Medtronic corporate inversion deal seeks lower rates & avoidance of repatriation rules

Shortly after several key lawmakers introduced legislation that would curb foreign inversions, U.S. medical device maker Medtronic announced that it is taking over competitor Covidien and moving its tax residence to Ireland. Although this deal bears many similarities to the highly publicized Pfizer takeover attempt last month, Medtronic's main tax motivation sets the deal apart in that its stated primary motivation is access to overseas cash as opposed to a significantly lower tax rate.

Background on repatriation. U.S. corporations are taxed on a worldwide basis-meaning that they are generally taxable on income from outside the U.S. just as they are on income from inside the U.S. (Code Sec. 862) Thus, a U.S. corporation that receives foreign-source income from a low-tax country theoretically shouldn't have any tax advantage by virtue of the low rates because all income, whether U.S. or foreign source, is taxed at the same U.S. rate.

However, a foreign corporation with U.S. owners (for example, a foreign subsidiary) can often earn and accumulate certain types of income at tax rates below the U.S. rate. This is because, subject to certain limitations, the foreign-source income is insulated from U.S. tax until it is actually brought back to the U.S. (i.e., repatriated and distributed to the U.S. owners), at which point it is income to the U.S. owners. Thus, there currently exists an opportunity to indefinitely defer U.S. tax on foreign-earned income, and because the U.S. provides a credit for foreign taxes paid, there is little to no cost to the corporation.

In an effort to stimulate the U.S. economy by triggering the repatriation of foreign earnings that otherwise likely would have remained abroad, Congress enacted Code Sec. 965. This provision allowed U.S. companies to repatriate earnings from their foreign subsidiaries at a reduced tax rate in 2004 if several conditions and restrictions were satisfied. Specifically, under Code Sec. 965, U.S. companies could elect, for one tax year, an 85% dividends received deduction for eligible dividends from their foreign subsidiaries.

There have been numerous proposals for, and studies regarding the effectiveness of, subsequent repatriation holidays. These proposals have recently picked up some traction, most recently in the context of providing much needed funding for the federal Highway Trust Fund

Background on corporate inversions. In corporate inversions (also called "expatriation transactions"), a U.S. corporation (typically the parent of an affiliated group) becomes a wholly owned subsidiary of a foreign corporation (through a merger into the foreign corporation's U.S. subsidiary) or transfers its assets to the foreign corporation. If the transaction is respected, U.S. tax can be avoided on foreign operations and distributions to the foreign parent, and there are opportunities to reduce income from U.S. operations by payments of fees, interest, and royalties to the foreign entity. Inversion transactions are governed by Code Sec. 7874.

Under Code Sec. 7874, a foreign corporation is treated as a U.S. corporation for all purposes of the Code where, under a plan or series of related transactions:

> (1) the foreign corporation completes, after Mar. 4, 2003, the direct or indirect acquisition of substantially all the properties held directly or indirectly by a U.S. corporation;

dm-t
decoria · maichel · teague
P | 509.535.3503
F | 509.535.9391
7307 N. Division, Suite 222
Spokane, WA 99208
www.dm-t.com

(2) shareholders of the U.S. corporation obtain 80% or more of the foreign corporation's stock (by vote or value) by reason of holding their U.S. shares; and

(3) the foreign corporation and corporations connected to it by a 50% chain of ownership (the "expanded affiliated group") don't have substantial business activities in the foreign corporation's country of incorporation or organization when compared to the total business activities of the group. (Code Sec. 7874(b); Code Sec. 7874(a)(2))

The same rule applies where a domestic partnership transfers substantially all the properties of a trade or business to a foreign corporation and the same stock ownership and absence of business activities tests (i.e., (2) and (3), above) are met. (Code Sec. 7874(b))

However, where the inversion transaction satisfies the above three tests, except that the domestic corporation's shareholders (or a domestic partnership's partners) obtain at least 60% but less than 80% of the foreign corporation's stock, the foreign corporation is a "surrogate foreign corporation" respected as a foreign corporation. (Code Sec. 7874(a)(2)) However, inversion gain recognized by the "expatriated entity" (i.e., the U.S. transferor and "related" persons; see below) in the expatriation transaction from the transfer of stock or other property, or from licenses, is taxable in full with no reduction or offset for losses, credits or other tax attributes. Also, for ten years after the expatriation transaction is completed, the expatriated entity's gain on transfers or licenses to the surrogate foreign corporation or to a "foreign related person" is taxable without offset (with an exception for inventory and like property). (Code Sec. 7874(a)(1); Code Sec. 7874(d))

An expatriated entity includes the U.S. corporation or partnership that is the transferor (or is treated as the transferor where stock or interests are transferred) and any person related (under Code Sec. 267(b) or Code Sec. 707(b)(1)) to the U.S. entity. (Code Sec. 7874(a)(2)(A)) The tax on inversion gain is to be at the maximum corporate tax rates for a corporation expatriation and at the maximum rate applicable to a partner for a partnership expatriation.

Medtronic facts. Approximately one month after a number of prominent lawmakers proposed legislation that would make it more difficult for a transaction to qualify for the tax benefits of an inversion, Medtronic announced its acquisition for $42.9 billion of Covidien, a "global healthcare products company." According to Covidien's website, it has over 38,000 employees worldwide, "nearly two-thirds of whom work in 41 manufacturing facilities located in 17 countries," and 50% of its sales are derived from outside the U.S.

Covidien's principal executive office is located in Ireland, but it maintains a U.S. headquarters in Massachusetts. It has been incorporated in Ireland since 2009. According to a Covidien press release, the combined company will have its principal executive offices in Ireland, "where both companies have a longstanding presence." Medtronic will, however, continue to have its operational headquarters in Minneapolis.

The press release stated that the transaction "is expected to be taxable, for U.S. federal income tax purposes, to shareholders of both Medtronic and Covidien." It also emphasized that the combined company would commit "$10 billion in technology investments over the next 10 years in areas such as early stage venture capital investments, acquisitions and R&D in the U.S., above and beyond Medtronic's and Covidien's existing plans."

dm-t
decoria • maichel • teague
P | 509.535.3503
F | 509.535.9391
7307 N. Division, Suite 222
Spokane, WA 99208
www.dm-t.com

According to reports, Medtronic is currently subject to an effective tax rate of somewhere in the 16% to 18% range. Although this rate is somewhat higher than the 12.5% corporate tax rate in Ireland, the entity indicated that its prime tax-related motivating factor of the transaction isn't the lower rates, but rather the ability to access and use overseas cash without having to repatriate it to the U.S.

The Medtronic-Covidien merger agreement specifies that either company can cancel the transaction in the event of a law change on the tax treatment of inversions.

Political reaction. Shortly after the Medtronic deal was announced, Senate Finance Committee Chairman Ron Wyden (D-OR) issued the following statement on corporate inversions: "America should not be part of a race to the bottom. It's clear that America must establish a more efficient and competitive corporate tax rate. However, any company who is paying U.S. taxes today should expect to pay U.S. taxes for years to come regardless of how they try to game the system."

House Ways and Means Committee Ranking Member Sander Levin (D-MI) met with representatives of both companies and said that "[t]hey set forth the benefits for their business operations of combining their resources, irrespective of taxation. At the same time, Medtronic's reincorporating in Ireland would enable the combined company to lower its U.S. taxes. Congress owes it to the American people to inquire seriously into each and every acquisition given the dramatic increase in the number of corporate inversions in recent years, while Congress undertakes the necessary and serious effort of tax reform on a truly bipartisan basis."

The bills that were advanced when the Pfizer deal was unfolding, including one by Rep. Levin have thus far failed to gain traction, perhaps due to the fact that the Pfizer deal didn't ultimately go through.

> **RIA observation:** The timing of the Medtronic announcement seems to indicate that companies don't expect these bills to go anywhere. The prevailing notion in Congress seems to be that corporate inversions are a symptom of a broken, uncompetitive tax system, and that the system should be reformed so that the U.S. is a more attractive place to do business. Thus, inversions are perhaps more likely to be addressed in the context of overall tax reform (a lengthy proposition) rather than in a one-off bill.

Similarly, proposals for another repatriation holiday have failed to advance, while reports indicate that U.S. companies have as much as $2 trillion parked overseas. But while these proposals haven't progressed yet, their ultimate fate, as well as that of corporate tax reform, still remains to be seen.

dm-t
decoria • maichel • teague
P | 509.535.3503
F | 509.535.9391
7307 N. Division, Suite 222
Spokane, WA 99208
www.dm-t.com