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Whopper Reason Shareholders Should Hate Inversions? (Hint, It's Not About Patriotism)

Sure, Burger King is going Canadian, but it's only one of dozens of American companies doing inversions or at least eyeing the border. Inversions are like marrying a foreign spouse that gets you out of paying taxes. They are ideal for a company expanding overseas since they reduce U.S. taxes on foreign income, not on U.S. based income.

Inversions are the hottest trend in years. Still, the deals and those perpetrating them are pariahs carrying negative press and investor relations backlashes. They even carry the possibility of a retroactive legislative fix that may scuttle tax benefits. However attractive they are, that makes them unpredictable.

Inversions commenced in the 1980s, but few were closed even through the 1990s. But by 2004, Congress thought they were out of control so started requiring inversions to have more than 20% foreign ownership. Clearly, 20% foreign isn't enough today. One of several 2014 proposals to stem inversions would increase this 20% rule to 50%.

(AP Photo/Camden Courier-Post, Douglas Bovitt)

But as all the hype continues, what group is often ignored? Shareholders, who can face increased taxes from inversions, not to mention complex reporting. Shareholders are likely to owe capital gains taxes if the deals occur. That is a surprise to many, and can seem unfair.

After all, in most stock deals, there is no tax at the shareholder level. In a taxable merger, there is almost always cash to pay the tax. Here, the shareholder is taxed, but unlike with other taxable mergers, they won't receive cash to pay their tax.

This is a taxable swap to the IRS. And tax bills when you don't receive cash are especially painful. The duration of the shareholder's holding period and the amount of the gain are big variables. But the bigger the gain, the bigger the tax problem to the shareholder. It's hardly an academic point.

In addition to Burger King, there's Medtronic, Abb-Vie, Mylan Laboratories, and many others. But as market reaction seems positive, who is being left out? Shareholders, of course. For while their overall share price may go up, so do their taxes and in ways that can be devastating.

Shareholders often owe capital gains tax. However, unlike in many mergers where there's a swap of old shares for new on a non-taxable basis, shareholders pay tax. And unlike many taxable stock swap deal, inversions usually don't hand out cash.

So shareholders can get a tax bill but no tax with which to pay it. Ouch. They will owe tax even if they don't sell their shares. Even the computations can be tough, since some shareholders get part dividend treatment.

Can taxes hurt? They sure can. To take an overly simply example, say you bought stock for $10 that is now worth $110. Suppose the inversion means you swap your old shares for shares in a new reformed company worth $110. Sounds OK, but suppose you don't get any cash and you receive a tax bill from the IRS on $100 of gain! With a 20% capital gain tax and a 3.8% Obamacare tax, that's 23.8%.

A $23.80 tax bill on a purely paper transaction can be smart. But at least this kind of unhappy tax treatment shareholders receive in inversions can encourage planning. For example, some shareholders consider it an ideal time to make gifts to children.

You can give up to $14,000 of stock to any person without gift tax, including those in lower tax brackets. And there is no limit on how many $14,000 gifts you can make. Of course, regulatory uncertainty can impact timing. Some shareholders don't want to make a gift of shares until the deal is certain, and that can present a timing dilemma.

Do all U.S. shareholders get a lousy tax deal on inversions? Not always. One favored category tends to be directors, officers and other executives. They may get a better deal, including having the company pick up their tax liabilities. Gee, do you think that makes them like the inversion deal more?

Contact me at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.

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