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How to Prepare for U.S. Government Action to Address U.S. Corporate Inversions

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CURRENT ACTIVITY IN U.S. CONGRESS TO ADDRESS CORPORATE INVERSIONS

U.S. Congress

- Two main legislative options:
 - General reform of the U.S. tax code
 - Targeted legislation to address corporate inversions
- Democrats have been vocal in their support of administrative action, as well as specific legislation to target corporate inversions.
- Republicans generally prefer broad corporate tax reform but some have expressed interest in narrow provisions like targeting income stripping.

The Politics of Corporate Inversions

- Attention on corporate inversions is being driven in part by the November mid-term elections.
- Democrats believe the issue is a winning one politically, though there are disagreements on how best to proceed.
- If Congress doesn't act, it becomes increasingly likely that the administration will take executive action.
- It is clear that this issue will carry over into the 114th Congress.

Congressional Republican Principles

- In conversations with senior Republican tax staff, we have learned that any legislation related to corporate inversions must:
 - Refrain from any retroactivity;
 - Be revenue neutral;
 - Move closer to territorial regime; and
 - Not undermine comprehensive tax reform
- It is unclear if Republicans are willing to be flexible with any of these principles.

Congressional Democratic Principles

- Democrats have introduced a variety of legislative fixes, as detailed below.
- Most, if not all, apply retroactively to previously-completed inversions. Some are retroactive to May 2014, while some reach much further into the past as a means of raising revenue and sending a strong message against the procedure.
- Senate Democrats and the administration are each encouraging the other to take action.
- Contrary to what many people believe and to what the media reports reveal, we believe there is an underlying and fairly substantial appetite among Democrats, including among many liberal Democrats, especially those who represent areas with high-tech companies and other headquarters of global companies, for substantial tax reform.
- We believe the outlines of a deal that would find a considerable number of Democrats supporting broad tax reform would be something they could say restricted the ability of companies to move headquarters offshore in return for incentives for US companies to bring more of their profits back home without a huge tax penalty.

Current Legislative Options

- New Legislation to Address Income Stripping

- S. 2786 introduced by Senator Charles Schumer (D-NY); bill is a rallying point for Senate Democrats
- Would reduce the amount of deductible interest for inverted companies to 25% of U.S. taxable income from 50%
- Would require such companies to obtain approval from the IRS for transactions between different parts of the same company for 10 years
- Proposes restrictions on companies' ability to carry deductions forward to future years
- Limited to inverted corporations
- Applies to any inversion after April 17, 1994

Current Legislative Options

- Stop Corporate Inversions Act of 2014

- S. 2360 introduced by Senator Carl Levin (D-MI)
- H.R. 4679 introduced by Rep. Sander Levin (D-MI). Strong support among House Democrats
- Would lower ownership threshold ceiling from 80% to 50%
- Would treat merged corporations as U.S. entity if:
 - Management and control of entity remained in the U.S.
 - 25% of an entity's employees, employee compensation, income or assets is located in or derived from the U.S.
- Not limited to inverting corporations; would apply broadly to all U.S. subsidiaries
- Applies retroactively to May 8, 2014

Implications

- U.S. Government interest and activity surrounding corporate inversions is not going away.
- On the contrary, a series of actions in the coming weeks and months is likely.
- Government action could be varied and far-ranging.
- Some actions being considered would impact companies that are not even involved in an inversion transaction.

Recommendations

- Businesses that have entered into inversion transactions or are planning to in the future need to engage with experts who can advocate on their behalf to seek to avoid provisions that would undermine the financial viability of those transactions.
- If the company has business as a government contractor, engaging additional experts with respect to Federal Acquisition Regulations and experience working with policy makers at the agencies is crucial.

Recommendations (con't)

- Multinational businesses not involved in inversion transactions but that have significant operations in the U.S. may also be at risk and should similarly engage experts to help develop a strategy to avoid broad legislation and regulation.

CONSIDERATIONS AND RISKS FOR GOVERNMENT CONTRACTORS

Current Statutory and Regulatory Framework

- “Inverted domestic corporation” defined in Homeland Security Act of 2002 - 6 U.S.C. 395(b)
- Annual Appropriations
- Federal Acquisition Regulations (FAR)
- Agency Acquisition Regulations

Inverted domestic corporation - 6 U.S.C. 395(b)

- Inverted Domestic Corporation. For purposes of this section, a foreign incorporated entity shall be treated as an inverted domestic corporation if, pursuant to a plan (or a series of related transactions):
 1. the entity completes before, on, or after November 25, 2002, the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation or substantially all of the properties constituting a trade or business of a domestic partnership;
 2. after the acquisition at least 80% of the stock (by vote or value) of the entity is held:
 - in the case of an acquisition with respect to a domestic corporation, by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation; or
 - in the case of an acquisition with respect to a domestic partnership, by former partners of the domestic partnership by reason of holding a capital or profits interest in the domestic partnership
 3. the expanded affiliated group which after the acquisition includes the entity does not have substantial business activities in the foreign country in which or under the law of which the entity is created or organized when compared to the total business activities of such expanded affiliated group.

Appropriations Legislation

- FY 2014: “None of the funds appropriated or otherwise made available by this or any other Act may be used for any Federal Government contract with any foreign incorporated entity which is treated as an inverted domestic corporation under section 835(b) of the Homeland Security Act of 2002 (6 U.S.C. 395(b)) or any subsidiaries of such an entity.”
 - The Consolidated Appropriations Act, 2014, § 733

Appropriations Legislation

- The Government-wide prohibition first appeared in FY 2008 and has been enacted every year since, with the exception of FY 2011.
- Agency-level restrictions were enacted in FY 2006 and FY 2007.
- The provision is not retroactive – it only applies to contracts entered into after the date of enactment – as it applies only to funds appropriate for that fiscal year.
- There is a waiver provision, which provides that any Secretary may waive the prohibition if the Secretary determines that the waiver is required in the interest of national security. The Secretary is required to report each waiver to Congress.

Federal Acquisition Regulation

- 9.108-1 Definitions

- As used in this section: Inverted domestic corporation means a foreign incorporated entity which is treated as an inverted domestic corporation under 6 U.S.C. 395(b), i.e., a corporation that used to be incorporated in the U.S., or used to be a partnership in the U.S., but now is incorporated in a foreign country, or is a subsidiary whose parent corporation is incorporated in a foreign country, that meets the criteria specified in 6 U.S.C. 395(b), applied in accordance with the rules and definitions of 6 U.S.C. 395(c). An inverted domestic corporation as herein defined does not meet the definition of an inverted domestic corporation as defined by the Internal Revenue Code at 26 U.S.C. 7874.
- Subsidiary means an entity in which more than 50 percent of the entity is owned:
 - Directly by a parent corporation; or
 - Through another subsidiary of a parent corporation.

Federal Acquisition Regulation

- 9.108-2 Prohibition
 - (a) Section 738 of Division C of the Consolidated Appropriations Act, 2012 (Pub. L. 112-74) *prohibits* the use of 2012 appropriated funds for contracting with any foreign incorporated entity that is treated as an inverted domestic corporation or with a subsidiary of such a corporation.
- This prohibition applies only to the appropriated funds for the Government Fiscal Year in which the prohibition is contained.

Federal Acquisition Regulation

- 9.108-3 Representation by the offeror
 - In order to be eligible for contract award when using FY 2008 through FY 2010 funds or FY 2012 funds, an offeror must represent that it is not an inverted domestic corporation or subsidiary. Any offeror that cannot so represent is ineligible for award of a contract using such appropriated funds.
- Clause 52.209-2-Representation is made by submission of the offer
- Clause 52.209-10-Prohibition on Contracting With Inverted Domestic Corporations
 - If the contractor reorganizes as an inverted domestic corporation or becomes a subsidiary of an inverted domestic corporation at any time during the period of performance of this contract, the Government may be prohibited from paying for contractor activities performed after the date when it becomes an inverted domestic corporation or subsidiary. The Government may seek any available remedies in the event the contractor fails to perform in accordance with the terms and conditions of the contract as a result of Government action under this clause.

Department of Homeland Security – Statutes

- The Secretary may not enter into any contract with a foreign incorporated entity that is treated as an inverted domestic corporation under subsection (b) of this section, or any subsidiary of such an entity – 6 U.S.C. 395(a)
- The Secretary shall waive subsection (a) of this section with respect to any specific contract if the Secretary determines that the waiver is required in the interest of national security – 6 U.S.C. 395(d)

Department of Homeland Security – Procurement Regulations

- Contract Clause 3052.209-70 -Prohibition on contracts with corporate expatriates.
 - (f) *Disclosure*. The offeror under this solicitation represents that:
 - It is not a foreign incorporated entity that should be treated as an inverted domestic corporation pursuant to the criteria of (HSAR) 48 CFR 3009.108-7000 through 3009.108-7003;
 - It is a foreign incorporated entity that should be treated as an inverted domestic corporation pursuant to the criteria of (HSAR) 48 CFR 3009.108-7000 through 3009.108-7003, but it has submitted a request for waiver pursuant to 3009.108-7004, which has not been denied; or
 - It is a foreign incorporated entity that should be treated as an inverted domestic corporation pursuant to the criteria of (HSAR) 48 CFR 3009.108-7000 through 3009.108-7003, but it plans to submit a request for waiver pursuant to 3009.108-7004.

Application in Practice

- Despite the existence of the prohibition, virtually no companies have to date been denied federal contracts due to the inversion prohibition (although some took precautionary measures in advance).
- Government Contracting Officers have not been analyzing a company's/offerator's compliance; the representation by submission of the offer typically is accepted without review.
- There has been one reported bid protest, which was denied (*Inchcape Shipping Services (Dubai) LLC*, B-409465, May 12, 2014).

Application in Practice (con't)

- Agency contracting processes are currently not set up to conduct analysis of a company's inversion status, and the contracting staff have not been trained to undertake such analyses.
- In some instances, a company with a concern has requested an opinion from an agency. Some agencies have been willing to provide opinions (even if advisory only), but others have not.

RECENT EVENTS

Letter from Congress

- In August, six House and Senate Democrats (Reps. Rosa DeLauro (D-CT), Lloyd Doggett (D-TX), Sander Levin (D-MI) and Sens. Carl Levin (D-Mich.), Dick Durbin (D-III) and Jack Reed (D-RI)) wrote a letter to President Obama that asked the administration to deny federal contracts to companies that have inverted.
- “When the tax bill comes due, they renounce their citizenship. But, perhaps even more outrageously, they also seek, and win, taxpayer-funded federal contracts from the same country they renounced. Our federal contracting rules should not allow these companies to be rewarded with federal contracts.”
- The members asserted that there is a loophole in the current law that allows an inverted company to qualify for federal contract if the company merges with a smaller foreign company that is at least one-fourth the size of the U.S. company.
- The members called for a law that would not be renewed annually, as is the case with the prohibition in the appropriations act.

Amendment 1012 to H.R.4923 Energy and Water Development and Related Agencies Appropriations Act, 2015

- “None of the funds made available by this Act may be used to enter into any contract with an incorporated entity if such entity’s sealed bid or competitive proposal shows that such entity is incorporated or chartered in Bermuda or the Cayman Islands, and such entity's sealed bid or competitive proposal shows that such entity was previously incorporated in the United States.”
- Passed the House 221-200 on July 10, 2014.
- The bill is now in the Senate Appropriations Committee.

PROPOSED & CONTEMPLATED ACTIONS

No Federal Contracts for Corporate Deserters Act

- H.R. 5278, S. 2704 introduced by representatives Rosa DeLauro (D-CT) and Lloyd Doggett (D-TX) and Senators Dick Durbin (D-IL) and Carl Levin (D-MI).
- The legislation would bar contracts from going to businesses that incorporate overseas, are majority-owned by shareholders of the old U.S. corporation, and do not have substantial business opportunities in the foreign country in which they are incorporating.
- The bill would amend the Tax Code:
 - Under current law, a company is inverted if, after the acquisition, at least 80% of the stock (by vote or value) of the entity is held by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation.
 - The legislation would lower the threshold to 50%.
- The bill would allow agencies to ban businesses from holding federal contracts if the subcontract was with inverted corporations.
- The bill was referred to the Committee on Oversight and Government Reform and the Committee on Armed Services.

Executive Actions and Implications

- Executive Order and/or FAR Amendment: There are strong indications that either an Executive Order or a revision to the FAR to strengthen the prohibition related to federal contracts is under serious consideration – and likely in the final stages of the internal OMB approval process.
- Amendments to the FAR: Are relatively simple to accomplish by use of an interim rule.
- Nature of an Amended Rule: An amended rule is expected to: (i) provide a more detailed definition – more stringent than the current definition at 6 U.S.C. 395(b); (ii) provide for an affirmative representation of compliance – with each offer (and possible updates for pending contracts); (iii) require substantially more process – perhaps along the model of the recent labor reporting EO which requires more detailed reporting (and thus due diligence), more oversight and referrals to the SDO; (iv) flow down to subcontractors – perhaps on the lines of the labor reporting EO – all tiers; and (v) may apply to current contracts, as well as new opportunities.
- Implications: Potential for detailed submissions, strict scrutiny, need for mandatory disclosures, potential IG investigations, risk of debarment and other remedies.

Conclusion

- Expect regulatory action – soon.
- Agency contracting processes and staff are not prepared for enforcement – likely to defer to IG and SDO.
- Expect focus on vigorous enforcement.

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Questions?

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