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Practitioners: Tax Residency Big Issue in Inversions Guidance

By Alison Bennett

The issue of when companies will be considered tax residents of foreign countries under guidance intended to curb inversions is a critical one, practitioners told Bloomberg BNA in a series of interviews.

As more companies go global, answers to that question are becoming increasingly complex, they said.

“There are a lot of countries where it may not be entirely clear where a company is resident and it's not immediately obvious where they are a tax resident,” John Harrington, a partner with Dentons LLP, said Jan. 14. “You can be a tax resident in more than one country.”

Notice Raises Issues

The most recent Internal Revenue Service guidance cracking down on inversions, Notice 2015-79, throws that issue into sharp relief, practitioners said (224 DTR GG-1, 11/20/15).

Two provisions in the notice call for companies to be tax residents of particular countries for their transactions to work, with the definition of that residency still unclear, they said.

One sets out a tough standard requiring companies to be tax residents in a foreign country to show they meet a difficult test for determining whether they have substantial business activities there.

A second is an effort to limit the ability of U.S. companies to combine with foreign entities when the new foreign parent is in a third, low- or no-tax country. The notice requires these companies to pass a tax residency test in that third country, among other requirements, for their inversions to pass muster.

Treasury Considering More Residency Guidance

Brenda Zent, a special adviser in Treasury's Office of International Tax Counsel, said at a Jan. 13 tax forum that the government is considering more guidance on what it means to be a tax resident, but didn't give details on the direction the government might go (09 DTR G-6, 1/14/16).

It remained unclear whether that guidance would be part of a large package of regulations implementing both Notice 2014-52—Treasury's 2014 inversions guidance—and Notice 2015-79. Officials have said that package will be considerably longer than 150 pages and will be issued in “coming months.”

Residency Question Increasingly Tough

Paul Schmidt, chair of tax at BakerHostetler LLP, told Bloomberg BNA the difficulties of determining residency are increasing at a record pace.

“There are different standards of residency around the world,” Schmidt said in a Jan. 15 interview. He said determining this issue is tough because some countries say residency is based on where a company is created and organized, while others say it depends on where the business is managed and controlled.

The structure of the business also raises questions, Schmidt said. “What is the residence of a hybrid entity? Will the government look at whether the residences of stakeholders in those entities really determine whether the company itself is a resident?” he said.

Treaty Difficulties Cited

Both Harrington and Joe Calianno, partner and international technical tax practice leader at BDO USA LLP, said major issues arise when treaties are involved.

“The situation can be complex when there is a treaty,” Harrington said. “Do you look at how much income is covered by the treaty? Do you understand what the treaty does in instances where a company is resident? These are issues that need to be answered.”

Calianno questioned whether the government might apply the analysis set out in a 2004 IRS revenue ruling that determined how U.S. treaty benefits would apply for a firm operating in two foreign countries.

Practitioner Raises Questions on IRS Revenue Ruling

Rev. Rul. 2004-76 addressed circumstances where a tax treaty between those two foreign jurisdictions treats the corporation as a tax resident of one country but not the other country.

Even though the two countries also have treaties with the U.S., the ruling makes clear that the foreign corporation would be treated as a tax resident for U.S. tax treaty purposes only of the country to which residence has been assigned under the tax treaty between the two foreign countries.

Without recommending that the government take this path, Calianno said he has questions about whether Treasury would apply this type of analysis in determining tax residency in inversion transactions.

Attorneys Raise Authority Question

In yet another issue under the guidance, several practitioners also questioned Treasury's authority under Section 7874 to require tax residency, and said Congress should be solving this problem.

BakerHostetler's Schmidt said the guidance raises the issue of whether there is any limit to the government's authority under Section 7874, noting that “the statute doesn't use the term ‘residence' at all."

Schmidt said while "Treasury's position that residency should matter as a policy matter makes sense," at the same time, "the new question is when will the statute be revised."

Harrington said the two provisions represent "a policy-related change that seems to be going beyond what the statute provided."

Adding his voice on this issue, Jeffrey L. Rubinger, a tax partner at Bilzin Sumberg Baena Price & Axelrod LLP in Miami, said Jan. 20, "I'm not sure where the IRS gets its authority. They are constantly expanding their inversions guidance. It's hard to say where they're getting it from."

Law Changes?

When Notice 2015-79 was released in November, Treasury Secretary Jacob J. Lew said the administration was well aware legislation will be needed to truly combat inversion structures designed to avoid taxes, but in the interim, the guidance is intended to shut down certain transactions that create major concerns.

Lew and other Treasury officials have insisted the statute gives them the authority to issue the two notices. Zent told Bloomberg BNA following the tax forum Jan. 13, "We looked at our authority, we analyzed it closely, and we're very comfortable with it" (09 DTR G-6, 1/14/16)

Difficulties Cited for Multinationals

Practitioners said the increasing inversions activity shows that companies are simply trying to escape a U.S. system that creates burden and reduces profits.

"The reality is that with the 35 percent tax rate in the U.S., companies are going to keep looking for structures where they can do business and pay lower taxes," said Alan Lips, a partner with Gerson, Preston, Robinson & Company, P.A.

Speaking to Bloomberg BNA Jan. 19, Lips said, "Inversions are one way for them to do that."