An 'Inversion' Deal Could Raise Your Taxes

Shareholders Are Likely to Owe Capital-Gains Tax

By
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Aug. 1, 2014 12:34 p.m. ET

U.S. companies are busy buying overseas firms in deals that reduce their tax payments. Ironically, though, these mergers could saddle shareholders with higher tax bills.

In an "inversion," a U.S. firm merges with a foreign one, and shifts much of its income abroad.

For corporations, the goal is simple: to exchange the U.S.'s steep corporate tax rate, which runs as high as 35%, for a much lower one elsewhere. Take AbbVie, a U.S. pharmaceutical firm that plans to merge with Irish drug firm Shire this year. Once the deal is consummated, the combined company will be taxed as a U.K. corporation with an estimated rate of about 13% by 2016.
Other U.S. companies that have considered or are pursuing inversions are Pfizer, Medtronic, Walgreen, Chiquita Brands International, Applied Materials, Salix Pharmaceuticals, Mylan andAuxilium Pharmaceuticals.
Shareholders in companies pursuing inversions are likely to owe capital-gains tax if the deals occur, but, unlike with other taxable mergers, they won't receive any cash payment to help cover it.

The deals are taxable because the U.S. company, although it will ultimately control the foreign firm, is technically the one that's being acquired, says Robert Willens, an independent tax adviser in New York. The U.S. firm's shareholders will receive new shares to replace their old ones. That exchange is considered taxable by the Internal Revenue Service.

Shareholders of the U.S. firm usually don't receive cash in a merger of this kind, Mr. Willens adds.

As a result, if an investor bought shares in a firm at $10 apiece, and the firm "sells" itself in an inversion merger at $40 a share, the investor will typically receive shares in the new firm and owe tax on the $30 per-share difference between the original cost and the price at the time of the merger.

The new shares' cost is $40 each for future tax purposes, but the tax on the $30 must be paid using other funds, says Mr. Willens.

Currently, the rate on long-term capital gains ranges from zero to nearly 24%, depending on an individual's taxable income.

Pains on Gains

Shareholders in companies undergoing inversions often owe capital-gains tax and an additional levy. Here are the current rates and thresholds.

Tax on Long-Term Capital Gains		Taxable Income
0%	Single filer	$36,900 and under
	Joint filers	$73,800 and under
15%	Single	$36,901 – $406,750
	Joint	$73,801 – $457,600
20%	Single	$406,751 and above
	Joint	$457,601 and above
Net Investment Income Tax		**Adjusted Gross Income***
	Single	Above $200,000
3.8%	Joint	Above $250,000

Note: These rates apply to sales of securities held longer than a year. Short-term capital gains are typically taxed at ordinary income rates.

*Modifications apply for some taxpayers

Source: Internal Revenue Service

The Wall Street Journal

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Inversions will be especially unwelcome for long-term investors who were planning to hold their shares until death for estate-planning purposes. At that point, there is no capital-gains bill, so some shareholders in firms doing inversions will owe taxes they would never have had to pay. Brian Shields, who has a large holding of AbbVie shares with capital gains of as much as $45 a share, is one of these investors.

"This deal's structure unfairly burdens long-term shareholders," says Mr. Shields, who works at a nonprofit group in Chicago. Many will likely need to sell shares to pay the tax, he adds.

Suzanne Shier, chief tax strategist at Northern Trust in Chicago, says the firm has received many inquiries from surprised investors about the effect of inversions. She is reminding people that they won't have a tax bill if they hold stocks in individual retirement accounts, Roth IRAs, 401(k)s and other tax-deferred retirement vehicles.
If stock is in a taxable account, however, she urges investors "to think about options now, because time is of the essence." Once an inversion is complete, it may be too late to make useful moves.

Careful planning is especially important if the gain from an inversion would bump the investor into owing a higher capital-gains rate or the new 3.8% tax on net investment income, says Ms. Shier.

That tax, which applies to income such as capital gains and dividends, kicks in at $250,000 of adjusted gross income, the number at the bottom of the front page of Form 1040, for most married couples and $200,000 for most singles.

Here are three tax-minimizing strategies for investors coping with inversions.

Offset gains with losses. The simplest way to reduce an inversion tax hit is to offset any capital gains with capital losses from the sales of other assets, such as stock or investment real estate. Because unused losses carry forward indefinitely, some investors may still have them from prior years.
Investors can also sell other underwater assets to realize losses that will offset gains. But don't reacquire securities for at least 30 days, or use of the loss will be suspended.

Give the stock to someone in a lower tax bracket. For people who plan to help a relative or friend in a lower capital-gains bracket, giving inversion stock could be a smart way to do it. Typically, the recipient will owe tax when the deal is done, but at a lower rate than the giver, and recipients with a zero capital-gains rate will owe nothing.
A taxpayer can give recipients up to $14,000 each a year with no gift-tax consequences, and one member of a married couple can give up to $28,000 if the other doesn't use this break.

There are caveats. One is that the gift must be made before the inversion deal is complete. Robert Gordon, a tax strategist who heads Twenty-First Securities, a brokerage firm in New York, recommends giving the shares away while certain hurdles still need to be cleared, such as government approval or a shareholder vote.

Yet people who give stock away early risk donor's remorse if the inversion doesn't actually happen.

Critics of inversions are urging Congress to act quickly to restrict these deals, and some want limits to be retroactive to May, when legislation was first introduced.

There is precedent for such retroactive tax changes, but Congress won't act until the fall, if it acts at all, making it even harder for shareholders to know what to do.

Another caveat involves the "kiddie tax." Nearly all children under 18 and many under 24 owe tax on investment income above $2,000 at their parents' rate, so take this into account when making gifts.

Donate the stock. Charitably-inclined people should consider donating stock in a company that is doing an inversion, say experts.
One of the tax code's notable breaks allows donors a deduction for the full market value of appreciated stock that is publicly traded, up to 30% of adjusted gross income. Leftover amounts can be carried forward and used for up to five years.

Thus, if a donor bought a stock at $20 a share and the company does an inversion at $45, the donor owes no capital-gains tax and can deduct $45 a share.

Many tax-exempt charities now accept gifts of securities. If the donation is large or a donor wants to postpone picking recipients, a "donor-advised fund" could be useful.

People who donate to these funds get a current tax deduction, but they can delay recommending recipients until later, at which point there's no deduction.

Fidelity Investments, Charles Schwab and Vanguard Group all sponsor separate donor-advised funds, as do many other firms.
As with gifts to individuals, the caveat on timing applies to donations. Says Mr. Gordon, "Don't wait until the deal is complete to make the gift."

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