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CFIUS: How U.S. National Security May Affect Transactions Between Non-U.S. Parties

Foreign investments in the United States may be subject to national security review by the Committee on Foreign Investment in the United States ("CFIUS"). CFIUS has broad powers and a mandate that extends across industry sectors. It even may apply to a transaction between two non-U.S. entities if the transaction involves the transfer of U.S. assets, irrespective of the size of the transaction, as is illustrated by the failed attempt of Royal Philips, a Dutch entity, to sell its lighting components business spread across 30 countries to a consortium led by GO Scale Capital, a Chinese entity. This transaction was ultimately abandoned earlier this year, as CFIUS declined to give clearance for the transfer of the U.S. assets included in the deal. In another recent development, on CFIUS' recommendation the U.S. President prohibited the acquisition of U.S. assets of Aixtron SE, a German chip equipment manufacturer, by a Chinese owned entity. As a result, the transaction for the acquisition of the German parent company was unsuccessful.

When is CFIUS Scrutiny Triggered?

CFIUS is an inter-agency U.S. government committee, chaired by the Treasury Department. Its members include, among others, representatives from the Defense Department, the Justice Department, the State Department and the Commerce Department. CFIUS has extensive authority to review, from a "national security" perspective, foreign investment which results in "control" of a business in the United States by a foreign investor. "National security" and "control" are both interpreted broadly, with the result that CFIUS review can be triggered in a wide variety of cross-border transactions.

Given this broad mandate, CFIUS has over the years reviewed foreign investments in a number of sectors, including manufacturing, finance, technology, information and services, mining, utilities and construction, wholesale, retail and transportation. CFIUS has not prescribed a bright line test for determining "control" and, generally, looks at all relevant facts to ascertain if the foreign investor has the power to decide matters affecting U.S. business. Nonetheless, an acquisition of ten percent or less of voting interests, solely as a passive investment, will not trigger CFIUS review.

The CFIUS Scrutiny Process

The parties to a transaction may voluntarily elect to undergo CFIUS review. To do so, the parties must file a notice with CFIUS and provide certain information relating to the transaction, including the purpose and value of the transaction and the identity of the foreign parties and their ultimate owners. Nevertheless, regardless

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whether voluntary review is pursued, CFIUS may at any time undertake review of a transaction on its own initiative.

CFIUS generally concludes its review within a 30-day period; however, at the end of the 30-day period, CFIUS may initiate an additional 45-day investigation. Such an investigation is mandatory for transactions involving a state-owned foreign investor or the acquisition of "critical infrastructure" in the U.S. Following the applicable review period, a CFIUS clearance provides a safe harbor barring any subsequent review of the transaction, unless there are impugning circumstances, such as submission of false or misleading material information.

As a condition for clearance, CFIUS may impose certain restrictions, including reducing non-U.S. ownership or control or restricting access to critical technology. Nonetheless, if security concerns persist, CFIUS may recommend to the U.S. President that the acquisition be blocked or that a completed transaction be unwound. In the event CFIUS declines to give clearance, the ability to seek relief from U.S. courts is limited.

Conclusion

Recently, certain members of Congress requested that the U.S. Government Accountability Office ("GAO") review the powers of CFIUS to determine if they should be expanded, specifically in light of increased investment activity by state-owned Chinese and Russian entities. The GAO acceded to the review request and, accordingly, the broad powers of CFIUS may be further strengthened in the future.

Any sale of a U.S. business, even if entirely between non-U.S. parties or where the transaction may not have an apparent nexus to U.S. national security, may trigger CFIUS scrutiny. CFIUS may block a transaction, impose a wide range of conditions or may require that a closed transaction be unwound. Thus, it is critical that cross-border transactions involving U.S. assets be evaluated for potential CFIUS scrutiny and be structured accordingly.

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Consequences of Brexit for EU Trade Marks and Registered Community Designs

1. INTRODUCTION

23 June 2016. On that day the United Kingdom (UK) decided to leave the European Union (EU). While there is currently uncertainty about specific exit scenarios it is very likely that the UK, after a corresponding exit agreement becomes operative, will no longer be affected by existing EU rights such as the EU trade mark and the Registered Community Design.

Applicants and proprietors of EU trade marks and Community designs are therefore advised to make timely arrangements before the UK leaves the EU.

2. UNION TRADE MARK

Once the exit agreement becomes operative proprietors of EU trade marks may be at risk to lose their trade mark protection in the UK. That is because third parties could then legally file a new UK trade mark which corresponds to a former EU trade mark and possibly even derive rights from such a UK trade mark against the proprietor.

However, there are ways for EU trade mark proprietors to be prepared. For example existing EU trade mark rights can be secured in the UK by refiling a national UK trade mark before the UK Intellectual Property Office (UKIPO). The Brexit is not expected to affect the UK´s membership of the Madrid Agreement and the Madrid protocol both concerning the international registration of trade marks. Thus, EU trade mark proprietors may also apply for a UK trade mark by having their existing EU trade mark entered in an international register. Advantageously the application for international registration can be filed before almost any national IP Office, such as the United States Patent and Trademark Office. Hence, there is no need for a domestic representative in the UK if the international route is selected. Likewise applicants of EU trade marks may consider to either file a separate UK national application or to directly apply for an international trade mark registration and designate both the EU and UK.

3. COMMUNITY DESIGN

A Registered Community Design may also be wholly unprotected in the UK once the exit agreement becomes operative. Given that the term of protection for a Registered Community Design is limited to a maximum of 25 years, naturally, older Registered Community Designs would not be affected on the long term as strongly by UK´s exit from the EU as younger Registered Community Designs would. The existing publication of a Registered Community Design is most likely to be novelty destroying for refiling

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a corresponding design in the UK. Hence, design proprietors would have to rely on appropriate transitional legislation in the UK which would have to allow for maintaining design rights in the UK. Only when the filing date of the Registered Community Design is not older than twelve months it is possible to refile the design in the UK by validly claiming the priority of the Registered Community Design, i.e. the Registered Community Design would in that case not be novelty destroying. Currently the UK is not a member of the Hague Agreement concerning the registration of designs with international effect. Therefore it will not be possible to obtain design protection in the UK via an international design application. Thus, applicants may have to apply for both a Community design and a UK design in order to maintain design protection in both territories throughout a Brexit scenario. Hereby the aforesaid twelve months priority term allows to first file the Registered Community Design and then to file the UK design within the priority term.

4. PRACTICAL ADVICE

Since the EU cannot determine how the future non-EU member UK will deal with the EU trade mark and the Registered Community Design, applicants and proprietors of such rights might suddenly be without protection in the UK. Applicants and proprietors of EU trade marks can close the unprotected gap in any case by filing a new trade mark either before the UKIPO or based upon an international trade mark registration and designating the UK therein. Refiling a Registered Community design in the UK is – in contrast to the situation for an EU trade mark – only possible within twelve months (priority term) upon the filing date of the Registered Community design. Otherwise applicants and proprietors of Registered Community Designs have to rely on appropriate transitional legislation in the UK to secure their designs rights after the UK leaves the EU. Such transitional legislation, however, does not yet exist. In the worst case, for IP owners, no transitional legislation would be in place when the Brexit happens.

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New ICC-Expedited Procedure Rules to enter into force March 1, 2017

In cross-border transactions one of the most difficult issues to agree upon is the venue for a possible litigation that may arise out of the agreement. And at the same time this topic is most often not handled with the necessary attention. Be it for lack of experience or the unawareness of alternatives, jurisdiction clauses are too often not considered to be of any specific importance. This is, of course, a huge error since the location of the venue can have a decisive influence on the outcome of a litigation.

However, the parties do not need to agree on the venue of the place of business of either company. A valid alternative to litigation before public courts is an arbitration agreement. It should be included in the transaction agreement. Perhaps the most important international arbitration institution is the Court of Arbitration of the International Chamber of Commerce (ICC) in Paris, France. One of the many misconceptions on the ICC Court of Arbitration is the fact that the venue for the arbitration proceedings need not be in Paris. Any place of the world can be chosen as a venue. Arbitration proceedings are usually quicker than litigations before public courts. The proceedings as such are not public which is considered to be an advantage in many international transactions and deals because in the event of a dispute which cannot be amicably settled there is no risk that third parties or the general public will get to know any details of the business relationship. Another advantage is the free choice of the language of the proceedings.

The ICC recently adopted new rules for "Expedited Procedures" which will come into force on March 1, 2017. The Expedited Procedure Rules shall apply if the amount in dispute does not exceed US$ 2,000,000. The new rules aim to shorten the arbitration proceedings by reducing the number of procedure steps. The cost of the arbitration shall also be lower because a sole arbitrator shall decide the matter (while under the traditional rules three arbitrators are to be appointed).

The following features shall help simplify the procedures:

- The Court will appoint a sole arbitrator in the time limit set by the Secretariat or, in the absence of such nomination, within as short a time as possible;
- The provisions relating to the terms of reference (Article 23) shall not apply under the Expedited Procedure Rules;
- Neither party shall make new claims after the Arbitral Tribunal has been constituted unless authorized to do so by the Tribunal;

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- The case management conference shall take place no later than 15 days after the date on which the file was remitted to the Arbitral Tribunal;
- The Arbitral Tribunal is given discretion to adopt the procedure measures it considers appropriate;
- The Tribunal may also decide the dispute – after consultation with the parties – solely on the documents submitted by the parties, even without hearing and examination of witnesses;
- Hearings may be held by video or telephone conference.

The Expedited Procedure Rules will not apply to arbitrations agreements entered into before March 1, 2017. The parties may opt-out of the Expedited Procedure Rules. They may they also opt-in for cases with an amount in dispute higher than US$ 2,000,000. The ICC Court of Arbitration provides standard clauses for arbitration agreements which should be used in order to avoid "pathological" clauses which may cause the arbitration clause to fail.

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Foreign-owned disregarded entities must now file Form 5472

U.S. tax laws allow taxpayers to elect to classify a U.S. limited liability company as a corporation, if the U.S. entity qualifies as eligible entity under section 301.7701-3 (Check-the-Box Regulations). The default rule for a non-election of such a status is either the characterization as a “flow-through” entity or as “disregarded entity” depending on the number of the company’s shareholders or partners. For example, a Delaware LLC with just one shareholder is treated as disregarded entity (DRE) for federal tax purposes. In case this shareholder is a non-U.S. entity, the LLC qualifies as its U.S. branch.

On Dec. 12, 2016, the IRS released final regulations under sections 6038A and 7701 that would for the first time require foreign-owned U.S. DREs, such as a single-member Delaware LLC owned by a German corporation, to obtain an employer identification number and file an information return with the IRS. The IRS has justified this proposed requirement by citing its obligations to exchange information with its treaty partners, which would presumably include information on U.S. DREs owned by persons or entities in treaty partner jurisdictions such as Germany. No comments were received in response to these regulations when previously proposed, and thus, the final regulations differ very little from the original proposal.

The final regulations treat a DRE as a domestic corporation and a reporting corporation, solely for purposes of the certain information reporting and recordkeeping requirements of the Internal Revenue Code, if its single owner is foreign. Under these rules, a U.S. corporation with greater than 25 percent foreign ownership must report certain information about itself and its transactions with related parties on Form 5472, and must keep records relating to the same. Under the proposed regulations, foreign-owned DREs would also be required to file Form 5472 and report similar information, including information regarding distributions and contributions to or from its sole owner. However, several exceptions that currently apply to reporting corporations (including the small corporation, de minimis related party transaction, parent filing 5471 and foreign sales corporation exceptions) do not apply to foreign-owned U.S. DREs. Thus, these rules are much more expansive in scope in their application to DREs.

These new disclosure rules will apply to taxable years of DREs beginning on or after Jan. 1, 2017, and ending on or after Dec. 13, 2017. The tax year of a DRE is the tax year of its sole owner if the sole owner has a U.S. filing requirement, otherwise it is deemed to be the calendar year. Penalties for failure to comply are the same as for any other failure to file a required Form 5472: generally $10,000, with increased penalties for failure to comply after notification by the IRS and/or willful failures to file.

Foreign-owned disregarded entities must now file Form 5472

Because a foreign-owned U.S. DRE has never had to file its own U.S. return in the past, it is possible that tax advisors may not even be aware of DREs in some inbound investment structures. Foreign tax advisors, in particular, should review structures with their clients and determine if an entity viewed as a 'U.S. limited liability company' from the perspective of a foreign country's tax system might be a DRE with new reporting and recordkeeping obligations under the final regulations to avoid unpleasant surprises in the future.

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The Importance of Basis in the Tax Law

Often we don't realize the importance of certain information until we do not have it. Tax basis in property (e.g.- real estate or stocks) is a good example of information that is often misplaced, especially if a number of years have passed since the property has been purchased or the taxpayer acquired the basis in the property. The basis in property is usually the cost to the taxpayer.

There can be very negative consequences if a taxpayer is not able to substantiate the basis of property. One area where basis is a crucial component of determining the tax gain is when stock or securities are sold. The gain or loss for tax purposes is the difference between the fair market value of the property and the cost basis. While the fair market value of the securities is easily provable when a broker handles the sale, the basis is often not known to the selling broker and needs to be provided by the taxpayer. The basis of stocks or bonds is generally the purchase price plus the costs of purchase such as commissions and recording or transfer fees.

If the taxpayer does not know or cannot prove the tax basis, the IRS can hold that the tax basis is zero and that the full fair market value of the investment will be taxed in the year of sale. Therefore, it cannot be stressed enough that records establishing the cost of securities be carefully held for years after the year of sale. The documents should be retained for as long as the IRS can still audit the tax return containing the stock sale information. If the taxpayer is unable to prove the basis but knows the date when the security was purchased, it is often possible to make a reasonable estimate of basis for purposes of reporting; however, the IRS may not accept this estimate.

The concept of basis is also important in other areas of the tax law such as casualty losses. The taxpayer is entitled to a deduction which is calculated utilizing the lesser of tax cost or fair market value decrease less any insurance recoveries. A recent Tax Court case illustrates that the inability to prove basis can be very costly. In that case, Howard Bruce Coates and Tandi A. Coates, Petitioners v. Commissioner of Internal Revenue, Respondent (T.C. Memo. 2016-197), the Tax Court upheld a 2010 disallowance of a casualty loss deduction in the amount of $88,000 because the taxpayer could not prove they had basis in the property destroyed by a tornado. Although the taxpayer claimed that the property had been purchased from his mother, he could not produce substantiating evidence of the purchase including the amount he claimed to have paid for the land parcel. This case once again points out the importance of documents substantiating the basis of property. In addition, it is important that the taxpayer retain the documents in the event of challenge by the IRS.

While the general rule is that tax basis is the cost to the taxpayer, there are several areas of the tax law where the basis can be a carryover basis (i.e.-the basis in the

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hands of a predecessor owner or of a previous property). Furthermore, there are times when the basis can be the fair market value at the time of acquisition by the taxpayer or some other defining date. These special basis rules will not be discussed here; however, if these situations are applicable the carryover or fair market value basis must be able to be proved to the satisfaction of the taxing authorities at the time they become relevant for tax purposes.

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Election 2016: Tax Policy Decisions Ahead

On November 8, the US elected Donald Trump as its forty-fifth president and in so doing handed him significant authority over federal tax law and regulations. The election of a new president typically ushers in the prospect of significant policy changes and along with it an awareness of the complexity involved as proposals are released, debated, modified, and, in some cases, enacted. From the standpoint of tax policy, however, it is unclear whether the tax code changes that Trump has envisioned will be enacted into law in their current form.

This lack of clarity could be due in part to the fact that in the months leading up to the election tax policy never really emerged as a top-tier issue on the campaign trail or in the general media.

To be sure, Trump and his Democratic challenger Hillary Clinton acknowledged the importance of tax policy and each developed proposals to show how they hoped to reshape the tax code in their respective administrations. But Trump, like Clinton, generally addressed tax issues only in broad strokes. The proposals he discussed in his speeches and position papers in many cases lack technical details to explain how specific provisions would operate, and we may not see any fully fleshed-out proposals until his administration sends its first tax-and-spending plan to Congress in 2017.

Based on the public statements Trump has made regarding tax policy, two things seem apparent. First, he appears intent on changing the nation's tax laws by working within the confines of the current income tax system rather than attempting to move toward a consumption-based tax or other alternative system.

Second, the changes he is likely to propose once in office largely reflect the Republican Party orthodoxy of lowering tax rates for business and individual taxpayers while simultaneously broadening the base through limiting – or in some cases eliminating – some longstanding tax deductions, credits, and incentives.

In some ways, Trump's tax policy platform is a work in progress. He released his original tax reform plan in September 2015, well before he had won the GOP nomination. That plan was criticized by Democrats, as well as some Republicans, for being too costly – the nonpartisan Tax Policy Center estimated the plan could lose nearly $10 trillion in revenue over the next decade – and for targeting its tax reductions primarily at upper-income households. More recently, he has attempted to recalibrate his plan in an effort to make it less costly and target its benefits on the individual side more toward the middle class.

Trump's goal of reforming the tax code likely will be made easier by the fact that Republicans will control the House of Representatives and the Senate in 2017. But the president-elect and Republican congressional leaders do not necessarily walk in lockstep

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Election 2016: Tax Policy Decisions Ahead

on all issues related to tax reform. House Republicans unveiled a tax reform “blueprint” in June of this year, which they intend to develop into a formal legislative proposal that they hope to move through the chamber next year. Although Trump’s plan and the blueprint overlap in some key areas – such as individual tax rates – they differ in others. Moreover, the GOP will have smaller majorities in both chambers in the incoming 115th Congress than it currently enjoys. In the Senate, Republicans remain well short of 60-vote threshold needed to avoid the threat of a Democratic filibuster and advance controversial legislation. If Trump and Republican lawmakers come to an accord on tax reform, they conceivably could take advantage of the “budget reconciliation” process to sidestep Democratic opposition. But that option involves some very real policy and procedural challenges. If Republicans opt not to use reconciliation, they likely would need to work with Senate Democrats to ensure that legislation can move through that chamber.

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U.S. Federal Regulations during the Obama-Trump Transition

Questions about the status of U.S. federal regulations during the transition between the Obama and Trump administrations have arisen in four major areas:

Executive Orders

Most Executive Orders are not enforceable in court and do not grant legal rights to third parties. They are statements of the President's policy priorities, expressed as a formal directive to agency heads.

- Such Order can be repealed immediately by issuing a new Order invalidating it. Or, the new President may simply tell his staff to instruct the agency heads to ignore his predecessor's Order. This silent repeal is typical when a new President does not want to take the political heat for abandoning a predecessor's policy.
- The President may implement by Executive Order authority delegated directly to him by statute, the most important area of which involves economic sanctions under the International Emergency Economic Powers Act. Here, the President must follow the procedures established by the statute.

The President cannot invalidate or modify final actions taken by an agency to implement his policy directives. Those remain in full force and effect unless revoked or amended by the agency, or overturned by a court.

Midnight Rules

From now until January 19, 2017 the Obama administration will promulgate economically significant regulations, commonly known as "Midnight Rules," many of which have been held back to avoid creating political issues during the campaign.

Shortly after noon on January 20, 2017, President Trump's chief of staff likely will issue a Memorandum to the heads of all Executive agencies subject to presidential direction, instructing them (1) to withdraw any rules signed by their predecessor and waiting to be published; and (2) not to submit any additional rules without White House authorization. Anticipating this, the Obama administration likely instructed agencies to prioritize their new regulations so they would be ready shortly after the election.

Such Midnight Rules must be **published** in the *Federal Register* by January 19, 2017. An unpublished rule is not a final agency action, and has no legal force and effect, while a published rule can be revoked or amended only if the agency undertakes a new notice and comment rulemaking, which is subject to judicial review.

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U.S. Federal Regulations during the Obama-Trump Transition

Congressional Review Act

Under the CRA, rules with an annual economic effect of more than $100 million adopted during the transition can be overturned by adoption under expedited procedures (including no filibuster in the Senate) of a Joint Resolution of disapproval, passed by Congress within 60 days after the 15th day of business of the new Congress convening on January 3, 2017, and signed by the President (or, if the president vetoes, the veto is overridden). Opponents of individual Midnight Rules, and other rules adopted since last June, are seeking to have a Republican Congress adopt resolutions of disapproval and forward those laws to President Trump for signature.

The major constraint on the CRA during the transition and first weeks of the Trump administration is the scarcity of floor time, as other policy priorities are before Congress, including passing an appropriations bill, confirming senior Trump appointees, funding infrastructure, revising the Tax Code, and modifying Obama Care.

But on November 17, 2016, the House of Representatives adopted a bill amending the CRA to permit a block vote to disapprove all Midnight Rules in one vote. This bill is unlikely to be signed by President Obama.

Judicial Review in Court

Many Obama administration initiatives are under appellate court review. The Trump administration could decide to drop the defense of controversial rules issued by the Obama administration and support the challengers instead. Such a "confession of error," based on the outcome of the election and change in Executive Branch policy, has rarely happened in prior transitions.

- The Trump administration would have to take full political responsibility for the abandonment of an Obama rule. But political benefits seemingly could be gained by this.
- Positions taken by the Obama administration in defending a rule typically are supported by private sector intervenors with full authority to continue litigation. If the court were to uphold the Obama administration action, the Trump administration would have taken all the political heat for little gain.

Federal regulation uncertainty looms during the presidential transition. German businesses are well served to keep abreast of developments, and to consult with U.S. counsel as the new administration takes office, and beyond.

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