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U.S. anti-inversion regulations badly miss target

According to the simple Civics 101 view of American government, laws are passed by the legislative branch, interpreted by the judicial branch, and enforced by the executive branch. In reality, both the president and his executive agencies exercise broad rule-making authority, either because Congress has delegated it to them or, more commonly, because they grabbed it for themselves. This is particularly true in the area of tax, where unelected bureaucrats create and amend rules at tremendous cost to private firms and the economy. Examples include the so-called debt equity regulations proposed under Section 385 of the U.S. tax code and related anti-inversion rules.

Medtronic joined a parade of prominent U.S. companies that have set up operations overseas to lower their tax bills. Medtronic shifted its official headquarters to Ireland after acquiring Dublin-based rival Covidien for $50 billion in January 2015. - PHOTO: BLOOMBERG

Targeting inversions

The White House and Democrats in Congress have made corporate inversions a political campaign issue. They have demonized companies moving offshore as "unpatriotic" because they refuse to pay their "fair share." Rather than reform the problems with the tax code that are driving companies away – high rates, a world-wide system – they think it's possible to tweak the rules and limit corporate mobility.

Trying to stop companies from moving to jurisdictions with more favorable tax and regulatory systems is a fool's errand, but it is nevertheless what Treasury Department regulators are seeking to do.

In April they proposed sweeping new regulations that had the immediate effect of scuttling a planned merger between Pfizer and Allergen. In order to make inversions less attractive, the rules require that certain kinds of debt common in inverted and other multinational corporations be treated instead as equity, which is taxed at a higher rate. But the rules are so broadly constructed that they will hinder ordinary business and financial transactions not typically associated with inversions or tax avoidance, like shareholder loans, securitization transactions, and cash pooling. And in addition to the debt equity rules are changes to how multistep acquisitions are considered for tax purposes under Section 7874.

Questionable authority and process

Section 385 was established in 1969 as part of the Tax Reform Act of 1969. Seeking to address a growing body of inconsistent case law, Congress gave Treasury authority to establish guidelines and factors to consider for courts distinguishing between debt and equity. Congress intended for regulators to inform the judiciary by clarifying the law, not for them to take on the role of the courts and make those determinations of fact for themselves.

In a prior and equally foolhardy attempt in 2004 to limit reincorporation abroad, Congress enacted Section 7874. It established that a foreign corporation must own over 20 percent of the U.S. corporation in order for the inversion to be valid. The new rules would make it harder to reach that threshold by discounting other acquisitions within the last three years even if they are not directly related. Although Congress set clear guideposts, Treasury is doing everything in its power to undermine or disregard them altogether.

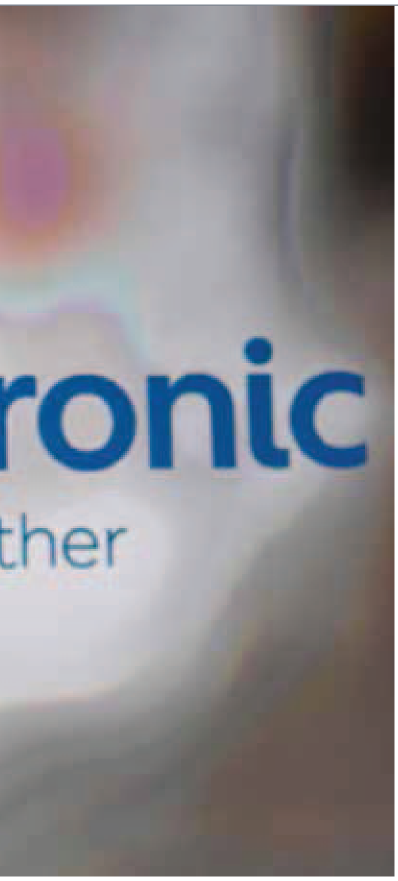
Their procedures are also questionable. In a recent letter, Senate Finance Committee Chairman Orrin Hatch observed, "the Treasury Department is moving at an unprecedented pace and is attempting to regulate a very complex area on a very short timeline." He faulted regulators for providing, "no advanced notice of the proposed regulations … prior to the early April promulgation." Further, "Only the standard 90 days was given for written comments to be submitted – despite their tremendous complexity, and despite numerous calls from the business community and tax-writing members of Congress to extend the comment period."

The U.S. Chamber of Commerce filed a lawsuit in August, arguing that the multiple acquisition rules are not a good faith interpretation of the law and were tailored specifically to impact the Pfizer-Allergen deal. They cite the fact that, once finalized, the rules will be retroactive to the date they were first proposed and thus capable of thwarting current deals despite not going through the full regulatory process. Courts have struck down other overreaching agency interpretations in the past.

Congressional opposition

Distraught businesses have found generally receptive ears in Congress. Republicans on the Senate Finance Committee noted in an Aug. 24 letter to Treasury Secretary Lew noted that they "have repeatedly raised concerns … in regards to the range of negative, unintended consequences of these proposed rules, if finalized without substantial reforms." In his separate letter, Committee Chairman Hatch asked for the rules to be re-proposed in light of the questionable nature of their original introduction and the rushed procedures.

Even Democrats have raised concerns. Although supportive of the rule's intentions, their members on the House Ways and Means Committee noted in their own letter to Treasury that there are "broader concerns related to various internal cash management practices such as cash pooling," and asked for consideration of exceptions or transitional rules. Their Republican colleagues were more direct: "The proposed regulations in present form will have a profound and detrimental impact on business operations nationwide."



Offshore and economic impact

Perversely, the debt equity regulations aimed at preventing inversions will likely lead to more corporations leaving U.S. shores. Only instead of inverting, they will simply be acquired by foreign firms. That's because complexity and costly regulatory burdens put American companies at a global disadvantage. Ernst & Young already estimated a loss of $769 billion to the U.S. over the last decade from such mergers and acquisitions, but that figure would surely increase under the new rules.

Much of the added burden is thanks to the added information reporting required to enforce the regulations. Businesses will have to supply loads of documentation just to make a transaction between two subsidiaries of the same business. The IRS estimates the reporting costs at $15 million annually, though business groups argue they severely underestimate the impact. Business Roundtable suggests the costs of compliance could reach into the millions just for each company.

Ernst & Young's James Tobin rebuts the Treasury claim that the rules address the problem of inconsistent analysis by different courts, arguing, "the Proposed Regulations merely add costs and the administrative burden of threshold documents for all intercompany debts but with no added certainty." And the fact that U.S. companies operating overseas must not only comply with the regulations in the country they are operating in, but also with the new reporting burdens from the debt equity regulations, further adds insult to injury. The rules provide yet another reason for new businesses to choose to headquarter anywhere but the United States.

Compounding the damage to the economy is the fact that the rules are backdated to an effective date of April 4, 2016. So even though the rules may not be finalized until later this year or even next year, they are impacting the behavior of companies right now. Businesses are operating under significant and unnecessary uncertainty as the regulations proceed through the rule-making process, a price which Treasury consciously calculated was worth paying in order to torpedo the Pfizer-Allergen deal for political reasons.

The proposed regulations are having an impact now. They will do even more damage if Treasury follows through on its original intention to rush the regulations out the door before the end of the current administration. Given historical precedent, however, we can expect even more aggressive attempts to follow closely behind, as no amount of bureaucratic rule-making will render the hostile U.S. corporate tax code attractive. Only Congress has that power.

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