

# Substance over Form and Sham Arguments Rebuffed: Perrigo Co. v. United States

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Corporate planning involving the transfer of activities and property between affiliates under common control is sometimes undertaken with a view to minimizing tax obligations. In those cases, one important consideration is the potential for the transfer to be disregarded for tax purposes under substance over form, sham, or other doctrines. In *Perrigo Co. v. United States*, 136 AFTR 2d 2025-\_\_\_\_, Dkt No. 1:17-CV-737 (D. Ct. Mich.), the court was persuaded that an assignment, from a U.S. pharmaceutical company to a limited liability company owned by a foreign affiliate, of a supply and distribution agreement relating to an over-the-counter drug developed by a third party had economic substance and should be given effect. However, the court also concluded that the income reflected on the U.S. corporate group's returns should be increased through adjustments under Internal Revenue Code section 482.

## Facts in Perrigo

During the tax years at issue (2009-2012), Perrigo was a U.S.-based multinational pharmaceutical company, with its U.S. business being focused predominantly on distribution of over-the-counter products to retailers, for sale as store brand products. In the course of that business, Perrigo researched prescription drugs that seemed likely to be switched to the over-the-counter market. Such a switch would have to be initiated through application to the FDA by the owner or developer of the prescription drug. Upon FDA approval of the switch, other companies could launch equivalent generic products under an FDA-supervised process. One such product identified by Perrigo was omeprazole, sold by AstraZeneca plc under the brand name Prilosec.

After unsuccessful internal efforts by Perrigo to develop a generic equivalent to Prilosec, L. Perrigo Co. (a U.S. affiliate of Perrigo) entered into a supply and distribution agreement on August 15, 2005, with Dexcel Pharma, a generic pharmaceutical company based in Israel (Dexcel agreement). Dexcel had no significant presence in the United States. Dexcel undertook to develop an omeprazole product for sale in the U.S. market, with Perrigo to provide funding for product development and patent litigation to defend against anticipated patent infringement claims by AstraZeneca.

Under the Dexcel agreement, Dexcel took the lead in developing the product and obtaining FDA approval. The FDA provided tentative approval on June 14, 2007, subject to the outcome of a lawsuit filed by AstraZeneca against Dexcel on May 30, 2006. That litigation was settled by an

agreement between AstraZeneca and Dexcel on September 21, 2007. The FDA granted final approval of Dexcel's product on December 4, 2007, and sales of the generic drug in the United States commenced in February 2008.

Perrigo had begun to expand into international markets in the 1990's. By 2006, it was doing business in the U.K., Mexico, Israel, India, and China. Perrigo engaged a large accounting firm in 2005 for advice regarding cross-border transfer pricing matters and planning opportunities to achieve a more tax-efficient structure. Under a plan developed by the accounting firm, Perrigo formed in June 2006 a U.K. partnership ("Finco"), to act as an in-house bank for Perrigo's non-U.S. affiliates, and then an Israeli subsidiary of Finco, PITLP, that elected to be classified as a corporation for U.S. tax purposes effective October 2006.

A limited liability company based in Delaware of which PITLP was the sole member was formed on November 29, 2006 (the LLC). The LLC acquired the Dexcel agreement by assignment from L. Perrigo Co. and entered into another contract with a different Israeli drug company for distribution and sale of a different generic drug. The assignment was made effective as of the date of formation of the LLC, which was disregarded as separate from PITLP for U.S. tax purposes, and the LLC then engaged L. Perrigo Co. to distribute the Dexcel product in the United States. L. Perrigo Co. received as consideration for this assignment a promissory note of the LLC for \$877,832. That amount was the estimated value of the assignor's interest in the Dexcel agreement, determined based on an analysis by the accounting firm.

The LLC initially had no assets other than the Dexcel agreement and the related distribution agreement with L. Perrigo Co., and no employees. Finco lent funds to the LLC from 2006 to 2009 to cover the LLC's expenses, and Perrigo provided to Dexcel, in connection with an amendment of the Dexcel agreement effective as of the date of its assignment to the LLC, a guarantee of the performance by the LLC of its obligations under the Dexcel agreement. The promissory note of the LLC to L. Perrigo Co. was ultimately paid with funds contributed by Finco to PITLP and by PITLP to the LLC in 2009.

The omeprazole product proved to be highly successful, and Perrigo realized \$297.5 million in pre-tax profits from the product during the tax years at issue.

The IRS audited Perrigo for the years 2007 through 2012, but did not propose any adjustments for 2007 and 2008 with respect to the assignment. Those earlier years were closed (by the statute of limitations) at the time of trial. For 2009 through 2012, the IRS proposed various adjustments relating to the omeprazole business. The rationale of the adjustments was that the assignment of the Dexcel agreement to the LLC should be disregarded under various substance over form and other tax common law doctrines. Alternatively, and in the event the assignment was determined to be effective for tax purposes, the IRS reallocated almost all of the income reported as earned by the LLC for those years to Perrigo by means of Code section 482 adjustments. Perrigo paid the tax, interest, and penalties asserted based on the application by the IRS of common law sham and substance over form doctrines, filed claims for refund, and ultimately brought suit.

The IRS determination apparently also reflected the conclusion by the government that Perrigo could not deduct currently and was required to capitalize legal fees incurred in connection with the patent litigation with AstraZeneca. That issue was resolved by the district court in Perrigo's favor in a manner consistent with the analysis in *Mylan, Inc. v. Commissioner*, 76 F.4th 230 (3d Cir. 2023), and *Actavis Laboratories FL, Inc. v. United States*, 131 F.4th 1345 (Fed. Cir. 2025), and is not further discussed below.

## Analysis

The government's arguments against giving effect to the assignment of the Dexcel agreement apparently included that the assignment lacked economic substance, that it did not change the identity of the person with control over the income and had no purpose apart from tax avoidance,

that the LLC should be disregarded as a sham entity, and that the assignment of income doctrine required that the intercompany transactions that shifted income to PITLP (through the LLC, its subsidiary) should be disregarded.

The court asserted that it "need not go line by line through the various doctrines" and concluded that none was applicable. On the basis of cases cited in the opinion, the court observed that taxpayers are entitled to structure their affairs, including transactions with affiliates, with a view to minimization of tax obligations. The court concluded that there was significant uncertainty at the time of the assignment as to whether the product could be brought to market and, assuming that it could, whether the product could be launched with the economic success that was ultimately achieved. The court also concluded that there were credible business rationales for the assignment, including the recognition of geopolitical risk in relying on a producer (Dexcel) located in Israel and a desire to have the business risks associated with the distribution of the product borne by an entity (PITLP) in that same jurisdiction.

The court also noted that Finco, PITLP, and the LLC implemented the offshore structure through the execution of appropriate documentation for assignment of the Dexcel agreement to the LLC and sale and distribution of the product in the U.S. by L. Perrigo Co. and recorded payments believed to be appropriate for the assignment of the Dexcel agreement and for distribution.

It is not clear from the opinion that the court fully analyzed the potential for application of assignment of income principles to negate the effectiveness of assignment of the Dexcel agreement. However, the extent of the uncertainties at the time of that assignment as to the outlook for profitable exploitation of the product and the additional work needed to be performed after the assignment to bring the product to market appear to provide substantial support for the conclusion that such an application of assignment of income principles was not appropriate.

In respect of section 482, Perrigo apparently chose not to contest the government's assertion that the value assigned to the assignment, less than \$1 million, was too low. Nevertheless, Perrigo was successful in its argument that the court should apply a different valuation methodology, presented by Perrigo at trial, that resulted in income for the Perrigo U.S. group that, although significantly greater than what was initially reported, was much less than what the result would have been under the government's section 482 allocation methodology.

The government argued in post-trial briefing that, taking into account that Perrigo had relied in its initial claim for refund upon a cost-plus-markup allocation methodology, the "variance rule" caused the court to lack subject matter jurisdiction over the refund claim as presented by Perrigo at trial based on a different (discounted cash flow) allocation methodology. The court disagreed on two grounds.

The court concluded that by not raising the subject matter jurisdiction argument earlier in a meaningful manner – such as, for example, through a pretrial motion in limine -- the government had waived or forfeited the ability to pursue it later.

The court further observed, citing *McDonnell v. United States* (180 F.3d 721 (6<sup>th</sup> Cir. 1999)), that the purpose of the variance rule is to require that an administrative claim for refund set forth in detail the ground on which a credit or refund is claimed and facts sufficient to apprise the Commissioner of the basis for the claim. By doing so, a claim prevents surprise to the government and provides the government adequate notice of the refund claim so that it can be appropriately evaluated at the administrative level. Because Perrigo's intent to challenge the government's section 482 allocation adjustments as arbitrary and capricious was made clear by the refund claim filed with the IRS, there was no surprise to the government in Perrigo's challenging those allocations at trial by presenting a different pricing model. Accordingly, the court's consideration and ultimate approval (subject to certain tweaks) of the allocation approach presented by Perrigo at trial was not precluded by the variance rule.

## Observations

The Perrigo opinion indicates that the tax common law doctrines relied upon by the government, though very important to the tax law, are also characterized by vagueness and uncertainty in application. There is a lack of clarity as to the scope of the economic substance doctrine in particular, both as developed by cases and as "clarified" through its codification in Code section 7701(o). Taking these circumstances into account, it is not surprising that the application of that doctrine and other common law doctrines at issue in this case continues to be the subject to frequent contention between taxpayers and the government, as illustrated by Perrigo. The decision itself should be welcomed by taxpayers as an indication that transactions between affiliates should be respected for tax purposes, even when apparently executed with a view to tax minimization, so long as those transactions are also motivated by a business purpose and are appropriately documented and implemented.

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