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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Inversion Regs Cast Net Wider Than Pfizer-Allergan Deal

By **Eric Kroh**

Law360, New York (April 5, 2016, 8:55 PM ET) -- The U.S. Department of the Treasury on Monday issued rules to curb tax-motivated inversions, and while much of the immediate attention focused on how they would affect the proposed Pfizer-Allergan merger, the regulations could ensnare other kinds of cross-border deals or even domestic transactions.

The bulk of the regulations issued Monday formalized notices put out by the Treasury in 2014 and 2015 saying the administration would write rules to make it more difficult for companies to merge with competitors in low-tax jurisdictions and reduce the economic benefits of doing so. The regulations included new measures not mentioned in the previous announcements, such as a provision to prevent companies from getting around existing inversion rules by acquiring multiple companies over a short time, as Allergan Inc. has done.

The Treasury also issued proposed regulations to combat the practice of earnings stripping, one of the primary ways inverted companies reap tax benefits from inversions and which involves saddling domestic affiliates with debt and taking a U.S. tax deduction on the interest.

The government may have written the rules to target inversions, but the more than 300 pages of regulations touch on so many different sections of the tax code that other transactions could be caught up as well.

Companies engaging in "pretty much any kind of cross-border deal would need to take a very close look at these regulations," said John L. Harrington of Dentons, "even if it's not something anyone would think of as an inversion."

Firms may have to take another look at deals going back more than a year and a half to see if they comply with the rules. The regulations implementing the 2014 notice apply to transactions completed on or after Sept. 22, 2014, while the regulations formalizing the 2015 announcement apply to acquisitions completed on or after Nov. 19, 2015. The new measures introduced Monday apply to transactions completed on or after April 4.

The proposed earnings-stripping regulations in particular have a wide scope that goes well beyond inversions and would encompass debt transactions that are commonly used by multinational or domestic groups of related corporations.

Under the proposed rules, the IRS said it would treat as stock certain transactions that would otherwise

be considered debt, such as instruments issued by a subsidiary to its foreign parent in a shareholder dividend distribution or instruments issued in connection with some acquisitions of stock or assets from related corporations in transactions economically similar to dividend distributions.

"The scope of these regulations is very broad in terms of its implications," said Jason S. Bazar, a partner with Mayer Brown LLP. "Companies regularly finance their operations with debt and equity. Now they must wade through a new set of rules in determining what is the most efficient structure from both a commercial and tax perspective."

The proposed regulations specifically mention a court case from 1956, Kraft Foods Co. v. Commissioner, in which the Second Circuit considered a domestic corporate subsidiary that issued indebtedness in the form of debentures to its sole shareholder, which was also a domestic corporation, in the payment of a dividend. In the case, the government argued that the transaction may have been a sham and should have been treated as stock, but the court sided with Kraft, saying the debentures should be respected as debt.

In the proposed regulations, the IRS said going forward it would treat a debt instrument issued in fact patterns similar to that in Kraft as stock.

"That seems to be a pretty big sea change," Mayer Brown partner Brian W. Kittle said. The regulations "take issue with some areas that people may have thought were well-settled areas of law."

The breadth of the regulations will have implications well beyond inversions and will affect not only foreign companies and inverted companies but U.S. companies as well, Bazar said.

Of course, the regulations also imperil the merger between Allergan and Pfizer Inc., which was expected to close later this year. While the Treasury officially did not write the anti-inversion regulations to prevent any specific transaction, they appear to have had the Pfizer-Allergan merger in the back of their minds when formulating them, according to John F. Settineri, a partner with Loeb & Loeb LLP.

One of the new provisions in Monday’s regulations would target so-called serial acquirers who purchase multiple U.S. companies in quick succession to get around an existing rule that penalizes inversions in which the former stockholders of the U.S. company retain at least 60 percent ownership in the newly combined foreign company. If the former stockholders retain at least 80 percent ownership of the new company, the transaction is completely disregarded for U.S. tax purposes.

In the regulations, the Treasury said it was concerned that a serial acquirer could subvert the rule by issuing stock with each successive purchase of a U.S. company, thereby increasing its ownership and enabling acquisition of an even greater domestic company without crossing the 60 percent threshold. To that end, the regulations exclude from that ownership calculation stock that is issued by a foreign corporation in connection with the acquisition of U.S. entities in the prior three years.

Those are precisely the kinds of transactions that Allergan has engaged in, Settineri said. In November 2014, Allergan merged with rival Actavis PLC in a deal worth some $66 billion. Earlier that year, Actavis purchased Forest Laboratories Inc. in a $25 billion transaction and, the year before, it swallowed Warner Chilcott PLC in an $8.5 billion deal.

Under the terms of the merger with Allergan, Pfizer shareholders would retain 56 percent ownership of the new company. If stock issued in connection with Allergan's prior acquisitions were not counted, it

would "make it more likely that Pfizer would cross the 60 percent threshold," Settineri said.

John Colley, a professor at the Warwick Business School, said Allergan may terminate or renegotiate a lower price for the deal, which appeared to be based mostly on its potential tax benefits. The drop in Allergan's stock price following the Treasury's release of the regulations, which wiped $20 billion off of the company's market capitalization, is in line with the merger's purported tax savings, Colley said.

"The stock market thinks that the U.S. government is likely to be successful with this move," Colley said in a statement. "Several pharmaceutical deals are based on similar tax benefits. Indeed, this move may well prevent recent tax inversion deals altogether."

Pfizer and Allergan said in a joint statement Monday they were reviewing the Treasury's actions and "won't speculate on any potential impact."

President Barack Obama on Tuesday said the anti-inversion regulations will make it more difficult for companies to exploit loopholes in the tax code, but that only congressional action can stop inversions for good.

"I've often said the best way to end this kind of irresponsible behavior is with tax reform that lowers the corporate tax rate, closes wasteful loopholes, simplifies the tax code for everybody," Obama said at a news conference.

--Editing by Katherine Rautenberg and Kelly Duncan.

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