Basics of Inversion Transactions for Canadians

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Overview

(1) What is an Inversion?

(2) What factors are driving Inversion activity?

(3) U.S. tax rules applicable to Inversions

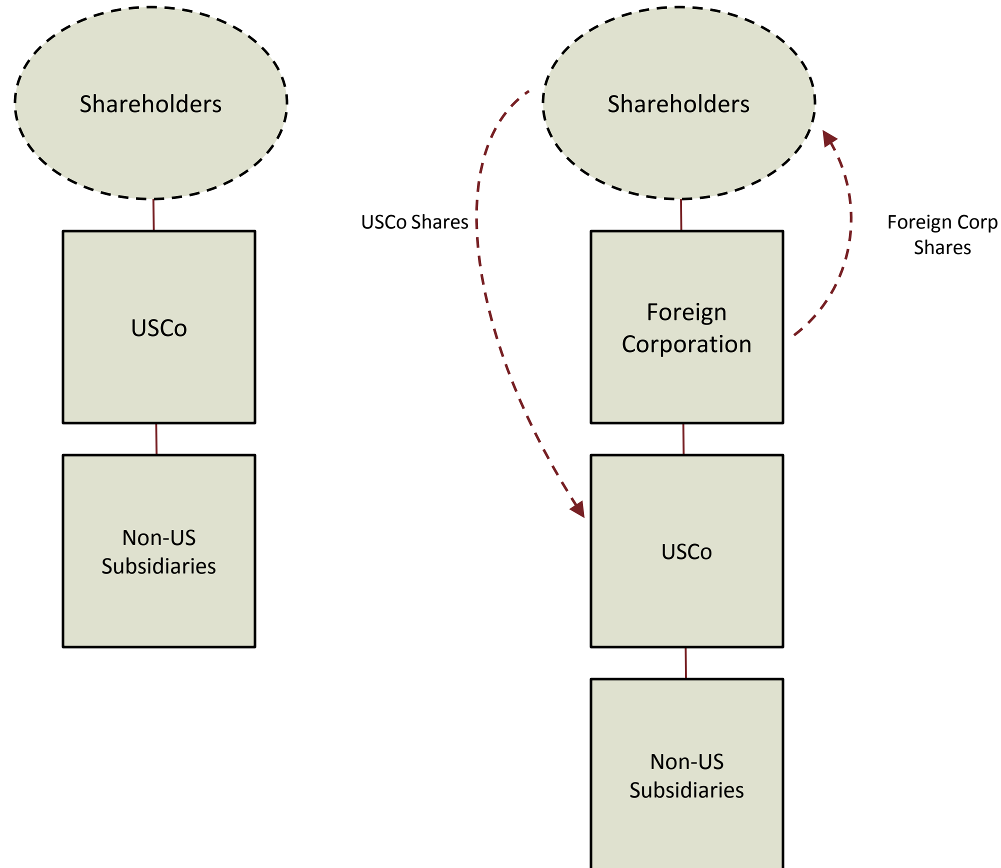
(4) Inversion transactions involving Canadian corporations

(5) Recent developments

What is an Inversion?

What is an Inversion Transaction?

- A transaction in which a U.S. corporation (or U.S. multinational group) restructures so that the U.S. corporation becomes a subsidiary of a non-U.S. corporation.



What factors are driving Inversion activity?

What factors are driving inversion activity?

- Increasingly pronounced structural differences between the U.S. tax system and tax systems in other OECD countries has created pressure for U.S. corporations to exit the U.S. tax net.

- 2002 U.S. Treasury Department Report on Inversions: "The U.S. international tax rules can operate to impose a burden on U.S.- based companies with foreign operations that is disproportionate to the tax burden imposed by our trading partners on the foreign operations of their companies. The U.S. rules for the taxation of foreign-source income are unique in their breadth of reach and degree of complexity. "

What factors are driving Inversion activity?

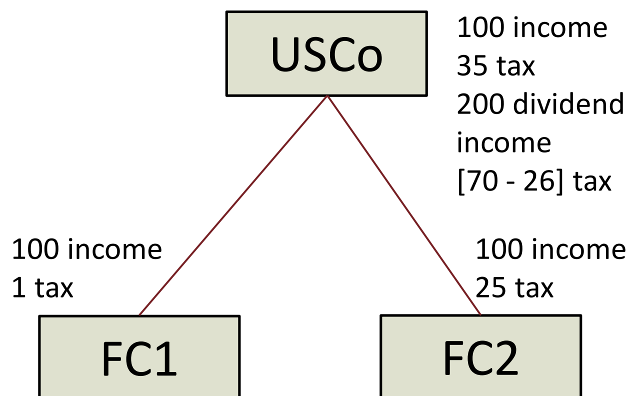
- *Higher Headline Tax Rates* – the U.S. currently has the highest combined statutory corporate income tax rate of any OECD country (39.1%). The GDP-weighted combined statutory rates of other OECD countries is 28.5%. However, the effective rate of tax paid by U.S. corporations appears to be much lower (U.S. GAO estimates 22.9%).

- *Worldwide Basis of Taxation*
  - Foreign earnings subject to high headline rates when repatriated (subject to foreign tax credit and CFC rules).
  - Deferral of repatriation creates "trapped" offshore cash.

- *Corporate Taxation based on place of Incorporation* (rather than place of management).

- Frustration with slow pace of U.S. tax reform?

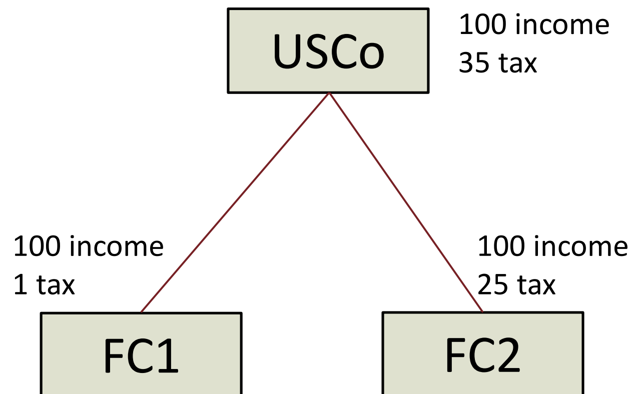
Foreign Tax Credit Mechanism – With Repatriation



If all income is repatriated to the US, then there is $300M of income, with a tax expense of $105

- $35M US tax paid on US income
- $26M of foreign tax paid on foreign income
- $44M of US tax paid on foreign dividend

Foreign Tax Credit Mechanism – Without Repatriation



If no foreign income is repatriated to the US, then there is still $300M of income on a consolidated basis, and a tax expense of $61M

- $35M US tax paid on US income
- $26M of foreign tax paid on foreign income
- [$44M US tax not applicable]

This is why many US companies have cash “trapped” offshore

Exemption System

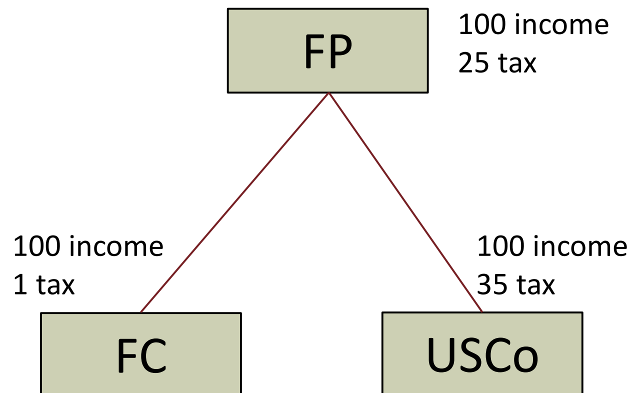
- Most OECD countries have some form of exemption system for foreign dividends

  - Based on 2012 information (Evolution of Territorial Tax Systems in the OECD, April 2, 2013): 28 of 34 OECD countries have exemption system for dividends received

  - Most OECD countries also have exemption on gains on sale of shares

  - Only 6 OECD countries have worldwide taxation of foreign dividends: US, Ireland, Chile, Israel, Korea, Mexico

Exemption System - Example



Whether or not all funds are repatriated to FP, then there is still $300M of income on a consolidated basis, and a tax expense of $61M

- $35M US tax paid on US income
- $26M of foreign tax paid on foreign income

Cash is not “trapped” offshore

Indicative Tax Effects of Inversion Transactions

- **Paladin Labs (Canadian) & Endo Pharmaceuticals** – estimated tax savings of $50 million/year.
  - Endo’s global tax rate dropping from 28% to 20%.

- **Actavis (Irish) & Forest Laboratories** – estimated tax savings of $100 million/year.

- **Valeant (Canadian) & Bausch & Lomb.**
  - B&L’s effective tax rate reportedly falls from 32% to approx. 5%.

- **Elan (Irish) & Perrigo**.
  - Perrigo’s effective tax rate expected to drop from approx. 25% to 17%.

Indicative Effects of Inversion Transactions

- **Valeant (Canada) & Allergan**
  - Bill Ackman: “[Valeant] has the benefits of being based in Canada. There are some unique attributes of the Canadian tax system. And then they used some of the same structures as a typical pharmaceutical company. But we wanted to understand the sustainability of the tax structure of the company.”
  - Allergan’s effective tax rate is expected to drop from approx. 26% to a “high single-digit tax rate.”

- **Pfizer (U.S.) & AstraZeneca** (U.K.)
  - WSJ (4/29): “Company executives were outspoken about how their attempted takeover of AstraZeneca…would help Pfizer slash its tax bill, saving $1 billion or more each year by one estimate.”

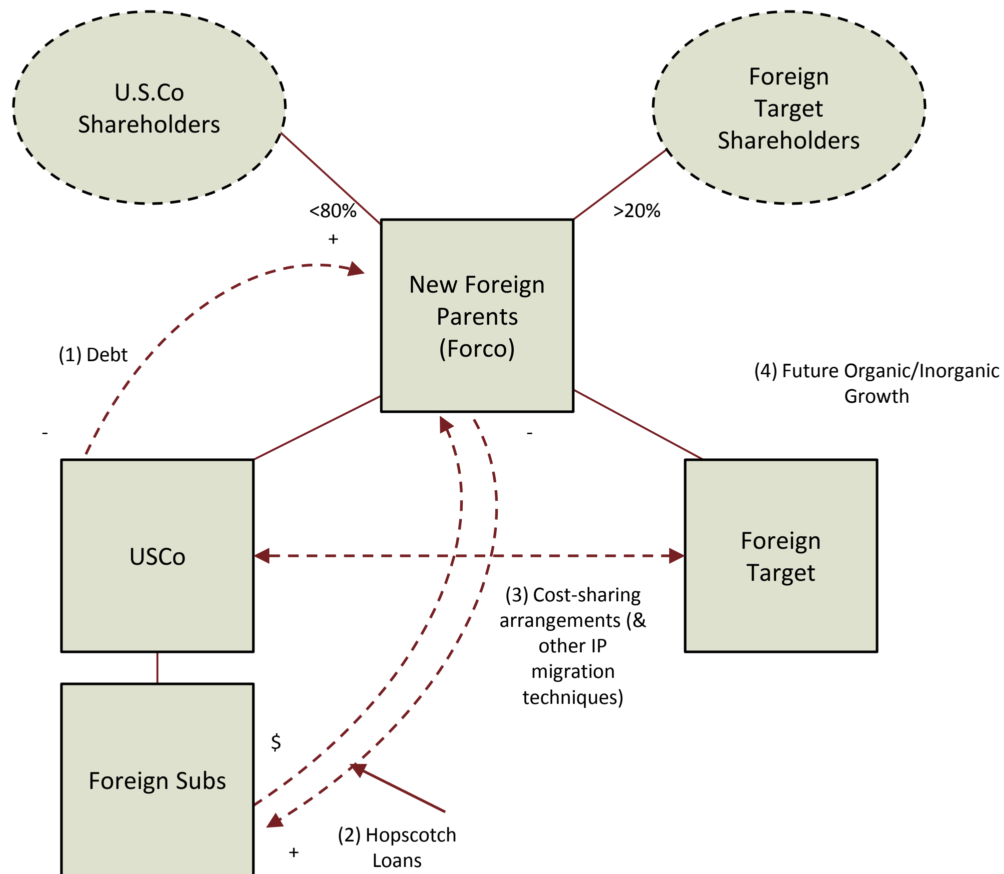
What are the potential benefits of an Inversion Transaction?

- Becoming a subsidiary of a non-U.S. parent offers the U.S. corporation a more effective structural platform for managing its global effective tax rate.

- Following an inversion transaction, the U.S. company frequently engages in cross-border tax planning to reduce its U.S. tax liability. In many cases, this tax planning parallels planning frequently engaged in by foreign based multinationals with U.S. subsidiaries (i.e., increasing leverage of the U.S. corporation, offshore migration of intangible property, stripping-down functions of U.S. entities, other business restructuring).

- Accessing foreign earnings that had been “trapped” offshore.

Illustrative Example



(1) Earning Stripping – USCo may distribute its note to Forco generating a stream of future interest deductions (subject to little or no U.S. withholding tax) and creating a "pipeline" for future cash repatriations to Forco.
(2) Hopscotch Loans – upstream loans by CFC subsidiaries "hop" over USCo allowing access to trapped cash with little or no current U.S. tax.
(3) IP migration – transactions intended to move existing IP (or develop future IP) outside the U.S.
(4) Future growth – migration of future business opportunities and acquisition opportunities outside the U.S.

U.S. tax rules applicable to Inversions.

A Brief History of Inversions

- **1982:** McDermott Inc. (oil & gas) migrates to Panama.
- **1994:** Helen of Troy (household products) reincorporates in Bermuda.
  - Led to introduction of so-called "Helen of Troy" regulations under Section 367 of the Code which impose shareholder level taxation on outbound migrations in some cases.
- **Late 1990s-Early 2000s (Inversion 1.0):** outbound migrations to Cayman/Bermuda (e.g., Tyco International, Ingersoll-Rand, Accenture, Cooper Industries).
  - Led to introduction of Section 7874 of the Code in 2004 (retroactive to transactions after March 4, 2003).
- **2011-present (Inversion 2.0):** inversion occurs in conjunction with merger with foreign target (e.g., Liberty/Virgin Media, Eaton/Cooper, Actavis/Warner Chilcott, Endo/Paladin).
  - Led to Notice 2014-52.

367 Regulations

- Introduced in 1994, these regulations impose shareholder level gain on U.S. shareholders transferring shares in U.S. corporation in exchange for shares in a foreign corporation if:
  - More than 50% (by vote or value) of the stock of a foreign corporation was issued in the acquisition of a U.S. corporation; or
  - The FMV of the foreign corporation was less than the FMV of the U.S. corporation
- These regulations have proven not to be an effective deterrent against outbound migrations (which led to the introduction of section 7874).
  - One study (April 2014) indicated that capital market receptivity (measured by reference to median price reaction on announcement in the U.S. company's stock) has been more positive for taxable deals than non-taxable transactions.
- Foreign shareholders not subject to U.S. tax (unless FIRPTA applies).
- 367 "toll charge" may be mitigated by timing inversions to occur during market dips.

Section 7874

- Acquiring Foreign corporation ("Forco") will be treated as a U.S. corporation for all U.S. federal income tax purposes if:
  - Forco acquires, directly or indirectly, substantially all of the properties of a U.S. corporation ("USCo");
  - After the acquisition, former shareholders of USCo hold at least 80% of the stock (by vote or value) of Forco by reason of holding shares in USCo; and
  - The expanded affiliated group including Forco does not have "substantial business activities" in the jurisdiction in which Forco is created or organized, relative to the group's worldwide activities.
- If former shareholders of USCo hold between 60-80% of Forco by reason of holding shares in USCo, Forco is not deemed to be a U.S. corporation for U.S. tax purposes, but alternative adverse rules apply which (a) limit the ability of USCo to utilize certain tax attributes (i.e., NOLs, credits), and (b) impose a 20% excise tax on equity based compensation of certain insiders.

Section 7874 – Shareholder Continuity

- A number of complex rules apply for purposes of measuring the level of ownership in Forco by former shareholders of USCo:
  - Shares of Forco issued in exchange for cash or certain other liquid asset in a transaction related to the inversion are not taken into account for purposes of this testing. For example, Forco shares issued in a public offering that occurs in conjunction with the inversion are disregarded.
  - Certain options or instruments that are convertible/exchangeable for Forco stock (or that carry substantially similar distribution entitlements to those of Forco stock) are treated as Forco stock for purposes of this test.

Section 7874 – Substantial Business Activities

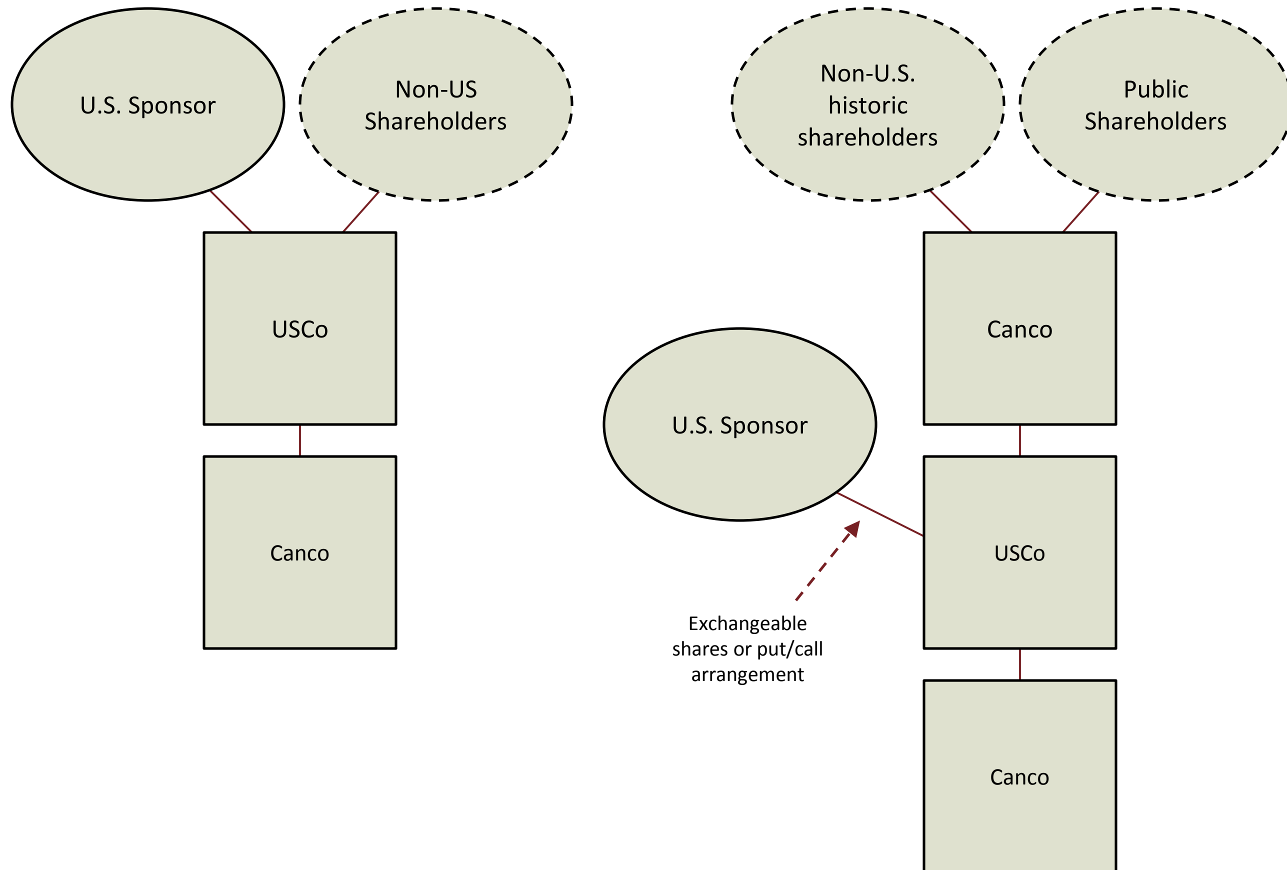
- The SBA threshold has been modified substantially over the years:
  - 2006 Rules – facts & circumstances test with a safe harbor (safe harbor generally was satisfied if at least 10% of the employees, assets, and sales of the expanded affiliated group were in the relevant foreign country)
  - 2009 Rules – facts & circumstances test with no safe harbor
- Since 2012, in order to establish existence of "substantial business activities" ("SBA"), Forco must establish that each of the following 3 requirements are met immediately after the inversion:
  - At least 25% of the Forco group's employees (by headcount and compensation) are based in Forco's jurisdiction;
  - At least 25% of the Forco group's tangible assets are located in Forco's jurisdiction; and
  - At least 25% of the Forco group's ordinary course gross income is derived from transactions with unrelated customers located in Forco's jurisdiction.
- Difficult test to meet.

Inversion transactions involving Canadian companies

Inversion Transactions with Canadian Companies

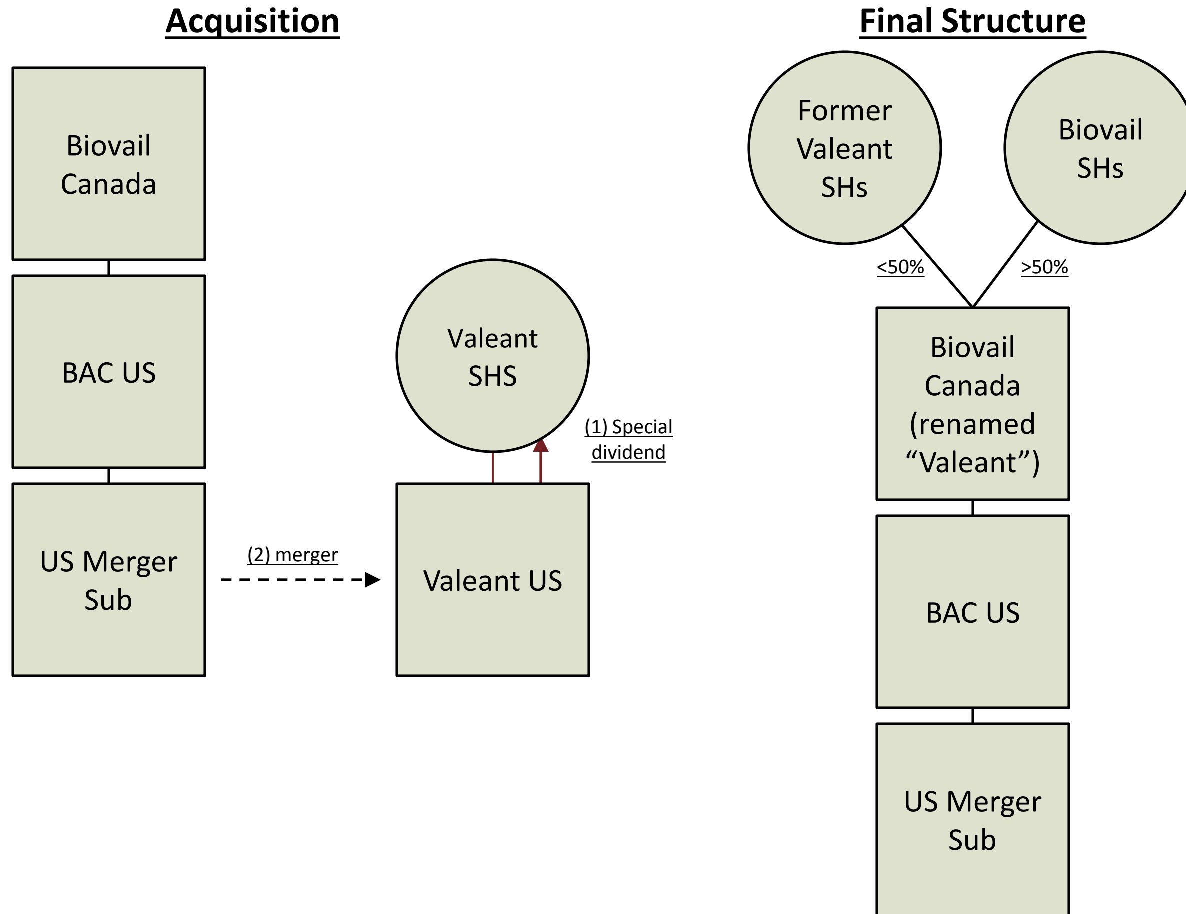
- Canadian corporations have been involved in recent transactions that have facilitated an inversion of a U.S. Corporation.
- Canadian tax system has characteristics that may make it an attractive foreign domicile for an expatriating U.S. Corporation
  - Foreign income can often can be repatriated without Canadian tax.
  - Interest on leverage into U.S. not subject to Canadian tax if financed through a third-country.
  - Favourable tax treatment of intercompany IP payments.
- Maintenance of US Head Office more convenient.

Pre-2012 Canadian IPO structures



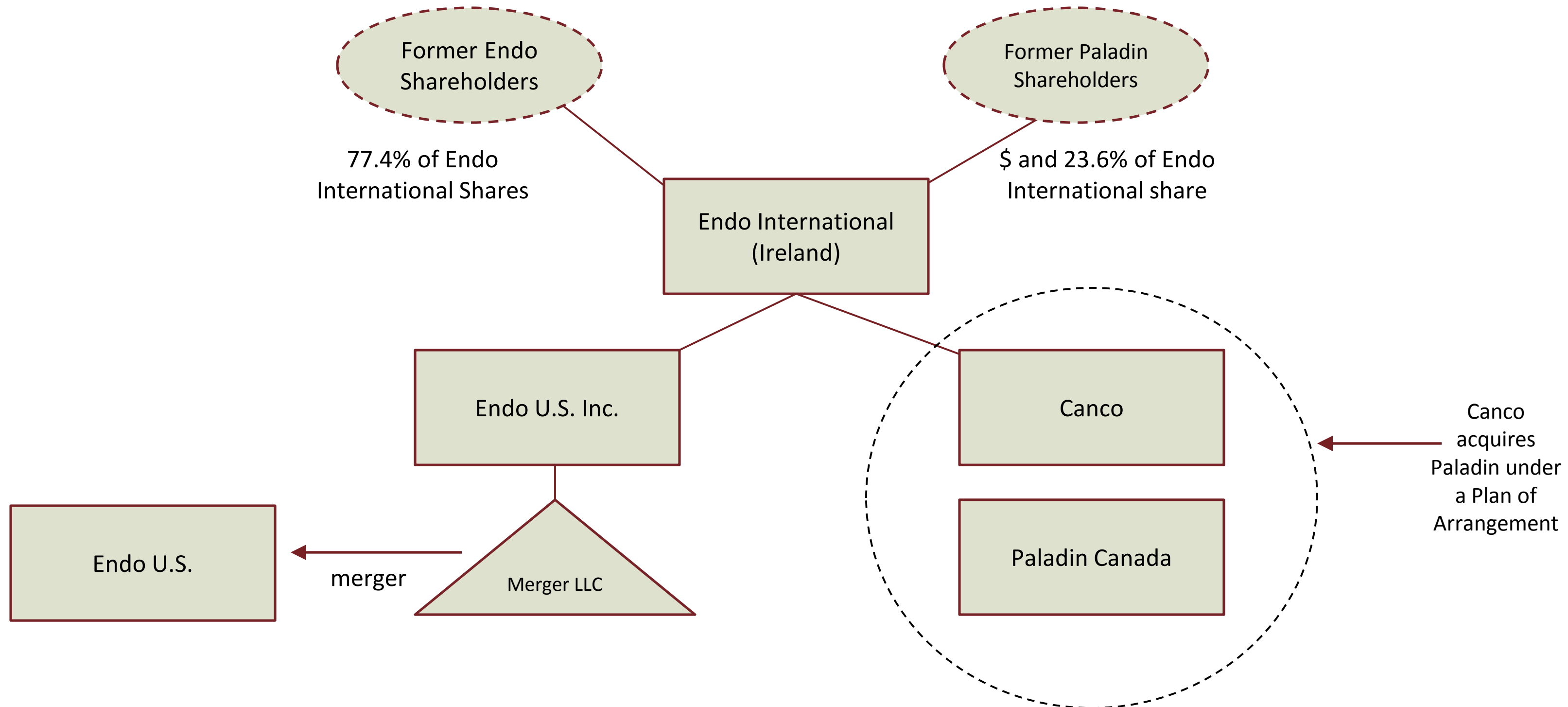
- USCo shares held by U.S. Sponsor likely treated as shares of Canco for purposes of inversion rules.
- Shares issued to public in IPO disregarded for purposes of inversion rules.
- Canco takes the position that the Canco expanded affiliated group has substantial business activities in Canada under the pre-2012 regulations (based on all “facts and circumstances”).

Biovail-Valeant Combination



- Special pre-merger dividend reduced Valeant's value to less than 50% of the value of the combined company (note: this special pre-merger dividend is no longer effective after the September Notice)
- Biovail shareholders remained as shareholders of Biovail. Valeant shareholders received Biovail shares
- Tax-free to Biovail shareholders and to Valeant shareholders
- Biovail renamed "Valeant"

Endo Health Solutions and Paladin Labs Inc.



- Taxable to Paladin shareholders
- Tax-free to Endo shareholders (subject to Section 367)

Recent Developments

Notice 2014-52 Proposal to Limit Inversions

- IRS & Treasury Department announce new regulations that target inversion transactions.
- The new rules generally apply to an inversion in which
  - Former shareholders of the U.S. corporation own at least 60% of the stock of the new combined company, and
  - New foreign parent does not satisfy the "substantial business activities test".
- The new regulations apply to inversion transactions closing on or after September 22 (no grandfathering for existing contracts).

Notice 2014-52 Proposal to Limit Inversions

1. Restrict post-inversion planning designed to access "trapped" offshore earnings of U.S. corporation
   - Impose current U.S. tax on "hopscotch" loans
   - Prevent de-controlling of CFC subsidiaries of U.S. corporation
   - Neutralize expatriation of offshore earnings through intercompany stock sales.
2. Tighten the Section 7874 Stock ownership tests
   - Disregard pre-inversion "slim-down" distributions by U.S. corporation for 80% and 60% threshold (similar rule to apply for Section 367 purposes)
   - Disregard passive assets held by certain "cash-box" foreign corporations participating in inversion transaction.
3. Stop so-called "spinversion" transactions.

Reaction to September Notice

- Some proposed inversion transactions have been aborted:
  - October 3: U.S.-based Salix Pharmaceuticals Ltd. Announced that it terminated its planned $2.7 billion merger with the Irish unit of Italy-based Cosmo Pharmaceuticals SpA (Salix required to pay a $25 million termination fee).
  - October 3: Medtronic Inc. announced that it was modifying the financing of its planned mergeer with Covidien PLC. Medtronic will now use $16 billion in external financing to complete its acquisition of Covidien, rather than using cash from its foreign subsidiaries as it had planned.
  - October 9: U.S.-based Auxilium Pharmaceuticals announced that it was terminating its proposed inversion transaction with Canadian company QLT Inc. ($28.4 million termination fee payable by Auxilium).
  - October 15: Abbvie Inc.'s board of directors withdraws support for $52billion proposed combination with Shire PLC (Abbvie to pay a $1.635 billion termination fee).
- New inversion transactions have been announced:
  - September 29: Houston based Civeo Corp announces a "standalone" inversion to Canada.
  - October 13: U.S.-based Steris Inc. announces $1.9 billion combination with U.K. based Synergy PLC.
  - October 27: U.S.-based Wright Medical Group Inc., announces it has agreed to merge with fellow orthopedic manufacturer Tornier N.V. and reincorporate into the Netherlands with Wright shareholders receiving 52% of the combined company. $3.3 billion transaction.
  - October 28: Pfizer Inc. CEO Ian Read says that Pfizer has not ruled out an inversion transaction (despite aborting its earlier attempt to acquire AstraZeneca PLC).

Legislative Proposals to Curb Inversion Transactions

- Obama FY 2015 Budget Proposals.
  - Reduce USCo shareholder continuity requirement from 80% to 50%.
  - Even if shareholder continuity below 50%, foreign acquireco treated as U.S. corporation if (a) substantial business activities in U.S., and (b) ``primarily managed`` in the U.S.

- Levin Bills (House & Senate).
  - Similar to Obama budget proposals but retroactive to May 8, 2014 (Senate bill has 2 year sunset).

- Schumer Bill
  - stiffens ``earnings stripping`` rules for any U.S. corporation that inverted in the last 20 years.
  - Imposes sweeping obligation for inverted U.S. corporations to enter into ``Approval Agreement`` for transactions with foreign related persons.