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Tax Maneuver Criticized by Obama Helped U.S. Craft Delphi Rescue

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Delphi's world headquarters in Troy, Michigan, in this 2007 file photo, before the company changed its legal address to England.
Photographer: Jeff Kowalsky/Bloomberg

August 6, 2014 – President Barack Obama says U.S. corporations that adopt foreign addresses to avoid taxes are unpatriotic. His own administration helped one $20 billion American company do just that.

As part of the bailout of the auto industry in 2009, Obama's Treasury Department authorized spending $1.7 billion of government funds to get a bankrupt Michigan parts-maker back on its feet – as a British company. While executives continue to run Delphi Automotive Plc from a Detroit suburb, the paper headquarters in England potentially reduces the company's U.S. tax bill by as much as $110 million a year.

The Obama administration's role in aiding Delphi's escape from the U.S. tax system may complicate the president's new campaign against corporate expatriation. After a wave of companies announced plans to shift addresses this year, Obama last month labeled the firms "corporate deserters."

The Delphi case also highlights how little attention the administration paid to the tax avoidance technique until recently. Only this year did Obama include a measure in his annual budget proposal to prevent some tax-driven address changes, which are known as "inversions." Thanks to gaps in a Congressional ban on contracts with inverted companies, his administration continues to award more than $1 billion annually in government business to more than a dozen corporate expats.

IRS Case

The Obama administration is now trying to rescind the tax benefits of the Delphi deal that it helped broker. In June, the Internal Revenue Service told Delphi that the 2009 address change should be disregarded for tax purposes, and that Delphi must pay taxes as a U.S. company. Delphi says in a securities filing that it will "vigorously contest" the IRS's demand.

"The recent rise in inversion transactions has the IRS and Treasury and the president understandably rattled, so they're now trying to play catch up," said Julie Roin, a tax professor at University of Chicago Law School. "They were worried about other things in 2009."

U.S. companies have been inverting for decades. The pace of departures began to quicken about two years ago, as a series of drugmakers sought to become Irish. The issue caught the attention of lawmakers and the Obama administration this year. The companies are trying to escape the country's 35 percent corporate income tax rate, the highest in the developed world.

With some of the country's biggest companies, including Deerfield, Illinois-based Walgreen Co. and New York-based Pfizer Inc., having considered such plans, legislators are increasingly concerned that the U.S. corporate income tax base will dwindle. One Congressional estimate puts the cost of inaction at $19.5 billion in forgone revenue over the next decade.

Examining Options

The Treasury Department said yesterday that it is examining options for curbing inversions that wouldn't require Congress to act. Such changes could limit inverted companies' ability to claim interest deductions that reduce their U.S. taxable income.

To be sure, the administration's goal in helping Delphi in 2009 was to prop up its main customer, Detroit-based General Motors Co. – not the corporate tax base. The Treasury Department said at the time that it wouldn't micro-manage GM or force changes for government policy reasons, although it did intervene in the politically sensitive area of executive pay.

Adam Hodge, a Treasury Department spokesman, said the department's work with Delphi was limited to providing funding through GM in order to shore up a crucial supplier for the automaker.

Saving Car Industry

"We weren't involved in that decision regarding the tax implications in their emergence from bankruptcy," he said, adding that he got his information from the former Treasury officials who worked on the bailout. "We were focused on trying to save the auto industry." He declined to answer specific questions, citing the pending IRS dispute. Timothy Geithner, the Treasury secretary during Obama's first term, also declined to comment.

Claudia Tapia, a Delphi spokeswoman, declined to comment on the IRS dispute or the government's role in Delphi's address change. The company's shares have more than tripled since a 2011 initial public offering.

"Delphi was on its deathbed. They had to do something to keep the company from being liquidated," Roin said. The favorable tax treatment may have helped save Delphi, she said.

Delphi's official home base is now an hour's train ride east of London, at a plant and research compound in the county of Kent. Inside windowless gray factory walls, workers in navy blue uniforms make pumps for diesel engines. Employees there said last week that top executives rarely visit.

Delphi's Beginnings

These days, most U.S. companies trying to escape the domestic tax system do so by buying a smaller company abroad and adopting its address. Delphi took a different route, through a courtroom in Manhattan.

The journey began in 1999, when GM, the largest U.S. automaker, spun off some of its parts-making operation as an independent company. The plan was to separate Delphi so that it could thrive on its own, supplying not just GM but rivals around the world.

That didn't work out so well. Saddled with legacy obligations to union workers, Delphi filed for bankruptcy protection in federal court in 2005. By 2009, with the nation in recession and GM itself tottering, Delphi was still limping along in bankruptcy, sustained by occasional cash infusions from GM.

Rescue Loans

Facing the worst car market in decades, GM and Auburn Hills, Michigan-based Chrysler were themselves running out of cash. Some officials said they feared an economic catastrophe if the automakers were forced to liquidate and put hundreds of thousands out of work.

In December 2008, the outgoing Bush administration approved $17.4 billion in rescue loans for GM and Chrysler. In February, Obama assembled a task force led by Steven Rattner, a Wall Street financier, to oversee the bailout.

The Treasury task force had broad authority at the automakers, because the terms of the government loans propping them up gave it veto power over major decisions.

One of the team's first jobs was to fix Delphi. GM still depended on its former subsidiary for crucial parts like steering assemblies. A liquidation of the supplier could end up shutting down many of GM's assembly lines, too. But the team members didn't want GM to dump money into Delphi indefinitely. In March, the night before GM was slated to get court approval to hand over another $150 million to Delphi, the task force rejected the plan. Delphi would get no more cash from GM unless it was part of an exit from bankruptcy.

Platinum Deal

Negotiations ensued between Rattner's task force, GM, Delphi's executives, and its creditors.

By June 1, the task force found a solution it could endorse: the bulk of Delphi's assets would be sold to Platinum Equity LLC, a Los Angeles-based private-equity firm. GM would provide most of the financing, and then separately would buy Delphi's steering unit and four U.S. factories.

In his 2010 book about the bailout, "Overhaul," Rattner credits his team with sealing the Platinum deal, working through sleepless nights to "put the parts company onto a glide path toward successful resolution."

Tax-Friendly Luxembourg

He doesn't mention one detail of the transaction that was disclosed three weeks after the Platinum agreement in a public court filing: Platinum was considering registering the new Delphi in tax-friendly Luxembourg rather than in the U.S. The following month, Platinum took steps to carry out the plan, dispatching lawyers to register two Luxembourg entities. Both bore the name Platinum used for its Delphi project:

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Photographer: Tom Beardsworth/Bloomberg

Parnassus, the mountain in Greece where, according to legend, the oracle of Delphi issued her prophecies.

Meanwhile, GM made its own trip through bankruptcy court to shed its debts. On July 10, 2009, it emerged under the formal control of the Treasury Department, which had swapped some of its debt for stock and now held 61 percent of the shares. Rattner stepped down, and his task force began disbanding, handing much of its authority to a reconstituted GM board.

In an interview, Rattner said as far as he can remember, he wasn't aware of any plan for Delphi to take a foreign address until Bloomberg News asked him about it a few weeks ago. He said others on his team handled the details of the Delphi negotiations, which he said contributed to the industry's revival.

"The companies are making money. They're hiring more workers. The whole supplier base, including Delphi, is doing well," Rattner said. "In 2009, they were about to evaporate from the planet."

Platinum Out

The deal with Platinum soon ran into trouble.

Creditors including Elliott Management, the hedge fund run by New York billionaire Paul E. Singer, said Platinum was buying the company too cheap. So Elliott and another hedge fund, Greenwich, Connecticut-based Silver Point Capital LP, put in their own bid for the company, offering to swap their debt for new shares. On July 26, 2009, they agreed with GM to cut Platinum out of the deal.

In some ways, the Elliott deal was similar to the one Rattner's task force approved the previous month. GM would provide crucial financing for the new company – a $1.7 billion direct investment in its equity, making it a shareholder alongside the hedge funds. GM would also buy the steering business and other assets for about $1.1 billion.

All this spending would depend on the Treasury Department's approval. After it emerged from bankruptcy, GM ended up with $16 billion of Treasury Department funds in a special escrow account that could be tapped only with the government's blessing.

Another detail remained the same as well: GM and the hedge funds agreed to register the new Delphi in Luxembourg or another, mutually agreeable foreign country.

Complex Discussions

The agreement was "the result of complex and extensive arms-length discussions among Delphi and its various stakeholder groups," including creditors, GM, and the Treasury Department, Delphi said in a July 27, 2009, court filing.

A few weeks later, Elliott and Silver Point dispatched lawyers in London to register a new limited-liability partnership, Delphi Automotive LLP, using the law firm's address near Finsbury Square.

In October, GM, with authorization from the Treasury Department, pumped $1.7 billion from its government escrow account into its new English partnership with the hedge funds. GM's contribution entitled it to about half of the initial cash generated by Delphi, dropping to about 35 percent over time.

English Home Base

England wasn't an obvious choice as a new home base. For years, Delphi had sought to diversify its customer base and shift production to lower-cost nations around the world; only about 5 percent of its workforce remained in the U.S. Still, the U.S. was its biggest market, and GM its largest customer. Most top executives lived near the company's headquarters in Michigan. Delphi had some factories and employees in the U.K., but it had more in the U.S. And the three lead investors in the new Delphi – Elliott, Silver Point, and GM – were all American.

One reason for choosing England was its tax system, according to two people who were involved in the discussions and who spoke on condition of anonymity because the matter is politically sensitive. Given Delphi's long struggle to achieve viability, a lower tax rate would give it a "fighting chance," one of the people said.

Lower Corporate Taxes

Along with Ireland and the Netherlands, the U.K. is becoming increasingly popular with companies seeking to flee the U.S. system. In addition to Pfizer, AbbVie Inc., an Illinois drugmaker with a market value of about $85 billion, announced plans last month to become a U.K. taxpayer.

The U.K. not only has a lower corporate tax rate – 21 percent – than the U.S., but it taxes companies only on their domestic earnings. U.S. companies must pay taxes on the profits of their foreign operations – a major hindrance for Delphi, whose factories are spread around the world.

Judge Robert Drain, who approved the sale in bankruptcy court, declined to comment. Spokesmen at Elliott and Silver Point also declined to comment, and Mark Barnhill, a partner at Platinum, didn't respond to requests for comment.

Hedge Funds Win

The Delphi takeover proved to be a huge win for the hedge funds, and for Treasury-controlled GM. Stripped of its debts and its U.S. tax domicile, the company surged in value.

GM sold its stake back to Delphi in 2011, recognizing a $1.6 billion after-tax gain. Elliott did even better, according to the New York Post. Singer's fund turned a $300 million investment into $1.3 billion by the time Delphi sold shares to the public that year, the Post reported at the time.

After Delphi got its New York Stock Exchange listing in 2011, its stock continued to advance. With a market capitalization of about $20 billion, it's now among the biggest and most profitable U.S. corporate expatriates.

Going public required Delphi to switch from partnership to corporate form. Becoming a U.K. corporation, though, would have required an accounting change that could have threatened its eligibility for inclusion in the Standard & Poor's 500 Index of the largest U.S. companies. Instead, Delphi incorporated in the tiny English Channel island of Jersey, a self-governing Crown dependency that didn't require the accounting change. Still, Delphi retained an English address for tax purposes.

Under U.K. law, a company incorporated elsewhere can be deemed domestic if it's "managed and controlled" from there. Chief Executive Officer Rodney O'Neal, 60, an Ohio native who studied engineering at a GM-sponsored college, continues to work in Troy, Michigan, along with most of his top officers.

Delphi meets the "managed and controlled" requirement by holding the majority of its board meetings in England, said Tapia, the Delphi spokeswoman. Ten of the 11 Delphi board members are Americans. The other is from Germany.

IRS Notice

One cloud on Delphi's horizon is the IRS case.

In September 2009, just before GM and the creditors bought Delphi, the IRS surprised them by issuing a notice interpreting a five-year-old law meant to prevent companies from shifting their legal addresses offshore. This reading of the law threatened to imperil the tax benefit of Delphi's shift to England. In securities filings, Delphi said its lawyers disagree with the interpretation.

In June of this year, the tax agency sent Delphi a notice saying that it is still a U.S. company for tax purposes. Although the back taxes it would owe wouldn't be material, Delphi said in a securities filing, its future annualized effective tax rate would rise to 20 percent to 22 percent if the IRS prevails. That's well below the U.S. statutory rate of 35 percent, but 3 to 5 points more than the effective rate of 17 percent Delphi paid last year. Most U.S. companies pay less than the statutory rate because of various breaks, including tax credits and deferred taxes on foreign earnings.

Tax Costs

Analysts expect Delphi to earn about $2.2 billion before taxes next year, according to the median estimate of 12 surveyed by Bloomberg. Based on that estimate, an additional 3 to 5 percentage points in its tax rate would cost Delphi $66 million to $110 million. The analysts expect pre-tax profit to increase the following year. The IRS declined to comment.

Companies renouncing their U.S. tax citizenship became a front-page issue in April, when the drugmaker Pfizer announced plans for a British address. A few days later, Rattner wrote a column in the New York Times urging Congress to revamp the tax code, and take quick action in the meantime to prevent such tax flights.

"These days, tax avoidance feels like a full-fledged business strategy, with American citizens as the losers," he wrote.

President Obama took up the theme last month in a speech at a college in Los Angeles, where he called for an end to what he called an "unpatriotic tax loophole."

"My attitude is I don't care if it's legal – it's wrong," the president said. "You shouldn't get to call yourself an American company only when you want a handout from American taxpayers.

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