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Contracting With Inverted Corporations: The Latest Rules

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On Dec. 15, 2014, the Federal Acquisition Regulation Council announced two new rulemaking actions aimed at further tightening restrictions on the award of federal contracts to companies that have relocated overseas in inversion transactions. The two rules — one interim, one proposed — would reinforce the existing ban on contracting with so-called "inverted domestic corporations" (IDCs), while also imposing new, more onerous reporting obligations on government contractors concerning their IDC status.

The FAR Council's announcement represents only the latest development in a recent flurry of inversion-related actions from a variety of government authorities. As discussed below, the myriad proposals and rules advanced in recent months have resulted in regulatory thicket of restrictions and obligations that has the potential to ensnare even sophisticated contractors.

Existing Ban on Contracting With IDCs

The governmentwide prohibition on contracting with IDCs came into being with the passage of the Consolidated Appropriations Act for fiscal year 2008, which prohibited any FY 2008 funds from being used for contracting with IDCs. Since that time, identical or nearly identical prohibitions on contracting with IDCs have been included in each successive annual spending bill. The current FY 2014 version of this statutory ban, as in previous years, prohibits IDCs from receiving appropriated funds under prime government contracts:

None of the funds appropriated or otherwise made available by this or any other Act may be used for any Federal Government contract with any foreign incorporated entity which is treated as an inverted

domestic corporation under section 835(b) of the Homeland Security Act of 2002 (6 U.S.C. 395(b)) or any subsidiary of such an entity.[1]

Although this language is straightforward enough, the application of the ban is more nuanced. To begin, the definition of an IDC for government contracting purposes, found at 6 U.S.C. § 395(b), differs in some respects from the more familiar definition of an inverted company used in the tax area, found at 26 U.S.C. § 7874. For example, Section 7874 applies only to companies that underwent an inversion after the IRC provision took effect, but a company may be considered an IDC for government contracting purposes if it underwent an inversion "before, during or after" the effective date of definition of an IDC. In other words, the government contracting prohibition can extend back to capture companies that redomiciled at any time — even years or decades prior to the adoption of the prohibition. The result of such a rule is that even a company that never considered that it might be an IDC may suddenly find itself excluded from federal contracting.

Moreover, even wary contractors can have difficulty determining their IDC status. Whether a company is an IDC for purposes of the government contracting ban is often a complicated question that implicates many factors related to the structure of the inversion transaction and the nature of the company's operations. One key metric to keep in mind, however, is the degree of continuity in equity ownership following the transaction. Under the current ban, a domestic corporation that has redomiciled abroad may be considered an IDC if "after the [redomiciliation] at least 80 percent of the stock (by vote or value) of the entity is held ... by former shareholders of the domestic corporation." In other words, if a company redomiciles abroad and there is at least 80 percent continuity in ownership interests, then it may be an IDC subject to the contracting ban.

It should be noted, however, that although the current law prevents IDCs from receiving funds under prime contracts, it does not prohibit IDCs from receiving federal funds indirectly under a subcontracting arrangement. Other exceptions to the current ban also may apply, though this will depend on the subject matter of the contract in question and the source of contract funding.

Proposed Legislative Expansions of Contracting Ban

Although the existing restrictions on contracting with IDCs are complicated in their own right, this analysis may become even more complex in light of several pending legislative proposals. These proposals have the potential to significantly expand the current prohibition in ways that could have far-reaching effects on the contracting community. Contractors should be particularly aware of two ways in which the ban could be broadened.

First, Congress could expand the definition of an IDC so as to capture companies that redomicile via transactions in which there is less than an 80 percent continuity of ownership. If the continuity-of-ownership threshold is lowered from 80 percent to some lower figure (say, 50 percent or 60 percent), the contracting ban could be applied to contractors that otherwise would not otherwise be subject to the existing ban.

Second, Congress could expand the existing contracting ban to encompass subcontracts. Given the prevalence of complex government subcontracting arrangements, as well as expansive agency views on when a company's participation in federal programs renders it a "subcontractor," a legislative proposal that expands the existing contracting ban to subcontractors may have a wide-ranging — and possibly unintended — impact on the contracting community and beyond.

Nor are these potential expansions purely hypothetical. In recent months, several new proposals have been advanced that are aimed specifically at preventing the award of federal contracts to companies that redomicile abroad. Of particular relevance is the so-called No Federal Contracts for Corporate Deserters Act ("NFCCDA"), which would both lower the continuity-of-ownership threshold to 50 percent and extend the contracting ban to subcontract arrangements, as discussed above.

Aside from the NFCCDA, other recent anti-inversion proposals include Section 8122 of the Senate FY 2015 defense spending bill, which also proposes to expand the definition of an IDC by lowering the continuity-of-ownership threshold to 50 percent, as well as a series of identical amendments to House appropriation bills designed specifically to prohibit the award of federal contracts to IDCs domiciled in Bermuda or the Cayman Islands.[2]

Recent Regulatory Developments

In addition to these legislative proposals, concerns about IDCs winning federal government contracts have also spurred regulatory action. As mentioned above, the FAR Council recently announced two rulemaking actions to reinforce the existing ban on contracting with IDCs.

First, the Council issued an interim rule, effective Dec. 15, 2014, that revises the language of FAR 9.108, the provision governing IDCs. Among other things, the revised rule provides a reformulated summary of the history of the prohibition and a streamlined explanation for its coverage exceptions. It also includes updated references to the successive enactments of the contracting ban in more recent annual appropriation bills, and it makes clear that the FAR prohibition will remain in place "for as long as Congress extends the prohibition in its current form through subsequent appropriations action." The interim rule notice characterizes its revisions as "technical changes," but the intent of the revisions is clear: to emphasize "the ongoing nature of the prohibition for as long as Congress extends the prohibition in its current form through subsequent appropriations action."

In addition to revising existing regulations, the FAR Council also simultaneously announced a new proposed rule that would impose additional disclosure and reporting requirements on contractors. Currently, FAR 52.209-2(c) provides that by the act of submitting a given offer, a contractor impliedly represents that it is not an IDC or a subsidiary of an IDC. The proposed rule would recast this representation "to require an affirmative act by the offeror to complete two yes/no check-off boxes on whether it is an inverted domestic corporation, or a subsidiary of one." Although the substance of the representation would remain essentially unchanged, the new format of the representation would give it a prominence that is reflective of the government's increased focus on the inversion issue.

Moreover, the proposed rule also would amend FAR 52.209-10 to require a contractor, in the event that it becomes an IDC during contract performance, to give "written notification of its change in status as an inverted domestic corporation to the contracting officer within five business days from the date of the inversion event." This would be an entirely new obligation, and it raises further questions in its own right, including the form and content of such a notification, as well as whether the contractor would be permitted to continue performance of the contract following a change in IDC status.[3] In short, although the stated purpose of the proposed rule is to facilitate "clear, current, accurate, and complete disclosure," its application in practice may ultimately create additional uncertainty for contractors.

Implications of Recent Developments

The proliferation of legislative proposals to enhance the IDC contracting ban demonstrates Congress'

increasing concern with the recent trend of companies reincorporating abroad for tax purposes. Whether any of these proposals comes to fruition remains to be seen, but the sheer number of proposals underscores how politically attractive it is for lawmakers to trumpet efforts to prevent "corporate tax dodgers" from receiving taxpayer dollars. Given the political expedience of the issue, contractors should expect continued congressional involvement in the advancement of bills to enhance prohibitions on contracting with IDCs.

This is not to say, however, that interest in the issue is driven entirely by election-year politics. To the contrary, the two proposed rulemaking actions announced this week illustrate that the contracting ban for IDCs continues to garner attention even outside the frenzied political climate of Capitol Hill.

These relatively brief notices in the Federal Register did not receive much fanfare, but they warrant the attention for two reasons. First, the announcements signal an escalation in the government's efforts to enforce the IDC ban that has been in existence since 2008. Second, the proposed rule would impose upon contractors additional tracking and reporting obligations in what can be a complex area of the law. Given the combination of closer scrutiny by the government and additional obligations for contractors, this is an issue that may warrant not only close monitoring, but also proactive engagement and planning.

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[1] The FY 2015 appropriations bill passed by Congress last week contains an identical provision at Section 733.

[2] The amendments were added to the Fiscal Year 2014 Financial Services and General Government Appropriations Act, the Fiscal Year 2015 Transportation-Housing and Urban Development Appropriations bill, the Fiscal Year 2015 Energy and Water Appropriations bill, and Fiscal Year 2015 Department of Defense Appropriations bill.

[3] The interim rule is similarly unclear about this latter point. The notice accompanying the interim rule states only that contracting officers should "consult with legal counsel if a contractor becomes an inverted domestic corporation (or a subsidiary of one) during contract performance to ensure appropriate application of the prohibition."

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