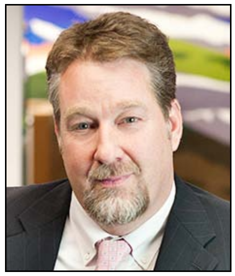
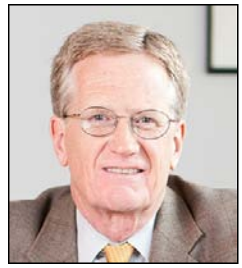
RESEARCH NOTES

July 30, 2014

The Portfolio Implications of Tax Inversions





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Tax inversion mergers have been prominent in the financial headlines this year. A tax inversion occurs when a U.S. company uses a cross border merger to re-incorporate in a more tax-friendly country. These mergers create unique tax consequences in portfolios, most notably; shareholders of *both* the target company and the acquiring company will potentially realize capital gains. In this note, we explain the benefits of these mergers, why these mergers create taxable events, and discuss how charitable giving may reduce or eliminate negative tax consequences for the taxable investor.

While there may be several incentives for U.S. companies to initiate tax inversions, the primary motivator tends to be a reduction in a company's tax bill. The United States has one of the highest stated corporate tax rates in the world. By re-incorporating in a country with a lower tax rate, companies create shareholder value through increased net income and cash flows. This is in addition to the increased earnings and cash generated from possible synergies and cost-cutting.

Also, many large domestic companies have billions of dollars in cash (profits) held outside the United States because repatriating this cash triggers a U.S. tax to the company. Reorganizing in a more tax-friendly country allows the U.S. company to repatriate foreign profits without paying the top 35% corporate tax rate. The company can then use the cash to reduce debt, pay dividends, and/or reinvest the capital.

In most of the tax inversion deals recently announced, the share price has risen for both the target company and the acquiring company. Unless Congress changes corporate tax law, more U.S. companies will likely consider a tax inversion strategy as a means to boost share price, reduce long term tax obligations and repatriate foreign profits.

There are offsets to the benefits of this type of merger. For example, taxable investors may have to pay a capital gain upon the completion of the transaction of the tax inversion. In a typical domestic merger, target company owners exchange their shares for shares of the acquiring company. There is no realized capital gain for the shareholders of the acquired company and shareholders' cost bases simply carry forward to shares of the acquiring entity. Further, shareholders of the acquiring company do not realize a capital gain under the "typical" merger scenario. In a tax inversion, however, U.S. tax authorities treat the merger as the formation of a new entity. Shareholders on *both* sides of the merger exchange shares for a new entity, thereby creating a taxable event. Under these circumstances, taxable *investors may realize a capital gain even though there is no sale of shares.*

Investors have limited opportunities to avoid capital gain consequences once a tax inversion deal is set into motion. For charitably minded shareholders there is an opportunity to gift appreciated shares to avoid capital gains. When donating shares to a qualified charity, taxable investors transfer the gain to an entity that does not have to pay a tax. This scenario may create a "win-win" for both the donor and the charity. If the investor decides to donate the shares, he/she must also take care to make the gift before both the shareholder approval vote and certain regulatory consents are obtained by the company in order to avoid realizing any capital gain.

Since January, 2012, at least 20 U.S. headquartered companies have announced or attempted acquisitions designed to change their country of domicile. The list includes several companies held in H.M. Payson client portfolios; shares in Medtronic (MDT), Abbvie (ABBV), Covidien (COV) and Pfizer (PFE), to name a few. Congress has taken notice and the Obama Administration has proposed changes in the law that would make it very difficult for U.S. based companies to purchase smaller non-U.S. entities; the chief purpose of which is changing the larger company's domicile in order to reduce or eliminate its U.S. tax liabilities. Political rhetoric aside, current law, provided certain conditions are met, allows mergers principally driven by tax inversion considerations. However, the situation is obviously fluid and dynamic and we will continue to monitor developments and the potential impact it represents to our clients' portfolios.

Market Log- July 29, 2014

S&P 500: 1,969.95
10 year T-Note: 2.46%
Crude Oil: $100.93
Gold: $1,319.40