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Inversions Heating Up Again After Crackdown Froze Deals

By **Karlee Weinmann**

Law360, New York (December 10, 2014, 5:02 PM ET) -- A battery of restrictions imposed by the U.S. government this fall dampened tax-motivated deals but a couple of big-ticket plays barreling toward the finish line have revived the spotlight on tax-inversion transactions — ones that remain on the radar and will recapture momentum in the new year, experts say.

Shareholder approval for $11.4 billion plans to unite Burger King Worldwide Inc. with Canadian coffee chain Tim Hortons Inc., expected Friday, will set up the merger to become the first inversion to close since the Obama administration clamped down on tax-motivated deals. A second inversion, Medtronic Inc.'s more controversial $42.9 billion tie-up with Covidien PLC, isn't far behind.

The sunny forecast for the pending transactions is a reminder that inversions, cross-border deals structured to allow a U.S. company to redomicile in a tax-friendly jurisdiction abroad, can still be viable even in the wake of hard-line restrictions that strip many of the benefits previously attached to the hotly contested moves.

It's welcome optimism for the pro-inversion camp after a slow-going stretch since the U.S. Department of the Treasury debuted the new rules in September, amplifying the scrutiny on companies dipping into the strategy and threatening more limitations. But the agency hasn't piled onto its initial notice, leaving companies in a more comfortable position to explore their inversion options under a dimmer spotlight.

"There was a period where people were still working on deals but moving very, very slowly," said Linda Swartz, who heads the tax group at Cadwalader Wickersham & Taft LLP. "But as more time has passed without additional notices, people have begun to more aggressively pursue transactions again."

Deal makers have had nearly three months to deepen their understanding of the fresh parameters, which attack a bulk of the benefits that made inversions a popular choice this year. Beyond tightening stateside stock-ownership requirements, the rules prevent companies from using "hopscotch loans" to bypass a hefty 35 percent U.S. corporate tax rate when accessing offshore cash.

The limitations apply to any inversion not completed before Sept. 22, the day the rules debuted. The retroactive measure left nearly a dozen deals — among them the Burger King and Medtronic plays — in limbo, and rejiggered the blueprint for tax-motivated deal-making.

"People have a pretty good lay of the land of what the rules are right now and they've identified the issues and potential impediments. They're just deciding whether the risks and benefits make sense," said Jason Bazar, co-chairman of the tax transactions and consulting practice at Mayer Brown LLP. "You can look at the rules right now and see whether or not you can do a deal."

Two announced inversions crumbled because of the restrictions, showcasing added risk under the new framework. In particular, the collapse of a closely tracked $55 billion merger between AbbVie Inc. and British drugmaker Shire PLC exposed the cost of failure and fleshed out the landscape for other deals moving forward.

AbbVie's downfall plays up one of the biggest lessons from the inversion fallout. What the drugmaker lacked — and what Burger King and Medtronic have made clear in their deals — is a significant upside outside of the prospective tax breaks. The rule tweaks gave way to a tougher climate but if it's obvious that a deal makes strategic sense, a proposed inversion can still avoid failure.

"A few of the cars may have fallen off the tracks but the train's going to keep going for those deals that the business rationale is significant and/or the structure just works," said Hogan Lovells partner Jason Kaplan, a transactional tax specialist.

Still, the long-term outlook for inversions is far from settled. Though the Treasury has stayed quiet since it rolled out its rules, it could still further cloud inversion prospects.

When it introduced the stricter guidelines in September, the agency hinted it could tackle earnings stripping, a tactic that can carry a huge upside for inversion hopefuls. The strategy lets U.S. merger partners reduce future U.S. tax bills when their foreign parent provides a loan with deductible interest, then the deductions can offset taxes owed to the U.S.

The Treasury is scheduled to further address inversions sometime in the first quarter, but it's unclear whether the agency will bring earnings stripping into sharper focus or simply refine the existing restrictions. Regardless, deal watchers say sustained inversion interest suggests prospective deal makers in the still-sizzling marketplace aren't too worried.

"While people may have slowed down a little in considering inversion transactions, if their long-term strategy is focused on overseas growth, then I think they'll continue to consider that as an option," Bazar said.

The ongoing inversion push — especially considering the blowback against the controversial deals — is a touchstone in a debate raging for years over the proper course for the U.S. tax regime. Inversion advocates have said the quick fixes so far imposed by the government do little to address the broader issue of a too-high tax rate driving companies overseas.

At 35 percent, the U.S. corporate tax rate is substantially higher than many other developed countries, including inversion hot spot Ireland with a rate that hovers around 12.5 percent. A hunger in the U.S. for a streamlined tax load, coupled with robust M&A activity, virtually ensures transformative strategic transactions will remain a gateway to lighter taxes.

"We're having a narrowing window of the ability to do [inversions] but it doesn't mean there won't be a new generation of deals," Kaplan said. "All the pressures are there and there are other ways to achieve an inverted — or at least more ideal — corporate structure."

Inversion proponents theorize that additional limits on tax-motivated M&A would clear the way for overseas outfits to swoop in with acquisition offers for U.S. companies handcuffed in their own cross-border deal-making efforts. Spinoffs and joint ventures could also help U.S. firms skirt around standard inversions to still achieve an inverted structure.

"Stopping inversions won't stop the flow of capital out of the U.S., it will just change the vehicle," Swartz said. "That's the obvious boomerang effect of taking any action possible to stop inversions."

--Editing by Katherine Rautenberg and Kelly Duncan.
