INTERNATIONAL TAX REVIEW

Foreign investors pressure young US businesses into inversions

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The US Tax Cuts & Jobs Act (TCJA) is failing to prevent inversions, with the lure of foreign capital often outweighing the tax challenges for rapidly expanding businesses.

Young businesses on the private market are less likely to be hit hard by protectionist and anti-inversion legislation if they invert while they are still relatively small. Inversions are particularly common in the tech sector, where private equity cash is readily available.

"I can say that I have seen [inversions] more than seven times now in 2018 and early 2019, and I think it may be a trend going forward," said Alexander Lee, a tax partner at Cooley US. "If these businesses need funding then then they are going to get funding any way they can."

Lee explained that Asian investors from China and South Korea that are interested in funding emerging businesses in the technology and biotechnology sectors sometimes make their funding conditional on the business inverting so that it can be listed on a foreign exchange such as Hong Kong's Hang Seng.

Nonetheless, given the provisions within the TCJA which make inversions less attractive tax-wise – such as the low 21% tax rate, global intangible low-taxed income tax (GILTI) provision and base erosion and anti-abuse tax (BEAT) – some professionals find the trend surprising.

"The TCJA has left inversions as a thing in the past and there is not much reason to move forward with them, if you drop the tax rate that low then the incentive to invert just disappears" said a tax director with the Samsung Group.

"It is possible [that] there are more business reasons for inversions to go forward in the private market," they added, on why inversions may still be taking place under TCJA. I can definitely see interest from foreign investors, especially from Asia."

Inversion considerations for businesses

Pre-tax reform rules introduced by the US to limit inversions treated businesses that inverted as US-based and taxed them at the pre-TCJA rate of 35%. Businesses that invert continue to be seen as US-based while those rules still exist, but they are taxed at a 21% rate instead under the TCJA. Thus, the lower post-TCJA rate is an incentive to remain headquartered in the US, but also less of a disincentive to leave.

As such, emerging businesses in the private market are just as happy to agree to foreign investors' demands given the need to continue receiving funding in later financing rounds to stay operational. US advisors suggest venture capital term sheets are not looking as attractive as the foreign capital that Asian investors have to offer.

Another consideration for emerging businesses and their Asian investors is GILTI. "The imposition of GILTI would be of particular concern to a Chinese company holding investment in a US Company," said Anthony Tam, a tax partner at Mazars Hong Kong. "This is quite common."

Size matters

A business's size, location, and operations are key considerations toward whether inverting is a good idea, according to tax directors. These factors mark the differences between why an emerging business may find this option feasible instead of a large multinational.

"BEAT is a big consideration in this kind of planning, and if you are below a certain size then you are outside of it," said a tax director at a US subsidiary of a media conglomerate. Many of the emerging businesses that Lee has seen undergo an inversion have no foreign operations and are valued at around $200 million, a workable combination for inversions under the TCJA.

Large US-based multinational parent companies are going to continue to face significant disadvantages in inverting into a foreign company when pre-TCJA concerns around inversions still exist, including the creation of inter-company debt. "In the past, when businesses inverted, seven out of ten cases created inter-company debt," said a tax director of the media conglomerate.

"Of course, a public company [such as] Disney is not going to invert, there is no foreign investor that is going to write a big enough check in order for them to go ahead and invert," said Lee. "The damage that the company would take to invert would be disastrous. The negative elements of the TCJA that work against inversions would certainly apply in those situations," added Lee.

Modelling is an exercise that can help determine whether a business should undergo an inversion. This is a process that far more businesses, especially MNEs, are adopting to understand the impact of tax reform and to pay a fair portion of tax.

Jan Martin, vice president of tax at Baker Hughes, has hired additional technology specialists in her tax department to model different tax structuring options, including, the option of undergoing an inversion, following the impact of the US tax reform. "We definitely found it to be necessary," she said.

Private market businesses in the technology and biotechnology sectors in the US that need funding in order to continue to stay afloat are the most likely targets to bring back the inversion boom. As long as foreign investors are keen on providing greater financing options to these businesses than US investors then there is a chance that inversions will continue in 2019.

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