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International Taxation

**A Great International Tax Structure
Taken Too Far?:
The Case of the Valeant – Biovail Merger**

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Introduction

“This merger is justified just on the tax structure. It’s a great one, but they’re taking it way too far and I think they’ll ruin it for everyone. Do you think they’ll get away with this? Who will complain? Someone’s got to.” I had just returned, September 27, 2010, from the Shareholders Meeting to vote on the merger between Biovail and Valeant (2010), two leading specialty pharmaceutical companies, one Canadian, one located in California, when I got this surprising call from a former Biovail executive who in a shocked voice expressed his concern about the merger and the tax structure. While the shareholders were excited about the cost cutting prospects, and the synergy between the two companies, and approved the merger by 99.9%, the most valuable and yet least understood source of value creation in the combination was a complicated international tax structure. I was the recipient of this call because as the former CFO of the Company, negotiating numerous acquisitions, financings and a few potential mergers, I had looked at the international tax issues numerous times before.

The Biovail international tax structure was built on a Canadian parent company, a Barbados intellectual property subsidiary, third party supply pricing, lots of intercompany debt, tax loss carry-forwards, and a low tax-paying U.S. operating company. For the structure to work, the original shareholders of the Canadian Biovail target in the merger needed to end up with a majority of the shares to represent Canadian ownership and control. They would achieve this in the merger proposal but only after a sizeable special dividend was paid to the American company shareholders and only by 0.1%, a mere 50.1% ownership. At the same time the American CEO was going to be the continuing company CEO, the company would take on the American name and the head office would be in California. This looked like form, and only 0.1% form, over substance. Would 50.1% pass the smell test with tax authorities and the market?

The assignment for this paper is to discuss what is international tax and international tax planning including residence, source, treaties, foreign-controlled corporation rules, thin capitalization rules, repatriation of profits and tax avoidance versus tax evasion and substance over form (Horn 2010). I can think of no better way to address many of these issues, and others, than to discuss both my experience with the Biovail international tax structure as a former CFO of Biovail and several issues and questions about its validity moving forward into the Biovail Valeant merger as an interested on-looker and shareholder.

This paper will use a case study of the 2010 merger between Biovail Corporation of Toronto, Canada, and Valeant of California, USA, to describe a comprehensive and successful international tax structure but also to explore some of the challenges of implementing it, particularly in a merger and some of the “smell test” issues managers need to face. We will start with explaining the two predecessor companies, then outline the Biovail international tax structure and the reasons why it works, then describe the merger proposal and finish with an assessment of its validity and outline some issues for consideration. The conclusion will set out some suggestions for international tax practitioners, not the technical lawyers and tax accountants, but the finance and operation management that need to implement and live with an international tax structure. This paper should be of interest to practitioners of international tax because it will show both the technical and practical issues associated with an effective but complicated tax structure.

The Predecessor Companies –Biovail

Biovail is a Canadian specialty pharmaceutical company founded over two decades ago in Mississauga, Ontario, Canada and focused on once-a-day drug delivery solutions to prior pharmaceutical products that were dosed more often than that. Once-a-day delivery improved patient compliance because that’s the way North American’s tend to take their pharmaceutical products, and thereby improving safety and outcomes. But importantly, once-a-day delivery was a life cycle solution, changing a pharmaceutical product such that the company could extend its life as a branded product not subject to generic substitution, through a new FDA (Federal Drug Administration) approval and a modified name. Biovail had developed a series of once-a-day versions of other people’s products and licensed them to a series of different pharmaceutical companies including mid-sized companies such as Forest Laboratories of New York and Teva Pharmaceuticals of Israel as well as major companies such as GSK. (An example is Wellbutrin XL, a once a day version of GSK’s very successful Wellbutrin SR, developed by Biovail and licensed and supplied to GSK for a very significant percentage of GSK Wellbutrin XL revenue.) The company grew rapidly from no sales in the mid nineties to a few hundred million in 2000 and then with two acquisitions, to half a billion by 2001. These acquisitions, and others, along with organic launches of new products, had the company reaching almost a billion dollars in sales by 2004. The Company’s growth-by-acquisition strategy came into heavy criticism by the market however, compounded by a quarterly earnings shortfall in Q3, 2003. A resultant change of corporate strategy from licensing-out to a launch of a U.S. sales force, which in the crowded U.S. market resulted in significant losses, and then the subsequent closure of that sales force and the failure of an important product formulation, led to stagnation for the company in 2007 and on.

In 2006 the former CEO of the Company, and a significant 15%+ shareholder, attempted a \$4.5 billion privatization of Biovail. The CEO and CFO working on the deal had to take a paid leave of absence from the Company and exclude themselves from management and management meetings during the process. The Board declined the LBO offer and several of the founding executives of the Company left in disputes over the privatization and the appropriate corporate strategy going forward. In 2006 and 2007, the

Company with its “new management” hired a major consulting firm, did a review of its strategy and embarked on a new corporate strategy, abandoning its drug delivery heritage and launching a new product development strategy in the CNS (Central Nervous System) sector competing with big pharmaceutical companies and scientifically-oriented biotech companies. One of the last big opportunity drug delivery products failed in its FDA approval resulting in a 50% decline in the stock. In 2008, the former CEO led a proxy fight against the “new management” and remaining Board, disputing their new strategy, their overpaid inexperienced new executives and calling for a return of old management and the drug delivery heritage of the Company. He lost. In 2009, the proxy fight returned this time ending in a negotiated settlement with the former CEO nominating one member of the Board and having his costs paid for. In late 2009, the former CEO announced he had sold his remaining stock in the Company. The whole time, 2006 to early 2010, the “new management” had over-seen a 50% decline in the Biovail stock and then a languishing of it thereafter. Not a great record of achievement.

This all changed in mid 2010 when Biovail announced a proposed merger with Valeant of California and the stock almost doubled. The newly merged Company would take the name Valeant, operating management and the headquarters of the Company would be California, but the shareholders of Biovail would be granted 50.1% of the new Company so therefore the continuing Company was deemed a Canadian Company. Most of the “new management” of Biovail would receive extremely generous change of control termination payments and leave the Company with several millions of dollars of exercised option proceeds. The newly merged Company decided to drop the new corporate strategy. The CEO of Biovail, who was the driving force in ousting the former CEO, changing the Company’s strategy and proceeding with the merger with Valeant, agreed to stay on as Chairman of the newly merged Company. On December 13, 2010 he announced his resignation. He lasted two and a half months.

The Predecessor Companies – Valeant

Valeant was a specialty pharmaceutical company headquartered in Orange County, California. It was a part of a former larger specialty pharmaceutical company that grew by way of many acquisitions both in the U.S. and abroad, primarily Europe. The former founder and CEO was ousted eight years ago, and replaced with a management team that didn’t execute any significant business strategies for most of the 2000’s. However, in 2008, a new CEO was appointed, the former head of Health Care Consulting for McKinsey and Company. He narrowed the focus of the company into three therapeutic areas, executed a dramatic restructuring of the Company changing businesses and management, and at the same time initiated again an aggressive acquisitions program. The Company grew dramatically, again, both in the U.S. and abroad. The market reacted favourably to this reinvigorated Company even though it was executing the previously disliked growth-by-acquisitions strategy. In the industry people commented on how market interests in different strategies seemed to come and go every few years.

In mid 2010, Valeant announced that it would merge with Biovail. The merger sounded more like a Valeant take over of Biovail with most of the Valeant management staying in control of the Company and most of the Valeant businesses remaining but with plans to sell some of the Biovail ones. There were not many obvious synergies from the merger as the Companies weren't in the same therapeutic areas or the same geographical ones, outside of North America. In fact, the Companies weren't really seen as peers by industry analysts so many wondered what the benefit was. Then, in the announcement, the structure was released that showed Biovail shareholders receiving 50.1% of the newly merged Company and then the last slide of the presentation stated that the Company would continue to enjoy Biovail's favourable international tax structure. For Valeant, a Company with significant foreign operations, a U.S. parent company was probably not the most tax efficient. Through this merger Valeant would reduce its tax rate by close to 30 points. Biovail's average tax rate over the past ten years has been 7%.

Biovail's International Tax Structure

While Biovail was a Canadian company, in the early nineties the CEO relocated to Barbados and established a subsidiary company that owned all of the intellectual property for the Company's products. Biovail Barbados also contracted for all of the Research and Development that was performed for the Corporation worldwide and arranged for all of the manufacturing. Products were supplied by Biovail Barbados to the American, Canadian and overseas subsidiaries. Biovail Barbados also lent money and provided management services to the operations subsidiaries. With tax rates of greater than 30% in most of the operating countries Biovail was active in, the Corporation reported tax rates, on average since the late 1990's, of around 7% because of this international tax structure. An outline of the international tax structure follows (in excel file attached).

When the CEO relocated to Barbados, corporately and personally, all assets were valued in Canada, taxes paid, and only then were the assets moved to Barbados. This relocation was done before the Company had any revenue and before the products had been approved by the FDA so the tax values were reasonable. The Barbados subsidiary was set up with an independent Board with a majority of the directors being local residents. The CEO became President of the subsidiary in Barbados and eventually relinquished his position in the Canadian parent, remaining Chairman of the Board.

The Barbados subsidiary contracted with both internal and external R&D (research and development) entities in Canada, the U.S., Ireland and France for the development of products, the conducting of clinical trials and for the regulatory approval process. The R&D facilities were all paid a cost plus arrangement for their work. Biovail owned an R&D clinical laboratory in Toronto that performed clinical trials for Biovail projects as well as 50% of the time for third party clients. Some of the work that the other facilities did was also for third parties. In addition, Biovail contracted on a regular basis with other third parties for similar and sometimes duplicative or competitive R&D work. There were therefore several proxies for third party typical pricing for contract R&D work.

The Barbados subsidiary paid for and funded significant expenditures on R&D on the entire Company's pipeline or products over several years, through numerous development thresholds, approvals and clinical trials, each containing significant risk of failure. Many analysts have suggested that 80% of pharmaceutical products initiated are not successful. Given that the Barbados subsidiary expended the funds and took the risk that the products / projects would be successful, some potentially very valuable R&D development could take place for a cost plus payment. The Barbados subsidiary would also have quarterly meetings, mostly taken in Barbados, where the pipeline of products was presented, debated, valued and decisions on continued funding taken on them. These meetings would include representatives from the corporate parent office, the operating subsidiaries, the R&D facilities and would be chaired by the President of the Barbados Subsidiary, who also happened to be Chairman of The Board and the largest single shareholder in the Company. On a regular basis consultants would be hired to analyse different product opportunities and these arrangements would be with the Barbados subsidiary.

The Barbados subsidiary also contracted with Biovail's operating manufacturing facilities to manufacture products on a cost plus basis. The manufacturing facilities did not do any third party work, but typical third party margins were available from the many other companies in the contract manufacturing business. Manufacturing meetings would also be held in Barbados, often in concert with the R&D meetings, to discuss manufacturing issues such as the expected timing of the launches of products, scale up, demonstration runs, clinical runs and launch quantities. These meetings would include personnel from the Canadian parent, marketing and sales people from the operating businesses and R&D project managers, chaired by the President of the Barbados subsidiary. Sometimes, the meetings would be held in either an operating company manufacturing or R&D facility, but that was the exception, not the typical rule.

The Barbados subsidiary would contact with the manufacturing facility to produce a product and would then take title to the product, shipping it to the sales and marketing entity that would distribute the product, which sometimes were a third party and sometimes a sister Biovail operating company. The Barbados subsidiary would always take title to the product, but usually just at a point in the distribution and for just a point in time. For example, most products would be shipped FOB (Free on Board) the manufacturing facility, which meant that the manufacturing facility would sell the products to the Barbados subsidiary as the product was leaving the plant doors and then immediately the product would be sold to the third party or to the sister company. In other instances the product would be FOB the customs point if shipped from Canada to the U.S. In this situation the Canadian manufacturing subsidiary would keep title until the product reached the border, selling to the Barbados subsidiary at the border, who in turn would sell it to the sale and marketing distributor as it left the border. In all these circumstances the Barbados subsidiary did not hold the product in inventory or arrange and pay for lengthy shipping, but it did take title to the product at one point in its travels.

With this corporate structure, the R&D facilities would make a small mark-up on their costs, declaring after fixed costs, breakeven or a small profit, and therefore low taxes payable. Similarly, the manufacturing facilities would make a small profit on top of the costs of production. The bulk of the profit would be earned by the Barbados subsidiary because of its ownership of the IP and the significant funds it had expended on developing the product and the risk in gaining approvals. The tax rate in Barbados was 5% until \$2 million dollars and then 1% thereafter for corporations of Biovail's kind.

The Barbados subsidiary would be funded by equity injections from the Canadian parent. No interest expense would be incurred in this low tax Barbados environment. However, a substantial amount of the funds were borrowed in Canada incurring an interest burden and a corresponding tax shield. Barbados used its funds to pay for all of the R&D development but would also lend some funds to the different operating companies. This banking relationship would create another interest burden in the U.S operating company and attract another tax shield for the interest. The interest income in Barbados would be taxed at the 1% rate indicated above. Thus one source of funding would create two interest tax shields with no off-setting interest income taxes payable. This was commonly referred to as the double dip. Barbados negotiated third-party-like loan agreements between itself and the U. S. operating subsidiary, with credit checks, financial statement filing obligations, regular interest and principle payments.

Corporate and Business Development searching, identifying and initial contacts were performed by personnel in the Canadian parent and the operation companies, however all final decisions, final negotiation direction, funding and Board approvals were done by the Barbados subsidiaries. All contracts and offer letters were signed in Barbados by the President of the Barbados subsidiary with date, time and place indicated on the form. When the President of the IP subsidiary is also the Chairman of the Board and the largest single shareholder in the Corporation it's very logical to make sure he agrees with anything and everything before proceeding.

The Board of the Barbados company would meet on a regular basis, at least quarterly, and included an experienced outside lawyer and an outside accountant, in addition to the President of the Barbados subsidiary and the controller of the subsidiary who acted as the secretary of the Board as well. Often Corporate or Operating Company personnel would also present to the Board of the Barbados subsidiary. If major products were to be purchased, the Board in Barbados would need to approve the acquisition and then it would be confirmed by the Corporate Board in Canada if above a certain threshold. All Board meetings would be minuted. Sometimes not all Board members or presenters would be present in person at the Board meetings, but nevertheless the meetings would always occur in Barbados.

To qualify under certain parts of the Canadian Barbados tax treaty, the Barbados subsidiary needed to have a minimum of six full-time equivalent employees working in Barbados. Biovail usually was in excess of this requirement as it needed accounting personnel, secretarial staff, and pilots, in addition to the President. Numerous other off-shore companies were resident in Barbados and on visiting a local law firm or accounting

firm one would see dozens of company name plates on the wall. How they exceeded the six person requirement is a valid question, but Biovail never had that challenge.

The key to making this structure work was that “Mind and Management” or control had to be in Barbados relative to the R&D, product and acquisition decisions, not in the parent office back in Toronto, Canada or in any of the operating businesses. In my time flying back and forth to Barbados, usually once a quarter or so, I’d meet many other companies with off-shore offices in Barbados. None of them had such a well established and documented framework and structure. Often when negotiating a deal for a product or a company or an R&D opportunity, various executives, particularly if they had the title President of this country or SVP of this function, they’d think they could make the final decision and sign the agreements and I’d have to remind them, no Barbados has to make all decisions and sign all agreements. I frequently was thankful that the Chairman and major shareholder was the person I was speaking about, not just some IP subsidiary president. I wondered how other companies honoured their tax structure in the heat of deals if the IP subsidiary president was just one nameplate of dozens and didn’t have the respect and bonus decision over the operating executives in Toronto, New York, Raleigh and Dublin. I often joked to people that all they needed to do was look at my Blackberry and they’d know based on all the emails from one person in Barbados, where “Mind and Management” was.

Through my time at Biovail, questioning numerous tax accountants and lawyers and answering questions to auditors, analysts and investors and meeting and comparing notes with numerous other companies, I came to several rules to ensure the structure works:

1. **Move early.** Establish the international structure early on in the corporate life when it’s relatively cheap to move assets and you can establish norms and frameworks that people will honour. Often advisors will say to wait until you’ve got a big enough business where the tax savings will make sense. However my sense is if you wait that long then it will be too expensive to move assets and too difficult to change the reporting and decision making lines of authority. In negotiating a sizeable LBO I once had a drink with a senior Wall Street banker who said of the founding CEO of Biovail, ‘People hate him because they’re jealous. And they’re jealous because he’s a billionaire. But you know what makes people really mad and jealous? That he was smart enough to move to Barbados before he or anyone else knew he was destined to become a billionaire’.
2. **“Mind and Management” needs to be constantly reminded to people.** Control being exercised in the intellectual property owning subsidiary is a very difficult concept for a lot of operating management to understand and even more difficult for them to honour. They all have egos and don’t want to always have to go back to a sister subsidiary for approval to take any significant actions or to sign any term sheets, contracts or documents. The key is constant reminders and attention to detail. Triggers such as forcing all documents to have a line for where they are signed remind people of where things should be signed.
3. **Process is important.** Regular meetings held to ensure management in accordance with the international taxation structure are very helpful. If there was

- not the requirement for quarterly meetings to be held in Barbados busy managers would have come up with dozens of reasons to not do so. But the quarterly meeting with an agenda and minutes and a presentation, along with a little golf or dinner or bar hopping, reminded people of the importance of the process and the structure.
4. **Documentation is critical.** Minutes of meetings, agenda, intercompany agreements and contracts, and email traffic lists, all made proving that the structure was being honoured much easier.
 5. **Third party comparables are very helpful.** Even better than comparables enter into some yourself. Because Biovail had outside licensees, developers and manufacturers, establishing and proving third party based transfer pricing was so much easier than for a company that has to try to create it from scratch.
 6. **Always abide by the spirit as well as the letter of the law.** In my opinion, some companies I came across would not have the required six people in Barbados or would add in questionable staff. Some companies might have intercompany transfer prices that were not based on any reasonable third party comparable and might be difficult to substantiate. Some companies might have overused the double dip debt structure to leverage operating companies to unsustainable levels. Whenever you go to close or across the line, someone will notice. New rules in the U.S. restrict overly leveraged companies. Canadian tax auditors started a practice of actually visiting the Barbados off-shore companies and asking to be introduced to the required six people and then asked them what they did and who they did it with.
 7. **Live the international tax structure, don't just do it.** What I mean by this is if the structure means control needs to be in Barbados, put a senior enough person in the Barbados subsidiary such that people ask for approval from that subsidiary, not because they need to for a tax structure reason, but because that's where the true decision making power in the corporation really is. With the Chairman of the Board and the major shareholder living and working on a daily basis as the President of the Barbados subsidiary. Biovail lived the tax structure. When I met other off-shore executives that were mere functionaries, that just were a conduit for documents and not true decision makers, golfing every day and dinning every night, I got concerned.

In summary, I think the Biovail international tax structure worked because we adapted the reality of the corporation to the tax structure by having the Chairman live in Barbados and take the job of President of the IP subsidiary. I worry that some companies may have an international tax structure but don't really change the company to adapt to it or honour its structure. They sort of just put up with it and try to get things done in accordance with the tax structure, but often as a second thought after the real decisions have been made.

The Biovail Valeant Merger Proposal

Valeant was an acquisition-oriented company with numerous international organizations that would benefit from an international tax structure comparable to

Biovail. Valeant was paying full U.S. tax and could get an approximate 30% increase in earnings through reducing its tax rate to equal to the Biovail tax rate. However, the problems with merging with Biovail were several fold, including:

1. Valeant was the bigger company and for the structure to work, Biovail shareholders needed to be the majority of the newly merged company so that the company would be deemed a Canadian company.
2. Valeant as a Canadian company needed to have “Mind and Management” of the parent company in Canada while the CEO and most of the critical managers of the continuing company would be current Valeant executives.
3. To keep the off-shore IP company, that Barbadian company needed to decide on all R&D products, manufacturing and business development decisions. This is not how Valeant conducted its CEO led growth by acquisition strategy. A senior person needed to be in Barbados such that executives would live by the tax structure.
4. Valeant needed to convey to the market the significant value creation that would come from adopting the Biovail tax structure without drawing too much tax auditor or regulatory concern to it.

The Valeant proposal was to reduce the Valeant valuation prior to the merger by paying a very significant special dividend that would reduce the value of Valeant shares to less than Biovail's. To entice Biovail shareholders to sell, and to make it easier to ensure Biovail was bigger than Valeant, Biovail shareholders were offered a small 10% premium to the value of their stock prior to announcement. (Though on announcement, because of the synergy inherent in the merger, particularly, but not just from tax, the stocks of both companies appreciated almost 100%). The resultant share exchange ratio would mean that former Biovail shareholders would own 50.1% of the newly merged Company, a 0.1% majority.

To ensure that the newly merged Company would have control in Canada, the majority of the new Board would be Canadian, the CFO would be from Biovail and be resident in Canada and the Biovail CEO, a Canadian, would be Chairman. To ensure that the Barbadian subsidiary was the decision making body that it needed to be, the Chairman was to live and work in the Barbados subsidiary.

However, the CEO of the newly merged company was to be the former Valeant CEO and he would remain in sunny southern California with the bulk of his management team. The SVP of human resources was a former Biovail SVP, a Canadian, but who worked in New Jersey and had been in the U.S. for over 25 years. The only other senior manager who was from Biovail and a Canadian was the CFO. She was only in her job less than a year and was thought of as mainly an external-oriented, investor-relations oriented CFO and not the true controller of the company. The newly merged company would take on the Valeant name and stock ticker symbol. The former Biovail CEO, who was to become Chairman and live and work in Barbados, resigned two and a half months after the deal closed. All of the Biovail executives received change of control termination payments when on paper Biovail maintained control. Biovail shareholders received the smallest

amount they could have to be in control, 50.1%. All of these issues suggested potential problems with the tax structure.

Discussion

There are several issues resulting from the Biovail Valeant merger and the continuation of the original Biovail international tax structure including:

1. **Tax planning:** To start with, there is nothing wrong with Valeant trying to minimize its tax by entering into this merger for several reasons, one of which was to enjoy a far superior international tax structure and thereby a substantially lower tax rate. As was originally found in the Duke of Westminster case: “It was ruled that it is an accepted principle of taxation that it is lawful and sensible to arrange business and personal affairs in such a way as to attract the lowest possible incidence of tax” (Horn 2010).
2. **Source:** It is key to figure out which company is the actual parent and what is the source for earnings. Under Canadian tax law a Canadian company is only taxed in Canada on its Canadian earnings with Canada assuming that all other countries are charging their fair share of tax. U.S. tax law is different in that the U.S. taxes U.S. companies on all their global income, with a credit for taxes paid elsewhere. The key here is that if the U.S. company is seen as the parent, then all of the preferential tax rates enjoyed because of the Barbadian structure would be offset by a higher equalization tax in the U.S. Even if the Canadian company is legally the parent, issues of is it practically a Canadian company and under controlled foreign company rules is it as well need to be assessed.
3. **“Mind and Management”** might be seen to be in Orange County, California where the new CEO is located along with several important members of his management team. This may impact the determination that the Canadian company is the ultimate parent company if “Mind and Management” of corporate decisions are not in Toronto, and it may also negate the benefit of the Barbadian tax advantage if “Mind and Management” of the Barbadian IP subsidiary is not in Bridgetown. The De Beers case will be instructive here as it was found in that case that even though the company was located in South Africa, the key decisions were made in London and the key contracts were negotiated there, and therefore the company should be taxed in the U.K. (Horn 2010). With the CEO of an acquisitive company, formerly head of Health Care Consulting for McKinsey and Company living, working and managing from Orange County, I find it very difficult to believe that the key management decisions will not take place there. The CFO is maybe a glorified Investor Relations person and certainly not the key corporate development / finance person that has worked side by side with the CEO in the past. The SVP HR is a Canadian but has been working in New Jersey for the past 20+ years. Will he be in Orange County or Toronto and will he be a key decision maker? Complicating this is the resignation on December 13, 2010 of the Canadian Chairman of the Board. In addition, there appears to be no senior Valeant or Biovail management in Barbados. When either of the two prior Chairmen of the Company’s Board lived in Barbados and were responsible for the

- product and R&D decisions, “Mind and Management” in Barbados was easy to get comfortable with. No longer.
4. **International Tax Treaties:** There are the practical “Mind and Management” rules which are most important but also international tax treaty rules (Horn 2010) that have been changing recently. The Canadian Barbados Tax Treaty was recently renegotiated making it more difficult for a Barbadian subsidiary of a Canadian Company to not be subject to Canadian tax. The American attitude is interesting as they don’t tend to wait for the negotiation of a tax treaty with another country, they just institute changes. The most recent of those have been rules restricting leverage on what they see as overly levered subsidiaries or sister companies learnt to by other companies in the same group. The key is to understand current treaties and rules and anticipate coming ones.
 5. **High Leverage:** The U.S. has instituted rules to restrict intercompany financing and to reduce the benefit from companies exploiting the double dip outlined previously. Valeant proposed raising third party debt in the American company, which was very doable given that it previously was an independent company which created an interest expense in the U.S. and thereby a tax shield. The American high leverage rules only apply to intercompany debt and not to third party debt. The debt must be non-recourse to the Canadian parent company as then it would be deemed to be intercompany debt. Valeant didn’t need any parent company guarantee as the bulk of the assets were in the U.S. already.
 6. **Permanent establishment rules will also be difficult to manage.** The determination of what the source of income for a specific jurisdiction has taxing power over will be determined by permanent establishment (PE) rules (Horn 2010). If the new CEO of Valiant, who is a U.S. resident, spends a great deal of time in Toronto, as CEO of the newly merged company, when he is also an officer of the U.S. company, working out of the U.S. headquarters, signing contracts in Toronto and making decisions in Toronto, then the U.S. business will have a PE in Canada and subject Canadian earnings to U.S. tax. Conversely, if the new CEO is not an officer of the U.S. company, just of the Canadian parent, but spends most of his time in Orange County, making decisions and signing contracts, then the Canadian business will have a PE in the U.S. subjecting U.S. income to Canadian tax. And finally, if he spends way too much time in Barbados, then the Barbados IP subsidiary will be subject to maybe both Canadian and U.S. tax.
 7. **Intercompany supply prices** shouldn’t be a problem as the Biovail long experience with both third party and intercompany pricing should be used as the best proxy for appropriate third party arm’s length pricing.
 8. **Tax Evasion:** The biggest concern with the Biovail Valeant merger is has the planning for it crossed the line from tax avoidance, which is legal and makes sense for any person or company to investigate opportunities to lessen their tax, to tax evasion. For the entire international tax system to work for Valeant, the parent company needs to be a Canadian company and thereby subject to Canadian, not American, corporate tax rules that tax a company on domestic not global income. To ensure the combined company is a Canadian, which means the prior Biovail shareholders own a majority of the newly merged companies shares, Valeant,

prior to the merger, paid a sizeable one time special dividend to the former Valeant shareholders. This sizeable dividend had the impact of reducing the value of the Valeant share such that combined with the small premium paid to the Biovail shareholders, Biovail shareholders received 50.1% of the newly merged companies shares. The dividend was dependent on the merger being approved and going through and was explicitly not to be paid if the merger was defeated by shareholders or denied by regulators. In several prior merger contemplations none of the tax lawyers or tax accountants I dealt with felt comfortable with a 50.1% majority. They all felt that was just too close to the legal line. I and they all thought that the majority for Biovail needed to be in the 55% or even higher range. Some argued that 51% or 52% might work but would lead to uncomfortable conversations with regulators and would attract unnecessary attention. Now some of the potential American merger partners on the other side of these discussions saw these arguments as self serving negotiating positions since by achieving these higher shares we would benefit Biovail at the cost of the American merger partner. They would argue “If the speed limit is 100, you can go 100, and sometimes 10 more!”

9. **Foreign controlled company:** A Canadian company that has a majority of its shareholders American can be determined to be a Foreign Controlled Company for American tax purposes and thereby subject to American tax. This does not usually happen for large publically-traded companies as determining who on a daily basis owns a company’s share and where they are located is challenging. This is complicated by many Canadian institutions purchasing Canadian shares on American stock exchanges where the liquidity is greater. Some estimates of Biovail’s American ownership were greater than 40% and a majority of its shares traded on the New York Stock Exchange. If any American shareholders were added into the calculation of the 50.1% arithmetic above on the percent of the newly merged company owned by American’s, then the new Company would be a foreign controlled entity. However it seems these two calculations are independent ones. Valeant, the American company, needed to receive less than 50% of the merged company to not be in American control and no previous American resident Biovail shareholders would count in the calculation. This does not make logical sense to me even if it is the law and I worry it could come back to haunt the new Valeant.
10. **Substance over Form:** The special dividend paid to Valeant shareholder prior to the merger has no purpose other than ensuring that they are not majority owners of the combined company. Another way of achieving this would have been to pay a far greater premium to the Biovail Shareholders, which would have been rewarding them for the substantial value in the tax structure they were bringing to the merger. Through the special dividend it was the Valeant shareholders that effectively got the premium. While this structuring technique doesn’t fit the typical descriptions of substance over form (Horn 2010) it certainly looks like something just done for tax purposes with no commercial benefit, both in the achievement of the Canadian majority ownership as well in the leveraging up of the U.S. company, higher than would be allowed with intercompany debt.

The Biovail Valeant merger was approved by regulators and shareholders, the special dividend has been paid, the merger completed, the shares have traded up and the Biovail sign is down on the Canadian office building, and the Biovail Canadian executives are almost all gone, more than 500 lay offs in total. One Senator in California made some noises about the merger and the impact on American tax revenue but seemed to quiet down when it was pointed out that jobs in California would be saved.

Conclusion

International tax structure can be very value creating. Just think how long it would take to increase earnings by 30%, forever. And the impact on the stock value of the company of that higher level of profitability. Even more impactful would be the compounding impact of all the extra cash flow, debt service and leverage capability and the competitive advantage of a one third higher after tax margin, than any other competitor, would garner the Company. In any acquisition the Company could afford to bid one third higher and still make a comparable after tax return, or said better, get a one third better return for the same bid. This is the benefit that Biovail enjoyed because of its well structured and appropriately adhered to international tax structure which brought its tax rate from somewhere around 40% on average internationally, to just 7%.

Biovail enjoyed this advantage for numerous reasons but most importantly because the President of the IP Barbadian Company, lived, worked and made daily decisions in Barbados. Because he was also Chairman of the Board of the Parent Company and also the largest single shareholder, everyone in the Company knew he made the decisions. So managing in compliance with the tax structure took no special management intervention or reminders, it was automatic, he was the boss.

However, I have significant concerns as to if Valeant can continue to exploit this tax advantaged international tax structure. I fear “Mind and Management” are not in Toronto or Bridgetown but in Orange County. I also fear that in trying to mitigate this first concern, the CEO will spend considerable time in both those cities which might actually make matters worse as its determined that the U.S. Company now has a PE in both Canada and Barbados. I also fear that the 50.1% Canadian ownership will be seen as almost tax evasion, not just tax avoidance, as it is too close to the letter of the law, not in concert with the spirit of the law, and may actually be off-side the legal interpretation when American shareholders of Biovail, prior to the merger, are taken into consideration. Most problematic is the proverbial “proof in the pudding” that the Biovail executives demanded and received their change of control termination provisions, when on paper Biovail kept control!

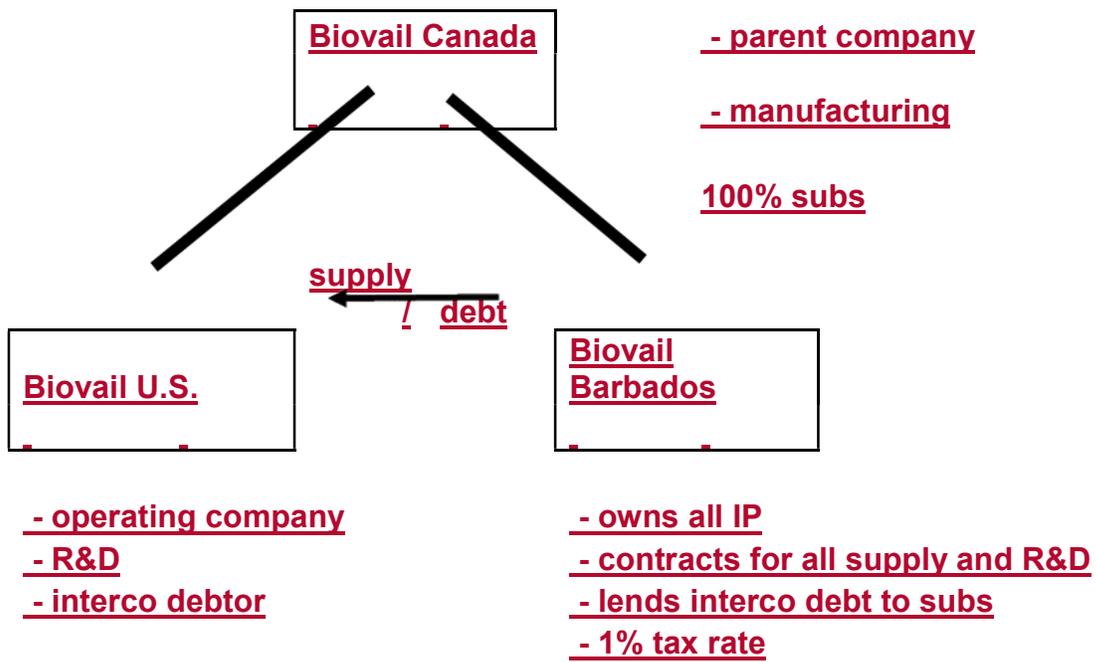
My personal conclusion is that international tax structures, while legal and in accordance with the law, may sometimes go too far and many may not be in accordance with the spirit of the law. If a company is seen to be exploiting tax advantages too much, managing too close to the legal line and not paying its fair share of country corporate tax, it risks losing the confidence of its stakeholders, its investors and losing its effective license to conduct business. I think of several American companies that relocated to

Bermuda to reduce tax and then got pilloried in the marketplace. My mother used to warn me that too much of a good thing always leads to problems. I think an easy solution here would have been for the merger to have been done with a clear majority of shares in the merged company to have been Canadian, such as 55:45 or 60:40.

However, the value impact of the new international tax structure for Valeant is huge proven by the 100% appreciation in the Biovail stock price upon announcement and the continued appreciation since then. A 30% increase in bottom line earnings from tax savings, with no typical post merger integration issues like firing people, closing factories, improving revenue etc. A 30% increase in cash flow. Leveragability allowed the raising of substantial debt to pay a special dividend and to increase leverage against the American assets creating a sizeable tax shield. Going forward, every acquisition is worth 30% more to Valeant than any competitor as they can continue to exploit the international tax structure. For a growth-by-acquisition company, this is the largest competitive advantage they could create.

The Biovail Valeant merger, and the adoption of the Biovail international tax structure created sizable shareholder value, but I think it went too far. What do you think?

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Sources

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