JUNE 11, 2015

Feldberg Fellows Lecture - Master in Business Event

Inversions

An “inversion” is a transaction in which a foreign corporation acquires, directly or indirectly, substantially all of the properties of a U.S. corporation, and after the acquisition (i) the former shareholders of the U.S. corporation hold at least 60 percent of the stock of the foreign corporation as a result of holding stock in the U.S. corporation; and (ii) the expanded affiliated group does not have substantial business activities in the foreign country in which, or under the laws of which, the foreign corporation is organized.

Once an inversion takes place, the parties are positioned to reduce the group’s expected effective tax rate through the institution of “income shifting” transactions, transactions which create tax deductions at the U.S. corporation level counterbalanced by income at the level of the foreign corporation. Since tax rates in the U.S. are much higher than in most foreign countries, such income shifting, which “replaces” U.S. taxable income with foreign taxable income, allows the group to reduce its effective tax rate.

The most popular income shifting tactic, known as “earnings stripping,” is implemented through intercompany loans. The U.S. corporation pays tax deductible interest to the foreign corporation with respect to debt that’s created shortly after the inversion is completed. There are limits imposed on the amount of interest on such debt which can be deducted by the U.S. corporation. The interest so paid is deductible only if, and to the extent that, it exceeds the corporation’s “excess interest expense,” the amount by which its net interest expense exceeds 50 percent of its EBITDA.

In the past, an inverted company could engage in “hopscotch lending,” a tactic that enabled the group to gain access to the U.S. company’s undistributed foreign earnings without incurring a U.S. tax cost. The technique involved the U.S. company causing its foreign subsidiaries to lend their unremitted earnings to the foreign acquiring corporation. This was not, due to the nationality of the borrower, an investment in U.S. property on the part of the foreign subsidiaries and, hence, the amount so loaned was not includible in the gross income of the U.S. corporation. Notice 2014-52, issued last September, converts such a loan into an investment in U.S. property and, therefore, the amount so loaned will have to be reported as gross income by the U.S. company, rendering hopscotch loans no longer viable. The inability to engage in hopscotch lending may well have killed off the Shire/AbbVie deal; and it certainly made the Medtronic/Covidien deal more expensive, forcing Medtronic plc to borrow externally to fund the cash portion of the merger consideration.

The Treasury Department did not attack earnings stripping in Notice 2014-52, perhaps because it lacks the “authority” to do so. Recently, it has adopted a different approach to earnings stripping, seeking, through tax treaties the U.S. has entered into with its trading partners, to render earnings stripping unattractive. This would be done by imposing full withholding taxes on interest, royalties, and dividends paid by “expatriated entities,” i.e., a U.S. corporation which has been inverted, to a foreign person. It is unclear whether our treaty partners would go along with such a punitive rule.

Roll-Up

In a roll-up, the corporate sponsor (and general partner) of an MLP acquires the partnership interests owned by the public partners in exchange for stock of the sponsor (in the case of WMB) or a combination of such stock and cash (in the case of KMI). In either case, the stock is taxed to the selling partner, even where the selling partner receives solely stock in exchange for his or her interest in the partnership. The receipt of stock is taxable because the transaction (in which the partnership interests are sold to the sponsor) does not qualify under Sec. 351 of the Code. It does not so qualify, because the transferor partners are not “in control” of the sponsor immediately after the exchange.

Where, as here, one partner purchases all of the interests in the partnership held by the other partners, the transaction is governed by Rev. Rul. 99-6, 1999-1 C.B. 432. The transaction is treated as a sale of partnership interests by the sellers. The gain from a sale of a partnership interest is treated as a capital gain. However, to the extent the partnership is in possession of certain “hot assets,” which all MLPs are, a portion of the gain will be treated as ordinary income and taxed at top marginal rates.

From the buyer’s point of view, the transaction is treated as if the partnership had liquidated and distributed its assets to each of the buying and selling partner(s); and as if the latter had then sold its share of the assets to the purchasing partner. This view of the transaction provides the buyer with a “cost” basis in the assets deemed purchased and that cost basis enables the buyer to enjoy substantial depreciation and amortization deductions for the foreseeable future, which reduces its taxable income and tax liability.

Spin-Offs

The most controversial spin-off we’ve seen in recent years involves Yahoo! Inc.’s attempt to dispose of its highly appreciated stake in BABA on a tax-efficient basis. Yahoo! Is conveying its BABA stock and a small, active trade or business to Spinco and will distribute the stock of Spinco to its shareholders as soon as the “lock up” agreement, between Yahoo! and BABA expires.

For a spin-off to be tax-free, certain requirements, found in Sec. 355 of the Code, including the “active business” requirement, the “device” test, and the “business purpose” requirement, must be satisfied. The active business test is met so long as both the distributing corporation and the controlled corporation (i.e., Spinco) are engaged in the active conduct of a trade or business immediately after the distribution. There has never been a requirement that the active business assets comprise any particular percentage of the total assets of the corporation. There is, in other words, no requirement that any particular percentage of the corporation’s assets be devoted to the active conduct of a trade or business. Here, of course, Spinco’s active business assets will probably represent less than 1 percent of the value of its total assets.

The percentage of assets devoted to the active conduct of a trade or business is a relevant factor in determining whether the transaction was used principally as a device. The greater the percentage of the corporation’s assets which are “inactive,” the greater the likelihood the spin-off will be seen as used as a prohibited device. However, a spin-off which exhibits, as this one does, “device factors,” can avoid classification as a device if it also exhibits countervailing non-device factors. This transaction does so, since it will be carried out for a valid corporate business purpose by a corporation which is widely-held and publicly traded. The business purpose for this spin-off is that it is likely that the stocks of Yahoo! and Spinco, in the aggregate, will trade for a higher price than would the stock of Yahoo! without the spin-off. Counsel for Yahoo! has rendered an opinion that the spin-off will qualify for tax-free treatment.

Two weeks ago, the I.R.S. expressed reservations about spin-offs in which the active business being relied upon represents only a small percentage of the value of the total assets owned by the corporation engaged in the small business. It seems possible, though unlikely in my view, that the I.R.S. will adopt a new interpretation of the active business test to incorporate a “size” requirement. If they do, the Yahoo! spin-off would be threatened. However, it seems unlikely that such a new interpretation would be upheld by the courts since it is not authorized by the statute. As indicated, the statute merely requires that each corporation be engaged in the active conduct of a trade or business and does not impose, or even imply, that such business must be of any particular size. The market, however, is nervous and the stock of Yahoo! seems to be trading at a price that implies that Yahoo! will have to pay tax on the gain inherent in its BABA stake. We do not agree with the market's assessment, however, and feel that Yahoo! is now undervalued to a considerable amount.

This new policy, it should be noted, might also impact "Opco/Propco" spin-offs in which the Propco is a real estate holding company which seeks to elect to become a REIT. Propco's active business assets, inevitably, also represent a very small percentage of its total assets, the vast majority of which consist of passive real estate.

Net Operating Losses (NOLs)

Where a loss corporation (a corporation with NOLs or with net unrealized built-in losses) experiences an "ownership change," certain limitations are placed on the amount of taxable income, for any post-change year, that can be offset by the pre-change losses (or the recognized built-in gains). This limitation is known as the "Sec. 382 limitation" and it's calculated by multiplying the value of the loss corporation immediately before the ownership change by the long-term tax-exempt rate. This limitation can be augmented by "recognized built-in gains." That term generally includes gains from the sale of assets that are realized within the first five years following the ownership change. It also includes the excess of the depreciation and amortization that would have allowable had a Sec. 338 election been made for the loss corporation at the time of the ownership change over the depreciation and amortization actually allowable for such loss corporation. See Notice 2003-65, 2003-2 C.B. 747.

Charter Communications, Inc. has approximately $9.5 billion of NOLs, $5.3 billion of which are "restricted" (they arose before Charter experienced its most recent ownership changes—Charter experienced an ownership change in 2009 upon emergence from bankruptcy and; also experienced a second ownership change in 2014 precipitated by Liberty's acquisition of a substantial amount of Charter's stock.

The merger with Time Warner Cable will give rise to a third ownership change since the Time Warner shareholders will acquire a large stake in the combined company sufficient to create an ownership change with respect to Charter. Thus, the previously unfettered $4.2 billion of Charter's NOLs will become subject to a Sec. 382 limitation. Charter, however, is saying that the merger will, even after taking into the account the fact that all of its NOLs will now be subject to a Sec. 382 limitation, actually accelerate the use of its NOLs. This is so because (i) the Sec. 382 limitation calculated with respect to this third ownership change will be large, and (ii) Charter, once the income produced by the former Time Warner business is accounted for, will have much more income against which the NOL, even after taking into account the Sec. 382 limitation, can be offset.

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