Bloomberg BNA

January 13, 2016 UMV: 242,290

Corporate Inversions

Inversions Face Tricky Road in 2016, but Unlikely to End

BNA Snapshot

- Development: Corporate inversions won't stop despite roadblocks in 2016, practitioners say.
- Takeaway: Legislation needed to halt deals, but unlikely in coming year.
- Looking Ahead: Significant package of inversion regulations expected in coming months.

By Alison Bennett

Jan. 12 — Corporate inversion deals are likely to continue in 2016 despite a challenging tax landscape and big questions surrounding the treatment of earnings stripping, while the outlook for legislation remains bleak.

The issue comes alongside the government's efforts to combat foreign structures that allow U.S. multinationals to move cash, intangibles and other assets offshore without paying U.S. tax—work that could gain momentum in the year ahead.

On the inversions front, the Internal Revenue Service and the Treasury Department are expected to continue targeting transactions they see as abusive, and a huge package of regulations is coming down the pike—guidance that some may view as a very broad interpretation of Treasury's legislative authority, practitioners told Bloomberg BNA in a series of interviews.

A key issue is whether any further guidance will address earnings stripping. Top officials have said the issue is still being considered but haven't yet said exactly how or when the government will take action.

International Overhaul Urged

Both officials and attorneys said legislation will be needed to halt inversions, yet the most beneficial vehicle—an international tax revamp—is going to be a tough hurdle in 2016.

Treasury Assistant Secretary for Tax Policy Mark Mazur told Bloomberg BNA at a December tax conference that Treasury will continue to work with Congress on legislation that would give the administration more authority to shut the deals down—provisions President Barack Obama has put in White House budget proposals—but said that could remain a difficult task.

Jeffrey Paravano, managing partner of Baker & Hostetler LLP in Washington, said without an overhaul that makes U.S. companies more likely to stay in this country, such as a territorial tax system, they are going to keep heading offshore. "None of the proposals from the White House or Congress are enough," he told Bloomberg BNA. "Rather than making it more difficult and expensive to leave, they should make it more attractive for companies to stay," he said.

Guidance Issue

Taxpayers are closely watching for inversions guidance expected in 2016 to implement two notices the IRS has issued in a little over a year—both are milestones in the government's battle against deals that let U.S. companies move their addresses outside the U.S. to reduce taxes.

The government plans to issue a single package of regulations to flesh out both Notice 2014-52 and Notice 2015-79—a package that will be "well north of 150 pages," according to Daniel McCall, special counsel to the IRS Associate Chief Counsel (International).

Speaking at a December tax conference co-sponsored by the IRS and George Washington University, McCall said the regulations will be released “in coming months.”

Steptoe & Johnson LLP Chairman Philip R. West and firm partner Amanda Varma said some types of inversions may no longer be feasible after the two notices, although viable transactions and structures remain. However, companies still need to take into account the forthcoming regulations, as well as possible anti-earnings stripping rules, they said.

Earnings Stripping

In releasing Notice 2015-79 in November, Treasury Secretary Jacob J. Lew said earnings stripping remains a significant issue on Treasury's radar screen, and there is likely to be action “in coming months.” However, it remains unclear whether the issue will be addressed as part of the forthcoming regulations, in separate guidance or at all in 2016.

Summer Ayers LePree, a tax partner at Bilzin Sumberg Baena Price & Axelrod LLP in Miami, said if the government doesn't act, it will leave a door open for companies to get money out of the U.S. without paying tax.

“At the end of the day, if people can still get around those rules and strip earnings out of the U.S., that's going to keep happening,” LePree told Bloomberg BNA.

Paravano said “Treasury's guidance to date has been very aggressive, but given the stakes at issue and the transactions at issue, perhaps they had to be.” It is very important that the government's guidance “stay limited to the transactions they're targeting and doesn't spill over or have unintended consequences,” he added.

That said, Treasury's efforts so far “won't stop inversions,” Paravano told Bloomberg BNA. Rather, he said, “it may put the brakes on some transactions.”

Paul Schmidt, chair of tax at BakerHostetler LLP, said in the same interview that the deals will continue, “but not at the same pace.”

Pfizer-Allergan Deal

An illustration of Treasury's struggle was its inability to stop the biggest inversion in U.S. history in November, a $160 billion deal between U.S.-based Pfizer Inc. and Allergan Plc, based in lower-tax Ireland. The two companies combined in November to create the world's largest pharmaceutical giant—in a transaction explicitly structured to avoid the U.S. inversion rules.

John Harrington, former Treasury international tax counsel and now a partner at Dentons LLP, told Bloomberg BNA that pressure to invert is going to continue as shareholders see their counterparts making more money at companies that have made the jump. “This is the consequence of the U.S. tax rules,” he said.

In an interview with Bloomberg BNA, Steven Klein of Gerson, Preston, Robinson & Co. P.A. said the Pfizer deal may encourage other inversions by making it clear that Treasury can't stop some of the biggest deals. “As long as we have one of the highest corporate tax structures in the world, it's going be happening,” said Klein, the accounting firm's partner in charge of corporate and financial reporting.

While the U.S. will be able to go after some transactions that are clearly abusive, there is still a wide gray area, he said.

Third-Country Provision
As one example of the aggressive nature of the inversions guidance so far, practitioners said they don't like a provision in Notice 2015-79 intended to make it tougher for companies to structure their operations through a third, lower-tax country.

The provision limits the ability of U.S. companies to combine with foreign entities when the new foreign parent is located in such a country, and drew heavy criticism when it was released. In a November notice, Treasury said the provision is designed to stop companies from cherry-picking a tax-friendly country for their tax residence.

Treasury officials strongly asserted their authority under tax code Section 7874 to take this and other actions in the two notices, but some practitioners have said this could be a bit of a question mark in the coming year.

Broad Treasury Interpretation?
With regard to the third-country provision, “It's very apparent that they're reading their authority very, very broadly,” Joseph Calianno, partner and international technical tax practice leader for BDO USA LLP, said in late December. “It wasn't something I was expecting.”

Calianno said the authority question probably wouldn't get a final answer unless it goes to court. A legal challenge is possible in 2016, he said, but companies will be taking the provision into account as they structure their transactions despite the uncertainty.

Brenda Zent, a special adviser in Treasury's Office of International Tax Counsel, said the government was aiming at narrow fact patterns where it was clear companies were structuring through third countries to get out of paying U.S. tax. These situations in some cases involved advertising, she said at the IRS-GWU conference.

“I think it's what Congress would have wanted us to do,” Zent said.

Dentons' Harrington said the provision “creates a premium on entities that are already in low-tax jurisdictions. It does seem to me to be removed from the statutory framework” under Section 7874, he said.

Movement of Intangibles Targeted
Calianno said even apart from regulations implementing the two notices, taxpayers could see more action targeting specific transactions in the coming year.

“It seems as if the IRS has become aware of different transactions in the marketplace,” he said. “To the extent that they see a transaction or deal that they don't see as appropriate, we could see more guidance.”

Practitioners said Treasury's work to combat inversions is just one facet of its efforts to prevent U.S. multinationals from avoiding tax using a variety of foreign structures. Those efforts are likely to play out in guidance in 2016, they said.

One example of this is rules proposed in September attacking aggressive positions on outbound transfers of intangibles under Section 367(d). Treasury and IRS officials have said that even though the rules (REG-139483-13) are proposed, they have an immediate effective date because they are aimed at abuses the government is seeing now. That effective date is likely to come under fire as the IRS works on final rules in 2016.

The rules eliminate exceptions to tax for foreign goodwill and going concern to take away incentives for inappropriate transfer pricing positions on such transfers. The guidance also limits the scope of property eligible for the active trade or business exception under Section 367(a).

CFC Loans to Partnerships

Another piece of guidance likely to play a key role in 2016 is a set of proposed rules (REG-155164-09) intended to make it harder for controlled foreign corporations to use loans to foreign partnerships as a way to avoid income inclusions under Section 956.

When the rules were proposed in September, practitioners said they were overbroad, had a wide reach and would sweep in a range of transactions—including some that shouldn't be targeted. That criticism is expected to continue as the work on final rules goes forward.

Harrington told Bloomberg BNA that the guidance calls for multiple inclusions, and “there's general agreement that that's not the right answer from a policy standpoint.”