

Tax inversions - a major deal driver

US-based Horizon Pharma's acquisition of Ireland-based Vidara Therapeutics, Mylan's acquisition of one part of Abbott's generic business, and Pfizer's proposed acquisition of AstraZeneca. These deals of 2014, even though not all of them successfully closed, had one major objective in common: tax savings by shifting the US Company's headquarters to a different country with a more favorable tax system. These transactions involving a so-called corporate tax inversion have been a much discussed topic and a major driver of global M&A throughout 2014, particularly in the Pharmaceutical industry.

Three decades of tax inversions

Transactions by US companies leading to tax inversions have been performed since a long time, but in the recent years, their frequency increased dramatically. Between 1984 and 2004, there were

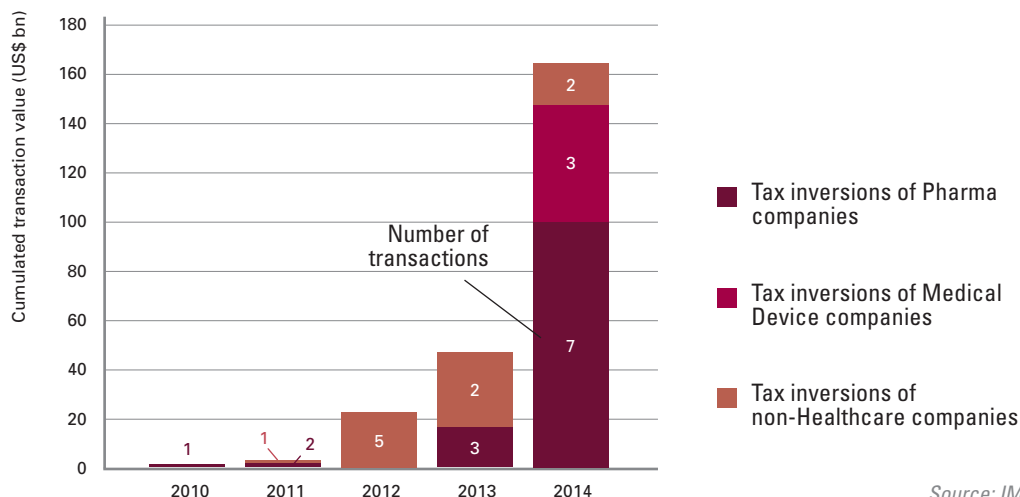
28 transactions which involved a tax inversion (on average 1.4 per year). Since 2004, there have been 47 inversions (almost 5 per year), thereof 22 in 2012-2014 (7 per year). In the last two years, there were ten transactions by Pharma companies which included an inversion, or were done by an acquirer which recently had done an inversion, amounting to a total volume of US\$ 117bn (see figure 1). Why are transactions involving inversions accelerating? And why are those transactions particularly attractive for US Pharma companies?

Drivers for corporate tax inversions

The combined corporate income tax rate (combined federal rate and average rate of US states) of US-domiciled corporations has stayed between 39% and 40% since 1993, while the comparable tax rate of all OECD countries declined steadily over the years (see figure 2). The US corporate

tax rate today is the highest amongst all OECD countries. Thus it has become more and more alluring for US companies to move their tax domicile abroad. Moreover, the US taxes foreign incomes of US-domiciled companies as soon as these earnings are repatriated (applying the incremental rate between the US and foreign tax rate). Trying to avoid these taxes made US corporates leave cash in their foreign subsidiaries, piling to an amount across all industries of US\$ 947bn, according to Moody's, a rating agency. Other estimations amount to US\$ 2tn. Performing an acquisition abroad using these monies means that the tax for repatriation can be avoided: an immediate benefit of any inversion, and certainly a driver of valuations of US-based companies purchasing foreign targets. The Pharma industry is disproportionately exposed to this cash pile phenomenon. Moody's estimates around 15% of global ex-US cash piles of US domiciled

FIGURE 1 TRANSACTIONS INVOLVING TAX INVERSIONS OR COMPANIES HAVING INVERTED RECENTLY, BY INDUSTRY



Source: IMAP research.

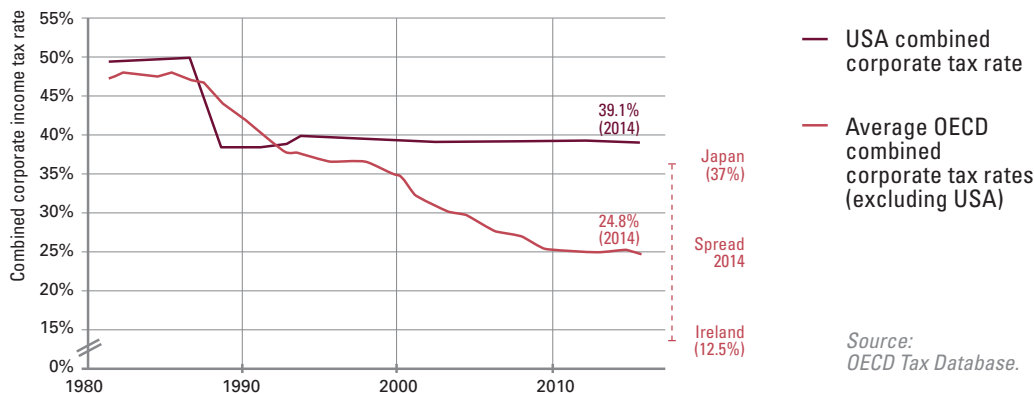
JANUARY FEBRUARY MARCH APRIL MAY JUNE JULY **AUGUST** SEPTEMBER OCTOBER NOVEMBER DECEMBER

/ Merck & Co purchases Idenix for US\$ 3.5bn

/ Endo swallows DAVA for US\$ 575m

/ Mallinckrodt acquires Questcor for US\$ 5bn

FIGURE 2 COMBINED CORPORATE TAX RATES



companies are owned by Pharma companies, compared to an estimated 2.9% contribution of this industry to the total US economy.

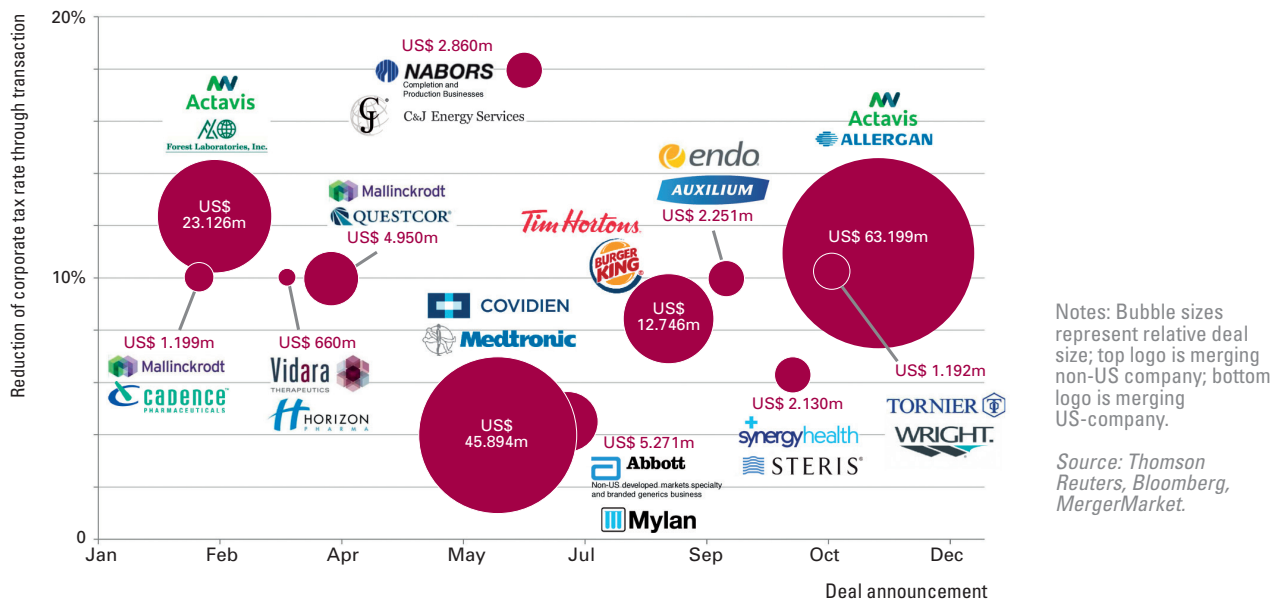
2014 – The year of tax inversions

The year 2014 saw 12 high-profile tax deals leading to inversions or

deals by companies which had done an inversion very recently, thereof seven in the Pharma industry and three in MedTech, accounting for a cumulated transaction volume of US\$ 160bn (see figure 3). The merged entity’s corporate tax rate fell around 8.9% compared to the tax rate of the acquiring or merging US Corporation

before the transaction (weighted average). However, throughout the year 2014, public resistance against tax-moving deals increased. AbbVie’s US\$ 53bn bid for Shire and Pfizer’s US\$ 116bn bid for AstraZeneca both came to a halt, at least partially due to the US Treasury’s new rules on tax inversions

FIGURE 3 NOTABLE TRANSACTIONS IN 2014 INVOLVING TAX INVERSIONS, OR ACQUIRERS WHICH INVERTED BEFORE



JANUARY FEBRUARY MARCH APRIL MAY JUNE JULY AUGUST **SEPTEMBER** OCTOBER NOVEMBER DECEMBER

Abbot enters Chile with CFR buy for US\$ 3.3bn

Roche buys Intermune for US\$ 7.5bn

J&J acquires Alios for US\$ 1.8bn

issued in September 2014. This is to be expected, when the bottom line impact is considered which tax inversion transaction cause for the US tax system. Table 1 shows the estimated pre- and post-transaction corporate tax rates and annual tax savings (using the pre-tax profit of the previous fiscal year) resulting from selected healthcare deals in 2014. Of importance, this calculation does not take into account tax savings from the possibility to invest overseas cash piles without repatriation. The total loss for the US tax systems from these inversions amounts to billions of dollars.

The strategic advantage of a lower tax base

Obviously, lowering the company's tax burden is desirable per se. In the context of deal making, which is such a central part of any Pharma company's strategy, a low tax base is also a key competitive advantage. Pfizer's CEO Ian Read emphasized the point when he stated that, due to taxes, Pfizer is "at a tremendous disadvantage" because it cannot pay the same prices for target companies.

TABLE 1
TAX SAVINGS OF SELECTED TRANSACTIONS OF PHARMA AND MEDTECH COMPANIES IN 2014

US COMPANY / NON-US COMPANY	TAX RATE US-COMPANY, PRIOR TRANSACTION	TAX RATE US-COMPANY, POST TRANSACTION	ANNUAL TAX SAVINGS (US\$ M)
Allergan / Actavis	26%	15%	190
Mylan / Abbott (non US markets)	25%	21%	33
Medtronic / Covidien	20%	16%	148
Questcor / Mallinckrodt	35%	25%	44
Forest / Actavis	28%	16%	10

Source: IMAP research.

Furthermore, one of the objectives of some tax inversion transactions involving Pharma companies, was building a "tax-efficient acquisition platform". Several post-inversion transactions of 2014 exemplify the point: Mallinckrodt, since recently based in Ireland, acquired Cadence Pharmaceuticals (US\$ 1.2bn) and subsequently Questcor Pharmaceuticals (US\$ 5bn); Actavis, an Irish company since 2013, acquired Forest Laboratories (US\$ 23bn) and subsequently Allergan (US\$ 63bn). On a smaller scale in 2014, Horizon Pharma started to build an M&A platform with its US\$ 660m acquisition

of Ireland-based Vidara Therapeutics, officially with the aim to establish a tax-efficient corporate structure for future acquisitions. Arguably, Actavis' huge acquisitions past year may not have been possible without the lower Irish tax base it enjoys. Ironically, through its mergers, Actavis is now one of the few targets for Pfizer which would qualify as a target for a tax inversion.

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HOW DOES A TAX INVERSION WORK?

In a typical tax inversion transaction, a new non-US holding corporation ("Foreign Hold Co") which is based in a favorable tax system (e.g. in Ireland) is "built" in between existing shareholders ("US Co Shareholders") and the US Company ("US Co") through a "reverse triangular merger".

This structure at the same time acquires a foreign target ("Foreign Target Co", typically based in the same jurisdiction as the Foreign Hold Co) by way of a "cancellation scheme arrangement". The pre- and post-transaction structures typically look as outlined on the right side.

