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National Security, Foreign Influence, and Code Sec. 1504(a)(2)(A)

By Donald P. Board • Wood LLP

As promised during the 2016 campaign, national security has emerged as one of the signature themes of the Trump Administration. Skeptics have raised questions about the Administration's lax "friends-and-family" approach to security clearances, and the President's seeming indifference to Russian attempts to subvert the U.S. electoral process. Yet it is hard to deny the significance of the recent $700-billion defense appropriation for FY 2018—an $80 billion increase over FY 2017.

There have been major qualitative changes as well. The Trump Administration has turned to a concept of "national security" that does not stop at the Departments of Defense and Homeland Security. In the Administration's view, national security can justify actions intended to protect specific sectors of the U.S. economy.

Actually, it would be more accurate to say that the Trump Administration has *returned* to this more capacious notion of national security. When the President imposed tariffs on imported steel and aluminum on March 8, 2018, he did so pursuant to Section 232 of the Trade Expansion Act of 1962, which is captioned "Safeguarding national security." Critics from both parties have dismissed this as a pretext—after all, the Administration is really concerned about *economics*, which everybody knows is a different matter.

A sharp distinction between economics and national security may be current orthodoxy, but Congress certainly didn't see things that way in 1962. Section 232 *requires* the President to "recognize the close relation of the economic welfare of the Nation to our national security." Under the statute, the President:

> shall take into consideration the impact of foreign competition on the economic welfare of individual domestic industries; and any substantial unemployment, decrease in revenues of government, loss of skills or investment, or other serious effects resulting from the displacement of any domestic products by excessive imports shall be considered, without

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> excluding other factors, in determining whether such weakening of our internal economy may impair the national security.

The drafters of the statute might not have agreed with the imposition of tariffs under the present circumstances. But there is no doubt that they would have *understood* the President's tweeted rationale: "We must protect our country and our workers. Our steel industry is in bad shape. IF YOU DON'T HAVE STEEL, YOU DON'T HAVE A COUNTRY!"

CFIUS: More Than a Myth

As soon as Senator Ben Sasse (R-Neb.) heard the news, he denounced the President's "leftist" tariff. This is a striking perspective, especially coming from somebody who has a Ph.D. in American history from Yale. Dr. Sasse must have missed the part about the GOP spending its first 80 years as the party of industrial protectionism. It all goes back to Comrade Abraham Lincoln, the notorious *tariffista* who somehow got his name on Nebraska's capital.

When we move away from tariffs, however, we can now recognize something approaching Congressional consensus that *some* aspects of the U.S. economy—including the ownership and control of its "critical infrastructure"—cannot be left to the decisions of self-interested private actors here and abroad. In 2007, Congress passed the Foreign Investment and National Security Act (FINSA), which formally established the Committee on Foreign Investment in the United States (CFIUS). Congress is currently considering a bipartisan proposal, the Foreign Investment Risk Review Modernization Act of 2017, to strengthen and expand the FINSA regime.

CFIUS (commonly pronounced "SIFF-ee-us") is already familiar to cross-border M&A practitioners. If a proposed transaction could result in foreign persons gaining control of a U.S. business, the Committee can provide advance review of the national-security implications. That is helpful, because nothing can spoil a good acquisition like the buyer being forced to divest when national-security objections are raised *after* the closing.

CFIUS naturally takes a dim view of transactions in which a foreign person acquires control of a U.S. business that is located near sensitive military facilities, holds important government contracts, or engages in classified work requiring facility security clearances. The Committee is also concerned about foreign control of U.S. businesses when the national-security implications are less direct, *e.g.*, businesses that manufacture or sell sensitive technologies, compile personal data on Americans, or maintain the electrical grid.

CFIUS is headed by the Treasury Secretary and includes the Secretaries of State, Commerce, Defense and Homeland Security. During the first year of the Trump Administration, there was a 40-percent increase in the number of transactions that CFIUS chose to investigate. Specific figures are not made public, but some commentators report that there was also a 40-percent increase in the number of deals that got the thumbs down. There was also an estimated 100-percent increase in the number of transactions in which

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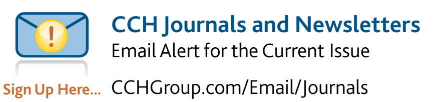

the Committee made its approval contingent on action being taken to mitigate the potentially adverse effects of "foreign ownership, control or influence" (FOCI).

All the Chips on the Table

Broadcom Corporation (Broadcom) is one of the world's leading semiconductor firms. It is also a wholly owned subsidiary of Broadcom Limited, a company chartered in Singapore. Early in 2017, Broadcom launched a campaign to acquire Qualcomm Incorporated, the world's other leading chip company.

Broadcom offered cash and stock worth $117 billion, but Qualcomm's management demurred. Broadcom then nominated its own slate of insurgent directors. On the eve of Qualcomm's annual meeting of shareholders (Mar. 6, 2018), CFIUS issued an order postponing the election of directors while it conducted a national-security review of the potential shift of control.

Broadcom denounced Qualcomm's request for CFIUS review as a "blatant, desperate" attempt to entrench its existing management. But many independent observers had already expressed concern about Broadcom's bid. Besides being deeply involved in sensitive projects for the Department of Defense, Qualcomm has been spearheading U.S. efforts to develop fifth-generation ("5G") wireless-communication technologies.

Can You Hear Me Now?

Leading the charge on 5G requires a massive commitment to R&D. Some analysts had worried that Broadcom's penny-pinching business model, combined with its highly leveraged offer, could end up degrading Qualcomm's research capabilities. Even if this were not the direct product of FOCI, it would still favor China in its race with the United States to set the standard in super-fast wireless tech.

Broadcom responded by pledging to maintain—indeed, to increase—Qualcomm's R&D spending. Broadcom also emphasized that it was in the process of reincorporating in the United States—as if having a new mailbox in Delaware would eliminate the risk that the acquisition could bring Qualcomm under FOCI.

President Trump did not wait for an extended CFIUS investigation. On March 12, he formally blocked the acquisition, including the election of Broadcom's nominees to Qualcomm's board of directors. The President's order stated that there was "credible evidence" leading him to believe that Broadcom and its affiliates might use their control of Qualcomm to "take action that threatens to impair the national security of the United States."

The President did not get into specifics. CFIUS had noted that the Defense Department relies on Qualcomm for a range of products, that Qualcomm holds security clearances, and that it works on a range of classified contracts with the United States. But the President may simply have been acting on his conviction, tweeted in November 2017, that "economic security is not merely RELATED to national security—economic security IS national security."

Code Sec. 1504(a) and the Mitigation of Foreign Influence

CFIUS is not the only organ of the U.S. government that worries about FOCI. Executive Order 12829 (Jan. 6, 1993) established the National Industrial Security Program (NISP) to safeguard classified information that the government shares with contractors and licensees. However, the NISP is also intended to advance national security by actively promoting the economic and technological interests of the United States.

The Defense Security Service (DSS) administers the NISP on behalf of the Department of Defense and 30 other federal agencies. The IRS, however, is not one of them. But it turns out that the IRS does have a role to play, because efforts to *mitigate* FOCI can raise questions about a U.S. corporation's qualification to participate in a consolidated return under Code Sec. 1504(a).

Operating Under the Influence

The DSS has a big job because there are approximate 13,000 contractor facilities that require access to classified information. To obtain a facility security clearance, a contractor must enter into a legally binding Defense Security Agreement with the DSS. The agreement binds the contractor to operate in accordance with an elaborate manual prepared by the DSS.

Most of the rules relate to the handling of classified information. But there are also rules

that address FOCI as it applies to contractors that have facility security clearances. After all, *promising* to operate a facility in accordance with a security manual is one thing. Actually doing so is another.

The DSS regards a company as operating under FOCI if a foreign interest has the power to decide matters affecting the management or operations of the company in a manner that could: (1) result in unauthorized access to classified information; or (2) adversely affect the performance of classified contracts. The foreign interest's power can be direct or indirect, and it need not have been exercised. It does not even have to be currently exercisable.

If a company is under FOCI, the DSS must determine how big a risk this poses to the classified information entrusted to it. This depends on the specific facts and circumstances. Factors the DSS will consider include:

- The source, nature and extent of the FOCI;
- The identity of the foreign interest and any foreign governments that might take an interest in obtaining the information;
- The record of economic and government espionage against U.S. targets;
- The foreign government's record on unauthorized technology transfer; and
- The record of compliance with pertinent U.S. laws, regulations and contracts.

Mitigating FOCI in Cross-Border M&A

To maintain its facility security clearance, a company operating a U.S. business (U.S. Company) must notify the DSS if it enters negotiations for a merger, acquisition, takeover or restructuring that would result in a foreign interest getting a place in the company's chain of ownership. The notification provides the DSS with information about the transaction, the foreign interest, and any plan to ask for CFIUS review.

U.S. Company must take steps to mitigate or negate any FOCI. The most important step, from an M&A perspective, is entry into a Special Security Agreement (SSA) with the Department of Defense. This is a corporate governance agreement designed to insulate U.S. Company from foreign influence.

In the SSA, U.S. Company, its immediate parent (U.S. Parent), and the foreign interest that may ultimately pull the strings (Foreign Parent) agree that U.S. Parent will appoint the board of directors of U.S. Company subject to the following typical conditions:

- There must be at least three directors who have no prior relationship with U.S. Company, U.S. Parent, Foreign Parent, or their affiliates (Outside Directors);
- U.S. Parent may remove or appoint Outside Directors only with the approval of the DSS;
- One or more directors must be officers of U.S. Company who have security clearances (Officer/Directors);
- The Outside Directors, the Officer/Directors, and the chairman of the board must be residents and citizens of the United States who are eligible for security clearances at the same level as U.S. Company's facility security clearance;
- One or more members of the board must represent U.S. Parent (Inside Directors);
- Inside Directors must be excluded from access to classified information; and
- Inside Directors must not constitute a majority of the board.

The SSA will also establish a permanent Government Security Committee, composed of the Outside Directors and Officer/Directors. This committee is charged with ensuring that U.S. Company maintains policies and procedures to safeguard classified information in its possession. The SSA also prohibits U.S. Company from taking certain actions (*e.g.*, merging) without U.S. Parent's consent.

Loss of Control?

Under Code Sec. 1501, an affiliated group of corporations may file a consolidated return. To qualify as an affiliated group, the corporations in question must all be "includible corporations" within the meaning of Code Sec. 1504(b). Foreign corporations, DISCs, and other exotics are generally not includible.

For a set of includible corporations to qualify as an affiliated group, they must constitute one or more chains of corporations connected through stock ownership with a common parent corporation. The common parent must "directly" own at least one of the includible corporations. Finally, each includible corporation other than the parent must be owned "directly" by one or more of the other includible corporations. [*See* Code Sec. 1504(a)(1).]

One or more corporations "own" another corporation only if they directly own stock possessing at least: (1) 80 percent of the *total voting power* of the stock of the corporation; and (2) 80 percent of the *total value* of the stock of the corporation, excluding non-voting preferred shares. [Code Sec. 1504(a)(2) and (a)(4).]

Under a Special Security Agreement, U.S. Parent retains the right to elect U.S. Company's directors. But the whole point of an SSA is to mitigate—or, ideally, negate—the control or influence that Foreign Parent could exercise over U.S. Company through its ownership of U.S. Parent. If there is an SSA in force, should U.S. Parent be treated as owning 80 percent of the total voting power of U.S. Company for consolidated return purposes?

Assessing Voting Power

Neither the Code nor the Treasury Regulations explain what Code Sec. 1504(a)(2)(A) means when it refers to ownership of stock possessing at least 80 percent of a corporation's voting power. However, it is well understood that this is not simply a matter of who owns 80 percent of the shares with voting rights. It is necessary to analyze how the shares relate to the actual management of the corporation, including the role that different shares play in the election of the board of directors.

Multiple Classes of Directors

Sometimes, this is a tidy, mathematical inquiry. In Rev. Rul. 69-126 [1969-1 CB 218], the IRS considered a situation in which the parent corporation owed 100 percent of its subsidiary's common stock and 50 percent of the subsidiary's voting preferred shares. The common shareholders were entitled to elect five directors, while the preferred shareholders could elect three.

To apply the 80-percent test, the IRS determined the parent's ownership of each class of voting stock and then calculated a weighted average based on the *number of directors* elected by each class. The parent owned: (1) 100 percent of the common stock, which was entitled to elect five out of eight (62.5 percent) of the directors; and (2) 50 percent of the preferred stock, which was entitled to elect three out of eight (37.5 percent) of the directors. The parent therefore owned stock possessing 81.25 percent of the total voting power—*i.e.*, 100 percent of the power to elect 62.5 percent of the directors *plus* 50 percent of the power to elect the remaining 37.5 percent.

Noncumulative Voting

Given Rev. Rul. 69-126's focus on the power to elect directors, one might expect that Code Sec. 1504(a)(2)(A) would be satisfied if the parent can elect at least 80 percent of the board. Suppose, for example, that a corporation does not employ cumulative voting—*i.e.*, the shareholders elect each director *separately*. In that case, the parent will be able to elect 100 percent of the directors as long as it owns a *majority* of the relevant voting shares.

Does the parent's stock represent 100 percent of the total voting power? The IRS doesn't think so. The parent corporation described in TAM 9714009 (Apr. 4, 1997) owned 74 percent of the voting shares of a corporation. The corporation did not have cumulative voting, so the parent was able to elect the entire board.

The IRS rejected the parent's contention that its shares satisfied the 80-percent test. The TAM acknowledged that the parent had the legal power to elect 100 percent of the subsidiary's directors. But the IRS maintained that this was irrelevant, because this power was not an *inherent* property of the shares themselves.

The IRS pointed to the language of Code Sec. 1504(a)(2)(A), which refers to ownership of *stock* possessing at least 80 percent of the corporation's total voting power. The IRS interpreted this to mean the voting power must be attributable to the shares *per se*, rather than to any facts about who owns them and in what proportions.

The IRS posited a case in which the same 74 percent of the voting shares was widely held. If the shares had been held equally by (say) 100 shareholders, it would have been "clear" (according to the TAM) that the aggregate voting power of the shares *per se* represented only 74 percent of the total. None of the 100 shareholders, acting alone, would have been able to elect 80 percent of the directors.

The problem with this argument is that it applies with equal force no matter what percentage of the voting shares the parent owns. Suppose that the parent owns *95 percent* of the voting shares. If these shares

were held equally by 100 shareholders, none of them would be able to elect 80 percent of the board, either.

Under the IRS's reasoning, the power to elect 80 percent of the directors would not have been "inherent" in the 95-percent block. This proves too much, because the parent would not satisfy Code Sec. 1504(a)(2). The result reached in TAM 9714009 may be correct, but its justification will not be found in the alleged distinction between inherent and accidental properties of voting stock.

"Direct" Ownership of Voting Shares

Where does this leave U.S. Parent if it enters into an SSA? Under the agreement, U.S. Parent has considerable discretion regarding the appointment of Inside Directors. But Inside Directors cannot constitute a majority of the board, so does U.S. Parent really have at least 80 percent of the total voting power of U.S. Company?

To satisfy Code Sec. 1504(a)(2)(A), U.S. Parent must be able to claim credit for some of the non-Inside Directors. Under the SSA, U.S. Parent appoints the Officer/Directors and the Outside Directors. The appointees must be citizens and residents of the United States, and they must be eligible for security clearance at the same level as U.S. Company.

These conditions constrain U.S. Parent's choices, but they don't raise any serious question about its ability to control U.S. Company. However, the SSA *also* requires U.S. Parent to obtain the DSS's consent to the appointment or removal of Outside Directors. If DSS has a veto, does U.S. Parent really have the power to elect the Outside Directors?

The IRS acknowledges that a parent corporation can satisfy Code Sec. 1504(a)(2)(A) even if it has something less than full and unencumbered ownership of its subsidiary's voting stock. In Rev. Rul. 70-469 [1970-2 IRB 179], for example, the parent had transferred title to certain shares to an individual to allow him to qualify as a director of the subsidiary under state law. The IRS ruled that the parent could still be treated as "directly" owning the transferred shares because it had the power to reclaim title at any time.

In *Miami Nat'l Bank* [67 TC 793, Dec. 34,251 (1977)], the Tax Court held that a parent could be treated as "directly" owning voting shares even after transferring title to a broker. The broker used the shares to satisfy its net-capital requirements, for which it paid the parent an interest charge. Significantly, the transferred shares were subject to the claims of the *broker's* creditors.

Nevertheless, the Tax Court concluded that the voting shares could be credited to the parent. The parent had exposed the shares to the claims of the broker's creditors, but it had retained: (1) the right to vote the shares; (2) the right to be paid any dividends; (3) the right to substitute cash or readily marketable securities of equal value; and (4) the right to assign its interest.

The Tax Court thought that the retention of these rights ensured that the parent had beneficial ownership of its sub. Beneficial ownership is generally sufficient to establish ownership of voting stock [*see* Rev. Rul. 55-458, 1955-2 CB 579]. Hence, the parent owned the transferred shares "directly" for purposes of Code Sec. 1504(a)(2)(A).

The IRS's emphasis on beneficial ownership has contributed to an indulgent view of the restrictions imposed by SSAs. Under an SSA, U.S. Parent must agree to limitations on its choice of directors, including the DSS's right to veto its selection of Outside Directors. But this does not alter U.S. Parent's underlying *economic* rights.

In LTR 201709004 (Mar. 2, 2017), the IRS considered the effect of an SSA with terms similar to those described above. The letter ruling observed that, even with the SSA in place, U.S. Parent retained all of the economic benefit and risk with respect to U.S. Company. U.S. Parent had the right to all distributions, as well as the right to sell or otherwise transfer its interest in its subsidiary.

LTR 201709004 recognized that there were limitations on U.S. Parent's right to appoint directors, including the DSS's veto. But these were outweighed by U.S. Parent's retention of unimpaired economic rights and the fact that U.S. Parent could still exercise a good deal of discretion in selecting U.S. Company's board of directors. The IRS's bottom line was that Code Sec. 1504(a)(2)(A) did not prevent U.S. Parent from including U.S. Company as a member of its consolidated group.

Conclusion

Whether the United States will warm up to tariffs remains to be seen. Senator Jeff Flake (R-Ariz.) has introduced a bill to nullify President Trump's action on steel and aluminum imports. The Administration's announcement (March 22) that it was imposing tariffs on $50 billion of Chinese imports was immediately controversial, especially after China imposed reciprocal tariffs.

However, concerns about foreign control or influence affecting sensitive sectors of the U.S. economy are likely here to stay. As the concept of "national security" expands, M&A practitioners will find themselves engaging on a more regular basis with CFIUS and the DSS. When they do, they will at least have the comfort of knowing that the IRS will accommodate common FOCI-mitigation arrangements within the regime established by Code Sec. 1504(a)(2)(A).