The Future of Corporate Inversions Under the Tax Cuts and Jobs Act

Adrian Lopez*

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* © 2018 Adrian Lopez. J.D. candidate 2019, Tulane University Law School; B.A. 2015, Texas A&M University. I would like to thank the *Tulane Journal of International and Comparative Law* for its pivotal role in my legal career. This Comment is dedicated to my family and friends for their continuous support and encouragement.

I. INTRODUCTION

The proposed 2015 merger between American drug maker Pfizer and the Irish company Allergen at $160 billion would have been the largest corporate inversion in history—had it come to fruition.[1] It would have resulted in over $1 billion in tax savings annually.[2] Over the past few decades we have seen such similar deals, though perhaps not of its magnitude.[3] But in the words of Carl Icahn, the "deal [was] a travesty."[4] Mergers are usually praised for their creation of synergies and cost-cutting measures resulting in higher earnings. So why was Icahn so strongly against the deal? The merger in that case was not for any reasonable business purpose such as creating synergies.[5] It was to leave our "uncompetitive international tax system"[6]—a merger for the sole purpose of inverting. That is why Icahn was so against the Pfizer/Allergen deal. But what exactly is an inversion, and why would a company choose to do it? What is it about our international tax system that incentivizes companies to invert? This is a question that can best be answered by looking at how the United States taxes corporations, specifically ones with income earned abroad. But before these questions are answered, we must ask whether inversions are even a good thing. Are they net positive, and if so, to whom? The corporation? The taxing jurisdiction? These questions can perhaps be answered by first looking at what an inversion is, and what it is not.

An inversion is the process whereby a U.S. corporation merges with a foreign one resulting in it being treated as a foreign corporation for tax purposes.[7] The United States has—or had—a worldwide tax system in place.[8] It taxed domestic corporations on their worldwide income

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1. Reuters Staff, *Trump to Keep Obama Rule Curbing Corporate Tax Inversion Deals*, REUTERS (Oct. 4, 2017), https://www.reuters.com/article/us-usa-tax-inversions/trump-to-keep-obama-rule-curbing-corporate-tax-inversion-deals-idUSKBN1C92RQ.
2. Caroline Humer & Ankur Banerjee, *Pfizer, Allergan Scrap $160 Billion Deal After U.S. Tax Rule Change*, REUTERS (Apr. 6, 2016), https://www.reuters.com/article/us-allergan-m-a-pfizer/pfizer-allergan-scrap-160-billion-deal-after-u-s-tax-rule-change-idUSKCN0X3188.
3. *See* Zachary Mider, *Tracking Tax Runaways*, BLOOMBERG, https://www.bloomberg.com/graphics/tax-inversion-tracker/ (last updated Mar. 1, 2017).
4. Carl Icahn, Opinion, *How to Stop Turning U.S. Corporations into Tax Exiles*, N.Y. TIMES (Dec. 14, 2015), https://www.nytimes.com/2015/12/14/opinion/how-to-stop-turning-us-corporations-into-tax-exiles.html?_r=0.
5. *Id.*
6. *Id.*
7. CONG. BUDGET OFFICE, 53093, AN ANALYSIS OF CORPORATE INVERSIONS 1 (2017).
8. *Id.* at 4; Cathy Hwang, *The New Corporate Migration: Tax Diversion Through Inversion*, 80 BROOK. L. REV. 807, 813 (2015).

regardless of where it was earned.[9] This is wholly different from the territorial tax system that most other developed countries use.[10] Under that system, a country only taxes income earned within its territory.[11] The result of the United States' worldwide tax system is that a domestic corporation can end up paying more in taxes than if it were a U.S. subsidiary of a foreign company.[12]

Though U.S. corporations are taxed on their worldwide income, there are some benefits that they receive—most notably foreign tax credits and the deferral of taxes on any income earned abroad.[13] Through foreign tax credits, a domestic corporation can offset any taxes paid on income earned in a foreign jurisdiction up to the U.S. corporate tax rate.[14] This difference is usually not paid until the foreign-earned income is repatriated back to the United States.[15] Nevertheless, upon repatriation, these domestic corporations will inevitably have to pay the full U.S. corporate tax rate.[16] Domestic corporations thus have two choices: repatriate their foreign-earned income and pay the tax or defer indefinitely and avoid U.S. taxes altogether.[17]

These U.S. corporations are at a serious disadvantage and as a result are incentivized to reincorporate abroad through inversions.[18] When looking at where to invert, the corporation looks at a jurisdiction with a lower tax rate and a territorial tax system, otherwise it would defeat the purpose of the inversion.[19] The net effect of inverting is that these previously domestic corporations save hundreds of millions of dollars by lowering their tax liability.[20] But this tax avoidance also results in the United States losing billions in revenue.[21] Whether this is good or bad depends on who you ask. Judge Learned Hand once said, "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not

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9. Hwang, *supra* note 8, at 813.
10. Hal Hicks, *Overview of Inversion Transactions: Selected Historical, Contemporary, and Transactional Perspectives*, 30 TAX NOTES INT'L 899, 925 (2003).
11. Hwang, *supra* note 8, at 813-14.
12. Zachary Mider, *Tax Inversion*, BLOOMBERG (Mar. 2, 2017), https://www.bloomberg.com/quicktake/tax-inversion.
13. CONG. BUDGET OFFICE, *supra* note 7, at 4.
14. Hwang, *supra* note 8, at 813.
15. *Id.*; DONALD J. MARPLES & JANE G. GRAVELLE, CONG. RESEARCH SERV., R43568, CORPORATE EXPATRIATION, INVERSIONS, AND MERGERS: TAX ISSUES 2-3 (2014).
16. Hwang, *supra* note 8, at 813.
17. *Id.* at 814.
18. CONG. BUDGET OFFICE, *supra* note 7, at 4.
19. MARPLES & GRAVELLE, *supra* note 15, at 11-12.
20. Hwang, *supra* note 8, at 812.
21. *Id.* at 810.

bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."[22] Conversely, Uncle Sam will do his best to recoup as much tax as statutorily allowed. Over the past few decades we have seen Congress tinker with the tax code a number of times but usually as a direct response to an inversion.[23] These incremental changes have slowed down inversions but have not constrained them altogether. As a result, a discussion has emerged as to what would curtail future inversions.[24] Commentators have claimed that lowering the corporate tax rate would slow down inversions,[25] as would the United States moving to a territorial tax system.[26] Last year, Congress passed the Tax Cuts and Jobs Act (Tax Act) with the goal of lowering the corporate tax rate, among other things. But a number of provisions, when taken together, also have the effect of making inversions increasingly difficult. This Comment will discuss whether the Tax Act packs enough punch to significantly lower (or constrain altogether) inversions when compared to the incremental changes we have seen over the past few decades. Two primary provisions of the Tax Act that could be instrumental in this are the lowering of the corporate tax rate and the change to a modified territorial tax system.[27]

The Tax Act lowered the corporate tax rate from 35%—the highest in the developed world—to 21%.[28] In addition, any foreign-earned dividends are exempted under the Act so long as the domestic corporation has a 10% stake in the foreign corporation declaring the dividend.[29] This in essence is a move toward a territorial tax system.[30] So is the Tax Act enough to stop inversions? This Comment will address this in three Parts. Part II will discuss the history of the U.S. International Tax system and the emergence of inversions. Part II will detail the United States' incremental response to inversions by adding or amending specific provisions of the corporate tax laws. Part III will discuss important amendments and additions to corporate tax under the Tax Cuts and Jobs Act. Part IV will discuss the nexus between these provisions and the future of inversions.

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22. Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).
23. *See, e.g.*, I.R.C. §§ 1248(i), 163(j), 7874, 367 (2017).
24. MARPLES & GRAVELLE, *supra* note 15, at 11.
25. *Id.*
26. *Id.* at 12.
27. *See, e.g.*, I.R.C. §§ 163(j), 59A, 951(a), 965.
28. *See id.* § 11(a), (b); Hwang, *supra* note 8, at 813; *see also* Mider, *supra* note 12.
29. *See* I.R.C. § 245A(a).
30. Frank J. Emmons et al., *The Tax Cuts and Jobs Act Moves the U.S. Closer to a Territorial Tax System*, NIXON PEABODY (Nov. 7, 2017), https://www.nixonpeabody.com/en/ideas/articles/2017/11/07/tax-cuts-and-jobs-act-moves-us-closer-to-a-territorial-tax-system.

II. THE UNITED STATES' INCREMENTAL RESPONSE TO INVERSIONS: A WHACK-A-MOLE APPROACH

As stated previously, the former U.S. corporate tax rate of 35% was the highest in the developed world.[31] To compare, the corporate tax rates in Ireland, the United Kingdom, and the Netherlands were 12.5%, 21%, and 25%, respectively.[32] In Bermuda, the tax rate is a dumbfounding 0%.[33] In fact, fifty-eight out of the eighty-five identified inversions (68%) are in these four countries.[34] Additionally, while the rest of the developed world implemented a territorial tax only taxing income that is earned within their respective territories, the United States taxed corporations on worldwide income—that is income earned both domestically and abroad.[35] By inverting, corporations reduce their tax liability on income earned outside the United States but also income earned within through a process known as earnings stripping.[36] This Comment will discuss earnings stripping under the new Tax Cuts and Jobs Act in further detail in Part III. Nevertheless, the United States has incrementally added a number of provisions over the years in response to inversions even before the Tax Cut and Jobs Act.[37]

A. The McDermott Inversion and I.R.C. § 1248(i)

One of the first significant inversions dating back to 1982 involved McDermott, Inc., a Louisiana engineering services company.[38] In an effort to reinvest earnings that would normally have been taxed, McDermott, Inc. chose to invert.[39] McDermott, Inc. had a Panamanian subsidiary called McDermott International.[40] McDermott International initiated a public tender offer for shares of McDermott, Inc. in exchange for shares

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31. Hwang, *supra* note 8, at 813.
32. Inho Andrew Mun, *Reinterpreting Corporate Inversions: Non-Tax Competitions and Frictions*, 126 YALE L.J. 2152, 2161 (2017).
33. *Corporate Tax Rates 2018*, DELOITTE, https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-corporate-tax-rates.pdf (last updated Feb. 2018).
34. *See, e.g.*, Mider, *supra* note 3.
35. Hwang, *supra* note 8, at 813; Chris Capurso, *Burgers, Doughnuts, and Expatriations: An Analysis of the Tax Inversion Epidemic and a Solution Presented Through the Lens of the Burger King-Tim Hortons Merger*, 7 WM. & MARY BUS. L. REV. 579, 584 (2016).
36. Hwang, *supra* note 8, at 815; Mun, *supra* note 32, at 2162.
37. *See, e.g.*, I.R.C. §§ 1248(i), 163(j), 7874, 367 (2017).
38. Hwang, *supra* note 8, at 821; *see, e.g.*, Mider, *supra* note 3.
39. Hwang, *supra* note 8, at 821.
40. *Id.*

in itself along with cash.[41] After the transaction, McDermott International became the parent of the U.S. corporation McDermott, Inc. and thus was no longer a U.S. corporation for tax purposes.[42] The McDermott inversion was estimated to have saved the company close to $200 million.[43]

A question arises, though, as to why McDermott, Inc. was being taxed on its foreign earnings when it could normally defer until repatriation back to the United States.[44] In the case of the McDermott transaction, McDermott International was considered a controlled foreign corporation (CFC), defined as any foreign corporation that is at least 50% controlled by United States shareholders.[45] In turn, McDermott, Inc. was considered a United States shareholder for owning all of the stock in McDermott International.[46] As a result, the United States shareholder—McDermott, Inc. in this case—would have had to include Subpart F income of McDermott International on its income tax return in the year it was earned.[47] Subpart F Income consists of a lot of moving parts, but, generally speaking, it includes the earnings and profits of the foreign corporation along with passive income such as "interest, dividends, annuities, rents, and royalties."[48] The inversion thus allowed McDermott Inc. to skid around this rule that otherwise recognizes Subpart F income immediately when earned.

As a response to the transaction, the United States implemented § 1248(i). Section 1248(i) states that when a domestic corporation that owns 10% or more of a foreign corporation exchanges its stock for stock in the foreign corporation it will be required to recognize a gain for the amount of the foreign corporation's earnings.[49] This would have essentially killed the McDermott inversion had it been in place at the time of the transaction because McDermott, Inc. owned more than 10% of

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41. *Id.*
42. *Id.*; Mun, *supra* note 32, at 2162.
43. Hicks, *supra* note 10, at 904; Hwang, *supra* note 8, at 821; Mun, *supra* note 32, at 2162.
44. Hwang, *supra* note 8, at 822.
45. *See* I.R.C. § 957 (2017).
46. Hicks, *supra* note 10, at 903; *see* I.R.C. § 951(b) (2017) ("For purposes of this title, the term "United States shareholder" means, with respect to any foreign corporation, . . . , 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation, or 10 percent or more of the total value of shares of all classes of stock of such foreign corporation.").
47. *See* I.R.C. § 957 (2017).
48. *See id.* §§ 952, 954; MARPLES & GRAVELLE, *supra* note 15, at 3.
49. *See* I.R.C. § 1248(i); Mun, *supra* note 32, at 2163; Hwang, *supra* note 8, at 823.

McDermott International.[50] Any earnings or profits of McDermott International would be deemed a dividend for recognition purposes.[51] But § 1248(i) itself created another loophole that corporations could use.[52] If the dividend is based on earnings of the foreign corporation, then inverting with a corporation that has no earnings gets around this requirement.[53] Consequently, if structured correctly, an inversion can substantially lower a corporation's tax liability. But more importantly, the inversion process can even lower the corporation's tax liability on U.S. earnings.[54]

B. Earnings Stripping and Business Interest Expense Under the Old I.R.C. § 163(j)

Though an inversion can give a corporation the benefit of lowering its tax liability on foreign earnings, the real advantage is in its ability to lower its tax liability on U.S. earnings.[55] In fact, the primary reason corporations invert is to lower their tax liability on the latter rather than the former.[56] Corporations lower their tax liability through a process known as earnings stripping.[57] Post-inversion, the new foreign parent company will issue intercompany debt to its U.S. subsidiary.[58] The U.S. subsidiary then deducts the business interest expense thereby lowering its overall tax liability.[59] But if the corporation's debt-to-equity ratio exceeds 1.5 to 1, § 163(j) is triggered.[60] Then, any business interest expense that exceeds 50% of the corporation's adjusted taxable income will be disallowed.[61] Nevertheless, any disqualified amount may be carried forward

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50. Hwang, *supra* note 8, at 823.
51. *See, e.g.*, I.R.C. § 1248(i)(1); *see also id.* § 1248(a)(2) ("[T]hen the gain recognized on the sale or exchange of such stock shall be included in the gross income of such person as a dividend, to the extent of the earnings and profits of the foreign corporation . . . .").
52. *Id.* § 1248(i).
53. *Id.*
54. MARPLES & GRAVELLE, *supra* note 15, at 3.
55. Jim A. Seida & William F. Wempe, *Effective Tax Rate Changes and Earnings Stripping Following Corporate Inversion*, 57 NAT'L TAX J. 805, 807 (2004); Hwang, *supra* note 8, at 815.
56. Seida & Wempe, *supra* note 55, at 806.
57. MARPLES & GRAVELLE, *supra* note 15, at 3.
58. *Id.* at 3-4.
59. *Id.*; Hwang, *supra* note 8, at 815; Seida & Wempe, *supra* note 55, at 806.
60. *See* H.R. REP. No. 101-239 (1989) (§ 7210 adding I.R.C. § 163(j) (2017)); Taylor Kiessig & Brian Tschosik, *The Interest Deduction Limitation Under Section 163(j)*, EVERSHEDS SUTHERLAND (2018), https://us.eversheds-sutherland.com/portalresource/TheInterestDeductionLimitationPresentation_20180212.pdf.
61. H.R. REP. No. 101-239 (amended by I.R.C. § 163(j)).

indefinitely.[62] However, the § 163(j) constraint does not apply if the corporation's debt-to-equity ratio is less than 1.5 to 1.[63]

C. *Helen of Troy and I.R.C. § 367(a)*

Helen of Troy was another significant inversion that occurred during the 1990s.[64] Helen of Troy was a Texas corporation that inverted to Bermuda where the corporate tax rate was—and still is—0%.[65] In the case of this corporation, its reason for inverting was similar to McDermott's the previous decade—to lower its tax liability on foreign earnings.[66] But, by this time, § 1248(i) was firmly in place.[67] Nevertheless, Helen of Troy exploited the loophole by creating a new corporation in Bermuda, Helen of Troy Limited, with no earnings.[68] Because this new corporation was a non-CFC, Helen of Troy was able to circumvent § 1248(i) and ultimately lower its tax liability on foreign earnings.[69] Additionally, no tax liability was incurred at the shareholder level under § 367(a).[70]

At the time of the Helen of Troy inversion, § 367(a) normally disregarded nonrecognition of certain exchanges.[71] Helen of Troy's inversion was not one of these exchanges.[72] If U.S. shareholders of a domestic corporation exchanged their stock for stock in a foreign corporation that amounted to less than 5% of the foreign corporation's stock, then no exchange would be recognized for tax purposes.[73] Helen of Troy initiated this type of exchange and thus incurred no tax liability.[74]

As a response, the United States implemented regulations to make these types of inversions less attractive.[75] Under the new regulations, in addition to the requirement that each individual U.S. shareholder own less

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62. *See* I.R.C. § 163(j).

63. Raymond Wynman & Andrew Wai, *Interest Expense Limitation and the New I.R.C. § 163(j): Not Just a Foreign Concept Anymore*, GLOBAL TAX MGMT.: TAX & TECH. BLOG (Feb. 13, 2018), https://gtmtax.com/knowledge/interest-expense-limitation-new-i-r-c-§-163j/.

64. *See, e.g.*, Mider, *supra* note 3.

65. *Id.*; *Corporate Tax Rates 2018*, *supra* note 33.

66. Hwang, *supra* note 8, at 824.

67. *See* Tax Reform Act of 1984, Pub. L. No. 98-369, § 133(a) (1984) (adding I.R.C. § 1248(i)).

68. Hicks, *supra* note 10, at 905; Hwang, *supra* note 8, at 824.

69. Hicks, *supra* note 10, at 905.

70. *Id.*; Hwang, *supra* note 8, at 825.

71. Hwang, *supra* note 8, at 825.

72. *Id.*

73. Hicks, *supra* note 10, at 905. Hwang, *supra* note 8, at 825.

74. Hicks, *supra* note 10, at 905; Hwang, *supra* note 8, at 825.

75. Treas. Reg. § 1.367(a)-3(c) (2016).

than 5% of the new foreign corporation, U.S. shareholders, as a whole, cannot own more than 50% of the corporation.[76] There are also some other requirements that must be met for the exchanges of shares of corporate insiders and large shareholders, but these go beyond this Comment's focus.[77] What is important to note is the regulation's final requirement that the foreign corporation satisfy the "Active Trade and Business Test."[78]

1. Treasury Regulation Section 1.367(a)-3(c)(3): The Active Trade or Business Test

Under the Active Trade and Business Test, the foreign corporation must have engaged in an active trade or business outside the United States in the thirty-six months immediately preceding the exchange.[79] Additionally, neither the transferors nor the foreign corporation can have any intention of discontinuing the trade or business.[80] Finally, a subtest known as the "Substantiality Test" must be satisfied.[81] The Substantiality Test is satisfied if, at the time of the transfer, the fair market value of the foreign corporation at least equals that of the domestic corporation.[82] After the regulation was put in place, it became more likely that corporations would fail its requirements for owning more than 50% of the foreign corporation, failing the Active Trade and Business Test, or even more likely, both.[83] Nevertheless, the regulation was not the deterrent effect that the United States expected[84] due to the fact that the regulation only affected U.S. shareholders' individual tax liability.[85]

D. *The American Jobs Creation Act of 2004 and I.R.C. § 7874*

In 2004, the American Jobs Creation Act added § 7874 to the Internal Revenue Code.[86] This section made it that much more difficult for domestic corporations to invert.[87] It states that the taxable income of an

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76. *Id.*
77. *See, e.g.*, *id.*
78. *Id.*
79. *Id.*
80. *Id.*
81. *Id.*
82. *Id.*
83. Hicks, *supra* note 10, at 906.
84. *Id.*
85. *Id.*
86. *See* I.R.C. § 7874 (2017).
87. Hwang, *supra* note 8, at 829.

expatriated entity shall be no less than the inversion gain of that entity.[88] It goes on to define an expatriated entity as any domestic corporation deemed a foreign corporation of a surrogate foreign corporation.[89] A surrogate foreign corporation, in turn, is defined as an entity in which after the acquisition is owned by at least 60% of the former shareholders of the domestic corporation (Ownership Test) and does not have substantial business activities in the foreign place of incorporation when compared to the overall business activities of the affiliated group (Substantial Business Activities Test).[90] Further, if ownership by the former shareholders passes the 80% mark, then the foreign corporation is flatly considered a domestic corporation for tax purposes.[91] So it is in the 60%-80% range where treatment differs.[92] When between this range, the taxable income of the corporation will be no less than the inversion gains for a period of ten years following the acquisition.[93] This substantially disincentives inversions, but if the corporation satisfies the Substantial Business and Activities Test or ends up owning less than 60% of the foreign corporation, then it does away with this treatment altogether.[94]

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88. *See* I.R.C. § 7874(a)(1).
89. *See id.* § 7874(a)(2)(A)(i).
90. *See id.* § 7874(a)(2)(B); *id.* § 7874(c)(1) ("The term 'expanded affiliated group' means an affiliated group as defined in section 1504(a) but without regard to section 1504(b)(3), except that section 1504(a) shall be applied by substituting 'more than 50 percent' for 'at least 80 percent' each place it appears."); *see, e.g.*, *id.* § 1504.

> (1) IN GENERAL The term 'affiliated group' means—
> (A) 1 or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation, but only if--
> (B)
> (i) the common parent owns directly stock meeting the requirements of paragraph (2) in at least 1 of the other includible corporations, and
> (ii) stock meeting the requirements of paragraph (2) in each of the includible corporations (except the common parent) is owned directly by 1 or more of the other includible corporations.
>
> (2) 80-PERCENT VOTING AND VALUE TEST The ownership of stock of any corporation meets the requirements of this paragraph if it—
> (A) possesses at least 80 percent of the total voting power of the stock of such corporation, and
> (B) has a value equal to at least 80 percent of the total value of the stock of such corporation.

Id.

91. *See id.* § 7874(b).
92. Mun, *supra* note 32, at 2166; Hwang, *supra* note 8, at 829-30.
93. *See* I.R.C. § 7874(a)(1), (d).
94. *Id.*

1. The Substantial Business Activities Test

In order to satisfy the Substantial Business Activities Test, the following requirements implemented by Treasury Regulation section 1.7874-3 need to be satisfied.[95] First, at least 25% of the total affiliated group's employees must be located at the place of inversion.[96] Second, at least 25% of the affiliated group's employee compensation must be incurred at the place of inversion.[97] Third, at least 25% of the total value of the affiliated group's assets must be within the place of inversion.[98] Fourth, at least 25% of the affiliated group's income must come from the place of inversion.[99] These requirements make it almost an impossibility to invert without triggering I.R.C. § 7874 and has led domestic corporations seeking to invert to do so through a merger with a well-established foreign corporation as opposed to empty shells.[100] In turn, likely places of inversion include the United Kingdom, Ireland, and Canada where corporations have substantial activity as opposed to Bermuda or the Cayman Islands.[101]

E. Skirting I.R.C. §§ 7874 and 367: Notice 2014-52, Notice 2015-79, and April 6, 2016, Temporary Treasury Regulation

With the advent of these new rules, mergers with well-established corporations have become the norm when deciding to invert. This can be done by either inflating the foreign corporation's assets or reducing the assets of the domestic corporation to avoid passing the 80% threshold of the Ownership Test of I.R.C. § 7874. Notice 2014-52, enacted in 2014, deals with the situation where the taxpayer is trying to avoid §§ 7874 and 367,[102] specifically when corporations are attempting to evade the 60% threshold of the Ownership Test.[103] Taxpayers can avoid § 7874 by

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95. *See* Treas. Reg. § 1.7874-3 (2018).
96. *See id.* § 1.7874-3(b).
97. *See id.*
98. *See id.*; *see*, *e.g.*, Steven M. Surdell, *Inversions 2014—Self Help International Tax Reform for U.S. Multinationals*, 92 TAXES 63, 79 (2014).
99. *See* Treas. Reg. § 1.7874-3(b).
100. Mun, *supra* note 32, at 2166-67; Hwang, *supra* note 8, at 831.
101. MARPLES & GRAVELLE, *supra* note 15, at 6.
102. *The IRS and Treasury Issue New Anti-Inversion Guidance*, MAYER BROWN (Sept. 25, 2014), https://www.mayerbrown.com/files/Publication/a469efe2-6c04-4106-add8-ca227088aea4/Presentation/PublicationAttachment/9de06344-d12d-46ed-9237-0155541810bf/UPDATE-Tax_IRS_Treasury_Anti-Inversion_Guidance_0914.pdf.
103. *Id.*

inflating the size of the foreign corporation.[104] To combat this, the Notice states that whenever more than 50% of the affiliated group's assets are in the form of nonqualified property—such as cash or cash equivalents, marketable securities, obligations, or property acquired related to the acquisition for the purpose of avoiding § 7874—then those assets will not be counted toward the Ownership Test of § 7874.[105] Similarly, the Ownership Test ratio can be reduced by declaring large dividends on the domestic corporation known as a "skinny-down dividends."[106] This, too, is disregarded for § 7874 purposes if made in the preceding thirty-six months and is not an ordinary course distribution.[107]

Notice 2015-79, enacted a year later in 2015, goes further and attacks those corporations that end up within the 60%-80% range that attempt to use the Substantial Business Activities Test to avoid § 7874. Many countries may be incorporated in one place but be a tax resident in another, such as the classic example of being incorporated in Ireland but a tax resident in Bermuda.[108] Notice 2015-79 seeks to address this situation and states that avoiding § 7874 through the Substantial Business and Activities Test will only apply when the foreign corporation is a tax resident at its place of incorporation.[109]

Finally, the April 6, 2016, Temporary Treasury Regulation was implemented making inversions even more difficult to overcome § 7874.[110] Under the Temporary Regulation, if a foreign corporation has been acquiring assets in the previous thirty-six months for purposes of avoiding the Ownership Test of § 7874, then such amount will be disregarded.[111] In the case of the Pfizer/Allergen merger, Pfizer would have owned 56% of the corporation with Allergen owning the remaining 44%.[112] But because

104. *Id.*
105. *Id.*
106. *Id.*
107. *Id.*
108. Kimberly S. Blanchard, *Notice 2015-79: The Latest Round of Inversions Guidance*, BLOOMBERG (Jan. 11, 2016), https://www.bna.com/notice-201579-latest-n57982065975/.
109. *Id.*
110. Richard Rubin & Liz Hoffman, *New Rules on Tax Inversions Threaten Pfizer-Allergan Deal*, WALL ST. J. (Apr. 6, 2016), https://www.wsj.com/articles/u-s-treasury-unveils-new-steps-to-limit-tax-inversions-1459803636?tesla=y; *see* Notice of Proposed Rulemaking Treatment of Certain Interests in Corporations of Stock or Indebtedness, 81 Fed. Reg. 20,911 (proposed Apr. 6, 2016) (to be codified as 26 C.F.R. 1).
111. Mun, *supra* note 32, at 2167; Jonathan D. Rockoff et al., *Pfizer Walks Away from Allergan Deal*, WALL ST. J. (Apr. 6, 2016), https://www.wsj.com/articles/pfizer-walks-away-from-allergan-deal-1459939739.
112. Rubin, *supra* note 110, at 2; Mun, *supra* note 32, at 2168 n.71.

Allergen had acquired a substantial amount of assets in the preceding thirty-six months, those were discounted for purposes of the Ownership Test—essentially killing the deal.[113] By discounting Allergen's acquired assets for the preceding three years that totaled roughly $90 billion, Allergen's assets were reduced substantially to only about $30 billion.[114] This would have put Pfizer ownership in the merged company at more than 80%, completely negating the tax benefits of the inversion as it would have been deemed a domestic corporation for tax purposes.[115]

III. THE TAX CUTS AND JOBS ACT OF 2017

On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act of 2017.[116] The Act has been the largest overhaul of the tax code since the reforms of 1986 under President Reagan.[117] In addition to lowering the corporate tax rate from 35% to 21%, the Act did a number of things that could affect the future of inversions.[118] First, it limited the allowable business interest deduction to 30% of a corporation's adjusted taxable income.[119] Second, it implemented a territorial tax system but also added the Base Erosion and Anti-Abuse Tax.[120] Third, it implemented a global intangible low income tax.[121] Fourth and finally, it implemented a one-time tax on repatriated foreign earnings.[122]

A. *The New I.R.C. § 163(j)*

The Act amended § 163(j), specifically by lowering the amount a corporation can deduct as a business interest expense from the previous 50% to 30% of adjusted taxable income.[123] Adjusted taxable income will

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113. Rockoff et al., *supra* note 111.
114. *Id.*
115. *Id.*
116. *See* H.R. REP. No. 115-97 (2017).
117. *Tax Reform Readiness: Base Erosion and Anti-Abuse Tax*, PRICEWATERHOUSE COOPERS 1 (Feb. 2, 2018), https://www.pwc.com/us/en/services/tax/library/insights/tax-reform-readiness-base-erosion-and-anti-abuse-tax.html.
118. *See* I.R.C. § 11(a)-(b) (2017).
119. *See id.* § 163(j).
120. *See id.* § 245A(a).
121. *See id.* § 951(a).
122. *See id.* § 965(a).
123. *See id.* § 163(j); *see also id.* § 163(j)(8).

> Adjusted taxable income.—For purposes of this subsection, the term "adjusted taxable income" means the taxable income of the taxpayer—
> (A) computed without regard to—

essentially be a calculation of Earnings Before Interest, Tax, Depreciation, and Amortization (EBITDA) at least until 2021, after which adjusted taxable income will be calculated similarly to EBIT.[124] The important thing to note though is that because the allowable business interest deduction is pegged at 30% of EBITDA for now—and EBIT after 2021—then any decrease in earnings will also lower the amount a corporation can deduct as business interest expense. Consequently, highly leveraged corporations that take a hit on their earnings will be impacted even more as it will have the effect of lowering its allowable interest deduction. Additionally, the new Tax Act did away with the debt-to-equity safe harbor provision.[125] Now, all business interest deductions are limited to 30% of adjusted taxable income irrespective of the corporation's debt-to-equity ratio.[126] Nevertheless, any disallowed business interest expense may still be carried forward indefinitely.[127] Overall, the issuance of intercompany debt by a foreign corporation to its domestic subsidiary, such as earnings stripping, are likely to decrease. But moreover, corporate borrowing in general is likely to decrease in an effort to bring down disallowed business interest deductions.

B. *The Territorial Tax System & I.R.C. § 59A: The Base Erosion and Anti-Abuse Tax*

Under the Tax Cut and Jobs Act, the United States has essentially moved to a territorial tax system, at least for corporate taxation.[128] A domestic corporation can take advantage of this new territorial tax system if a certain requirement is met, namely that it must own at least 10% of the foreign corporation.[129] If the domestic corporation meets this ownership

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(i) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business,
(ii) any business interest or business interest income,
(iii) the amount of any net operating loss deduction under section 172,
(iv) the amount of any deduction allowed under section 199A, and
(v) in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion, and
(B) computed with such other adjustments as provided by the Secretary.

Id.

124. *See id.*
125. *Compare* H.R. REP. 3299 (§ 7210 adding I.R.C. § 163(j)), *with* I.R.C. § 163(j).
126. I.R.C. § 163(j).
127. *Id.*
128. *See id.* § 245A.
129. *Id.*

requirement, then any foreign-sourced portion of a dividend it receives is fully deductible.[130] The foreign-source portions are considered all foreign earnings that are received by the domestic corporation as a dividend.[131] The Tax Act would further eliminate foreign tax credits except in a few circumstances.[132]

What is more important, however, is the Act's promulgation of § 59A, also known as the Base Erosion and Anti-Abuse Tax (BEAT).[133] Under this section an additional tax is imposed on any applicable taxpayer, defined as a corporation that earns more than $500 million, at a rate of 5% of its modified taxable income.[134] This rate increases to 10% the following year and then to 12.5% for years after 2025.[135] The modified taxable income provision essentially adds back any deductible base erosion payments the corporation made to a foreign person that is considered a related party.[136] A foreign person is considered related when it owns at least 25% of the domestic corporation.[137] Base erosion payments include any base erosion benefit from depreciation or amortization deductions if acquired from the related person, and any payments of interest, royalties, or services.[138] Once the modified taxable income is calculated, it is then compared to the corporation's regular tax liability.[139] Any modified taxable income in excess of regular tax liability is the Base Erosion and Anti-Abuse Tax that becomes due.[140]

With respect to interest payments, it should also be noted that if the corporation is subject to § 163(j), then any disallowed interest deduction is first allocated to unrelated parties then to related parties.[141] Because BEAT only adds back interest payments to *related* parties, this provision essentially preserves the full effect of the tax.[142] Moreover, § 951A was added to further attack earnings stripping, specifically for corporations that derive a substantial amount of their income from intangible assets abroad.

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130. *Id.*
131. *Id.*
132. *Id.*
133. *See id.* § 59A.
134. *Id.*
135. *Id.*
136. *Id.*
137. *Id.*
138. *Id.*
139. *Id.*
140. *Id.*
141. *Id.*
142. *Id.* (emphasis added).

C. *I.R.C. § 951(a): The Global Intangible Low Tax Income*

Section 951A is a new addition to the tax code that taxes global intangible low tax income (GILTI).[143] Under this provision, United States shareholders of CFCs are taxed at a rate of 10.5% on the excess of the shareholders net CFC tested income over the net deemed tangible income return.[144] The net deemed tangible return is the excess of 10% of the United States shareholder's pro rata share of a CFC's qualified business investment over the amount of interest expense taken into account to calculate the United States shareholder's net CFC tested income.[145] After GILTI is calculated, § 250(a) provides for a deduction of 50%.[146] Then, under § 78, shareholders can add back an 80% foreign tax credit on foreign taxes paid attributable to GILTI.[147]

As an example, imagine a United States shareholder that owns 100% of a controlled foreign corporation (CFC). The CFC has a GILTI income of $900 of which $100 was paid in foreign tax.[148] First, the GILTI amount of $1000 ($900+$100) would be allowed an interest deduction of 50% totaling $500.[149] The remaining $500 is taxed at the current U.S. corporate tax rate of 21% equaling $105.[150] A foreign tax credit is then added back at 80% of the amount of foreign tax paid—in this case $80 as 80% of the $100 in foreign tax paid.[151] Accordingly, the United States shareholder would have a GILTI tax liability of $25 ($105 - $80).[152]

Although the United States has moved to a territorial tax system, this particular tax provision still taxes income on a global level.[153] It is, however, limited to income derived from intangible assets.[154] This provision was implemented to curtail corporations from exploiting the new territorial tax system by moving their intellectual property overseas

143. *Id.* § 951A.
144. *Id.* § 951A(c)(2)(A) (stating net CFC tested income is essentially the gross income of the CFC other than income that is already subject to U.S. tax such as Subpart F income).
145. *Id.*
146. *Id.* § 250(a).
147. *Id.* § 78.
148. *See, e.g.*, Lowell D. Yoder et al., *Tax Reform: Taxation of Income of Controlled Foreign Corporations*, BLOOMBERG TAX 3 (Jan. 22, 2018), https://www.mwe.com/~/media/files/thought-leadership/publications/2018/01/mcdermott--tax-reform--cfcs-12218--published.pdf.
149. *See, e.g.*, *id.*
150. *See, e.g.*, *id.*
151. *See, e.g.*, *id.*
152. *See, e.g.*, *id.*
153. *Corporate Tax and the Trade Balance*, FIN. TIMES ALPHACHAT (Feb. 9, 2018) (downloaded using iTunes).
154. *See, e.g.*, I.R.C. § 951A (2017).

and lowering domestic earnings.[155] But, it should be highlighted that the provision has the effect of incentivizing moving tangible assets abroad because of the way GILTI is calculated.[156] Because GILTI is calculated as the net CFC tested income over the net deemed tangible income then increasing the amount of *tangible* income, let's say by opening a factory abroad, the CFC would result in a lower GILTI.[157]

D. I.R.C. § 965: Tax and the Deemed Repatriation of Foreign Earnings

Under § 965, Subpart F income, which is taxed immediately when earned, of any foreign corporation that has a United States shareholder owning at least 10% of it will include any post-1986 accumulated deferred income from earnings and profits of that foreign corporation on its income tax return.[158] This essentially is a deemed repatriation of all foreign earnings.[159] A 15.5% tax is placed on the United States shareholder's aggregate foreign cash position while an 8% tax is placed on everything else.[160] Cash position includes cash, net accounts receivable, and the fair market value of certain liquid assets.[161] But, the United States shareholder can choose to pay the tax on repatriated earnings over eight years if it so chooses.[162] If so, then the tax due for the first five years will be 8% with

155. *Id.*

156. *Id.*

157. *Id.* (emphasis added).

158. *Id.* § 965.

159. *Id.*; *see also* Jim Alajbegu, *Untangling Tax Reform: Repatriation Tax and Further Guidance*, BAKER TILLY (Jan. 4, 2018), http://www.bakertilly.com/insights/untangling-tax-reform-repatriation-tax-and-further-guidance/.

160. I.R.C. § 965; *see also Tax Reform Act—Impact on Taxpayers with International Operations*, BAKER BOTTS (Dec. 20, 2017), http://www.bakerbotts.com/ideas/publications/2017/12/tax-reform-act---international.

161. *See, e.g.*, I.R.C. § 965.

> (iii) the fair market value of the following assets held by such corporation:
>
> (I) Personal property which is of a type that is actively traded and for which there is an established financial market.
>
> (II) Commercial paper, certificates of deposit, the securities of the Federal government and of any State or foreign government.
>
> (III) Any foreign currency.
>
> (IV) Any obligation with a term of less than one year.
>
> (V) Any asset which the Secretary identifies as being economically equivalent to any asset described in this subparagraph.

Id.; *see also Tax Reform Act*, *supra* note 160.

162. I.R.C. § 965(h).

the tax on the following sixth, seventh, and eighth years being 15%, 20%, and 25%, respectively.[163]

Many corporations have elected to pay the repatriation tax over the eight-year installment.[164] Companies such as Apple, Microsoft, and McDonalds have also chosen to do this.[165] But these companies will still take large hits on their cash flow statements.[166] Microsoft, for example, will pay a repatriation tax of about $17 billion and cut over $4 billion from its operating cash flow.[167] For Apple, it will be even larger given that it will repatriate over $38 billion in deferred foreign earnings.[168] McDonalds, similarly, will pay close to $300 million a year on its $1.2 billion tax it will owe.[169] While the tax payments do not necessarily affect earnings, these payments will make it seem as if earnings are less supported by cash flow than they really are.[170] Cash flow can dip below net income—and in some cases already has—and can be misleading when comparing financial statements with other companies.[171]

IV. THE TAX ACT: THE SAME WHACK-A-MOLE APPROACH OR A SIGNIFICANT PUNCH TO INVERSIONS?

"Interest in reforming the corporate income tax is long-standing."[172] Two fundamental issues a corporation looks at when deciding where to incorporate—or reincorporate—is the overall corporate tax rate it will have to pay but also how the jurisdiction taxes its foreign earnings.[173] In order for a corporation to consider staying in the United States, comprehensive tax reform needs to be effected that would both lower the corporate tax rate and implement a territorial tax system.[174] Before the Tax Cut and Jobs Act, the United States taxed corporations at a rate of 35%.[175]

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163. *Id.*
164. Michael Rapaport, *The Tax Law Is About to Make Analyzing Earnings Trickier*, WALL ST. J. (Feb. 12, 2018), https://www.wsj.com/articles/the-tax-law-is-about-to-make-analyzing-earnings-trickier-1518431404.
165. *Id.*
166. *Id.*
167. *Id.*
168. *Id.*
169. *Id.*
170. *Id.*
171. *Id.*
172. MARPLES & GRAVELLE, *supra* note 15, at 11.
173. *Id.*
174. Hwang, *supra* note 8, at 851.
175. *Id.* at 813.

To compare, the average corporate tax rate of Organisation for Economic Co-operation and Development (OECD) countries—a membership of mostly advanced countries—was 24.18%.[176] With the enactment of the Tax Act, the United States' corporate tax rate is now well below the OECD average.[177] Furthermore, the Act changed the United States' taxation system from a worldwide tax system to a territorial tax system.[178]

The lowering of the corporate tax rate would likely not stop inversions on its own.[179] Ireland, for example, still has a corporate tax rate of 12.5%[180]—a rate much lower than the reduced corporate tax rate of 21% implemented by the Tax Act. Accordingly, corporations would still have an incentive to reincorporate abroad in order to lower their overall tax liability. Countries with zero corporate tax rate, although ideal, would not be feasible given that few, if any, have well-established corporations that would satisfy the Active Business or Trade Test of § 367.[181] If a corporation chooses to invert, it is still subject to § 7874 along with the Notices and Temporary Regulations that are still in effect, which push back on inversions. But the United States' implementation of a territorial tax system can be seen as the step toward substantially lowering (or stopping) inversions. Mimicking the corporate tax laws of jurisdictions such as Ireland, which include a territorial tax system in addition to a low corporate tax rate, would seem to generally restrict inversions as it would generate very little, if any, tax savings while simultaneously producing the transaction costs that come with inversions.[182]

Under the new territorial tax system, corporations are normally only taxed on income earned within the United States.[183] Any foreign earnings can be brought back as a foreign dividend with a 100% deductibility.[184] Further, under BEAT, payments of interest, royalties, or services would be added back to the corporation's income.[185] These two provisions work together to discourage companies from inverting. Additionally, because the Act made post-1986 foreign earnings deemed repatriated and

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176. Kari Jahnsen & Kyle Pomerleau, *Corporate Income Tax Rates Around the World, 2017*, TAX FOUND. (Sept. 7, 2017), https://taxfoundation.org/corporate-income-tax-rates-around-the-world-2017/.

177. *See, e.g.*, *id.*

178. I.R.C. § 245A (2017).

179. MARPLES & GRAVELLE, *supra* note 15, at 11-12.

180. Jahnsen & Pomerleau, *supra* note 176.

181. *See, e.g.*, I.R.C. § 367.

182. Hwang, *supra* note 8, at 853.

183. I.R.C. § 245A.

184. *Id.*

185. *Id.* § 59A.

disallowed deferrals indefinitely, there is still less of an incentive to invert since for many companies the bulk of their foreign profits are going to be taxed regardless. With respect to the new § 163(j), this will especially restrict corporations from the conduct of earnings stripping through the issuance of intercompany debt. Foreign corporations will no longer be able to issue large amounts of debt to their U.S. subsidiaries in an effort to lower domestic earnings by deducting the interest expense. Thus, if a domestic corporation wished to invert to take advantage of earnings stripping, this provision seriously restricts it.

With respect to corporations that derive a substantial amount of income from intangible assets, things get a little trickier. These corporations will be incentivized to increase tangible depreciable assets abroad in order to lower their GILTI liability. For these companies, foreign income can be invested abroad in tangible depreciable assets such as a factory or plant and never pay a U.S. tax. But, tangible assets such as these take years to build. It seems too soon to tell whether corporations will end up using the provision in this way, however.

V. CONCLUSION

We have seen various provisions added and amendments to the U.S. Tax Code in the hopes of curtailing inversions. It has been incremental, slow, and ex post facto. However, the new Tax Cut and Jobs Act could be seen as a substantial punch at inversions. But, there are many other reasons a U.S. corporation may choose to re-domicile abroad. Things that come to mind are the creation of synergies, sharpening business focus, increasing market share, and vertical and horizontal integration. Reducing tax liability is not the only one, nor has it been a particularly essential reason in the context of the larger mergers and aquisitions view. The future of inversions is still an area of interesting discussion and should be carefully watched and studied for years to come.