Tax Law Update

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IRS Continues Focus on Corporate Inversions

The Internal Revenue Service (IRS) continues its focus on perceived abuses in corporate inversion transactions. On November 19, the IRS released Notice 2015-79, which places new limitations on the ability of a U.S. multinational corporation to reduce its U.S. tax burden by inverting its corporate structure. U.S.-based multinationals are subject to U.S. federal income taxes on their worldwide net income. Subject to certain exceptions, a U.S. multinational's foreign subsidiaries generally are not subject to U.S. income tax on their earnings, and the U.S. parent is not subject to tax on the earnings until they are repatriated. Many U.S. multinationals are criticized for indefinitely holding income in foreign subsidiaries so that this income is never subject to U.S. tax. A recent article from Citizens for Tax Justice analyzed the financial statements of Fortune 500 companies and determined that “more than $2.1 trillion” of earnings is subject to “indefinite reinvestment,” representing “up to $600 billion in U.S. federal income taxes” that is not intended to be paid.

Foreign companies that do business in the U.S. through U.S. subsidiaries are not subject to the same rules. Only the U.S. activities of a foreign-based multinational generally face U.S. federal income tax. The foreign activities of the foreign parent and any affiliated entities located outside the U.S. are not subject to U.S. federal income tax, which is especially beneficial now that most of the developed world has corporate tax rates that are lower, usually significantly lower, than US tax rates. This disparity creates incentives for U.S.-based multinationals to invert their structure in a way that isolates non-U.S. activities in entities that do not have a direct or indirect U.S. corporate owner (the inversion transaction).

As part of the American Jobs Creation Act of 2004, IRC section 7874 was enacted. The intent of this provision is to hinder the ability of a U.S.-based multinational to reduce its tax burden by inverting. In the worst case scenario, Section 7874 causes the foreign parent of an inverted structure to be treated as a U.S. corporation. This tax fiction causes the new foreign parent to be taxed on its worldwide income.

Notice 2014-52, issued on September 22, 2014 stated that the IRS would issue regulations combating what the IRS considers to be perceived abuses or improper avoidance of the application of section 7874 and other Code provisions that generally apply to inversion transactions. Notice 2015-79 makes clarifications and corrections to Notice 2014-52, describing regulations that, when issued, will apply to transactions occurring after November 18, 2015. The newer guidance is intended to do the following:

1. Limit the ability of U.S. companies to obtain tax benefits when they combine with entities located in a foreign jurisdiction and subsequently use a new foreign parent located in a third jurisdiction;
2. Limit the ability of U.S. companies to inflate the new foreign parent corporation’s size, and therefore avoid the 80 percent ownership rule, which treats the new foreign parent as if it is a U.S. entity if at least 80 percent of the new foreign parent corporation is owned by former shareholders of the pre-inversion U.S. company; and
3. Require the new foreign parent to be a tax resident of the country where the foreign parent is created or organized in order to satisfy the business activities exception.

U.S. Treasury Secretary Jack Lew held a press conference call regarding Notice 2015-79. On the call he said, "U.S. companies are currently taking advantage of an environment that allows them to move their tax residence overseas to avoid paying taxes in the U.S." and "our actions can only slow the pace of these transactions."

U.S. Senator Ron Wyden of Oregon released a statement about Notice 2015-79, calling inversion transactions a "virus that is plaguing our country" and "a red flag on the urgent need for tax reform." Many business leaders are calling for comprehensive tax reform, hoping to change the U.S. Tax Code in ways that would lower corporate tax rates and transition to a territorial tax regime in place of the worldwide regime currently in place.

Despite the continued focus on corporate inversions, on November 23, Pfizer Inc. announced it would redomicile in Ireland as a result of a merger with Ireland-based Allergan PLC. The two companies issued a joint press release noting that current Pfizer stockholders will hold approximately 56 percent of the new company and Allergan stockholders will hold the remaining 44 percent. Pfizer CEO Ian Read held a public conference call regarding the merger, stating that the combined company "will have greater financial flexibility that will facilitate our continued discovery and development of new innovative medicines for patients, direct return of capital to shareholders and continued investment in the United States." Prior to the announcement, Pfizer had disclosed in its 2014 annual report that it held approximately $74 billion unremitted earnings offshore that were indefinitely reinvested. In addition, Pfizer recorded a deferred tax liability of $21.2 billion, representing future U.S. federal income taxes on an additional $74 billion of foreign earnings not subject to indefinite reinvestment. It remains to be seen if these accumulated earnings will be subject to U.S. taxation going forward, or if the merged companies will rely on the benefit of future foreign earnings not being subject to U.S. federal income tax. The merged companies anticipate that their worldwide effective tax rate will be roughly 17 or 18 percent in future periods. In comparison, Pfizer's 2014 worldwide effective tax rate was 25 percent.

The full text of Notice 2015-79 can be viewed here.

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