BLINDED BY DOLLAR SIGNS: FUTURE RAMIFICATIONS OF CORPORATE INVERSIONS

Demands for a massive overhaul of the United States Tax Code (the “Code”) can be heard from virtually every pocket of American society, with some of the fiercest coming from the executives of U.S. multinational corporations (“MNCs”). MNCs have engaged in aggressive tax planning for years, but more recently, corporate tax-planning practices have received increasingly negative attention. The favorite villain among both consumers and politicians is a practice commonly referred to as a ‘corporate inversion’.

I. WHAT ARE CORPORATE INVERSIONS?

Put simply, a corporate inversion occurs when a MNC inverts, causing a foreign corporation to replace the domestic parent, switching the domicile from domestic to foreign, in an effort to avoid the U.S. corporate tax rate. Under the Code, MNCs’ foreign earnings are not subject to a domestic corporate tax until the earnings are brought back to the U.S., or repatriated. As long as the money stays off shore, it is safe from the reaches of the U.S. corporate tax rate, causing many MNCs to “permanently reinvest” their foreign earnings as to shield them from domestic taxes. One of the main functions of a corporate inversion affords MNCs the power to utilize their overseas earnings, without repatriation and subsequent exposure to the U.S. corporate tax rate. Thus, it

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4 Id.
5 Edward D. Kleinbard, “Competitiveness” Has Nothing to Do With It, 144 TAX NOTES 1055, 1058 (Sept. 1, 2014).
follows that the main grievance with corporate inversions is their ability to erode the U.S. tax base. Under the direction of the Obama administration, the U.S. Treasury offered modifications to the Code, specifically targeting tactics to access foreign earnings that are frequently used in inversion type deals. It is undeniable that the Code needs reforming, especially in the context of foreign earnings, however, there is very little agreement on how it should happen. As such, I suggest we examine a different issue: is an inversion truly in the best interest of the corporations’ shareholders?

II. COMPETING INTERESTS

The executives’ and directors’ fiduciary duty to act in the best interest of their shareholders is one of the rudimentary principals of corporate law. Ideally, corporate inversions would fall neatly into a “good for shareholders” or “bad for shareholders” box; but as the Code consistently proves, nothing involving tax is ever that simple. Instead, the onslaught of negative publicity surrounding corporate inversions has facilitated a divide between consumers and investors. For example, in 2014, the American company Walgreens contemplated an inversion deal with the Swiss company Alliance Boots, but ultimately decided against moving forward with the inversion portion of the transaction due to consumer and political backlash. After announcing it would not go forward with the inversion portion of the deal, Walgreens’ share price dropped fourteen percent; suggesting investor disappointment with the decision not to invert and emphasizing the direct correlation between potential for inversion and an increase in the company’s value. Ignoring the potential underlying contractual constraints of the deal, Walgreens’ acquisition of Alliance Boots illustrates a unique challenge for executives and directors: Do you move forward with inversions and risk alienating consumers or do you pull back and risk of alienating shareholders by decreasing the value of the company? As evidenced by the abundance of articles offering analysis of the

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8 Kleinbard, supra note 5, at 1066.
9 Fact Sheet, supra note 3.
10 McKinnon & Palleta, supra note 7.
11 Sommer, supra note 2.
12 Id.
13 Id.
14 Id.
15 See Kevin Allison, Walgreen May be the Exception to the Logic of Inversions, N.Y. TIMES (Aug. 6, 2014), http://dealbook.nytimes.com/2014/08/06/walgreen-may-be-the-exception-to-the-logic-of-inversions/ (suggesting contractual limitations in the structuring of the deal deterred Walgreen’s from going forward with the inversion).
problem, the solution is unclear. However, a logical starting point in the assessment of the potential benefits of inversions is developing an understanding of both the scope and reasoning behind them.

III. SCOPE OF INVERSIONS

Although a relatively popular topic among politicians and the press, inversions are not very prevalent. From September 2014 to September 2015, only six MNCs engaged in inversion deals. Although reflective of the year after the Treasury modified the Code in hopes of deterring inversions, the prior year only saw nine inversion deals. Technically, any MNC may undertake an inversion; thus, the scope of the problem is surprisingly narrow when viewed in terms of companies qualified for inversions and companies completing inversions. The acquisition of American corporations by foreign counterparts is far more common and perhaps greater cause for concern. Foreign companies have been more aggressive in the acquisition of American rivals, spending twice as much as American corporations since 2014. American companies are attractive marks for foreign acquisition for the same reasons that tempt MNCs to invert: by acquiring a MNC, a foreign company can realize the same benefits a domestic corporation would achieve through an inversion. For example, a foreign company may pile debt onto its newly acquired U.S. subsidiary and deduct the interest payments from its taxable income. This decreases the taxable income of the company while simultaneously maintaining and even increasing its net value, translating into a higher value of the company and ultimately higher share prices. This practice exemplifies a problem that transcends the influx of inversions; it highlights globalization’s

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16 See, e.g., Kleinbard, supra note 5; Bogenschneider, supra note 2; Josh Barro, Inverting the Debate Over Corporate Inversions, N.Y. TIMES (Aug. 6, 2014), http://www.nytimes.com/2014/08/07/upshot/inverting-the-debate-over-corporate-inversions.html?_r=0.
17 Bogenschneider, supra note 2.
18 Hoffman & McKinnon, supra note 1.
19 Id.
21 Hoffman & McKinnon, supra note 1.
22 Id.
23 Id.
24 Id.
25 Cf. Kleinbard, supra note 5, at 1069–61 (explaining how a U.S. company can access foreign earnings through tax deductible interest rates, leaving the corporation “in the same economic position as if it had simply repatriated the cash tax free”).
outpacing of not only the U.S. Code but, also foreign tax regulations. Foreign jurisdictions currently used as tax havens are willing to capitalize on this disconnect, but it is hard to ignore the possibility that the future may bring backlash in response to the current boom.

IV. SHAREHOLDERS’ CONCERNS

The erosion of the corporate tax base attributable to inversions remains the hot topic in the press, but foreign takeovers of domestic MNCs happen with greater frequency. Therefore, shareholders must be wary of both the inversion and the foreign takeover. Foreign takeovers and inversions conveniently allow for the application of a similar analysis, and will hereinafter be treated interchangeably.

When approving a foreign takeover or inversion deal, shareholders should first consider the fact that this move will subject the corporation to the laws and regulations of a foreign jurisdiction. Accordingly, shareholders should pay special attention to how the laws of the foreign jurisdiction affect the following: (1) corporate governance; (2) fiduciary duties; and, (3) shareholder rights. In making these assessments, it may seem foolish to turn down the short-term benefits of projected savings and the accompanying increase in the company’s overall value. With figures like $562 million in savings by 2020, it is understandable that executives, directors, and shareholders are blinded by dollar signs. But, balancing the short-term benefits with the long-term risks complicates a seemingly easy decision.

V. LONG TERM IMPLICATIONS

There are several scenarios that ought to give shareholders pause when evaluating the long-term benefits of an inversion or foreign takeover. First, the expected savings that entice corporations and investors are just that:
While the potential savings will undoubtedly increase the value of the company and accordingly the value of the shares, the expected numbers are subject to all things remaining constant. These projections ignore the possibility that the foreign jurisdictions may update their tax codes to reflect the influx of foreign business. In the U.K., a popular relocation destination for MNCs, the tax code can and does change frequently. Additionally, there is added pressure from the Organisation for Economic Co-Operation and Development (“OECD”) and its Base Erosion and Profit Shifting project (“BEPS”) to acknowledge the tax evasion component of the relocations. The creation of the BEPS project provides an immediate threat to the profitability of inversions and foreign takeovers. The OECD heads the BEPS project, which seeks to establish solutions that eliminate the existing gaps in the international tax structure. Realistically, complete cooperation with the BEPS agenda is highly unlikely, however, its existence proves that the problem posed by inversions and foreign takeovers is receiving global attention and will not continue indefinitely without some degree of policing.

The U.K. is one example of possible long-term challenges for inversions and foreign takeovers. Logically, if these tax manipulations receive enough negative publicity, the facilitating countries will have to take some sort of action to curb the behavior. However, for some tax havens, there may be a more enticing motivation for limiting the number of acquisitions and reincorporations of MNCs. For example, when a U.S. company reincorporates in Ireland, the increased revenues resulting from the Irish company’s “parenting” of the U.S. company are treated as Irish for Gross Domestic Product (“GDP”) calculation purposes. This increase in GDP is as detrimental as it is artificial because Ireland does not receive an increase in tax revenue. However, Ireland must nevertheless take on a higher burden of the

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32 Id.
33 Kleinbard, supra note 5, at 1067.
34 Id.
36 Id; see also Kleinbard, supra note 5, at 1067.
37 OECD, supra note 26.
38 Id.
40 Kleinbard, supra note 5, at 1067; Farrell, supra note 39.
EU’s budget cost due to its increased GDP. The burden may eventually cause Ireland to reconsider its stance on MNC reincorporation.

Additionally, a foreign takeover or inversion subjects a company to the vulnerability of a hostile takeover. Foreign jurisdictions may structure their boards, afford shareholder rights, and approach corporate governance differently than the standards imposed in the U.S. For example, two of the jurisdictions frequently utilized as tax havens, Ireland and the Netherlands, do not provide the same amount of protection against hostile takeovers as many states in the U.S. Thus, a corporation may find itself at the mercy of a hostile takeover, effectively causing any remaining U.S. control to dissolve into the foreign corporation. This may bring short-term benefits to the shareholders through increased profits from the buyout, but they ultimately forfeit the chance of seeing greater returns over a longer time period.

The propensity for change among tax laws and the exposure to a foreign jurisdictions’ less favorable corporate structure are just two examples of long-term effects essential to a shareholders’ evaluation of whether an inversion or foreign takeover is in the best interest of the corporation. Acknowledging that the decision is not solely their decision, shareholders should nevertheless balance the potential for long-term detriments with the short-term benefits. Shareholders already assume some degree of risk by purchasing an interest in the company; however, this risk should not be unnecessarily increased by placing their investments into an ever-expanding bubble of offshore cash. Only time will tell how the inversion and global mergers and acquisitions craze will shape tax regulations across the world. But one thing is for certain: shareholders of MNCs contemplating an inversion or foreign takeover should think twice before supporting a deal premised on expected gains contingent on the global markets’ continued ignorance of the growing pile of tax exempt foreign earnings. This will expose them to an immediate capital gains tax and the potential for a future buyout, depriving

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41 Kleinbard, supra note 5, at 1067.
43 Cerutti & Lee, supra note 28.
44 Solomon, supra note 42.
45 Id.
46 Id.
47 Kleinbard, supra note 5, at 1067.
48 Solomon, supra note 42.
them of both control and the possibility of a long-term increase in value of their investment.

LAUREN Paine*

* Emory University School of Law, J.D. Candidate, (2017); B.A. English, University of Georgia. I would like to thank Bo Kamensky and Anne Kelley for providing extensive clarification and feedback during the development of this piece, and the editors of the Emory Corporate Governance and Accountability Review for their guidance during the editing process.