technique and the foreign spun off company would be treated as a domestic company.

The notice addresses two other techniques that inversion transactions employed to work around Section 7874. They are called the “cash box” and “skinny down” strategies. These techniques were used when the 80% threshold became an issue in valuing the relative size of the US to foreign entity. To change the relative sizes, a cash box strategy is used by counting passive assets to make the size of the foreign parent appear larger. In the skinny down transaction, the US company pays large dividends to the foreign entity to reduce the US entity size. With the new regulation, the stock of the US parent that is a passive asset will be ignored for determining whether the 80% requirement is met and dividends between the US and foreign parent/sub will be ignored in determining the ownership requirements.

There were other regulations for sections affected by inversions such as 956 and 304(b) that regulated access to deferred earnings and repatriation of funds. These regulations were amended to again make inversion strategies less enticing for US corporations.

Even with the new pending regulations, there continues to be inversion transactions as was seen with the Tim Hortons/Burger King transaction that proceeded in late December 2014.

The Secretary has stated that this amendment is the best the Treasury can do for now, and it is up to Congress to create legislation if they want to stop the inversion transactions. The US could consider amending the corporate tax rules and rates to make them more in line with the rest of the world (and with its personal tax rules and rates) and more enticing for the US parent to remain in the US and not look elsewhere to create tax minimization strategies.

For more information, please contact:

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