CCH
a Wolters Kluwer business

THE M&A Tax Report

VOLUME 18, NUMBER 4
NOVEMBER 2009

THE MONTHLY REVIEW OF
TAXES, TRENDS & TECHNIQUES

Plowing Through *Schering-Plough*

By Robert W. Wood • Wood & Porter • San Francisco

It's no secret that big, sophisticated and Byzantine transactions can sometimes have tax effects that seem, well, better than real life. The tax shelter era (at least the most recent one) certainly taught us that not all complex transactions will pass muster. That's also one lesson M&A TAX REPORT readers can take from a recent district court refund decision, *Schering-Plough Corporation*, DC-NJ, 2009-2 USTC ¶50,614 (Aug. 28, 2009).

This case examines a complex assignment by a domestic company of future income streams derived from third-party interest rate swaps. Schering-Plough assigned these income streams to its offshore subsidiaries in exchange for lump-sum payments. The court faced two basic questions:

- Were these transactions in essence loans from the subsidiaries?
- Alternatively, were they sales?

Treating the transactions as loans would result in the taxes remaining as assessed. Conversely, if the court found the transactions to actually constitute sales, Schering-Plough would receive a whopping $473 million refund, plus interest.

Loan vs. Sale

Tax old timers like me can think of a number of hoary old cases litigating the line between a loan and a sale. As usually only happens with really big companies, these transactions were themselves somewhat hoary. In fact, the transactions took place way back in 1991 and 1992.

In 2004, the IRS recharacterized the transactions as loans, although Schering-Plough had initially reported them as sales. The IRS assessed a deficiency for approximately $473 million with respect to Schering-Plough's 1991 and 1992 tax returns. Schering-Plough paid the deficiency and sued for a refund in district court. The district court's decision is lengthy and involved.

The court saw its task as examining both the "economic reality" and "economic substance" of the transaction. These seem to be different concepts, with the court formulating the first as whether the transaction—regardless of how characterized by the taxpayer—was in reality a loan or a sale. As for economic substance, the court queried whether the transaction had sufficient economic substance despite the existence of tax-avoidance objectives. Conversely, was this transaction a sham?

The swap structure in question was apparently created with the advice of the Skadden Arps law firm and Deloitte & Touche, Schering-Plough's outside counsel and independent auditor, respectively. All due heed was supposed to have been given to IRS Notice 89-21, 1989-1 CB 651. There was both a 1991 and a 1992 swap. The court attempts to describe and explain nuances of the transactions.

Freakonomics

The court begins its legal analysis with economics, starting with cash flows. The trial (which was conducted as a bench trial) involved a number of expert witnesses, both for the taxpayer and for the government. The district court quotes one of the government experts who analyzed the economic reality of the transaction, with particular focus on the cash flow.

Predictably, this expert testified that in essence, what transpired was a loan. Another government expert (who was experienced in capital markets) testified that the capital markets would view these transactions as loans. Of course, Schering-Plough presented testimony to the contrary. Its experts suggested that there were substantial differences between the rights and obligations of the parties pre-versus post-transaction.

Moreover, Schering-Plough argued that these swap transactions lacked many of the traditional loan characteristics one might expect. Nevertheless, regarding economics, the court simply said that the government's position—that these transactions were loans—"fits."

Substance over Form

The court begins a large legal discussion with *Gregory vs. Helvering*, 293 US 465 (1935), and the Learned Hand–like notion that taxpayers can legitimately arrange their affairs so as to reduce what otherwise would be their taxes due. Yet the court cites numerous cases for the proposition that courts must examine substance, not merely form. The legitimate operation of the tax laws, after all, should not be frustrated by forced adherence to the form in which the parties choose to reflect a transaction.

Platitudes aside, how does one analyze whether a particular transaction should be respected as following its form? How does one determine that an arguably quite different substance should be allowed to overtake the form? How, asks the court, do subjective business motivations militate in favor of one position or another?

These are large and weighty questions, and there are more. How should the step transaction

THE M&A Tax Report
THE MONTHLY REVIEW OF TAXES, TRENDS & TECHNIQUES

EDITOR-IN-CHIEF
Robert W. Wood

MANAGING EDITOR
Kurt Diefenbach

COORDINATING EDITOR
Tara Farley

THE M&A TAX REPORT (ISSN 1085-3693) is published monthly by CCH, 4025 W. Peterson Ave., Chicago, Illinois 60646. Subscription inquiries should be directed to 4025 W. Peterson Ave., Chicago, IL 60646. Telephone: (800) 449-8114. Fax: (773) 866-3895. Email: cust_serv@cch.com.

doctrine with respect to the structure be considered? Overall, what was Congress' intent in enacting Subpart F of the Internal Revenue Code? How did the swap transactions Schering-Plough pursued comport with it?

To be sure, these are broad, even almost philosophical, questions. The *Schering-Plough* opinion is so long and so detailed that it is difficult to give a pithy summary. Nevertheless, here are some high points worth noting:

1. **Related-Party Scrutiny.** Related-party transactions are going to be scrutinized much more than those between unrelated entities acting at arm's length.
2. **Objective Proof.** Contemporaneous intent and objective indications of same are going to be relevant, and particular communications can be quite damning. Thus, if correspondence or testimony indicates that you were really trying to craft (or obtain the effects of) a loan, the fact that you structured the transaction as a sale may not save you from loan treatment. The presence of notes and documents that you might not think are important might turn out to be enormously valuable or enormously prejudicial.
3. **Post-Deal Conduct.** How the parties behave *after* a transaction can also be telling. If the parties take steps that look (or that can be characterized as looking) like the actions of parties post-loan closing (with loan repayments, *etc.*), this too will be relevant.
4. **Other Transactions.** How you treat other transactions can be relevant to the treatment of the transaction in question. Thus, how you treat real loans may (or may not) spill over and impact how the subject transaction is viewed.
5. **Conduit Entities.** The IRS and the courts may disregard conduits, entities that can be viewed as having no independent act or role, and serving merely as an accommodation intermediary.
6. **Risky Business.** Risk matters, so that a party bearing a material economic risk is unlikely to be disregarded. Yet what is considered a real risk can vary, particularly in complex transactions. Inevitably, the fear of litigation or "reputation risk" is unlikely to be considered too telling by the IRS or the courts.
7. **Remember *Frank Lyon*.** *Frank Lyon Co.*, SCt, 78-1 USTC ¶9870, 435 US 561 (1978), may not save you. In *Frank Lyon*, the Supreme Court upheld a three-party transaction and declined to treat an entity as a conduit. *Frank Lyon* involved a sale and leaseback, with the IRS arguing that the taxpayer could not deduct depreciation and other expenses, because the taxpayer did not own the building.

   The Supreme Court disagreed with the IRS, giving legal effect to the financing structure and agreeing that the taxpayer was indeed the building's owner. Yet among other reasons for distinguishing Schering-Plough's situation from that in *Frank Lyon*, the district court here said that Schering-Plough had other means of conventional financing available, whereas the taxpayer in *Frank Lyon* did not.
8. **Step Transactions.** Even the step transaction doctrine still has teeth. The district court examines some of the myriad tests for applying the step transaction doctrine, including the "end result," "interdependence" and "binding commitment" tests. Some have suggested that adherence to the binding commitment test can render step transaction lore mostly a dead letter.

   The district court here found both interdependence and end-result authorities pertinent. The court's review of the facts makes it clear that both the end result and interdependence tests had the same result. Both tests revealed that the formal structure of these swaps could be disregarded, and the steps taken to achieve them could even be reordered, without disturbing the economic reality. These transactions, said the court, were simply loans.
9. **Subjective Too.** Both objective criteria and subjective evidence can be critical. The objective economic effect test asks whether the transaction has any practical economic effect other than tax avoidance. [*See ACM Partnership*, CA-8, 98-2 USTC ¶50,790, 157 F3d 231 (1998).] Schering-Plough argued that its own economics were indeed impacted.

   The court, however, focused primarily on third parties. In particular, there was the very accommodating banker, ABN. Finding virtually no risk to ABN (nor significant rewards, for that matter), the court found little *objective* economic effect.

10. **Whose Business Purpose?** Subjective business purpose may be the hardest one of all. You may need to consider not merely the end result you are trying to achieve, but how you get there. Schering-Plough had to argue that there were three nontax reasons for its transactions.

    There were financial reporting, cash management and balance sheet motivations. There was hedging potential on the interest rate spread in the 1991 transaction. There was even a yield-enhancement benefit in the 1992 transaction.

    Despite arguments, testimony, and considerable number-crunching, though, the district court simply found this to be hooey. These were tax-motivated transactions, the court found, failing the tests set forth in *ACM*.

11. **The Big Picture.** Even if you otherwise survive, the big picture can hurt. The district court here said it had to be careful not to miss the forest for the trees. All tax lawyers should take note. The myopia we as tax lawyers often display can be an occupational hazard.

    The court therefore examined the big picture. From the outset, it said, Schering-Plough desired to bring $690 million of previously untaxed foreign income back into the U.S. without paying an up-front tax. What about Subpart F of the Code?

    It was designed to expressly *prevent* such strategies. Notice 89-21 supplements Subpart F, but it certainly does not replace it. Indeed, while Schering-Plough argued that the district court holding would render Notice 89-21 meaningless, the court seems to admit that. The court flatly said that it did not disagree with this sentiment insofar as Notice 89-21 could be construed to allow repatriation of foreign E&P free from immediate taxation. Still, that didn't save Schering-Plough.

Conclusion

There is much to plow through in the *Schering-Plough* decision. If an appeal is taken, there may be much more to plow through. In the meantime, it would be smart to take advantage of its rich soil to sow a few seeds for the future.