Elsevier BusinessIntelligence

"The Pink Sheet"

PRESCRIPTION PHARMACEUTICALS AND BIOTECHNOLOGY

September 14, 2009 Volume 71 | Number 037 | page 23

Schering Transactions To Avoid Tax On Repatriated Income Nixed By Court

Schering-Plough lost its bid for a half billion tax refund when a court ruled that financial transactions set up to repatriate profits from foreign subsidiaries did not allow the company to delay paying taxes on the income. The decision has broad ramifications as it could impede corporations from forming similar arrangements.

On Aug. 28, Judge Katharine Hayden, of the U.S. District Court for the District of New Jersey, found that two transactions – consisting of 20-year interest rate swaps that Schering set up with the Dutch investment bank Algemene Bank Nederland and assignments by Schering of its rights under the swaps to foreign subsidiaries for lump sum payments – constituted loans by the foreign subsidiaries to Schering and were thus immediately taxable.

The judge also found that the transactions were no more than "tax vehicles lacking legitimate business reasons for entering into them, other than the repatriation of $690 million of previously untaxed foreign income." As a result, she said they failed the "economic substance" analysis.

This latter portion of the ruling on economic substance "is the most disturbing" part of the decision, Robert Wellen, a partner at Ivins, Phillips & Barker, said. "A good advisor now is going to be even more cautious about the kind of techniques [he or she proposes to reduce a company's taxes]. It's probably not good for industry in the short term."

Schering Assigned Rights to Its Swiss Subsidiaries

Steve Johnson, a professor at the William S. Boyd School of Law at the University of Nevada, Las Vegas, said the case will have a significant impact since companies have used or are considering using the financial techniques Schering employed. "I wouldn't say this would rock industry to its foundations, but it will be noticed and discussed within the industry," he said. "This is important enough to [generate] some important executive attention."

Repatriation has become an increasing industry interest lately as firms consider creative ways to finance mergers and other activities, but there appears to be slim hope for a congressional reprieve on the issue as there was in 2004 ("The Pink Sheet," Feb. 9, 2009).

Schering-Plough declined to discuss the ruling other than to issue a brief statement: "We disagree with the court's decision and are considering our options, including appealing the decision."

The structured transactions between Schering, ABN and two Swiss subsidiaries boil down to this: Schering and ABN agreed to exchange periodic interest payments based on a hypothetical amount (the "notional principal") and two different interest rate indices. The swap agreements required both parties to make periodic payments to each other reflecting the movement of the particular interest rate assigned to their respective sides of the transaction.

Schering assigned its right to receive interest payments from ABN to its subsidiaries Schering-Plough Ltd. and Scherico Ltd. In return the subsidiaries made lump-sum payments to Schering-Plough totaling $690.4 million. Schering did not report the lump sums as present income but deferred reporting the income until later years.

In 2004 the Internal Revenue Service determined that Schering owed $473 million in taxes. Schering paid the assessment under protest in September 2004 and filed a claim for a refund. When the IRS denied its request Schering filed suit against the government seeking a refund plus interest and costs.

Schering Claims Swap Was A Sale, Not A Loan

Schering contended that the IRS mischaracterized its transactions as loans or constructive dividends. It also claimed that the government had treated Schering differently from other similarly situated taxpayers. It said a direct competitor – which it did not

Reprinted with Permission from *"The Pink Sheet."* Please see Copyright Notice.

identify – had entered into a transaction identical to Schering’s swap-and-assignment transactions and the IRS had found the competitor’s transaction was not taxable in the year in which it was executed. The government said an IRS notice in effect at that time provided that such a lump-sum payment could be characterized as a loan.

The 91-page ruling says Schering turned to Merrill Lynch for advice on how to repatriate its offshore cash without triggering Subpart F of the Internal Revenue Code – which mandates taxation of foreign earnings and profits upon repatriation to the U.S. – and Merrill proposed the interest rate swap-and-assign transactions.

Schering testified that the transactions were sales, not loans. “But calling a club a spade does not make it one,” Judge Hayden stated. “Permitting a taxpayer to control the economic destiny of a transaction with labels would … exalt form over substance, thereby perverting the intention of the tax code.”

Documents Written in Dutch Are Acceptable

While the opinion is a dense analysis of tax law, the judge provided a moment of levity in noting Schering-Plough’s effort to exclude some evidence. She said Schering asked that the court not give weight to an internal ABN credit proposal since it was largely written in Dutch and the author was not identified. The judge responded that the document clearly contains ABN logos, gives an accurate description of the transactions and repeatedly refers to Schering-Plough as the client.

“Furthermore, it is rather unsurprising that portions of an internal ABN document proposing massive and complex transactions to the upper echelon of the investment bank are written in Dutch – after all, ABN is a Dutch bank!” the ruling states. In addition, the provision indicating the swap-and-assign transactions would provide a 20-year amortizing loan “is written in English and is thus readily comprehensible.”

The Schering-Plough decision is part of a trend in which courts have sided with the IRS in tax shelter disputes. Wellen said the government has been very successful in the last three or four years in convincing the courts that certain transactions are tax shelters. He said that when an entire transaction is in a bubble – i.e., was designed for no other reason than to create a tax benefit – courts have rejected it.

Wellen said Schering’s transactions do not appear to fall into this category but to have been a real business transaction (even though between affiliates) structured in a tax-optimal way. “We call that tax planning,” he said, as opposed to a tax shelter.

Johnson, the University of Nevada law professor, said Schering would have a hard time getting the decision reversed for two reasons: a trial court’s finding of fact is given deference by an appellate court and the case would go to the U.S. Court of Appeals for the Third Circuit, which has taken a government-friendly approach in evaluating the economic substance test.

Johnson added, however, that this is one decision by one trial court and doesn’t write the law in indelible ink. But it is significant for companies deciding if they want to go forward with such transactions when it is highly likely the IRS will disallow them, he said. “The question is: Are you willing to fight in court with the chance you will lose?”

– Brenda Sandburg (b.sandburg@elsevier.com)

Risk-Free Trial Offer

Click here to start your 30-day, risk-free trial of *"The Pink Sheet"* –
Top down, comprehensive weekly industry insight and analysis.

© 2009 F-D-C Reports, Inc.; an Elsevier company, all rights reserved.

Reproduction, photocopying, storage or transmission by magnetic or electronic means is strictly prohibited by law. Authorization to photocopy items for internal or personal use is granted by Elsevier Business Intelligence, when the fee of $25.00 per copy of each page is paid directly to Copyright Clearance Center, 222 Rosewood Dr., Danvers, MA 01923, (978) 750-8400. The Transaction Reporting Service fee code is: 1530-6240/09 $0.00 + $25.00. Violation of copyright will result in legal action, including civil and/or criminal penalties, and suspension of service. For more information, contact custcare@elsevier.com.