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NEWSLETTER

The "No Federal Contracts for Corporate Deserters Act of 2014"—Congress's Latest Attempt to Address Inverted Domestic Corporations

Fall 2014

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In late July, Democrats in both the House and the Senate introduced the "No Federal Contracts for Corporate Deserters Act." (H.R. 5278, S. 2704). The name of the bill alone betrays the views of its proponents. This proposed bill is the latest in a line of attempts to counter what the proponents consider to be the exploitation of laws governing inverted companies. (A previous bill, the "Stop Corporate Inversions Act," designed to tighten the anti-inversion provisions in the tax code, was introduced in the Senate and referred to the Committee on Finance in May). Currently, based on the adoption of the definition of inverted domestic corporation from a statute restricting the Department of Homeland Security (DHS) from contracting with such entities, the FAR prohibits the use of particular funds to award contracts to certain foreign incorporated entities that have absorbed U.S. companies. If passed, the Act would create a substantially broader definition of the term "inverted domestic corporation" and bar agencies (both civilian and defense) from awarding contracts to U.S.-focused and –controlled businesses that reincorporate overseas and cannot show "substantial business opportunities" in their new country of incorporation.

According to a recent analysis by Reuters, only 52 U.S. corporations have completed inversions over the past 32 years. *See* Kevin Drawbaugh, *Democrats urge no U.S. contracts for corporate tax 'deserters.'* But the pace appears to be quickening—19 of those inversions have occurred since 2009, and 10 more companies are in the process of inverting. *Id*. This rise in the numbers of inversions has led the President and Democratic members of Congress to decry the corporate reorganizations in low-tax countries, such as Bermuda, as unfair attempts to operate in the U.S. for all practical purposes, thus benefiting from the country's infrastructure, while avoiding paying U.S. taxes.

Currently, a company is classified as an inverted domestic corporation for purposes of federal contracting according to the complicated definition in 6 U.S.C. § 395, Prohibition on contracts with corporate expatriates. That statute prohibits DHS from entering into a direct contract with an inverted domestic corporation, meaning a company that appears to have reorganized to decrease its U.S. taxes rather than to accommodate any shift in the control of the company or the nature of its business. An inverted domestic corporation is defined under that statute as a foreign incorporated entity that implemented a plan to acquire substantially all the properties or assets of a U.S. corporation or partnership, provided that after the acquisition either (1) more than 80% of the stock (by vote or value) of the entity is held by former shareholders or partners of the U.S. corporation or partnership; or (2) the expanded affiliate group of the entity is managed and controlled primarily in the U.S. and has significant U.S. business activities, as measured by employee location and compensation, location of assets, and derivation of income. The statute further outlines special rules for the application of the above tests that relate to, among other things, what stock should be considered, and what constitutes a plan to invert.

The FAR Councils adopted DHS's definition to implement broader bans on contracting with inverted domestic corporations included in various Appropriations Acts beginning in 2008, and thus only applicable to funds from specified fiscal years. For example, in a 2012 protest by Inchcape Shipping Services Holding, Ltd., the Government Accountability Office dismissed the allegation that the award violated the FAR's prohibition on contracting with inverted domestic corporations because the contract's funds were for a fiscal year not covered by the bans and associated FAR rules.

Proponents of the Act believe that the current definition of inverted domestic corporation is too narrow, allowing a company to "invert" for all practical purposes, thus avoiding U.S. taxes, while U.S. shareholders retain control of the company and the company remains eligible to compete for federal government contracts. The Act aims to address these perceived loopholes in the current laws and regulations. Specifically, the Act would mandate the following:

- **More Encompassing Definition**—update and revise the definition of inverted domestic corporation. Under the Act, an inverted domestic corporation is
    - A foreign incorporated entity that has ever acquired substantially all the properties or assets of a domestic corporation or domestic partnership pursuant to a plan or series of related transactions; and
    - After the acquisition
        - More than 50% of the stock (by vote or value) of the entity is held by former shareholders or partners of the domestic entity; or

        - The expanded affiliate group which includes the entity—as defined by the Internal Revenue Code and the DHS statute above—is managed and controlled primarily in the U.S. and has significant U.S. business activities, measured by employee location and compensation, location of assets, and derivation of income.
    - Except, a company encompassed by this definition will not be treated as inverted domestic corporation if it has "substantial business activities" as compared to its "total business activities" in the foreign country under which the entity is created or organized. Substantial business activities is a term left to the Secretary of the Treasury to define.
- **Prohibition**—prevent agencies from awarding contracts, both civilian and defense, to an inverted domestic corporation, any subsidiary thereof, or any joint venture where more than 10% of the joint venture is held (by vote or value) by an inverted domestic corporation (collectively "inverted domestic corporations").
- **Prime/Sub Restrictions**—for non-commercial item contracts valued at over $10 million, prohibit prime contractors from awarding a "first-tier" subcontract greater than 10% of the value of the prime contract to inverted domestic corporations.
    - Also prohibit prime contractors from avoiding the "first-tier" prohibition by "structuring subcontract tiers" to allow an inverted domestic corporation to perform work valued at greater than 10% of the value of the prime contract at any subcontract level.
    - The Act provides that any violation of the subcontract limitations may result in the termination for default of the prime contract and is a basis for referring the prime contractor for suspension or debarment.
- **Waiver**—allow the head of an executive agency to waive the contracting prohibition if the agency head determines that the waiver is.
    - "Required in the interest of national security" or;
    - "Necessary for the efficient or effective administration of Federal or Federally-funded programs that provide health benefits to individuals."
- **Applicability**—the Act's prohibitions will not be applied retroactively but will apply to all new contract awards and to any task or delivery orders issued after enactment of the law regardless of whether or not the contract the order is issued under was "entered into before, on, or after such date of enactment."

It remains to be seen if and when this bill will be voted upon and what it will look like if and when it ever makes it to the floor of the House or Senate. Recent reports on the status of the legislation indicate that the Democratic lawmakers sponsoring the reform efforts are at odds with Republican lawmakers, who generally oppose any retroactive application of inversion penalties, and call instead for lowering the corporate tax rate cited as the impetus for inversion in other jurisdictions.

Joining the proposed Federal legislation are similar proposed laws introduced by Democrats before both the state Assembly and state Senate of New Jersey. (A3624, S2397). The New Jersey bills define an "inverted domestic corporation" as "a corporation incorporated or previously incorporated in the United States that becomes or has become incorporated in a foreign country or that becomes or has become a subsidiary of a corporation incorporated in a foreign country, primarily for the purpose of avoiding United States taxes" and, if passed, would bar inverted domestic corporations from receiving contracts or subcontracts for goods, services or construction projects funded by the state of New Jersey. The New Jersey senate also now has before it a proposed bill that would prohibit inverted domestic corporations from receiving state economic development grants and other financial aid. (S2397). As with the recently proposed federal legislation targeted at inverted domestic corporations, it remains unclear how much traction any of the New Jersey bills will get in either the state Assembly or state Senate.

Wiley Rein will continue to monitor the progress of the proposed federal legislation as well as similar state initiatives and provide updates.