

Back to Basics: Tax Merger & Acquisition Issues Within the Life Sciences Industry

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WHITE PAPER

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The life sciences industry comprises companies operating within various business segments, including pharmaceuticals and medical supplies (biotechs), devices, and equipment. According to First Data, the life sciences industry currently consists of more than 20,000 companies with revenues totaling more than \$350 billion.

Notwithstanding the current economic climate, merger and acquisitions activity within the industry continues, with numerous transactions taking place for a variety of reasons. One popular reason is that small and mid-sized life sciences companies often do not have the long-term capital resources necessary for developing and marketing products. Hence, larger life sciences companies either collaborate with, or acquire, their smaller competitors in order to expand offerings, increase sales and maximize shareholder value.

This back-to-basics paper discusses the tax considerations companies should address when deciding whether to acquire or dispose of mid-sized companies within the life sciences industry.

Specifically discussed are the considerations involved in choosing to undergo either a taxable or tax-free stock and/or asset acquisition. Beyond that issue, this paper also describes other considerations that may be pertinent to the analysis, including the preservation and utilization of net operating losses and other tax attributes (e.g., research and development credits), the treatment of transaction costs, potential “consolidated group” issues, and transfer pricing.

- John Lanza

Forms of acquisitive transactions

As mentioned, the life sciences industry is highly acquisition-driven in nature. To illustrate, French drug giant Sanofi-Aventis SA (“Sanofi”) recently announced its intention to seek small to mid-sized acquisitions as a means to boosting its drug development and diversification. Eli Lilly chief executive John Lechleiter has been quoted as saying he’s hungry for more takeover deals and actively shopping for more companies. Finally, Pfizer recently completed its \$68-billion acquisition of Wyeth, a purchase aimed at diversification. Obtaining drugs as they are in development and achieving diversification via acquisition is not unique in the space. Rather, such

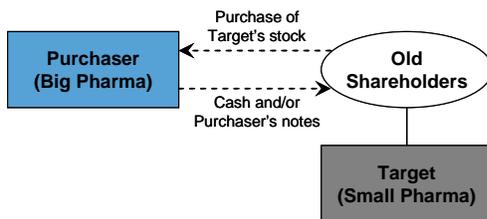
acquisitions are a norm within the life sciences industry and only expected to increase alongside patent expirations, as companies look to retool their pipelines, expand their presence and advance their portfolios in the life sciences industry.

To the extent that an acquisition is taxable, it is not uncommon for the target corporation (“target”) or its owners (“sellers”) to seek a stock sale. A stock sale allows the sellers to incur a single level of tax. Conversely, the acquiring corporation (“acquirer”) usually prefers to structure the acquisition as an asset sale. An asset sale potentially provides the acquirer with a higher basis for the acquired assets than the target company’s historic basis (i.e., a stepped-up basis). The overall tax implications for both corporations (and possibly shareholders) may vary depending on whether the transaction is structured as a stock or asset sale. On that note, it is possible to structure a transaction to include features of both a stock and asset sale. It is also possible to structure an acquisitive transaction so that tax consequences are deferred.

Taxable acquisitions

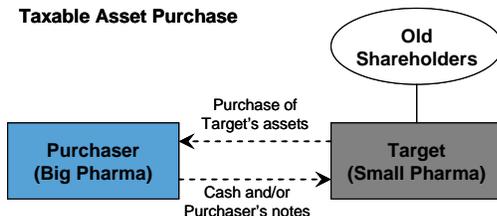
Taxable stock transaction. The “plain vanilla” stock acquisition involves the acquirer purchasing the target company’s stock. The acquirer’s basis in the purchased stock normally equals the consideration given for the stock, including cash, equity, debt and the fair market value of any other property provided to the seller. Following the acquisition, the target company generally continues to exist (along with any subsidiaries it may have) and retains its assets along with the historic bases of those assets. However, the acquiring company may decide to liquidate or merge the target out of existence. This generally will not affect the treatment of the transaction as a stock acquisition. A need to keep the corporate charter intact, or the existence of valuable contracts or liability protection,¹ can influence the decision to as to whether the target company remains in existence.

¹ Note that if the transaction occurs in the form of a merger of the entities, the entity that is merged out of existence loses its stock basis.

Taxable Stock Acquisition


Following a stock sale, the target retains its accounting methods and any tax attributes it may have, such as net operating losses and general business credit carryovers. The historical tax basis of the assets also continues, and no step-up in the basis of the assets occurs. Because much of the value of a life sciences target arises from self-created intangibles, which are generally non-amortizable in the hands of the target, the loss of step-up is often a significant detriment.

Taxable asset transaction. Target companies within this industry are generally either pass-through entities, or corporations with significant losses or credit carryforwards. The basic asset acquisition involves the acquirer purchasing the target's assets and assuming the liabilities associated with those assets. Upon the sale, the target recognizes gains or losses, and the shareholders of the target generally also recognize gain upon distribution of the proceeds. The character of gain or loss — i.e., capital or ordinary — depends on the character of the underlying asset.

Taxable Asset Purchase


The acquirer's aggregate basis in the purchased assets equals the sum of the cash paid, the fair market value of any property given, and the amount of liabilities assumed in connection with the purchased assets. Generally, this will result in a higher, or stepped-up, basis, as compared to the carryover tax basis stemming from a stock sale. This is usually desirable due to increased amortization and depreciation deductions, which results in a lower effective tax rate, and — assuming the assets are later sold for a gain — the

taxable income upon the sale will be lower due to the higher basis. Unlike with a stock sale, the tax attributes of a target are forfeited and do not carryover to the acquirer.

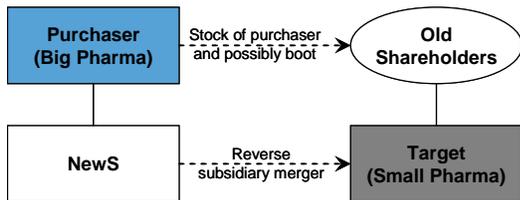
Section 338(h)(10) – Stock sale treated as an asset sale. In certain instances, the tax rules allow the acquirer and seller to elect to treat the purchase of the target's stock as an asset transaction. This provides the benefits of a step-up in basis of the acquired assets, most notably to the basis of the target's self-created intangibles. Only corporations that are Subchapter S corporations or subsidiaries of a consolidated tax group are eligible targets for this transaction. In an (h)(10) transaction, the seller is responsible for any tax resulting from the sale and may utilize any of the target's net operating losses or other attributes to offset the gain recognized on the sale. When the target is not a Subchapter S corporation, any net operating losses or other attributes remaining after the sale generally become attributes of the seller.

The tax liability to the seller is often very similar in either a taxable stock sale or an (h)(10) transaction. As a result, sellers are generally not opposed to the making of an (h)(10) election. However, there is one noteworthy situation where the (h)(10) election is unwise for a seller. This situation occurs when the target is acquired by the seller at a premium in a taxable stock transaction. Under these facts, the gain on the deemed asset sale will exceed the gain that would be recognized by the seller in a pure stock sale.

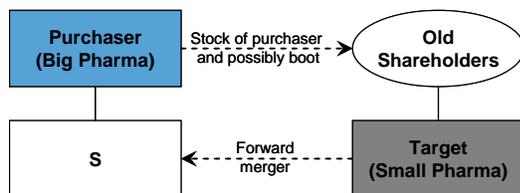
Non-taxable acquisitions

Instead of utilizing a transaction structure discussed above, life sciences corporations may engage in tax-free stock or asset transactions in one of several available tax-free reorganizations. As a prerequisite to engaging in a tax-free reorganization, the transaction must meet general requirements. Namely, the transactions must meet requirements associated with: 1) the continuity of the target shareholders' proprietary (ownership) interests; 2) the continuity of the target's business enterprise; 3) a bona fide business purpose; and 4) other judicial doctrine.

There are a variety of ways to accomplish a non-taxable acquisition, one of which entails the purchaser acquiring the target's stock in a tax-free reorganization.

Reverse Subsidiary A Reorganization


Alternatively, the purchaser may acquire the target's assets in a tax-free reorganization.

Forward Subsidiary A Reorganization


Overall, while an acquisition may be taxable or non-taxable and structured as an asset sale, stock sale, or combination thereof, the tax consequences of any of these options should be clearly understood to ensure an informed decision can be made.

Deductibility of transaction costs

Regardless of how a transaction is structured, both the buyer and seller companies often incur substantial costs in the course of completing the transaction. These costs are either deductible or subject to capitalization. Depending upon the type of cost and acquisition structure, capitalized costs may be deductible as amortization or depreciation over a period of years. If the company incurs investment banking fees related to an acquisition or sale, it must properly document the expenses by the due date of the company's timely-filed federal income tax return (including extensions) for the taxable year during which the transaction closes.

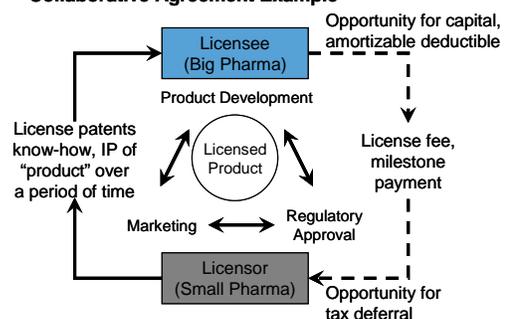
Collaborative agreements

The unfavorable economic environment has not deterred, and in fact may be a principal driver for, multiple transactions that have recently occurred within the life sciences industry. Besides acquisitions, life sciences industry participants also engage in joint ventures or collaborative agreements to boost their drug development and diversification. The desired results of these ventures are additional resources and

efficiencies in managing the process for regulatory approval.

In these arrangements, a life sciences company owns intangible assets and licenses them to another company for a particular term. Collectively, the companies develop and market a given product. The life sciences company owning the intangible assets (the "licensor") generally receives an initial fee and, often, milestone payments due upon the satisfaction of certain contingencies. These other payments may be triggered by the licensee achieving certain milestones in developing a product. Milestone payments may also include royalty payments based on the number of product sales made by the licensee.

Collaborative agreements should be structured with the current and future tax consequences in mind. Issues may arise regarding the tax year in which amounts received by the licensor must be recorded as income. Tax authorities have issued private letter rulings that prescribe certain conditions which, if met, may allow a licensor to defer amounts received past the taxable year in which received. Often the decisions in these rulings are based on the contract terms. In the absence of such rulings, the default rule is that the amount of any item contributing to gross income must be included as gross income for the taxable year in which the item is received. While that may appear to be the best option, deferring income may not always be the most efficient decision. It is also important to determine how the licensee will be able to treat the fees paid to the licensor (i.e., as capitalizable and amortizable versus deductible as paid). Therefore, the structure of a collaborative agreement should be based on a firm understanding of both current and expected future tax positions.

Collaborative Agreement Example


Other tax considerations

Section 382

Generally, Section 382 limits the amount of taxable income that can be offset by net operating losses following an ownership change. An ownership change occurs, in general, when the percentage of the loss corporation's stock owned by 5 percent of the shareholders increases by more than 50 percentage points over the lowest percentage of corporation stock owned by the shareholder(s) at any time during a specific testing period. The limitation is ordinarily computed based upon the value of the loss corporation, multiplied by the applicable long-term tax-exempt rate.

The development of a new product in the life sciences industry, such as a medicinal drug, can take more than a decade, cost nearly half a billion dollars, and result in substantial net operating losses. This is, to be sure, prior to the product receiving any requisite regulatory approval before reaching the consumer market. Consequently, life sciences companies often need large influxes of funding before significant revenues can be earned, and such funding is normally received via multiple rounds of capital infusions. The capital influxes often lead to the issuance of various classes of stock with different voting rights, liquidation and dividend preferences, and convertibility features. Eventually, when a product nears completion or shows significant promise, a large acquirer may decide to purchase the company. While it is generally understood that such an acquisition will result in a Section 382 limitation on the ability to utilize the net operating losses incurred during the development phase, the acquiring corporation must perform sufficient due diligence to determine whether prior capital raises also resulted in earlier limitations that may further restrict the utilization of net operating losses.

Consolidated group: Loss disallowance rules

Most early-stage companies in the life sciences industry are standalone — they neither own, nor are owned, by another company. However, larger, well-established companies in the industry generally operate within the consolidated tax group context. Recently-adopted rules greatly expand the parties affected by the consolidated loss disallowance rules. These rules can either disallow a loss on the sale of a subsidiary, or disallow an acquirer's use of a target's

losses following an acquisition. As a result, it is important to understand how these rules will affect an acquisition or sale, depending on whether a company is the buyer or seller.

Transfer pricing

The life sciences industry operates outside the U.S. and includes many multinational companies. For instance, the direct export market for U.S. companies operating internationally exceeds \$50 billion. In fact, several life sciences companies generate close to, if not more than, half of their revenue from international sales. Consequently, transfer pricing has become one of the most important international tax issues facing multinational life sciences companies. Many of these firms have expanded operations worldwide to continue business growth, or lower costs, and life sciences companies operating in more than one country are likely to have intercompany transactions that are subject to various transfer pricing laws. Transactions between related parties that involve the transfer of intangible goods, tangible goods or services constitute intercompany transactions.

As transfer pricing has become a crucial international tax issue, the level of documentation required to ensure compliance with the rules may be substantial. Through proper planning, a life sciences organization can position itself to optimize its tax situation by properly placing the correct combination of functions, assets and risks in a desired jurisdiction.

The migration of intangibles, such as patents, trademarks and knowledge, is considered acceptable tax planning in an effort to maximize after-tax profits. One should be cautioned, however, because transactions that include such intangibles, which have proven valuable and subsequently migrated, are more likely to be subject to scrutiny from tax authorities. Any strategic decision to transfer these intangibles must be supported by comprehensive transfer pricing documentation that incorporates as much evidence as possible in support of an arm's-length price.

Risks and functions. In any given intercompany transaction, the functions performed and the risks held by each related party affect the profitability allowed to each entity under the "arm's-length principle." Simply put, this principle aims to prevent life sciences companies from manipulating transfer prices and the resulting taxable profits. This is done by comparing the controlled intercompany transactions directly to

uncontrolled third-party transactions or taxpayers, depending on the situation. By working within the guidelines established by the arm's-length principle, multinational life sciences companies can legally shift taxable profit between tax jurisdictions.

Location of cash and profits. As a consequence of the downturn in the global economy, many life sciences companies will experience increased pressure on profit margins. The pressures on profit margins experienced by an individual firm may also be seen in the comparable margins that are used in transfer pricing analyses. Company transfer pricing policies will need to be reexamined or refreshed in light of any new data. The shift in comparable margins also represents an excellent opportunity for taxpayers to adjust their policies for tax-planning purposes.

The U.S. Internal Revenue Service (IRS) requires allocation of all controlled service costs where the service recipient receives a direct benefit. A controlled services transaction includes any activity by one member of a group of controlled taxpayers (the renderer) that results in a benefit to one or more other members of the controlled group (the recipient(s)). Through the use of a shared service contract, life sciences companies can shift income from foreign service recipients back to the service provider, effectively lowering taxable profits in a given jurisdiction. Services can include headquarters services, corporate and CEO services, back office services, human resource services, information technology services, as well as marketing and business development services, among others. Stewardship costs are not allocable.

Local jurisdiction requirements. Many foreign countries have adopted and implemented specific transfer pricing rules in addition to the arm's-length principle. Many of these foreign countries apply the Organization for Economic Co-operation and Development's "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" in addition to their specific local rules. Issued in 1999, the guidelines attempted to realize a consistent international approach for multinationals, including multinational life sciences companies and tax authorities towards transfer pricing issues.

U.S. documentation. In 1996, the IRS issued final penalty regulations to encourage taxpayer compliance with the Section 482 transfer pricing regulations.

Under these regulations, if the agency makes an adjustment to a taxpayer's tax liability relating to Section 482, penalties of up to 40 percent of the understatement of tax resulting from the mispricing of related party transactions can be imposed on top of any valuation misstatement.

Multinational life sciences companies with transfer pricing issues can avoid these penalties by meeting the contemporaneous documentation requirement for related party transactions. This requirement has several components, including the use of the arm's-length principle.

FIN 48/FAS 109 considerations. Financial Accounting Standards Board (FASB) Interpretation No. 48, "Accounting for Uncertainty in Income Taxes (FIN 48)," provides a comprehensive model for companies, including those in the life sciences industry, to determine and disclose uncertain tax positions in their financial statements or tax returns. FIN 48 became effective after Dec. 15, 2006 for all publicly traded companies. Transfer pricing continues to be a significant source of uncertain tax positions, with uncertainty often deriving from how much benefit a life sciences company claims from a position rather than whether or not a taxpayer's position is compliant with local transfer pricing rules.

Research and development

Congress enacted the research and development (R&D) tax credit to encourage businesses to perform their research and development activities in the United States. The R&D credit is geared toward industries with high dependence on technology as a means to developing new and improved products, or methods of production. To this end, the life sciences industry is a prime example of the kind of businesses Congress had in mind when implementing the R&D credit.

In order for a company's activities to qualify as R&D, the work performed must pass four individual tests. The most basic of these tests is that the research must be technological in nature. This means that it must be fundamentally based on principles of engineering or biological, physical or computer sciences. The next required test is the permitted purpose test. The research being performed must be for a permitted purpose, which indicates that it leads to a new or improved function, performance, reliability or quality of a business component. Third, the activity must eliminate an element of technical uncertainty. This

may refer to capability (can it be done?), methodology (how can it be done?) or determination of the appropriateness of final product design.

Finally, the research must be completed by utilizing some process of experimentation. This requirement ensures that at least one alternative is evaluated in order to derive the desired result.

If an R&D credit is being claimed on an amended return, it should be researched as to whether the §280C(c)(3) election was made to take the reduced R&D credit on a timely-filed return. If this election was not made on a timely-filed return and the company wishes to claim a credit for a year for which the return has already been filed, an amended return will need to be prepared in order to account for the required add back of expenses in an amount equal to the R&D credit claimed.

In calculating an R&D credit, it is critical to understand the types of documentation and resources available to support the calculation. The three types of expenses qualified for the R&D credit are wages, supplies and contract research. As such, records such as W-2s, prior year tax returns and general ledgers, which provide enough detail to fully understand the research expenses that were incurred should be available. If contract research expenses have been incurred, copies of the contracts and master services agreements should be reviewed in order to determine who retains the risk and rights to the research being performed. In the case of companies in the life sciences industry, particular attention should be paid to collaboration agreements to ensure that the company claiming the credit is entitled to the credit. Funding issues frequently arise in this area.

Conclusion

In the current economic climate, merger and acquisition activity within the life sciences industry will continue to increase, especially when the credit markets open up and as life sciences companies look to expand their offerings and increase shareholder value. As discussed in this paper, the tax considerations involved are numerous and care must be taken to fully analyze these issues before entering into any transaction.

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