National Security Implications of Corporate Inversion: FOCI, CFIUS, and Export Controls

There has been much recent focus on cross-border transactions in which U.S. companies re-domicle their corporate headquarters outside of the United States. The practice, known as “corporate inversion,” may allow the inverted domestic corporations to reduce U.S. taxes on overseas income. Practitioners and U.S. government officials acknowledge that a corporate inversion, whereby a U.S corporation is acquired by a foreign corporation or merges into a foreign corporation with the foreign corporation surviving, may create legally available tax benefits in part through the lower income tax rates of the foreign jurisdiction. The U.S. Department of the Treasury and U.S. Congress, however, are closely scrutinizing the practice, which has generated extensive recent political debate. To ensure regulatory compliance, U.S. companies contemplating a corporate inversion should be aware of potential national-security regulatory implications regarding foreign ownership, control or influence (“FOCI”), the Committee on Foreign Investment in the United States (“CFIUS”), and export controls.
Tax Inversion Background
Numerous U.S. companies have sought and continue to manage their global effective tax rate, and may have the opportunity to do so as they grow with acquisitions globally. Historically, a corporate inversion was effected on a standalone basis; this was done via the exchange of stock in the inverting U.S. company for shares of a new foreign parent company. These transactions resulted in the foreign entity becoming the ultimate parent (albeit with the same shareholders that had owned the U.S. company) and the U.S. company operating as its subsidiary.

Congress responded to concerns regarding this form of inversion by amending the U.S. Tax Code in 2004. The statutory amendments limited the ability of U.S. corporations to invert and imposed certain unfavorable tax consequences on the practice. For example, the amendments provided that if the former shareholders of a U.S. corporation owned at least 80% of the foreign corporation acting as the acquirer, that company was treated as a U.S. corporation. In addition, the amendments deny or limit the availability of certain U.S. tax benefits in an inversion transaction where the former shareholders of the U.S. corporation own at least 60% (but less than 80%) of the foreign acquirer. Furthermore, Congress amended the Homeland Security Act in 2009 (later applied to all U.S. Government agencies) to prohibit awarding federal contracts to impermissibly inverted domestic corporations.

In 2012 temporary regulations were issued providing that in order for an inverting U.S. corporation whose former shareholders own at least 60% of the foreign acquirer to avoid triggering these anti-inversion rules, the foreign acquirer’s corporate group must have substantial business activities in its country of organization (i.e., at least 25% of each of the corporate group’s employees and assets, and at least 25% of the group’s income located or derived in the relevant foreign country). Most recently, on September 22, 2014, the U.S. Department of the Treasury and the Internal Revenue Service (“IRS”), in what was referred to by Treasury Secretary Jacob Lew as the “first, targeted steps” addressing corporate inversions, provided guidance intended to diminish the ability of inverted companies to access the earnings of foreign subsidiaries of the U.S. company that inverted without paying U.S. taxes on such earnings.

The recent wave of corporate inversions through mergers with foreign partners does not trigger the prohibitions of the 2004 Tax Code or the 2009 amendments to the Homeland Security Act. This is primarily because these transactions do not result in 80% (or 60% with respect to limiting certain U.S. tax benefits) of the stock of new foreign entities being owned by former shareholders of the inverting U.S. corporations. (Note that legislation is being considered that would reduce the current 80% ownership threshold to 50% and limit the ability of a U.S. company to benefit from interest-expense deductions following inversion, thus requiring even more economic substance. It is unclear whether legislative proposals to curb inversions will proceed absent comprehensive tax reform).

National Security Considerations
Because the foreign-merger approach is structurally equivalent to the foreign acquisition of a U.S. company, these new corporate inversion transactions often have significant national-security regulatory and compliance implications. In particular, following an inversion, sensitive assets, including intellectual property and export-controlled articles and technology, or a U.S. Government contractor that works with such assets, may become foreign owned and controlled. As a result of the new foreign ownership, the inverting entities and the inversion transaction itself may be subject to industrial-security, CFIUS, and export-control regulations and requirements. Moreover, in light of the governmental scrutiny of these transactions, inverting companies should recognize that compliance with all applicable regulatory regimes is essential.

An inverting U.S. company (or any of its subsidiaries) that holds a U.S. Government facility security clearance (“FCL”—a prerequisite for accessing classified information—will be subject to restrictions based on industrial-security regulations and policies concerning FOCI. Pursuant to the National Industrial Security Program Operating Manual (“NISPOM”), a foreign company may not hold an FCL, and a U.S. company may not continue to hold its FCL after becoming foreign owned or controlled, unless its FOCI is appropriately mitigated (the NISPOM requires a company that possesses an FCL to notify the U.S. Government whenever it enters into discussions, consultations, or agreements that could lead to ownership or control by a foreign person). FOCI mitigation is generally

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2 See Temp. Treas. Reg. § 1.7874-3T.
required if the U.S. cleared company comes under foreign ownership as low as five percent, and it applies even if the company and its affiliates have no material operations outside of the United States. For example, a U.S. company with solely U.S. facilities but a foreign ultimate parent or significant shareholder (e.g., as a result of inversion) is under FOCI and will require appropriate FOCI mitigation to maintain its FCL and continue bidding and performing on classified contracts. As a result, it is possible for a large company to trigger FOCI requirements by inverting and risk endangering its FCLs by not properly addressing its industrial-security obligations. Complying with these requirements is critical, as failing to appropriately mitigate FOCI in coordination with the appropriate U.S. Government agency can lead to invalidation or termination of the company’s FCL, which will preclude the company from performing and/or bidding on classified work.

Even if an inverting company does not have an FCL, the very process of inverting may be subject to a national-security review by CFIUS, which has jurisdiction to review any transaction that could result in the control of a U.S. business by a foreign person. This jurisdiction plainly captures a typical foreign-merger inversion, though CFIUS focuses its reviews on assessing whether the contemplated transaction presents any national-security concerns. In addition, CFIUS review is a voluntary process (though in some cases, filing is effectively mandatory (e.g., acquisition of a cleared contractor), and CFIUS can—and does—“invite” parties to submit filings for transactions it would like to review). In general, if the transaction does not have a clear nexus to U.S. national security, the parties likely face low risks by not notifying CFIUS.

It is important to understand, however, that CFIUS interprets the concept of “national security” broadly to cover an array of industries, including defense, critical infrastructure, information technology, food safety, communications, cyber security, health care, energy, and identity authentication. Moreover, CFIUS may raise national-security concerns with respect to a specific transaction, even where the parties are unaware of the existence or scope of such concerns. Therefore, while CFIUS review is a voluntary process, companies contemplating an inversion merger are well advised to conduct CFIUS due diligence to assess whether a CFIUS filing should be submitted prior to completing the merger. This is an important step—if parties complete the transaction without CFIUS approval and CFIUS later requests a filing, the parties involved would be forced to accept any mitigation requirements the U.S. Government decides to impose. By completing a CFIUS review prior to closing, parties may utilize protective deal terms to ensure that they only must complete the transaction following CFIUS review if doing so fully satisfies the contemplated business goals. Moreover, preemptive CFIUS review and compliance may be less costly than measures imposed by CFIUS post-closing, which can include divestment of sensitive assets or entire businesses.

Of note, the U.S. Department of the Treasury, which chairs CFIUS through an appointed representative, recently stated that it “is reviewing a broad range of authorities for possible administrative actions that could limit the ability of companies to engage in inversions, as well as approaches that could meaningfully reduce the tax benefits after inversions take place.” Of the September 22, 2014, issuance of guidance by the U.S. Department of the Treasury and the IRS, referred to above, is an apparent example of such actions. While IRS seems to be leading this effort, one cannot rule out the possibility that part of Treasury’s “broad range of authorities” could include action taken through the CFIUS process. This underscores the importance of CFIUS due diligence for companies contemplating inversion.

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Apart from CFIUS and FOCI, an inverting company that deals with defense articles or technology will be subject to certain export-control requirements as a result of the inversion. In particular, a U.S. company that is a manufacturer, exporter, or broker of articles or services controlled under the International Traffic in Arms Regulations (“ITAR”) must be registered with the U.S. Department of State and satisfy ITAR requirements. When an ITAR registrant intends to enter into a transaction that will result in its foreign ownership, it must notify the State Department in writing at least 60 days in advance of any intended sale or transfer of ownership or control, and again within five days after its completion. In addition, export-control regulations—both under the ITAR and the U.S. Department of Commerce’s Export Administration Regulations (“EAR”)—can restrict the transfer of articles and information between the U.S. company and its foreign parent(s) and affiliates. This could happen, for example, if a U.S. company shares with its parent articles or technology that require ITAR or EAR licenses to export to certain countries. If the parent re-domiciles to such a country, the U.S. company may need to seek licenses to continue to share the articles and technology. Failure to comply with these requirements could subject the inverting company to revocation of exporting privileges as well as other sanctions.

In addition to considering various compliance issues, companies contemplating corporate inversion should plan for potential costs associated with FOCI, CFIUS, and export-control compliance. The costs of FOCI mitigation can vary widely depending upon, among other factors, the relative size of a corporate group’s classified business and the manner in which the classified business is structured in relation to the company’s unclassified activities. Moreover, although many transactions are approved by CFIUS without additional conditions, complex cases involving particularly sensitive assets or technology may involve extensive mitigation measures (e.g., separating facilities, appointing independent board members and managers, implementing physical and virtual safeguards), which can prove costly. Export violations can also yield penalties and additional costs associated with improving compliance measures. Thorough due diligence can also yield penalties and additional costs associated with improving compliance measures. Thorough due diligence can also yield penalties and additional costs associated with improving regulatory compliance.

FOCI, CFIUS, and export-control requirements can result in significant operational and financial implications for companies. Accordingly, it is critical for companies contemplating corporate inversion via a foreign merger to address these matters when planning the transaction.
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