Insight

Sinking Pfizer – Allergan: Treasury's Latest Round of International Tax Regulations

GORDON GRAY | APRIL 6, 2016

On April 4th, the Treasury Department issued a series of new rules aimed at restricting the tax benefits of so-called inversions, or mergers between U.S. and foreign corporations. Monday's regulatory fusillade comes after two previous issuances (2014 and 2015) of "guidance" from the IRS seeking to limit the benefits of corporate inversions.[1] Unlike the previous two regulatory approaches to this issue, Monday's release has already managed to sink the merger proposed between Pfizer and Allergan.

Broadly, the new rules approach the politically-charged topic of inversion in two ways. First, the Treasury Department issued "temporary regulations" that codify the guidance issued in 2014 and 2015 and take additional steps to make U.S. corporate expatriations more difficult.[2] Second, the Treasury Department has issued proposed rules that would place additional restrictions on debt transactions between domestic and international corporate affiliates.[3] The first approach continues Treasury's efforts to capture more inversions within existing laws that restrict the tax benefits of inverted firms depending on their share of residual U.S. ownership, while the second approach seeks to limit earnings stripping, whereby U.S. subsidiaries of foreign corporations shift profits overseas through tax-preferred interest payments. The former approach has already suppressed pending inversion transactions, specifically that between Pfizer and Allergan, while the latter may diminish future tax savings for multinationals with U.S. subsidiaries.

The first prong of the Treasury's April 4th efforts to address inversions would allow the IRS to disregard the stock, "attributable to certain prior inversions or acquisitions of U.S. companies," of a foreign firm that is merging with a U.S company. In general, this new regulation would allow Treasury to ignore shares of a foreign firm acquired reflecting U.S. acquisitions over the last three years. This is important in determining how a newly merged or inverted firm is treated for tax purposes post-transaction. [4] This new standard appeared to be tailor-made for the Pfizer-Allergan merger. Allergan, the foreign acquirer in the now-abandoned transaction with Pfizer, had engaged in several previous acquisitions of U.S. firms in the past three years, which if disallowed, would shrink the size of the foreign parent below the ownership threshold necessary to enjoy the tax benefits of an inversion.[5] Pfizer apparently concluded that the regulation would have just such an effect.

In addition to the new regulations restricting inversion transactions, Monday's regulations codify previous Treasury guidance in this area.[6] It is also important to note that previous efforts in this area have been issued as "guidance," which while lacking force of law or a formal rule is generally not ignored by regulated entities, and Treasury promised to follow-up these guidance notifications with rulemaking. Monday's regulations limiting inversions were issued as "temporary regulations," which take effect as soon as they are published in the federal register.[7] Accordingly, the strictures set forth by the Treasury Department are already in effect.

In addition to temporary regulations relating to inversions, the Treasury Department also issued proposed rules aimed at limiting earnings stripping from U.S. subsidiaries. The Treasury proposed three new avenues of limiting the use of tax-preferred debt by 1.) allowing the Commission of the IRS to classify some transactions between corporate entities (such as a U.S. subsidiary and a foreign partner) as being compromised of both debt and equity rather than entirely as a tax-preferred debt, 2.) requiring firms to prepare and maintain new documentation establishing a debt instrument as indebtedness for federal tax purposes,[8] and 3.) treating as stock debt instruments used as distributions and similar transactions.[9]

Earnings stripping is characterized by using tax-preferred transactions (such as intercompany loans) to shift profits from high-tax jurisdictions to low-tax jurisdictions. The prototypical example involves a multinational firm headquartered in a tax haven with a subsidiary in a high-tax jurisdiction such as the U.S. To avoid paying tax on its U.S. subsidiary's profits, the foreign parent loans its U.S. subsidiary funds on which the subsidiary must make interest payments. Interest payments are tax deductible in the U.S., therefore shrinking the company's tax bill, while directing income in the form of interest to the parent company (or conversely, "stripping" the earnings from the U.S. tax base). While not necessarily related to inversions, earnings stripping can follow an inversion transaction. As a public policy matter, the magnitude of earnings stripping is difficult to quantify. Indeed, a survey of 18 leading tax economists by the Tax Foundation revealed that the scope and scale of earnings stripping or profit shifting is highly uncertain.[10] Accordingly, efforts to reign in such practices could easily pose unintended consequences, and ultimately harm investment.[11]

[1] See: https://www.irs.gov/pub/irs-drop/N-14-52.pdf and https://www.irs.gov/pub/irs-drop/n-15-79.pdf

[2] https://s3.amazonaws.com/public-inspection.federalregister.gov/2016-07300.pdf

[3] https://s3.amazonaws.com/public-inspection.federalregister.gov/2016-07425.pdf

[4] Under current law, one of the key determinants for how an inverted firm is taxed is based on a test of what proportion of the newly inverted firm is owned by U.S. shareholders. In general, there are three ownership bands into which a newly inverted firm can fall: 80 percent and above, between 60 and 80 percent, and below 60 percent. For inverted U.S. companies that retain 80 percent or more U.S. ownership, the Treasury Department treats the firm as a U.S. company for tax purposes, meaning the inverted firm forgoes any tax benefit that would have been associated with the inversion. This test is designed to preclude transactions (known as naked inversions) where a U.S. firm essentially reincorporates itself abroad, but otherwise unchanged (or largely so). Firms falling the in the second band, where U.S. ownership in the newly inverted firms falls between 60 and 79 percent, must endure certain tax consequences, but are treated as foreign entities for U.S. tax purposes. For inverted firms where U.S. ownership falls below 60 percent, the newly inverted firms is treated as a foreign entity without tax penalty. Other tests also apply, http://www.americanactionforum.org/research/economic-risks-proposed-anti-inversion-policy-update/

[5] Allergan, the foreign acquirer in the Pfizer-Allergan merger, was once a U.S.-based company, but was acquired by Ireland-based Actavis, which itself had previously been a U.S. based company. Actavis also acquired Forest Laboratories for $25 billion in 2014. As of Monday afternoon, Allergan's market cap was over $109 billion. Stripping tens of billions of previous acquisitions from the value of the Pfizer merger clearly altered tax consequences of the inversion. See http://www.wsj.com/articles/u-s-treasury-unveils-new-steps-to-limit-tax-inversions-1459803636

[6] http://www.americanactionforum.org/insight/understanding-treasurys-newguidance-on-inversions/

[7] https://www.cchgroup.com/media/wk/taa/pdfs/accounting-firms/tax/understanding-treasury-regulations-fact-sheet.pdf

[8] The Treasury and the IRS have established four essential characteristics of indebtedness: “a legally binding obligation to pay, creditors’ rights to enforce the obligation, a reasonable expectation of repayment at the time the interest is created, and an ongoing relationship during the life of the interest consistent with arms-length relationships between unrelated debtors and creditors.” https://s3.amazonaws.com/public-inspection.federalregister.gov/2016-07425.pdf

[9] The Treasury has cited fact patterns where these new regulations would apply as circumstances that are economically similar to a dividend distribution and circumstances where the transaction has limited non-tax significance. Further the Treasury also prescribed proposed regulations that would limit the use of separate related-party entities from issuing debt to fund any of the transactions targeted by these regulations through a two-step approach.

[10] http://taxfoundation.org/blog/tax-foundation-forum-making-sense-profit-shifting

[11] http://www.ofii.org/news/nancy-mclernon-treasury-action