INVERTED DOMESTIC CORPORATIONS: THE GOVERNMENT CONTRACT RESTRICTION AND PROPOSED ENHANCEMENTS

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I. INTRODUCTION

In recent years, there has been a surge of U.S.-based companies that have relocated their legal domiciles to other countries to capitalize on lower corporate tax rates and other tax-saving opportunities. For example, in January 2016, Johnson Controls, Inc. announced that it would relocate its legal domicile from Wisconsin to Ireland as part of its merger with Tyco International and shift its global headquarters to Cork, Ireland, while maintaining its primary operational headquarters in Milwaukee.[1] At the time of the announcement, the companies expected the transaction to save the combined

1. Leslie Picker, *Tyco Merger Will Shift Johnson Controls' Tax Liability Overseas*, N.Y. TIMES (Jan. 26, 2016), http://nyti.ms/1PfIe6x; Press Release, Johnson Controls, Johnson Controls and Tyco to Merge (Jan. 25, 2016), http://www.johnsoncontrols.com/media-center/news/press-releases/2016/01/25/johnson-controls-and-tyco-to-merge.

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entity approximately $150 million in annual tax payments.[2] In another example, as the result of an $11 billion deal that closed in late 2014, Burger King Worldwide Inc., creator of the classic Whopper hamburger, combined with Tim Hortons Inc., the Canadian donut chain.[3] As a result of the transaction, Burger King and Tim Hortons each became wholly owned subsidiaries of a new Canadian parent company based in Oakville, Ontario.[4]

These so-called "inversions" have been on the rise in recent years as multinational companies have ridden a wave of mergers and acquisitions seeking to bypass the United States' thirty-five percent worldwide corporate tax rate, which is one of the highest in the developed world,[5] on their non-U.S. business activities.[6] Predictably, these deals have spurred public outcry and a flurry of legislative proposals seeking to discourage more firms from entering into such transactions.[7] These deals also underscore the limits of the existing rules on corporate inversions, which, despite recent regulatory actions, have failed to stem the tide of U.S. businesses relocating to a lower-tax overseas jurisdiction.[8] Congress has proposed changes to the relevant Tax Code provisions to limit the incentive to invert,[9] but political differences have prevented these changes from becoming law.[10]

Aside from changes to the Tax Code, another area in which the federal government can exert influence over firms' decision-making is through the award of government contracts. Although the acquisition regulations are only effective in deterring inversions for companies that work with the U.S. government,[11] federal procurement represents an approximately $530 billion annual market.[12] Over the past several years, Congress has attempted to discourage companies from inverting by prohibiting "inverted domestic corporations"

2. *See* Picker, *supra* note 1; *see* also Allan Sloan, *This Is Corporate Tax Desertion Taken to a Whole New Level*, WASH. POST (Feb. 4, 2016), https://www.washingtonpost.com/business/economy/this-is-corporate-tax-desertion-taken-to-a-whole-new-level/2016/02/04/c8087168-cb7a-11e5-a7b2-5a2f824b02c9_story.html.

3. *See* Anupreeta Das & Liz Hoffman, *Berkshire, Burger King Deal Draws Criticism Over Taxes*, WALL ST. J. (Aug. 26, 2014), http://www.wsj.com/articles/berkshire-to-pay-u-s-tax-rate-on-burger-king-investment-1409057047. Canada's corporate tax rate was lowered to fifteen percent in 2012. *See* Scott A. Hodge, *Canada Cuts Corporate Tax Rate to 15%, Lowest Overall Rate in G-7*, TAX FOUND. (Jan. 4, 2012), http://taxfoundation.org/blog/canada-cuts-corporate-tax-rate-15-lowest-overall-rate-g-7.

4. *See* Paul Vieira, *Canada Approves Burger King's Deal to Buy Tim Hortons*, WALL ST. J. (Dec. 4, 2014), http://www.wsj.com/articles/canada-approves-burger-kings-deal-to-buy-tim-hortons-1417728183; *see also* Das & Hoffman, *supra* note 3.

5. *See generally* CORPORATE TAX RATES 2012–2016, DELOITTE (2016), https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-corporate-tax-rates-2012-2016.pdf.

6. *See* DONALD J. MARPLES & JANE G. GRAVELLE, CONG. RESEARCH SERV., R43568, CORPORATE EXPATRIATION, INVERSIONS, AND MERGERS: TAX ISSUES 1– 3, 7 (2016).

7. *Id.* at 7–9, 16.

8. *See id.* at 9.

9. *See infra* Part VI.

10. *See* MARPLES & GRAVELLE, *supra* note 6 at 15–16, 19.

11. *See infra* Part IV.B.

12. *See Office of Federal Procurement Policy*, OFF. MGMT. & BUDGET, https://www.whitehouse.gov/omb/procurement_mission.

from receiving federal government contracts, thereby eliminating this revenue stream.[13] Since many firms, even those that sell primarily to commercial customers, also contract with the U.S. government, the potential loss of revenue from government contracts can be significant. Johnson Controls, for example, holds "several" indefinite delivery, indefinite quantity (IDIQ) government contracts and touts its "extensive federal government experience."[14]

Although corporate inversions are discouraged under both the Tax Code and government contract regulations, existing legal restrictions have been ineffective in stopping them.[15] Of note, because the minimum threshold for treatment as an inverted domestic corporation under the government contract rule is the same threshold at which the tax rules treat the foreign acquirer as a U.S. corporation,[16] the government contract rule does not provide a stand-alone deterrent to companies considering an inversion transaction. This article begins with a discussion of the motivations behind the recent upsurge in corporate inversions and executive branch responses to that upsurge. It then discusses the existing government contract regulatory environment, the rules' background and legislative history, and recent proposals to tighten the government contract rule. The article concludes by suggesting potential clarifications that will help the government enforce these rules and the business community better weigh the risks of an inversion.

II. THE TAX CASE FOR INVERTING

While there is no single definition of the term, "inversion" generally refers to an acquisition of the stock or assets of a U.S. company by a foreign corporation, as a result of which the shareholders of the U.S. company

13. *See* MARPLES & GRAVELLE, *supra* note 6, *passim*.

14. *See* JOHNSON CONTROLS, http://www.johnsoncontrols.com/buildings/solutions-by-industry/federal-government (last visited Feb. 8, 2016).

15. For example, although Burger King has contracts with the government to operate restaurants at 173 locations at U.S. military bases, an inversion would not affect those contracts because U.S. taxpayer money does not fund these concession contracts. Dietrich Knauth, *Congresswoman Demands Military End Burger King Contracts*, LAW360 (Oct. 1, 2014), http://www.law360.com/articles/583147/congresswoman-demands-military-end-burger-king-contracts. Since Burger King does not receive any "appropriated funds" under those agreements, the contracts are not subject to the existing government contract regulations prohibiting contracting with inverted domestic corporations. *See* FAR 9.108-2. Further, Burger King's inversion would not have triggered the current government contract restriction. As a result of its inversion transaction, Burger King's shareholders received (on a fully diluted basis) less than eighty percent of the stock of the newly formed Canadian company with the balance of the shares held by the former shareholders of Tim Hortons. *See* Burger King Worldwide, Inc., Information Statement Pursuant to Section 14(c) of the Securities Exchange Act of 1934 (Schedule 14C Information) (Nov. 5, 2014). The current government contract regulations require that at least eighty percent of the former shareholders of the U.S. corporation retain ownership of the foreign entity to trigger the prohibition. *See* 6 U.S.C. § 395 (2012); FAR 9.108-1.

16. *See* KATE M. MANUEL & ERIKA K. LUNDER, CONG. RESEARCH SERV., R43780, CONTRACTING WITH INVERTED DOMESTIC CORPORATIONS: ANSWERS TO FREQUENTLY ASKED QUESTIONS 3 (2015).

receive a controlling interest in the foreign acquirer.[17] U.S. corporations generally pursue inversion transactions as a method to lower their effective tax rates and access "trapped cash" held in existing non-U.S. subsidiaries.[18] The first generation of inversion transactions occurred under a more flexible anti-inversion regime and frequently involved single-company inversions (e.g., shareholders of the U.S. company exchanged their U.S. company stock for stock in a new holding company organized in a low-tax jurisdiction, such as Bermuda or the Cayman Islands).[19] More recent inversion transactions, by contrast, have been structured as business combinations between U.S. companies and similarly sized or smaller foreign competitors.[20] Consistent with this strategy, many of the largest mergers and acquisitions transactions announced in 2015 and in 2016 were inversion transactions.[21]

The United States taxes domestic corporations on their worldwide income at a rate of thirty-five percent, one of the highest tax rates in the world (contrast with the United Kingdom's corporate tax rate, which was reduced to twenty percent in April 2015).[22] The U.S. system of worldwide taxation

17. The 2016 inversion regulations define "inversion transaction" for purposes of Internal Revenue Code (IRC) section 7874. *See* Treas. Reg. § 1.7874-12T(a)(15), 2016-20 I.R.B. 743, 799. The new definition excludes the acquisition of a U.S. company by a foreign corporation if the former shareholders of the U.S. company receive less than sixty percent of the stock of the foreign corporation. *Id.*

18. *See* Timothy R. Larson, *2016–Another Year of the Inversion: Playing Whack-a-Mole with Corporate Taxes Until Congress Acts*, METRO. CORP. COUNSEL (Jan. 5, 2016, 2:33 PM), http://www.metrocorpcounsel.com/articles/33355/2016-another-year-inversion-playing-whack-mole-corporate-taxes-until-congress-acts.

19. MARPLES & GRAVELLE, *supra* note 6, at 5.

20. *Id.* at 6.

21. *See, e.g.*, Zachary Mider & Jesse Drucker, *Tax Inversion: How U.S. Companies Buy Tax Breaks*, BLOOMBERG QUICKTAKE (Apr. 6, 2016, 5:15 PM), http://www.bloomberg.com/quicktake/tax-inversion; Andrew R. Brownstein, *Mergers and Acquisitions–2016*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Feb. 10, 2016), https://corpgov.law.harvard.edu/2016/02/10/mergers-and-acquisitions-2016; Michael Hiltzik, *Solving the Inversion Crisis: How the U.S Can Keep Companies at Home*, L.A. TIMES (Dec. 4, 2015, 8:54 PM), http://www.latimes.com/business/hiltzik/la-fi-hiltzik-20151204-column.html; *see generally* Laurie Kulikowski, *The 10 Biggest U.S. M&A Deals in 2015*, STREET (June 12, 2015, 11:56 AM), https://www.thestreet.com/story/13184146/1/the-10-biggest-us-ma-deals-in-2015.html.

22. *See Corporate Tax Rates 2012–2016*, DELOITTE (2016), https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-corporate-tax-rates-2012-2016.pdf. Historically, the United Kingdom had a worldwide tax system much like that of the United States, and the U.K. corporate tax rate was significantly higher than the current rate (thirty percent as recently as 2007). TAX RATES 2007/08, DELOITTE 11 (2007), http://www.ukbudget.com/files/tax-rates-2007-08.pdf. In that environment, a number of U.K.-resident corporations moved their headquarters to more favorable tax jurisdictions. For example, the British advertising and public relations company WPP moved to Ireland in 2008 to take advantage of the 12.5% Irish tax rate. *See* A. Trotman, *WPP to Move HQ Back to UK After Coalition Changes Tax Laws*, TELEGRAPH (Aug. 30, 2012, 7:59 AM), http://www.telegraph.co.uk/finance/newsbysector/media technologyandtelecoms/media/9507931/WPP-to-move-HQ-back-to-UK-after-Coalition-changes-tax-laws.html. The United Kingdom subsequently transitioned from a worldwide tax system to a territorial tax system and embarked on a gradual reduction in the corporate tax rate to the current twenty percent rate. MARPLES & GRAVELLE, *supra* note 6 (Summary). These corporate tax reforms appear to have stemmed the tide of U.K. inversions, and some inverters, including WPP, returned to the United Kingdom. Trotman, *supra* note 22.

means that U.S. corporations are taxed on profits earned abroad, in addition to taxes paid in the jurisdiction in which the profits are generated.[23] The United States offers a credit against U.S. tax liability for foreign taxes paid on the same income,[24] but this foreign tax credit is subject to limitations that often make these credits difficult to use.[25] The U.S. tax regime can be contrasted with so-called "territorial" systems many other countries employ where income earned abroad generally is not taxed in a corporation's home jurisdiction.[26] The combination of these factors results in relatively high effective tax rates for U.S. multinationals when compared with similarly situated foreign competitors. Although the U.S. Tax Code's Subpart F regime[27] offers U.S. corporations a method to obtain deferral on operating profits earned abroad by doing business through foreign subsidiaries,[28] these profits remain subject to U.S. tax when repatriated.[29] This has incentivized U.S.-based multinationals to leave cash, sometimes tens of billions of dollars, in their non-U.S. subsidiaries to indefinitely defer payment of the additional tax upon repatriation.[30]

Inversion transactions have offered U.S. corporations relief from high domestic tax rates and a means to access "trapped" foreign cash. Following an inversion transaction, the resulting company can structure future non-U.S. growth in a manner that avoids subjecting it to U.S. taxation. Existing non-U.S. operations of an inverted company may be transferred outside of the United States, although section 7874 of the Internal Revenue Code (IRC)[31]—the government's primary anti-inversion statute—and the recent Internal Revenue Service (IRS) notices and 2016 regulations discussed below have made this more difficult.[32] Now, many such post-inversion

23. *See* I.R.C. § 11(a) (imposing a tax for each taxable year on the "taxable income" of every corporation); I.R.C. § 63(a) (defining "taxable income" as gross income minus allowable deductions); I.R.C. § 61(a) (generally defining "gross income" as "all income from whatever source derived" without limitation to income earned from U.S. sources).

24. *See* I.R.C. § 901(a).

25. *See, e.g.*, I.R.C. § 904.

26. Howard Gleckman, *A Look at the Territorial Tax Systems in Four Countries Finds No Magic Bullets*, FORBES (Jan. 22, 2015, 10:51 AM), http://www.forbes.com/sites/beltway/2015/01/22/a-look-at-the-territorial-tax-systems-in-four-countries-finds-no-magic-bullets/#32039fa77de2.

27. I.R.C. §§ 951–965 (2012).

28. Such foreign subsidiaries are referred to as "controlled foreign corporations," or CFCs. *See* I.R.C. § 957(a). In order to be considered a CFC, at least fifty percent of the stock of the foreign corporation must be held by one or more U.S. persons, each of whom holds at least ten percent of the stock of the CFC, *see* I.R.C §§ 951(b), 957(a); in other words, majority-owned foreign subsidiaries of U.S. corporations generally are CFCs. *See id.* § 957(a).

29. Daniel Soleimani, *The Difficulties with the Subpart F System of International Taxation: How the* Schering-Plough *Decision Indicates That the Status Quo Is Unclear and Unwise*, 60 EMORY L.J. 503, 505 (2010).

30. By way of example, as of 2013, Exxon Mobil had $47 billion in unrepatriated earnings, Pfizer had $69 billion, and IBM had $93 billion. *See* Mindy Herzfeld, *Inversions—Why Now?*, TAXNOTES.COM (Aug. 11, 2014), http://www.taxnotes.com/tax-notes-today/mergers-acquisitions-and-reorganizations/news-analysis-inversions-why-now/2014/08/11/2137951.

31. I.R.C. § 7874 (2012).

32. *See Fact Sheet: Treasury Issues Inversion Regulations and Proposed Earnings Stripping Regulations*, U.S. DEP'T TREASURY (Apr. 4, 2016), https://www.treasury.gov/press-center/press-releases/Pages/jl0404.aspx.

transactions will subject the inverted company to U.S. tax if undertaken in connection with, or during the ten-year period following, the inversion transaction.[33] However, while the U.S. earnings of an inverted company technically remain subject to U.S. taxation, corporations can still use a multitude of strategies to shift U.S. profits to lower-tax jurisdictions.[34]

III. OBAMA ADMINISTRATION EFFORTS TO LIMIT INVERSIONS

In the absence of comprehensive corporate tax reform to address the concerns that drive inversion transactions or stand-alone legislation to further discourage U.S. companies from engaging in such transactions, the Department of Treasury and the IRS released notices in 2014 and 2015 targeting inversions.[35] The IRS notices announced the intention of the Treasury and the IRS to issue regulations that will (1) make it more difficult for U.S. companies to successfully engage in inversion transactions under the existing statutory rules[36] and (2) limit certain strategies that have historically been used by inverted corporations to further reduce their U.S. tax liabilities following an inversion transaction.[37] The rules announced in the IRS notices were implemented, clarified, and expanded in Treasury regulations published on April 8, 2016.[38]

At the same time, the Treasury and the IRS published expansive proposed regulations concerning the reclassification of intercompany debt instruments as equity for U.S. federal income tax purposes.[39] The 2016 Debt-Equity Regulations, once finalized, would apply to all multinational groups that include U.S. entities, regardless of whether members of such groups engaged in an

33. *See* Treas. Reg. § 1.7874-12T(a)(2) (defining "applicable period," which is the period during which many of the new restrictions apply, by reference to I.R.C. 7874(d)(1)); I.R.C. § 7874(d)(1) (defining "applicable period" as the period beginning on the first date properties are acquired as part of an inversion transaction and ending ten years after the last date properties are acquired as part of such acquisition).

34. Renae Merle, *U.S. Companies Are Saving $100 Billion a Year by Shifting Profits Overseas, Report Says*, WASH. POST (May 10, 2016), https://www.washingtonpost.com/news/business/wp/2016/05/10/u-s-companies-are-saving-100-billion-a-year-by-shifting-profits-overseas-report-says/.

35. *See* Notice 2015-79, 2015-49 I.R.B. 775; Notice 2014-52, 2014-42 I.R.B. 712 [hereinafter IRS Notices].

36. *Fact Sheet: Additional Treasury Actions to Rein in Corporate Tax Inversions*, U.S. DEP'T TREASURY (Nov. 19, 2015), https://www.treasury.gov/press-center/press-releases/Pages/jl0281.aspx.

37. *Id.*

38. *See* Inversions and Related Transactions, 81 Fed. Reg. 20,857 (Apr. 8, 2016) (to be codified at 26 C.F.R. pt. 1) (amending and creating temporary Treas. Reg. §§ 1.304-7T, 1.367(a)-3T, 1.367(b)-4T, 1.956-2T, 1.7701(l)-4T, 1.7874-2T, 1.7874-3T, 1.7874-4, 1.7874-6T, 1.7874-7T, 1.7874-8T, 1.7874-9T, 1.7874-10T, 1.7874-11T, and 1.7874-12T). We refer to these regulations as the "2016 Inversion Regulations."

39. *See* Treatment of Certain Interests in Corporations as Stock or Indebtedness, 81 Fed. Reg. 20,912 (Apr. 8, 2016) (to be codified at 26 C.F.R. pt. 1) (proposing regulations under Treas. Reg. §§ 1.385-1, 1.385-2, 1.385-3, and 1.385-4). We refer to these regulations as the "2016 Debt-Equity Regulations," and together with the "2016 Inversion Regulations," as the "2016 Regulations."

inversion transaction.[40] Of note, one rule in these regulations targets an "earnings stripping" technique that has been widely employed by inverted corporations.[41] In connection with an inversion transaction, the U.S. corporation using this technique distributes a promissory note to the foreign acquiring corporation (or a related foreign corporation) or issues such a note as payment for shares of the foreign corporation or as "boot" in an asset reorganization.[42] The note enables the U.S. corporation, through deductible interest payments, to shift income that would otherwise be taxable in the United States at a thirty-five percent tax rate to the foreign corporation,[43] which typically pays little or no tax on the interest income.[44] Intragroup notes issued (or deemed issued) in this manner on or after April 4, 2016, subject to limited exceptions, will be recharacterized as equity, and "interest" payments under such notes will be nondeductible payments with respect to that equity.[45] As a result, income that previously could have been shifted outside the U.S. tax net through related-party interest payments will be fully taxable in the United States.

The most prominent casualty of the Treasury's recent anti-inversion efforts was Pfizer Inc.'s plan to merge with Allergan PLC, a rival drugmaker based in Ireland, in a tax-driven deal announced in November 2015.[46] Had the $160 billion transaction proceeded to closing, Pfizer would have become the largest American business to invert to a lower-tax jurisdiction while maintaining its primary business operations in the United States.[47] The transaction's fate was decided by a new rule, known colloquially as the "Serial Inversion Rule,"[48] that the Treasury announced unexpectedly on April 4,

40. *See generally* 81 Fed. Reg. at 20,912–30 (preamble to 2016 Debt-Equity Regulations describing rules generally applicable to "related parties").

41. Prop. Treas. Reg. § 1.385-3.

42. Steven M. Rosenthal, *Treasury Tackles Earnings Stripping*, TAX POL'Y CTR. (Apr. 5, 2016), http://www.taxpolicycenter.org/taxvox/treasury-tackles-earnings-stripping.

43. *Id.*; Kyle Pomerlau, *Corporate Income Tax Rates Around the World, 2015*, TAX FOUND. (Oct. 1, 2015), http://taxfoundation.org/article/corporate-income-tax-rates-around-world-2015.

44. Rosenthal, *supra* note 42.

45. *See* Treas. Reg. § 1.385-3; *see also* Elizabeth Boone, *Controversy Amid Unveiling of Proposed Earnings Stripping Regulations*, BLOOMBERG FED. TAX BLOG (Apr. 28, 2016), http://www.bna.com/controversy-amid-unveiling-b57982070420/. We refer to this rule as the "Inversion Note Rule," but caution that it will apply in a much broader range of transactions than those engaged in as part of an inversion transaction.

46. Don Lee, *New Tax Inversion Rules Kill Proposed Allergan–Pfizer Merger*, L.A. TIMES (Apr. 6, 2016, 7:45 AM), http://www.latimes.com/business/la-fi-tax-inversion-rules-allergan-20160405-story.html; John Cassidy, *The Pfizer–Allergan Merger Is a Disgrace*, NEW YORKER (Nov. 23, 2015), http://www.newyorker.com/news/john-cassidy/the-pfizer-allergan-merger-is-a-disgrace.

47. *See* Cassidy, *supra* note 46. Ireland's corporate tax rate is 12.5%, as compared to the U.S. corporate rate of approximately 35%. *See id.*

48. *See* Lee, *supra* note 46. On August 4, 2016, the U.S. Chamber of Commerce and the Texas Association of Business filed a federal lawsuit challenging the validity of the Serial Inversion Rule under the Administrative Procedure Act. *See* Complaint at 1–2, Chamber of Commerce et al. v. Internal Revenue Serv., No. 1:16-cv-00944 (W.D. Tex. Aug. 4, 2016). The complaint alleges that the Serial Inversion Rule exceeds the Treasury's statutory authority under IRC § 7874, is an arbitrary and capricious abuse of the Treasury's discretion, and was promulgated without adequate notice or opportunity to comment. *See id.* at 17–18, 19, 20.

2016, as part of the 2016 Regulations and that seemed tailored to prevent the Pfizer–Allergan merger.[49]

As a rule of thumb, a foreign corporation usually is not able to acquire, in exchange for its stock, a U.S. corporation that is four times its size or larger.[50] Although in reality Pfizer was less than twice as large as Allergan on the date of the Pfizer–Allergan merger agreement,[51] the Serial Inversion Rule required Pfizer and Allergan to compare their sizes without regard to the current value of stock Allergan issued to acquire U.S. targets during the thirty-six-month period ending on that date.[52] Because Allergan completed three significant U.S. acquisitions during that thirty-six-month period (i.e., it was a serial merger partner for inverting U.S. companies),[53] under the Serial Inversion Rule it was deemed to be substantially smaller than the value reflected in its market capitalization—too small, apparently, to acquire Pfizer without being treated as a U.S. corporation under the anti-inversion rules. Pfizer and Allergan terminated their merger agreement on April 6, 2016.[54]

49. *See id.*

50. *See* Victor Fleisher, *On Inversions, the Treasury Drops the Gloves*, N.Y. TIMES (Apr. 5, 2016), http://www.nytimes.com/2016/04/06/business/dealbook/on-inversions-the-treasury-department-drops-the-gloves.html?_r=0.

51. The Pfizer–Allergan merger agreement was signed on November 22, 2015. *See* Pfizer Inc., Current Report (Form 8-K) (Nov. 23, 2015). Pfizer's and Allergan's closing stock prices on November 20, 2015, the last trading date before the signing of the merger agreement, were $32.18 and $312.46, respectively. *See* YAHOO! FINANCE, https://finance.yahoo.com/quote/PFE/history?ltr=1 (last visited Sept. 13, 2016); YAHOO! FINANCE, https://finance.yahoo.com/quote/AGN/history?ltr=1 (last visited Sept. 13, 2016). On the date of the merger agreement, Pfizer had 6,173,503,089 shares outstanding and Allergan had 394,219,171 shares outstanding. *See* Agreement and Plan of Merger, by and among Pfizer Inc., Allergan PLC and Watson Merger Sub Inc., dated as of November 22, 2015, §§ 3.2(a), 4.2(a). These figures equate to a market capitalization on November 22, 2015, of approximately $199 billion for Pfizer and $123 billion for Allergan.

52. *See generally* Treas. Reg. § 1.7874-8T, 2016-20 I.R.B. 743, 792–94.

53. The Pfizer–Allergan merger agreement was signed on November 22, 2015. *See* Pfizer Inc., Current Report (Form 8-K) (Nov. 23, 2015). On October 1, 2013, Allergan's predecessor, Warner Chilcott PLC, completed its $8.5 billion all-stock acquisition of Actavis Inc. *See* Press Release, Actavis, Actavis Completes Warner Chilcott Acquisition (Oct. 1, 2013), http://www.allergan.com/investors/news/thomson-reuters/actavis-completes-warner-chilcott-acquisition. On July 1, 2014, the company (renamed Actavis PLC) completed its $28 billion cash and stock acquisition of Forest Laboratories, Inc. *See* Press Release, Allergan, Actavis Completes Forest Laboratories Acquisition (July 1, 2014), http://www.allergan.com/news/news/thomson-reuters/actavis-completes-forest-laboratories-acquisition. Finally, on March 17, 2015, Actavis PLC completed its $70.5 billion cash and stock acquisition of Allergan, Inc. (after which the company was renamed Allergan PLC). *See* Press Release, Allergan, Actavis Completes Allergan Acquisition (Mar. 17, 2015), http://www.allergan.com/news/news/thomson-reuters/actavis-completes-allergan-acquisition.

54. *UPDATE 2-Pfizer, Allergan scrap 160 bln deal after U.S. tax rule* change, CNBC (Apr. 6, 2016, 8:41 AM), http://www.cnbc.com/2016/04/06/reuters-america-update-2-pfizer-allergan-scrap-160-bln-deal-after-us-tax-rule-change.html. The consummation of this transaction and the subsequent classification of Pfizer as an inverted domestic corporation would have put Pfizer's significant government contract revenues in jeopardy under the government contract rule. Pfizer is reported to have received 190 federal contracts worth a total of $861 million in fiscal year 2014. *See* Lindsey McPherson & Andrew Velarde, *Should Corporate Inverters Worry About a Federal Contract Ban*, TAX ANALYSTS (Oct. 23, 2014), http://www.taxanalysts.org/content/should-corporate-inverters-worry-about-federal-contract-ban.

Although the Treasury and the IRS have had some success in combating certain types of inversion transactions (including, most notably, the Pfizer–Allergan transaction) and, in the 2016 Regulations, have taken away many of the tax benefits previously available to inverted corporations, their ability to take further action without congressional support is not without limit. One need not look far to see that inversion transactions remain possible and that post-inversion tax benefits remain available. For example, shortly after Pfizer and Allergan called off their merger, Johnson Controls and Tyco announced that they "will proceed with their merger plans and that the combined company expects to deliver $650 million in operational and global tax synergies over the first three years after closing."[55] Johnson Controls and Tyco announced the completion of their merger on September 6, 2016.[56]

IV. THE PROHIBITION ON FEDERAL AGENCY CONTRACTS WITH INVERTED DOMESTIC CORPORATIONS

As under the tax regulations, the existing government contract regulations are intended to discourage companies from inverting. Federal law generally prohibits U.S. government agencies from awarding prime contracts to any foreign-incorporated entity that is treated as an inverted domestic corporation (IDC) under the government contract rule as well as its subsidiaries.[57] This prohibition, however, has been implemented through a patchwork of statutes, appropriations acts, and regulations.[58] Members of Congress recently have reintroduced a long-term fix that will broaden the definition of an IDC for these purposes and provide a permanent government-wide

55. *See* Johnson Controls, Inc., Current Report (Form 8-K) (Apr. 21, 2016). One widely discussed article, published prior to the release of the 2016 Regulations, urges the Treasury and IRS to adopt an earnings stripping rule and to extend the reach of the so-called CFC-decontrol and anti-hopscotch loan rules beyond corporate groups that engaged in an "inversion transaction" under IRC section 7874. *See generally* Stephen E. Shay, J. Clifton Fleming Jr. & Robert J. Peroni, *Treasury's Unfinished Work on Corporate Expatriations*, 150 TAX NOTES 933, 933, 939, 941 (2016). Interest stripping, a type of earnings stripping that shifts income from the United States to lower-taxed jurisdictions through interest payments on intercompany debt, was a centerpiece of the 2016 Debt-Equity Regulations. *See* Treas. Reg. § 1.385-3. The 2016 Regulations did not extend, however, the application of the CFC-decontrol and anti-hopscotch loan rules beyond section 7874 transactions, as Shay, Fleming, and Peroni advocated. Without specifically addressing the proposals in their article, a Treasury official indicated in April 2016 that Treasury "will continue to consider what we might do, including potentially extending these beyond inverted companies." Andrew Velarde, *Treasury Hasn't Ruled Out Inversion Regs Expansion*, TAX ANALYSTS (Apr. 28, 2016).

56. Press Release, Johnson Controls, Johnson Controls and Tyco Complete Merger (Sept. 6, 2016), http://www.johnsoncontrols.com/media-center/news/press-releases/2016/09/06/johnson-controls-and-tyco-complete-merger.

57. MANUEL & LUNDER, *supra* note 16 (Summary).

58. *See id.*

prohibition on contracting with such IDCs,[59] but its route to passage remains unclear. Along with the possible tax consequences, the potential for further legislation in this area is a relevant consideration for government contractors contemplating an inversion.

A. *The Current Prohibition*

The U.S. government has attempted to limit federal contracting with IDCs for over a decade, but the only permanent statutory prohibition applies to just one agency—the Department of Homeland Security (DHS).[60] In 2002, contemporaneously with the establishment of DHS, Congress codified a statute prohibiting DHS from entering into contracts with "a foreign incorporated entity which is treated as an inverted domestic corporation under [the statute], . . . or any subsidiary of such an entity."[61]

The DHS statute—and government contract regulations as a whole—establish a definition of IDC that is not directly linked to the IRC provisions concerning the treatment of inverted corporations.[62] For purposes of the government contract prohibition, an IDC is defined as a foreign incorporated entity that acquires, pursuant to a plan, "substantially all of the properties held directly or indirectly by a domestic corporation."[63] After the acquisition, at least eighty percent of the stock (by vote or value) of the entity is held by former shareholders of the U.S. corporation[64] and the "expanded affiliated group,"[65] which after the acquisition includes the entity, "does not have substantial business activities in the foreign country" as compared to

59. *See generally* No Federal Contracts for Corporate Deserters Act of 2015, H.R. 1809, 114th Cong. (2015).

60. *See* Homeland Security Act of 2002, Pub. L. No. 107-296, § 835, 116 Stat. 2135, 2227–28 (2002) (codified at 6 U.S.C. § 395 (2012)).

61. 6 U.S.C. § 395(a). Notably, the ban extends only to prime contracts—IDCs and their subsidiaries remain eligible to receive federal funds under subcontract agreements. *See id.* § 395(a) ("*The Secretary* may not enter into any contract with a foreign incorporated entity . . .") (emphasis added).

62. *Cf.* I.R.C. § 7874 (2012); *see generally* Treas. Reg. §§ 1.7874-1T–12T, 2016-20 I.R.B. 743, 783–799.

63. 6 U.S.C. § 395(b)(1). All acquisitions of property that occur during the four-year period beginning on the date that is two years before the eighty percent threshold is met are considered to be acquired "pursuant to a plan." *See id.* § 395(c)(1)(B). However, certain transfers of properties or liabilities may be "disregarded" if such transfers are part of a plan designed to avoid the prohibition on contracting with IDCs. *See id.* § 395(c)(1)(C).

64. *Id.* § 395(b)(2)(A). For purposes of determining ownership, the rule does not consider stock held by members of the "expanded affiliated group" that includes the foreign incorporated entity or stock of an entity that "is sold in a public offering related to the acquisition." *Id.* § 395(c)(1)(A).

65. *Id.* § 395(b)(3). "'[E]xpanded affiliated group' means an affiliated group as defined in section 1504(a) of title 26 (without regard to section 1504(b) of such title), except that section 1504 of such title shall be applied by substituting 'more than 50 percent' for 'at least 80 percent' each place it appears." *Id.* § 395(c)(2). Generally, this means that an expanded affiliated group includes all corporations (foreign and domestic) that are linked by direct stock ownership of more than fifty percent.

its total business activities.[66] The prohibition on contracting with such firms may be waived if the Secretary of Homeland Security determines that award to an IDC is "in the interest of national security."[67]

This statutory prohibition has been extended periodically to cover other agencies through annual appropriations acts. Initially, the restriction was imposed on annual funds appropriated for specific government agencies, including the U.S. Departments of Transportation, Justice, and Housing and Urban Development, and the Treasury, and applied only to specific year funds.[68] Beginning in fiscal year 2008, Congress passed a government-wide prohibition on contracting with IDCs that applied to contracts awarded by *all* federal agencies using 2008 funds.[69] This government-wide prohibition was extended subsequently in appropriations acts and continuing resolutions, including most recently for fiscal year 2016, on a year-by-year basis.[70]

Despite Congress's general aversion to federal agencies contracting with inverted corporations, the continuity of the government-wide prohibition remains dependent upon annual appropriations acts. Accordingly, unless Congress includes the applicable language in each annual appropriations bill, the prohibition will not apply to that fiscal year's funds.

B. *Application of the Government Contract Prohibition*

The government contract regulations located in Federal Acquisition Regulation (FAR) subpart 9.108 reflect this patchwork approach. In December 2014, FAR subpart 9.108 was amended to "reflect the ongoing nature of the prohibition," but the drafters of the regulation acknowledged that the

66. *Id.* § 395(b)(3). A partnership also may qualify as an IDC when a foreign entity acquires substantially all of the properties "constituting a trade or business of a domestic partnership" where at least eighty percent of the stock is held by the former partners of the domestic partnership "by reason of holding a capital or profits interest in the domestic partnership." *Id.* § 395(b)(1)–(3). Accordingly, this prohibition would *not* apply if (1) the domestic entity is purchased by a foreign entity whereby over twenty percent of the stock is held by new owners; (2) the foreign incorporated entity, after the transaction, has "substantial" business activities in the foreign country; or (3) the transaction does not involve the "acquisition" of "substantially all the properties" of the domestic entity. *Id.* § 395(b).

67. *Id.* § 395(d).

68. *See* Transportation, Treasury, Housing and Urban Development, the Judiciary and District of Columbia, and Independent Agencies Appropriations Act, 2006, Pub. L. No. 109-115, § 724, 119 Stat. 2396, 2494 (2005); *see also* MANUEL & LUNDER, *supra* note 16, at 2 n.12; *see also* Inchcape Shipping Servs. Holding, Ltd., B-403399.3, B-403399.4, 2012 CPD ¶ 65, at 3 n.2 (Comp. Gen. Feb. 6, 2012) (dismissing allegation that the award of a government contract violated the prohibition on contracting with IDCs because the applicable contract funds were not covered by the prohibition).

69. Consolidated Appropriations Act, 2008, Pub. L. No. 110-161, § 745, 121 Stat. 1844, 2034 (2007).

70. *See* Prohibition on Contracting with Inverted Domestic Corporations, 79 Fed. Reg. 74,554, 74,555 (Dec. 15, 2014) (codified at 48 C.F.R. pts. 9, 52); Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, § 733, 129 Stat. 2242, 2480 (2015); *see also* Consolidated and Further Continuing Appropriations Act, 2015, Pub. L. No. 113-235, § 733, 128 Stat. 2130, 2386 (2014); Consolidated Appropriations Act, 2014, Pub. L. No. 113-76, § 733, 128 Stat. 5, 237 (2014).

prohibition applies only "as long as Congress extends the prohibition in its *current form*."[71]

The regulations and their associated contract clauses, FAR 52.209-2 and FAR 52.209-10, incorporate the definition of "inverted domestic corporation" provided in the DHS statute.[72] To enforce the prohibition on contracting with IDCs, the revised FAR 52.209-2 requires contractors to affirmatively state whether they are (or are not) an IDC or a subsidiary of an IDC.[73] A contractor that cannot make this representation is ineligible to receive a government contract that is awarded with covered funds.[74]

Contracting Officers (COs) may rely on a contractor's representation that it is not an IDC unless there is "reason to question the representation."[75] The accuracy of this representation is considered a part of the government's "responsibility" determination.[76] Although competing firms may challenge this determination, such findings are afforded significant deference. For instance, the U.S. Government Accountability Office (GAO) held in the *Inchcape Shipping Services* bid protest that a CO's determination that a firm qualifies as a domestic entity will not be reviewed by the GAO unless the protester identifies "evidence raising serious concerns that . . . the contracting officer unreasonably failed to consider available relevant information or

71. *See* Prohibition on Contracting With Inverted Domestic Corporations-Representation and Notification, 79 Fed. Reg. at 74,555 (emphasis added); Prohibition on Contracting With Inverted Domestic Corporations, 80 Fed. Reg. 38,309, 38,310 (July 2, 2015) (codified at 48 C.F.R. pts. 9, 52). The revised Federal Acquisition Regulation (FAR) subpart 9.108-2 streamlines a long list of exceptions that were set forth in the applicable appropriations acts but had become "increasingly difficult to understand with the passage of each appropriations act." Prohibition on Contracting With Inverted Domestic Corporations–Representation and Notification, 79 Fed. Reg. at 74,555. The regulations include a standard exception for any contract, or any task order issued pursuant to such contract, that is entered into before the date of enactment of the applicable appropriations act. FAR 9.108-2(b)(1).

72. *See* FAR 52.209-2(a); *see also* FAR 52.209-10(a).

73. *See* FAR 9.108-3(a). Under the prior version of FAR 52.209-2, contractors impliedly certified by submitting a proposal for a covered contract that it was *not* an IDC or a subsidiary of an IDC. *See* FAR 52.209-2(c) (May 2011). The new, positive representation was intended to "better ensure clear, current, accurate, and complete disclosure by offerors." *See* Prohibition on Contracting With Inverted Domestic Corporations-Representation and Notification, 79 Fed. Reg. at 74,558. The new rules also updated the standard commercial item representations and certifications clause (FAR 52.212-3) and statutory flow-down clause (FAR 52.212-5) to reference the modified representation requirement. *See* Prohibition on Contracting With Inverted Domestic Corporations-Representation and Notification, 79 Fed. Reg. at 74,557.

74. *See* FAR 9.108-3(a). The disclosure requirement will presumably increase focus on offerors' inversion status and bring the issue to the attention of government contracting personnel during the proposal evaluation process. This rule also appears intended to better enable the government to bring False Claims Act or other federal actions against contractors that are alleged to have purposely misrepresented their status as domestic corporations. Notably, this prohibition also "may" be waived if the agency head determines in writing that a waiver is required in the interests of national security, documents the determination, and reports it to Congress. *See* FAR 9.108-4.

75. FAR 9.108-3(b).

76. *See* FAR 9.104-1(g).

otherwise violated statute or regulation."[77] Given the facts of that case, the GAO upheld the agency's acceptance of the contract awardee's representation that it was not an IDC.[78]

While it may be difficult to challenge a firm's representation that it is not an IDC, there are potentially significant costs if a firm becomes an IDC after the contract is awarded. Namely, if an inversion occurs while the contractor is performing a contract subject to the prohibition, the government is entitled to withhold payment for activities performed after the date the contractor became an IDC.[79] Although the government presumably would terminate the contract for its convenience in that scenario, the contractor is legally required to continue to "perform in accordance with the terms and conditions of the contract" or risk a government action for default.[80] In that event, the government retains the authority to "seek any available remedies" from the contractor.[81] A contractor currently performing a contract that is subject to these regulations and contemplating an inversion should consider carefully the government's remedies in this area.

V. THE DISCONNECT BETWEEN THE TAX AND GOVERNMENT CONTRACT RULES

Although these recently implemented procurement regulations have attempted to assist federal agencies in enforcing the prohibition on contracting with IDCs, the enforcement mechanism remains opaque, in part because of the lack of a government-wide definition of "inverted domestic corporation." Notably, the DHS statute upon which the current government contract rule is

77. Inchcape Shipping Servs. (Dubai) LLC, B-409465, B-409465.2, 2014 CPD ¶ 152, at 6–7 (Comp. Gen. May 12, 2014) (quoting 4 C.F.R. § 21.5(c)). While an agency's responsibility determination is usually given only a cursory review, the record in *Inchcape Shipping* included the agency's detailed analysis concerning the awardee's corporate history, structure, and ownership interest, as well as whether there was a basis to find that each of the three mandatory IDC elements set forth in 6 U.S.C. § 395(b) had been met. *Id.* at 8.

78. *Id.* at 7–8.

79. FAR 52.209-10(b). Note an IDC may not receive covered funds either before *or after* award of the contract. The appropriations acts containing this prohibition provide that "*None* of the funds appropriated . . . may be used for any Federal Government contract with . . . an inverted domestic corporation." Consolidated Appropriations Act, 2010, Pub. L. No. 111-117, § 740, 123 Stat. 3034, 3215 (2009) (emphasis added). The recent FAR amendments added a new paragraph to FAR 52.209-10 that requires contractors to provide written notification to the Contracting Officer (CO) of a change in IDC status within five business days from the date of the inversion event. *See* Prohibition on Contracting With Inverted Domestic Corporations-Representation and Notification, 79 Fed. Reg. at 74,559; Prohibition on Contracting With Inverted Domestic Corporations-Representation and Notification, 80 Fed. Reg. at 38,307 (revising FAR 52.209-10(d)). The rule does not specify the contents of the notice, but failure to provide the requisite notice could support a government action against the contractor for breach of contract, among other remedies. *See* FAR 52.209-10(d).

80. FAR 52.209-10(b). COs are instructed to "consult with legal counsel" if, during the performance of a contract, a contractor becomes an IDC or a subsidiary of an IDC. FAR 9.108-2(b)(2).

81. FAR 52.209-10(b).

based was enacted almost two years *prior* to IRC section 7874,[82] but was modeled on early drafts of the legislation that was ultimately codified as section 7874.[83] The version of section 7874 that was enacted in 2004 differed in important respects from these earlier drafts, and as a result, the DHS rule and section 7874 have been out of sync with each other since section 7874's enactment.

In 2002, the sponsor of the Senate amendment to the Homeland Security Act that included the IDC prohibition, the late Senator Paul Wellstone of Minnesota, commented on the Senate floor that, "I have worked with Senator Grassley and Senator Baucus to conform this amendment with their bill that would close the tax loophole."[84] When the Senate agreed to the Wellstone amendment, it reflected a fifty-percent threshold (much like the proposed legislation described below).[85] The Grassley-Baucus tax bill that was pending in the 107th Congress at the time Senator Wellstone introduced his amendment included two relevant thresholds: (1) an eighty-percent threshold (substantially identical to the provision in the current DHS statute), which, if exceeded, would cause the foreign acquiring corporation to be treated as a U.S. corporation for U.S. tax purposes[86]; and (b) a fifty-percent threshold, which, if exceeded, would not cause the foreign corporation to be treated as a U.S. corporation for U.S. tax purposes, but would require the inverting company to recognize full taxable gain, without the benefit of offsetting tax credits, on certain post-inversion transactions for the ten-year period following the inversion transaction.[87] Thus, the Wellstone amendment would have imposed a meaningful disincentive for government contractors to engage in an inversion transaction that the existing tax rules alone did not adequately deter and, even under the then-pending Grassley-Baucus bill, would not have been meaningfully deterred.

By the time the Homeland Security Act was signed into law in 2002,[88] the Wellstone amendment's fifty-percent threshold had been raised to eighty

82. 6 U.S.C. § 395(a) (2012).
83. I.R.C. § 7874 (2012).
84. 107 Cong. Rec. S8184 (daily ed. Sept. 4, 2002) (statement of Sen. Wellstone).
85. *See* 107 Cong. Rec. S8257 (daily ed. Sept. 5, 2002) (statement of Sen. Wellstone).

> I am pleased with this amendment, and I want people to know about this because it has now passed the Senate. If a company reincorporates in a foreign country and 50 percent or more of the shareholders of the new foreign corporation are the same as the shareholders of the old U.S. company, then they do not get to contract with the Homeland Security Agency, and if the company does not have any substantial business activity in its foreign home. That is the two-part test. This is actually the two-part test in the Grassley-Baucus tax bill, and I thank them for their superb work.

Id.

86. *See* S. Rep. No. 107-188, at 5 (2002).
87. *See id.* at 5–6. In other words, under the Grassley-Baucus tax bill, exceeding the fifty percent threshold would have resulted in mildly unpleasant tax consequences, whereas exceeding the eighty percent threshold would have resulted in disastrous tax consequences.
88. Homeland Security Act of 2002, Pub. L. No. 107-296, 116 Stat. 2135 (2002).

percent.[89] Less than two years later, the Grassley-Baucus tax bill became law, in modified form, with the passage of the American Jobs Creation Act of 2004.[90] That legislation codified section 7874 with its own eighty-percent threshold intact.[91] The convergence of these two statutory thresholds is the fundamental flaw at the heart of the government contracting rules pertaining to IDCs. Because the tax consequences of exceeding the eighty-percent threshold are so harsh, it is exceptionally rare for any well-advised company to do so knowingly.

Given this history, it is not surprising that most companies that have relocated overseas do not meet the narrow eighty-percent threshold to be an IDC under the government contract rule. Although the definition of an IDC under the DHS statutory language shares a common origin with the substantially similar statutory language reflected in section 7874 (and, in fact, incorporates by reference certain definitions from the IRC),[92] the regulations and other administrative guidance promulgated under section 7874 are not binding authority for purposes of the DHS statute or the FAR.[93]

Like the DHS statute, section 7874 includes an eighty-percent ownership threshold for treatment as an inverted corporation.[94] From a policy perspective, applying the same eighty-percent ownership threshold to both rules makes very little sense. If the purpose of the government contract rule is to deter tax avoidance, then it applies precisely when it should not and does not apply when it should. A foreign acquiring corporation that fails section 7874's eighty-percent test will be treated as a U.S. corporation for U.S. tax purposes and, thus, will be subject to U.S. worldwide taxation on its income, just like any other U.S.-parented group. In that case, the attempted tax inversion has failed, and there is no independent basis to prohibit the corporation from contracting with federal agencies. A foreign acquiring corporation that does not fail section 7874's eighty-percent test will almost certainly fall outside the scope of the government contract rule. In that case, the government contract rule appears to have no deterrent effect independent of the tax rule.

VI. PROPOSALS TO STRENGTHEN THE GOVERNMENT CONTRACT PROHIBITION

Pending legislative proposals would significantly tighten these anti-inversion rules. On April 15, 2015, Democrats in the House of Representatives reintroduced the so-called "No Federal Contracts for Corporate Deserters

89. *Id.* § 835, 116 Stat. at 2227–28 (2002) (codified at 6 U.S.C. § 395 (2012)).

90. *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 801(a), 118 Stat. 1418, 1562–66 (2004).

91. While the eighty percent threshold remained unchanged, the final version of the law raised the fifty percent threshold to sixty percent. *See* I.R.C. § 7874(a)(2)(B)(ii) (2012).

92. *See* Homeland Security Act of 2002 § 835, 116 Stat. at 2227–28 (2002).

93. *See* MANUEL & LUNDER, *supra* note 16, at 3.

94. *See* I.R.C. § 7874(b).

Act,"[95] which seeks to make the prohibition permanent and close loopholes in the current law.[96] Substantially similar legislation, entitled the "American Business for American Companies Act of 2015," was introduced in the Senate on April 16, 2015.[97] This legislation was originally introduced in July 2014, but failed to gain support from Republican members, who generally support more comprehensive corporate tax reform in lieu of specific restrictions.[98] The proposed legislation and previous efforts would make the following changes:

- ***Make the Restriction Permanent***. The legislation would make the government-wide prohibition permanent and, therefore, applicable to all agencies and contracts awarded with funds that are appropriated in any year.[99]
- ***Cover Subcontracts***. The prohibition would be extended to first-tier subcontracts that represent greater than ten percent of the value of the federal prime contract.[100] Note that this prohibition would *not* apply to contracts valued at less than $10 million or subcontracts exclusively for commercial items.[101]
- ***Lower the Threshold to Fifty Percent***. Most significantly, the legislation would change the definition of IDC for purposes of the government contract prohibition.[102] Under this legislation, the prohibition would

95. *See* No Federal Contracts for Corporate Deserters Act of 2015, H.R. 1809, 114th Cong. § 2 (2015); *see also* No Federal Contracts for Corporate Deserters Act of 2014, H.R. 5278, 113th Cong. § 2 (2014) (first introduced in the House on July 30, 2014).

96. 160 CONG. REC. S5142 (daily ed. July 30, 2014) (statement of Sen. Levin).

97. *See* American Business for American Companies Act of 2015, S. 975, 114th Cong. (2015); *see also* No Federal Contracts for Corporate Deserters Act of 2014, S. 2704, 113th Cong. (2014).

98. *See generally* David Towarnicky, *Stop Calling Inverted Companies "Unpatriotic:" It Is Congress's Patriotic Duty to Provide a Competitive Corporate Environment*, 45 PUB. CONT. L.J. 163 (2015). Towarnicky argues that Congress should focus on creating tax conditions that allow domestic corporations to "compete with other global companies" instead of "punishing companies that chose to incorporate overseas by not allowing them to bid for government contracts." *Id.* at 182. The article focuses on lowering the corporate tax rate as the primary means of reducing the incidence of inversions, but another means of achieving this goal would be to further limit the ability of U.S. companies that relocate overseas to escape U.S. taxes. In the absence of comprehensive corporate tax reform, the Treasury has released new guidance that seeks to achieve this by further restricting the tax benefits of certain inversion transactions. *See* Notice 2015-79, 2015-49 I.R.B. 775, 755; Notice 2014-52, 2014-42 I.R.B. 712, 712. Although only legislative action can stop inversions, these rules will make it more difficult to achieve tax benefits from an inversion. *See* Notice 2015-79, 2015-49 I.R.B. at 775; Notice 2014-52, 2014-42 I.R.B. at 712.

99. *See* S. 975 § 2(a)(1) (proposing new 41 U.S.C. § 4713(a)); *id.* § 2(b)(1) (proposing new 10 U.S.C. § 2338(a)); *see also* MANUEL & LUNDER, *supra* note 16, at 10.

100. *See* S. 975 § 2(a)(1).

101. *See id.* Although this prohibition applies only to first-tier subcontracts, the proposed statute would prohibit further structuring subcontract tiers in a manner designed to avoid the limitation by enabling an IDC to perform more than ten percent of the total value of the contract as a lower-tier subcontractor. *Id.* The proposed statute provides that prime contractors that violate this rule may be subject to termination for default or referral for suspension or debarment. *Id.*

102. *See id.*

apply to entities for which, after the acquisition, more than fifty percent of the stock (by vote or value) is held by the former shareholders of the domestic corporation.[103] The prohibition would apply only where the "management and control" of the expanded affiliated group remains primarily within the United States and the group retains "significant" business activities in the United States.[104]

- ***Expand the Waiver Provision***. The Senate bill would expand the current waiver provision to allow the head of an executive agency to waive the prohibition in the interest of national security *or* when necessary for the "efficient or effective" administration of federal or federally-funded programs that provide "health benefits" to individuals or "public health programs."[105] "Health benefits" are not defined for purposes of this legislation, but could conceivably encompass inverters in the healthcare and pharmaceutical industries.[106]

As a result, these legislative proposals would make the restriction permanent and expand the definition of IDC to encompass more foreign-incorporated entities. These bills have been referred to the relevant congressional committees, but, as of this writing, have not been acted upon in either chamber.[107] Even if this legislation stalls again, the increased focus on this issue

103. *See id.*

104. *See id.* An "expanded affiliated group" is deemed to have "significant domestic business activities" if (1) at least twenty-five percent of its employees are "based in the United States"; (2) the "employee compensation is incurred" with respect to U.S. employees; and (3) the income of the group is derived in the United States. Foreign incorporated entities that have "substantial business activities" in the foreign country of incorporation remain exempt from treatment as an IDC. *See id.* This element of the No Federal Contracts for Corporate Deserters Act is similar to a provision in the Obama administration's FY 2017 budget, which would eliminate section 7874's sixty percent test and lower the eighty percent threshold to "a greater than 50 percent test." *See* DEP'T OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2017 REVENUE PROPOSALS 28 (2016). In addition, the Obama administration proposed to treat the foreign acquiring corporation as a U.S. corporation for tax purposes, regardless of the level of shareholder continuity, if (1) the U.S. company is larger (by value) than the foreign company, (2) the expanded affiliated group is "primarily managed and controlled in the United States," and (3) the expanded affiliated group "does not conduct substantial business activities in the country in which the foreign acquiring corporation is created or organized." *Id.* Similar proposals were introduced in the House and Senate at the beginning of the 114th Congress. *See* H.R. 415, 114th Cong. § 2 (2015); S.198, 114th Cong. § 2 (2015). Among other things, this would prevent the foreign acquiring corporation from paying a portion of the acquisition consideration in cash to avoid the inversion rules.

105. *See* S. 975 § 2(a)(1).

106. A similar provision is not included in the House bill. *See id. But see* H.R. 1809 § 2(a)(1) (2015). Given that pharmaceutical companies and other companies in the health care sector are disproportionately represented in recent inversion transactions and proposed inversion transactions, this could be a potentially broad exception.

107. Alternatively, the President could take executive action on this issue. On August 13, 2014, several Democratic lawmakers sent President Obama a letter calling for executive action to ban IDCs from receiving government contracts. Letter from Rep. Rosa DeLauro et al. to Pres. Barack Obama (Aug. 13, 2014), http://www.reed.senate.gov/download/letter-to-president-obama-urging-action-on-inverted-corporations. While the President has broad authority to take steps to promote economy and efficiency in federal procurement, the letter did

may spur additional regulatory action and agency oversight in the near future.

VII. PRACTICAL ISSUES IN APPLYING THE GOVERNMENT CONTRACT RULE

Until Congress implements a legislative fix, there will remain several loopholes that allow inverted corporations to receive U.S. government business under certain circumstances. For example, IDCs can act as subcontractors under federal prime contracts.[108] And because there is no permanent statutory authority for the government-wide prohibition, it could expire if Congress fails to include the applicable language in an annual appropriations bill.[109]

Even if this legislation is enacted, however, there will remain opportunities for IDCs to receive federal funds. The proposed legislation applies only to contracts subject to the FAR,[110] meaning that IDCs would remain eligible to receive federal funding through other means such as grants, cooperative agreements, state and local contracts, and loans.[111] Federal agencies may also waive the prohibition in the interest of national security or "health benefits."[112] As noted above, subject to certain thresholds, IDCs would also remain eligible to receive federal funds as first-tier subcontractors or, more broadly, as lower-level subcontractors or suppliers.[113] Commercial item subcontractors would be entirely exempt.[114]

Even as well-advised companies almost certainly structure cross-border transactions to avoid running afoul of the two eighty-percent tests, federal compliance officers, advisors and agency contracting officials face difficult interpretive questions in applying the rules to a particular transaction. The Treasury and the IRS have issued extensive regulations under section 7874, including the 2016 Inversion Regulations. These regulations significantly expand the scope of the statute and include a number of anti-abuse rules that, as a practical matter, make determinations of the statutory ownership percentage uncertain.[115] In addition, the Treasury regulations include a

not specify the basis under which the President has the authority to promulgate such a prohibition. *See generally id.*

108. *See* Manuel & Lunder, *supra* note 16, at 10.

109. *Id.* at 2 n.12. Of course, there are benefits to maintaining these "loopholes"—by participating in the procurement system, these companies encourage price competition and, in some cases, provide essential goods that cannot be produced by "domestic" suppliers. *See id.* at 1, 13. For example, drug makers (such as Pfizer) may produce pharmaceuticals that are critically important to the U.S. government and, as a result, the government may be unwilling to exclude these firms from the supplier base.

110. *See* S. 975 § 2(a)(1).

111. *See* FAR 1.104; FAR 2.101(b)(2) (limiting the FAR's applicability to acquisitions).

112. *See* S. 975 § 2(a)(1).

113. *Id.*; *see also supra* Part VI.

114. *Id.*

115. *See* Treas. Reg. § 1.7874-2(g) (2015).

definition of "substantial business activities" that few inversion transactions have been able to satisfy.[116] None of these regulations are directly applicable to the government contract rule. Given this complexity, and in an environment in which companies are asked to self-certify their status for purposes of bidding on government contracts, it can often be unclear whether or not a company is an IDC.[117]

COs—the agency officials primarily tasked with reviewing contractors' self-certifications and enforcing the restrictions—are not in the best position to make this determination. These individuals should not be tasked with interpreting nuanced tax and corporate law issues, and different COs could conceivably reach differing conclusions regarding the same contractor. There is essentially no government contract case law addressing the definition of IDCs, and COs and agency counsel have little guidance on how to determine whether a company has properly certified. Contractors typically are not asked to provide documents supporting their certifications.[118] One of the few ways in which a company's status as an IDC can be legally challenged is through the GAO's bid protest function, but, as the *Inchcape Shipping Services* case demonstrates, the GAO has established a high bar for challenging an agency's IDC determination.[119]

Nor do the rules call for an automatic referral to the Treasury when questions arise.[120] Implementing a system whereby contracting agencies consult the Treasury for an advisory opinion or official IDC determination could offer an effective means of establishing consistent treatment of such firms.

VIII. CREATING AN EFFECTIVE DETERRENT TO INVERSIONS

Coordination between Treasury and other government agencies would not, on its own, fix the problem. Until the government contract regulations are brought closer in-line with the IRC's treatment of inverted corporations, they will not serve as an effective deterrent to inversions.

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116. *See id.* § 1.7874-3(a), 2015-25 I.R.B. 1070, 1075.

117. For example, it has been reported that Ingersoll–Rand had avoided bidding on contracts subject to the ban, but changed course after conducting an "exhaustive legal analysis" and concluded it was not an IDC. *See* Zachary R. Mider, *Tax Runaways Win Billions in U.S. Contracts Despite Bans*, BLOOMBERG (July 8, 2014, 12:01 AM), http://www.bloomberg.com/news/articles/2014-07-08/tax-runaways-win-billions-in-u-s-contracts-despite-bans. Ingersoll–Rand subsequently argued in a non-public legal memorandum to DHS that banning inverted companies from receiving federal contracts was invalid, in part because U.S. trade agreements with foreign governments prohibit discrimination against certain foreign suppliers. *See* Towarnicky, *supra* note 98, at 169–70, 181–82. DHS appears to have privately accepted this argument and subsequently cleared Ingersoll-Rand for government work. *See* Richard Rubin & Zachary R. Mider, *Democrats Query Why Tax-Avoiding Company Won Contracts*, BLOOMBERG (July 10, 2015, 11:09 AM), http://www.bloomberg.com/news/articles/2015-07-10/democrats-question-why-tax-avoiding-company-won-u-s-contracts.

118. *See* FAR 52.209-2.

119. *See* Inchcape Shipping Servs. Holding, Ltd., B-403399.3, B-403399.4, 2012 CPD ¶ 65, at 3 n.2 (Comp. Gen. Feb. 6, 2012).

120. *See* FAR 52.209-2.

As discussed above, under the IRC's anti-inversion provision, a foreign-incorporated corporation will be treated as a U.S. corporation for tax purposes if it acquires a U.S. company, and after the acquisition the shareholders of the U.S. company own eighty percent or more of the foreign acquiring corporation and the foreign acquiring corporation does not have substantial business activities in its jurisdiction of incorporation (i.e., a "failed" inversion in tax parlance).[121] However, a foreign-incorporated corporation will be recognized as a foreign entity if the existing shareholders of the U.S. company receive at least sixty percent but less than eighty percent of the stock of the foreign company by reason of holding stock of the U.S. company.[122] The U.S. corporation in that scenario would be subject to additional U.S. tax if it engages in certain post-inversion transactions (typically, "out from under" transactions), but in practice, the rules triggering such taxes have not discouraged sixty percent inversions.[123]

As a result, if the former shareholders of the U.S. company own at least sixty percent but less than eighty percent of the stock of the foreign corporation, the adverse tax consequences generally will be limited, and there will be *no government contract consequences* for reincorporating abroad.[124] Since the tax rule, on its own, effectively deters these companies from exceeding the eighty-percent threshold, the government contract rule is not likely to provide any additional deterrent. For the government contract prohibition to actually discourage inversions beyond the tax rules, the threshold needs to be below the tax threshold for a failed inversion, i.e., the government contract threshold should be reduced, at a minimum, to sixty percent. If Congress were serious about preventing inversions of government contractors, it could reduce the threshold even lower than sixty percent or adopt the "management and control" test included in the pending legislative proposals described in Part V above.[125]

121. *See supra* Part IV.A (discussing 6 U.S.C. § 395 (2012)).

122. *See* I.R.C. § 7874(a)(2) (2012).

123. The full effect of the 2016 regulations, including the Inversion Note Rule, which takes away one of the most enticing post-inversion tax planning techniques, remains to be seen, but early indications suggest that even these aggressive new rules will be insufficient to stop outbound business combinations. *See, e.g.*, Boone, *supra* note 45.

124. *See* Joseph B. Darby III, *Inverted Priorities: Why the Proposed Treasury Rules Are Unlikely to Stop Inversion Transactions*, Practical Int'l Tax Strategies 3 (2014), http://www.sandw.com/assets/htmldocuments/Inverted%20Priorities.%20Darby%20Article%20B1777290.PDF.

125. One model for penalizing contractors that complete inversion transactions is the FAR prohibition on contracting with corporations with delinquent taxes, which became effective on February 26, 2016. *See* Prohibition on Contracting With Corporations With Delinquent Taxes or a Felony Conviction, 80 Fed. Reg. 75,903, 75,903 (Dec. 4, 2015) (to be codified at 48 C.F.R. pts. 1, 4, 9, 12, 52). The interim rule amends the FAR to implement sections of the Consolidated and Further Continuing Appropriations Act of 2015 to prohibit the federal government from entering into a contract with any corporation having a delinquent federal tax liability and adds a certification requirement regarding tax matters. *See* FAR 52.209-11; FAR 52.209-12; FAR 52.212-3(q). The rule prevents a CO from making an award to such a company unless an agency suspending and debarring officer has considered suspending or debarring the company and determined that this further action is not necessary to protect the interests of the government. *Id.*

Following the enactment of section 7478 in 2004, there is no longer any reason for the existence of a stand-alone definition of "inverted domestic corporation" under procurement law. The "No Federal Contracts for Corporate Deserters Act" would restore the fifty percent threshold that was included in the original Wellstone amendment to the Homeland Security Act and provide an independent deterrent for companies that contract with the U.S. government. Amending the government contract rule to more closely track or incorporate the IRC's treatment of inverted corporations could simplify this determination. In that case, the applicable standards would be more transparent and better allow companies to weigh the risks and benefits of an inversion transaction.

Adequately addressing the limitations of the current government contract rule will ultimately require congressional action. Such changes could come in parallel with corporate tax reform, but would need to be addressed separately. While comprehensive corporate tax reform may reduce the incentive for many companies to pursue inversion transactions, the government contract provisions also would need to be updated to reflect changes to the tax regime. Until the definition of "inverted domestic corporation" found in the government contract provisions is expanded to cast a broader net, these provisions will not serve as an effective deterrent to companies relocating to non-U.S. lower-tax jurisdictions.