

## Richard Fox: Charitable Gifts of Stock to Avoid Forced Gain Recognition When Shares Are Exchanged in Corporate Inversions

Date: 19-Aug-14

*“Although corporate inversions have come under fire of late, including President Obama calling them unpatriotic and urging Congress to stop them, many U.S.-based multinational companies have announced inversion plans in recent months, whereby the U.S. corporation changes its tax residence by acquiring a foreign corporation in a lower-taxed country. Post-inversion, the original U.S. corporation becomes a subsidiary of a foreign parent corporation.*

*Although the inversion transaction is structured to qualify as a tax-free reorganization (so that no tax is imposed on the U.S. corporation), the shareholders in the U.S. corporation are forced to recognize a taxable gain upon their required surrender of shares of the U.S. corporation in return for shares of the foreign corporation. This can result in the imposition of significant federal and state income taxes to long-term shareholders having significant inherent gain in their stock who never intended to sell their shares.*

*As an alternative to forced taxable gain recognition upon an exchange of shares in a corporate inversion, philanthropically inclined shareholders can donate their shares of the U.S. corporation to charity or, where they desire a stream of payments, to a charitable remainder trust (CRT), where the stock can be sold on a tax-free basis. In addition to avoiding gain recognition, a charitable income tax deduction is available based on the full fair market value of the contributed shares. It is imperative, however, that at the time of the contribution, the inversion transaction isn't at the point where the charity receiving the stock is under a legal obligation to surrender the stock. Otherwise, the anticipatory assignment of income doctrine will be applied, so that the donor will be taxed on the transaction, despite donating the shares to charity. To avoid this result, it is best to make the donation of stock before shareholder approval of the inversion occurs.”*

In his commentary, Richard L. Fox discusses how philanthropically inclined shareholders who are otherwise forced to face taxable gain recognition in an inversion transaction may avoid tax by contributing the shares to a charity or a charitable remainder trust. As Richard points out, however, it is imperative to properly time the contribution, as contributing the stock when the inversion transaction is too far along will trigger the anticipatory assignment of income rule, thereby resulting in the shareholder being subject to the very tax that he or she is attempting to avoid by contributing the shares to charity.

Richard L. Fox (rfox@dlworthlaw.com) is an attorney and partner in the Philadelphia office of the law firm of Dilworth Paxson LLP (www.dilworthlaw.com), where he heads the Philanthropic and Nonprofit practice. Mr. Fox is the author of the treatise, *Charitable Giving: Taxation, Planning and Strategies*, a Thomson Reuters/Warren, Gorham and Lamont publication, writes a national bulletin on charitable giving, and writes and speaks frequently on issues pertaining to nonprofit organizations, estate planning and philanthropy. He recently spoke on “The Top Ten Ways Private and Family Foundations Get into Trouble” at a Philadelphia Foundation Private and Family Foundation seminar. He has spoken at the Heckerling Institute on Estate Planning, where he delivered a presentation entitled “What Every Estate Planner Needs to Know about Tax-Exempt Organizations and Charitable Gift Planning.” On March 4, 2014, he spoke on “Charitable Planning for 2014” at the Second Annual Professional Advisors Seminar for the Community Foundation of South Jersey and spoke on May 1, 2014 on “Gifts of Property – Do You Know What You Don’t Know?” at the Univest Foundation Annual Planning Giving and Development Seminar at the PineCrest Country Club in Landsdale, PA.

Here is his commentary:

#### **EXECUTIVE SUMMARY:**

Although corporate inversions have come under fire of late, including President Obama calling them unpatriotic and urging Congress to stop them, many U.S.-based multinational companies have announced inversion plans in recent months, whereby the U.S. corporation changes its tax residence by acquiring a foreign corporation in a lower-taxed country. Post-inversion, the original U.S. corporation becomes a subsidiary of a foreign parent corporation. Although the inversion transaction is structured to qualify as a tax-free reorganization (so that no tax is imposed on the U.S. corporation), the shareholders in the U.S. corporation are forced to recognize a taxable gain upon their required surrender of shares of the U.S. corporation in return for shares of the foreign corporation.

This can result in the imposition of significant federal and state income taxes to long-term shareholders having significant inherent gain in their stock who never intended to sell their shares. As an alternative to forced taxable gain recognition upon an exchange of shares in a corporate inversion, philanthropically inclined shareholders can donate their shares of the U.S.

corporation to charity or, where they desire a stream of payments, to a charitable remainder trust (CRT), where the stock can be sold on a tax-free basis.

In addition to avoiding gain recognition, a charitable income tax deduction is available based on the full fair market value of the contributed shares. It is imperative, however, that at the time of the contribution, the inversion transaction is not at the point where the charity receiving the stock is under a legal obligation to surrender the stock. Otherwise, the anticipatory assignment of income doctrine will be applied, so that the donor will be taxed on the transaction, despite donating the shares to charity. To avoid this result, it is best to make the donation of stock before shareholder approval of the inversion occurs.

FACTS:

### **Background on Corporate Inversions**

Perhaps no greater attention has been focused on a tax issue of late than the phenomenon known as a “corporation inversion,” a process by which an existing U.S. corporation changes its tax residence by acquiring a foreign corporation in a lower-taxed country. Post-inversion, the original U.S. corporation becomes a subsidiary of a foreign parent corporation, and the typical result is that the new foreign parent company faces a lower home-country tax rate and no U.S. tax on the company’s income that is earned outside of the U.S.[i] Inversion transactions can shave hundreds of millions of dollars from corporate tax bills by shielding income earned in other countries from the U.S. Treasury’s reach, and effective tax rates for many companies can drop to percentages to the teens, or lower. The top corporate income rate in the U.S. is 35%, although many companies have a lower effective tax rate.

There has been a significant increase in the number of U.S.-based multinational companies “renouncing their U.S. citizenship” by moving their addresses overseas to avoid paying U.S. taxes. Since January 2013, 19 companies have announced plans to reincorporate via an inversion transaction – 14 of them having done so this year alone, according to the Wall Street Journal.[ii] Overall, 76 companies have inverted since 1983, according to the Congressional Research Service.

Although corporate inversions have come under fire of late, including President Obama calling them unpatriotic and urging Congress to stop them,[iii] U.S.-based multinational companies such as Medtronic, AbbVie and Mylan, have announced inversion plans in recent months.[iv]

So, too, has Chiquita Brands International Inc., the U.S. banana company, that is seeking to merge with Ireland's Fyffes PLC. In March, Chiquita and Fyffes announced that the combined company would relocate to Dublin in a deal structured as an inversion transaction.[v] Earlier in the year, Pfizer sought to acquire AstraZeneca and merge the two companies into a UK holding company with a UK tax domicile, while maintaining its operational headquarters in New York. It would likely have been the largest inversion deal ever done, but after the board of AstraZeneca rejected the proposal, Pfizer abandoned its attempt to acquire the British drugmaker for a reported \$118 billion.

### **Tax Consequences to Shareholders of U.S. Corporation Engaging in Inversion Transaction: Recognition of Taxable Gain**

In an inversion transaction, the shareholders of the U.S. corporation are required to exchange their shares of the U.S. corporation in return for shares of the foreign parent corporation. Although the inversion transaction is structured to qualify as a tax-free reorganization (so that no tax is imposed on the U.S. corporation), this exchange of shares is a taxable event. This is the case because Section 367, added to the Internal Revenue Code in 1998, requires gain recognition by U.S. transferors of stock or securities to a foreign corporation.[vi]

The taxable gain is equal to the excess of the fair market value of the shares of the foreign parent received over the income tax basis of the shares of the U.S. corporation surrendered. For long-term shareholders holding significant stock positions in a U.S. corporation engaging in an inversion transaction, the tax on the gain may be significant, as the gain may be subject to a 20% capital gain tax, a 3.8% net investment income tax, and state income taxes as well. Depending upon the state in which the shareholder is subject to tax, the total of the federal and state tax imposed on the gain may exceed 30%, a potentially huge loss of value to the shareholder.

The imposition of the tax on the exchange of shares in a corporate inversion may be upsetting to shareholders, particularly those who have held the stock in the U.S. corporation for years, have significant inherent gains in the stock, and never anticipated selling their shares, but intended for the shares to obtain a stepped-up income tax basis upon death and sold at little tax cost by their beneficiaries. In an inversion transaction involving an exchange of shares, however, shareholders have no choice: they must give up their shares in the U.S. corporation for shares in the foreign parent. In effect, a gain is forced upon them.

Many shareholders of U.S. corporations engaging in inversion transactions are not concerned about the tax ramifications and have no inclination, therefore, to vote “no” on a shareholder approval of the inversion. This is the case for institutions that don’t pay taxes, such as pension plans, endowment funds, and mutual funds (although for mutual funds, the taxes are passed on their shareholders), who typically hold the large majority of the shares of these corporations. For that reason, corporate inversion transactions are typically approved by shareholders.

### **A Solution for Philanthropically Inclined Shareholders: Donate the Stock to Charity or a Charitable Remainder Trust**

As an alternative to forced taxable gain recognition upon an exchange of shares in a corporate inversion, philanthropically inclined shareholders can donate their shares of the U.S. corporation to charity or, where they desire a stream of payments, to a charitable remainder trust (CRT). Where shares of appreciated shares of long-term capital gain stock are donated to charity or a CRT, a charitable income tax deduction is available based on the full fair market value of the shares. This is generally the case for donations to private foundations as well, as long as the stock contributed constitutes “qualified appreciated stock” under Section 170(e)(5).

Moreover, when the charitable donee engages in the exchange transaction, i.e., giving up the shares of the U.S. corporation in exchange for shares of the foreign corporation, no tax will be imposed because the donee charity is exempt from tax under Section 501(a) and, in the case of a CRT, exempt from tax under Section 664(c). Accordingly, rather than the imposition of a tax on the realized gain on the stock of the U.S. corporation exchanged in the inversion, perhaps at a rate in excess of 30%, no tax is imposed and the shareholder obtains a charitable income tax deduction based on fair market value (which is deducted against the highest-taxed income first).

**CAUTION:** As discussed below, it is imperative that the shares of stock subject to a corporate inversion are donated to charity prior to the time the inversion has been effectively completed. Otherwise, the anticipatory assignment of income doctrine will be applied, so that the donor will be taxed on the transaction, despite donating the shares to charity.

## **Consideration of When to Donate Shares of Stock Subject to Corporate Inversion in Order to Avoid Anticipatory Assignment of Income Doctrine**

The IRS and the courts have often considered whether the gain on stock donated to charity shortly before a merger, liquidation, or redemption transaction is taxable to the donor, notwithstanding that the stock in the transaction is actually disposed of by the charity. When the gain has been determined to be taxable to the donor, the decision has generally rested on an anticipatory assignment of income theory. That is, the right to the proceeds from the disposition of the shares was found to be so firmly fixed prior to the gift that the donor was, in effect, transferring the sale proceeds, not the stock. Whether the right to the proceeds from the disposition has become so firmly fixed is a question of fact. Generally, the realities and substance of the events, rather than technical details, determine whether an anticipatory assignment has occurred.

If the transaction has progressed to the point where the transaction has effectively been completed, there will be an anticipatory assignment of income. In the case of a pending merger, including one involving a corporate inversion, donors must be careful not to wait too long before donating their stock. If they do, they will be taxed on the gain, which is exactly what they are trying to avoid by making a charitable gift.[vii] Thus, if the anticipatory assignment of income doctrine applies in the context of a corporate inversion, the transaction will be recast as follows:

- (1) The exchange of the stock contributed to charity will be treated as a taxable exchange by the donor, notwithstanding that the charity is actually the party to the exchange transaction, and
- (2) The shares of stock in the foreign parent received by the charity will be treated as if they were received by the donor and then contributed to the charity, thereby resulting in an income tax deduction to the donor in an amount equal to the value of such stock.

One of the leading cases in the anticipatory assignment of income area in the context of gift of stock is *Palmer v. Com'r.*[viii] In that case, the donor, who was the controlling shareholder, transferred shares of stock of the corporation to a private foundation, which the donor also controlled. Subsequent to the transfer and pursuant to a prearranged plan, the shareholder caused the corporation to redeem the transferred shares from the foundation the very next day.

The Tax Court respected the form of the transaction and did not recharacterize the transaction as a redemption of the stock by the donor shareholder followed by a gift of the redemption proceeds to the private foundation. This conclusion was based on a finding that the gift of stock had in fact been made to the foundation and the foundation was not legally obligated to redeem the stock at the time it received title to the shares. In reaching its decision, the Tax Court noted:

[T]here were two paths which the [donor shareholder] could have taken – he could have had the stock redeemed and then made a contribution of the [proceeds], or he could have contributed the stock and let the donee arrange for the redemption. The tax consequences to the donor turn on which path he chooses, and so long as there is substance to what he does, there is no requirement that he choose the more expensive way.

Subsequent to the Palmer case, the IRS concluded in Rev. Rul. 78-197[ix] that it will treat the proceeds of a redemption of stock under facts similar to Palmer as income to the donor only if the donee is legally bound or can be compelled by the corporation to surrender the shares for redemption. In Gerald A. Rauenhurst,[x] the Tax Court characterized the “legally bound” standard in Rev. Rul. 78-197 as the “bright line” test for determining if a contribution of stock to a charity should be respected in form or recharacterized as a redemption of the stock from the donor followed by a contribution of the proceeds by the donor to the charity.

Based upon the foregoing, the donation of stock should occur at a time when the corporate inversion isn’t that far along so that upon the contribution of stock to charity, the charity isn’t, in effect, already under a legal obligation to surrender the stock pursuant to the inversion transaction. If it is, the transaction will be taxed to the donor under the anticipatory assignment of income doctrine. The best case scenario in an inversion transaction is for donors to transfer the stock before the shareholders of the U.S. corporation have approved the inversion, so that the donee charity holds the stock before such a vote has taken place.

The facts that the board of the U.S. corporation has already approved the inversion transaction, has announced to the public its intention to engage in the inversion transaction, or even if there is an inversion transaction agreement in place, subject to shareholder (and other) approvals, should not trigger the anticipatory assignment of income doctrine. This is the case because absent shareholder approval, the charity receiving the shares of stock is not under a legal compulsion to surrender the stock at the time of the contribution.

Even if there is already shareholder approval, there may be a position, depending upon the facts and circumstances of the particular transaction, that the shareholder can still donate the stock (without the assignment of income doctrine applying) if there are regulatory or other approvals required at the time of the contribution that have not yet been obtained and are not just ministerial in nature, so that at the time of the contribution, the charity would still not be considered to be under a legal obligation to surrender the stock.

Where, however, the inversion agreement has been approved by shareholders and other required approvals have been obtained so that all that is left is for the transaction to close, with only ministerial acts to be completed, the donation of shares of stock after that point will trigger the anticipatory assignment of income doctrine, notwithstanding that the charity itself is the party the exchange of stock of the U.S. corporation in return for stock of the foreign parent corporation.

**COMMENT:**

Philanthropically inclined shareholders who are otherwise forced to recognize taxable gain and pay substantial taxes in an inversion transaction can avoid this result by contributing the stock to charity or a charitable remainder trust. It is imperative, however, that at the time of the contribution, the inversion transaction isn't at the point where the charity receiving the stock is under a legal obligation to surrender the stock. To avoid this result, it is best to make the donation of stock before shareholder approval of the inversion occurs.

HOPE THIS HELPS YOU HELP OTHERS MAKE A POSITIVE DIFFERENCE!

Richard Fox

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IRC Section 367; Rev. Rul. 78-197, 1978-1 CB 83; Gerald A. Rauenhorst, 119 TC 157 (2002) ; See Michael Ferguson, 108 TC 244 (1997); Palmer v. Com'r, 62 TC 684 (1974) , aff'd on other grounds, 523 F2d 1308, 36 AFTR2d 75-5942 (8th Cir. 1975) , acq. 1978-1 CB 2.

CITATIONS:

[i] The United States uses a system that taxes both the worldwide income of U.S. corporations and the income of foreign firms earned within U.S. borders. All income earned within U.S. borders is taxed the same—in the year earned and at statutory tax rates up to 35%. U.S. corporate income earned outside the United States is also subject to U.S. taxation, though not necessarily in the year earned. This occurs because U.S. corporations can defer U.S. tax on active income earned abroad in foreign subsidiaries until it is paid, or repatriated, to the U.S. parent company as a dividend.

ii] “Race to Cut Taxes Fuels Urge to Merge,” July 14, 2014.

[iii] The Treasury Department is also reviewing a broad range of authorities for possible administrative actions that could limit the ability of companies to engage in inversions, as well as approaches that could meaningfully reduce the tax benefits after inversions take place.

[iv] Walgreens recently was poised to relocate to the lower-taxed jurisdiction of Switzerland in a corporate inversion involving a takeover of Alliance Boots, but in the face of wide-spread denunciation of corporate inversions, amended the takeover deal to keep the combined company in the U.S.

[v] A recent Wall Street Journal article discussing this deal, “Bid Seeks to Upend Chiquita Merger” (August 12, 2014), states that “in recent weeks, the structure has come under fire in Washington” and the “Obama administration has suggested it could act without Congress to limit the model’s advantages.”

[vi] This provision was added to the Internal Revenue Code as an "exit toll," with the intention of making inversions less palatable to U.S. corporations, which apparently had little success in deterring corporate inversions.

[vii] See Michael Ferguson, 108 TC 244 (1997), for an example of donors waiting too long prior to a merger before donating their stock.

[viii] Palmer v. Com'r, 62 TC 684 (1974) , aff'd on other grounds, 523 F2d 1308, 36 AFTR2d 75-5942 (8th Cir. 1975) , acq. 1978-1 CB 2.

[ix] Rev. Rul. 78-197, 1978-1 CB 83.

[x] Gerald A. Rauenhorst, 119 TC 157 (2002) .