Burgers, Doughnuts, and Inversion Transactions

United States ("US") burger behemoth, Burger King Worldwide, Inc. ("Burger King"), backed by financing from billionaire investor Warren Buffet, reached a tentative $11 Billion merger agreement with the Canadian coffee-and-doughnut chain Tim Horton, Inc. on August 26, 2014. The terms of the transaction move the headquarters of the combined enterprise to Canada and require its stock to be listed on the Toronto Stock Exchange and the New York Stock Exchange.

The merger was structured as a corporate inversion transaction, a type of reorganization in which a US corporation becomes the subsidiary of a foreign parent corporation. If an inversion transaction is well planned, future income from foreign operations and distributions to the foreign parent can avoid the US foreign income tax regime. Furthermore, US taxation of US source income may also be reduced by deducting the payments of fees, interest, and royalties payable to the foreign parent.

Another significant advantage is the tax-free repatriation of cash. The US is one of the few industrialized nations that tax their multinational corporations on their world-wide income, but under current US law, profits generated overseas are often not included in income until the foreign subsidiary that earned them repatriates the profits by declaring a dividend. Profits that have not been repatriated are known as “deferred earnings.” Research firm, Audit Analytics, has reported that deferred earnings topped $2.1 trillion in 2013. Inversion transactions, through the use of certain follow-on transactions, can allow for the repatriation of these deferred earnings (or at least for the ability of the US corporation to use the cash) without incurring the tax that would otherwise be imposed on repatriation.

Because of these tax advantages, the Burger King merger was perceived as a tax-avoidance scheme and set off a considerable backlash against corporate inversions. Since the announcement of the merger, President Obama has called inversion transactions “unpatriotic”; the Editorial Board of the New York Times has labeled them “corporate tax games”; the US Treasury has issued a recent Notice of its intent to issue anti-inversion regulations; and Senator Charles Schumer (D. NY.) has drafted proposed legislation that would limit certain deductions and tax breaks for companies that move out of the US for tax purposes. Warren Buffet, however, normally a crusader for tax reform, has given several interviews defending the legitimate business purpose of the Burger King transaction.

Corporate inversions are not new, and current law provides for adverse tax consequences for certain inversions. For example, US shareholders generally recognize gain (but not loss) on exchanging their stock in the US corporation for shares in the new foreign parent, and the US corporation may recognize gain on assets it transfers, including its foreign subsidiaries, to the new foreign parent.

In 2004 Congress enacted Internal Revenue Code § 7874 to further penalize those inversions that had two tax avoidance characteristics: (1) Less than twenty-five percent (25%) of the new multinational’s business activity originates from the home country of the new foreign parent; and (2) The shareholders of the old US corporation end up owning sixty percent (60%) or more of the new foreign parent. If the continuing ownership of the US shareholders is at least sixty percent (60%) and less than eighty percent (80%), the inversion is respected for US tax purposes, but the surviving US corporation is required to recognize an amount of income not less
than the “inversion gain” for a ten-year period following the inversion. Inversion gain includes certain gain and income from the transfer of stock or assets (or the licensing of assets) from the US corporation to a related foreign corporation. Inversion gain is determined without the benefit of certain offsetting tax credits and losses. If the shareholders of the old US corporation own eighty percent (80%) or more of the new foreign parent, the entire inversion is nullified and the new foreign parent is treated as a US corporation with its world-wide income still subject to the US foreign tax regime.

The US Treasury’s recent Notice proposes certain anti-inversion regulations that are to be effective as of September 22, 2014. The proposed regulations primarily strengthen and clarify the taxation of inversion transactions that fall under § 7847. They attempt to prevent several techniques used to avoid tax on the repatriation of deferred earnings and to eliminate certain transactions that manipulate the calculation of the continuing ownership percentage of the US shareholders. For the most part however, these regulations do not affect transactions that are outside the scope of § 7874.

Congress attempted to carve out certain cross-border transactions with real economic substance from the application of § 7874. The section does not apply if the resulting multinational company has a substantial amount of business in the home country of the new parent (twenty-five percent (25%) or more) or if the shareholders of the US corporation end up owning less than sixty percent (60%) of the stock of the new foreign parent company. Congress reasoned that corporations were unlikely to enter into such business-altering transactions merely to avoid taxes. Considering the large numbers of US multinational corporations, such as Burger King, engaging in inversion transaction by acquiring overseas businesses, Congress may have been wrong. Even if the new proposed regulations are promulgated, inversion transactions that escaped the application of § 7874 will continue to have the same appeal.

The political discourse resulting from the Burger King transaction has been almost entirely focused on building a legislative wall to stop the flight of US multinationals. There has been little to no discussion about overhauling the corporate and foreign tax regimes from which those companies are fleeing. Thus, while the current Congress is unlikely to pass any new legislation, it does seem likely that additional legislative restrictions will occur at some point.