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Table of contents

Johnson Controls-Tyco Deal Adds to U.S. Tax Exodus; Many offshoots of Tyco's empire have become targets of American firms seeking inversion partners

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Full text: Johnson Controls Inc. is set to become the latest American company to move abroad in search of tax savings--and to do so on the coattails of the dismantled Tyco empire.

Johnson Controls, an industrial-systems and battery maker whose Milwaukee roots stretch back to 1885, said Monday it will merge with Tyco International PLC and take on Tyco's Irish tax address. The deal, valued at roughly $14.4 billion, is a so-called inversion that should allow Johnson Controls to lower its tax rate over time.

The merger--the first fresh megadeal of 2016--highlights the self-perpetuating nature of inversions , as American companies that move their legal homes abroad create opportunities for others to follow. Those deals, in turn, further challenge U.S. regulators trying to stanch the exodus of tax dollars overseas.

Tyco was an early expat, decamping first to Bermuda in 1997 and finally settling in Ireland. Over the years, it spawned a crop of spinoffs and subsidiaries that inherited one of Tyco's most valuable assets: its foreign tax address. When M&A activity rebounded after the financial crisis, those new firms became major players in a wave of cross-border, tax-lowering deals, enabling American companies with about $70 billion in annual revenue to slip out of the U.S. tax net.

Tyco paid 12% of its profit in taxes over the past three years, versus an average 29% by Johnson Controls, according to S&P Capital IQ. Johnson Controls said its effective tax rate before certain items was around 19% over the past two years ended Sept. 30.

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In some ways, Monday's deal has its roots in the accounting scandal that rocked Tyco more than a decade ago. After CEO Dennis Kozlowski's conviction, breakup artist Edward Breen took over with a mandate to pare Tyco's sprawling empire, which at the time included companies making products from pharmaceuticals to burglar alarms. Many of the resulting offshoots have become targets for U.S. companies seeking inversion partners, while others have used their lower tax rates to become consolidators, buying U.S. assets--which on average pay higher rates--and squeezing tax savings that way. In 2012, Tyco sold its pump-and-filter business to Pentair PLC, an inversion that moved the U.S.-based company abroad. Last summer, Pentair bought U.S.-based Erico Global for $1.8 billion.

Tyco's health-care business was eventually hived off into two new companies, both of which have enabled tax-lowering combinations. A more than $40 billion takeover of Covidien PLC , which housed Tyco's medical-device business, allowed U.S.-based Medtronic Inc. to invert last year.

Meanwhile, Mallinckrodt PLC, Tyco's legacy pharmaceuticals arm, has used its lower tax rate to advantage as an acquirer. In its 2½ years as a stand-alone company, Mallinckrodt has spent nearly $11 billion on takeovers of higher-taxed U.S. drug assets.

Monday's deal also underscores the snowball effect of inversions. As such deals pile up in a particular industry, they enable more--and--bigger companies to follow suit. That is because U.S. rules require foreign targets to be of a certain size relative to their buyers.

Witness what happened in the pharmaceutical industry. In 2013, a New-Jersey based drug company called

Watson Pharmaceuticals inverted by buying a small Irish rival. After a series of deals, the resulting company--Allergan PLC, with a $117 billion market value--is big enough to serve as the inversion partner for Pfizer Inc. , in what would be the largest corporate expatriation ever. The deal is pending.
And if a combined Pfizer-Allergan spins off its generics business, as is widely expected, it would create a potential inversion partner for a host of big U.S. drugmakers.
The Johnson Controls-Tyco deal is at least the 12th inversion pursued by American companies since the U.S. Department of the Treasury moved in September 2014 to curb these deals , according to a Wall Street Journal review. That is roughly the same number in the 16 months before the move.
"This is yet another example of why we need tax reform to keep our employers and jobs in America, rather than encouraging them to move overseas," said House Speaker Paul Ryan (R., Wis.), who has pushed for a tax overhaul that would, among other changes, lower the rates U.S. companies pay. Johnson Controls is the largest public company based in Mr. Ryan's home state of Wisconsin. The company was founded 131 years ago by a Milwaukee professor who had received a patent for the first electric thermostat.
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The deal is likely to reignite a campaign-trail debate. Sen. Bernie Sanders, a Democratic presidential candidate said the deal would be "a disaster for American taxpayers" and denounced "corporate deserters."
Johnson Controls and Tyco structured their deal to reap maximum tax benefits. By giving Johnson Controls investors less than 60% ownership of the combined company, they sidestep regulations aimed at more-lopsided combinations that might have made the deal less attractive.
"Below 60 [%] is the Holy Grail of inversion planning," said Omri Marian, a tax law professor at the University of California, Irvine.
Inversions let U.S. companies lower their tax rates over time by giving them ways to shift profit out of the U.S. and move cash easily from low-tax jurisdictions back to shareholders.
Johnson Controls Chief Executive Alex Molinarolisaid the merger wasn't tax-driven and pointed to the roughly $500 million in annual savings expected to be wrung from combining the businesses. But, he said in an interview Monday, "we definitely get some benefits, so we'll take those benefits."
Back to 1997, when Tyco moved to Bermuda by acquiring home-security firm ADT, it was one of the earliest inversions. After Bermuda came under fire as a tax haven, the company moved in 2008 to Switzerland, and to Ireland in 2014, after Switzerland enacted tougher rules around CEO pay and corporate governance.
Just last week, Tyco settled a long-running dispute with the Internal Revenue Service for up to $525 million, far less than the government had sought. That controversy stemmed from what's known as earnings stripping, the practice of using internal company transactions to concentrate tax deductions in the U.S. and profit in low-tax countries.
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