Our thanks to Ken for this contribution.

In This Issue:
- So, What Are “Inversions”?
- A Look at Minnesota’s Real Personal Income Trends
- MCFE Annual Meeting to Examine Minnesota Tax Competitiveness

So, What Are “Inversions”?  

Editors Note: With all the attention being given to Medtronic’s purchase of Covidien specifically and the role tax considerations play in these types of business transactions generally, we asked MCFE board member and international tax expert Ken Levinson of Faegre Baker Daniels to provide a closer look at the realities, issues, and misperceptions surrounding this exceptionally complicated topic. Our thanks to Ken for this contribution.

Inversions Under U.S. Tax Law

In its simplest terms, an inversion is a situation in which a U.S. company is acquired in form by a foreign company, but the former owners of the acquired U.S. company end up with control, by vote or value, of the “acquiring” foreign corporation. There are, in fact, two separate sets of “inversion” rules: one when at least 60%, and one where at least 80% of the stock of the acquiring foreign corporation is controlled by the former owners of the U.S. “acquired” company afterwards. These rules apply whether the U.S. company is directly acquired by the foreign company or whether both entities (the U.S. and the foreign party) are technically acquired by a newly-created foreign “parent” company for the group. If the acquired U.S. company shareholders own at least 60% of the acquiring foreign company, the U.S. company is said to be an “expatriated entity” and must pay tax on its “inversion gain” and is subject to various additional U.S. tax issues and limitations as well. If, however, the acquired U.S. company’s shareholders end up with at least 80% of the acquiring foreign company, then the foreign company is considered to be a “domestic” company for U.S. tax purposes and is said to be an “inverted corporation.” Needless to say, this latter recharacterization of the foreign acquiring company as a “U.S.” company for U.S. tax purposes is a particularly unexpected and expensive outcome. (It’s one of the reasons that neither the AstraZeneca or Covidien structures involved ownership of the acquired U.S. companies having 80% or more of the acquired entity or new group parent.)

In general, under either the 60% or 80% situations, the tests (aside from the actual amount of vote or value of stock acquired by the former owners of the acquired U.S. corporation) for applicability of the statute are that the foreign company must acquire “substantially all” of the properties (a) held directly or indirectly by the U.S. company or (b) constituting a trade or business of the U.S. company, and, after the acquisition, the expanded group must not have “substantial business activities” in the foreign country in which the acquiring foreign corporation was created or organized when compared to the total “business activities” of the expanded group.

The Rest of the Story: Five Key Considerations

The federal tax rules and regulations surrounding inversions have substantial complexity to them. If one believes the outrage and calls for corrective action coming from Washington, there is more complexity to...
First, the notion that existing U.S. corporations are immediately reducing their direct, current federal tax burden through these transactions is drastically overstated. Public reporting of these inversion deals implies, wrongfully, that once the deal closes, the U.S. company’s tax rate will immediately fall to the tax rate of the jurisdiction of the foreign parent company. In the Medtronic/Covidien arrangement, much is made of the fact that Medtronic’s asserted effective tax rate was 18.4% last year, but that the Irish corporate tax rate (where the new group parent company will be domiciled) is 12.5%. The truth is that Medtronic will still be a U.S. corporation and will still be subject to U.S. taxation at our regular rates on its income (and that of its subsidiaries under our “controlled foreign corporation” (CFC) rules) after the transaction closes. The new group, overall, may be able to re-direct new income-generating activities or expansion loans to subsidiaries or affiliates in lower tax rate jurisdictions (transfer pricing considerations aside). However that could be done lawfully now under U.S. tax law by the acquired U.S. group.

Further, the discussions in inversions about changing “domicile” or determining the locus of “management and control” of the overall structure are NOT U.S. tax concepts; they relate, instead, to treatment of the foreign acquiring company (or the newly-created parent) under foreign law, such as whether that acquiring/parent company itself can qualify for the 12.5% corporate tax rate in Ireland. The part of the corporate group chain represented by the U.S. company chain (including its subsidiaries), that is, the Medtronic of the world, remains a “regular” U.S. corporation subject to all the same types of U.S. tax filing and tax payment obligations just as they had before the acquisition.6

Second, the rules and requirements concerning “post-inversion” treatment of foreign earned income are no less rigorous. The reasons why Medtronic and many other U.S. multinationals have accumulated so much “excess” cash overseas, without having to pay U.S. tax on it currently, are that: (1) they have avoided the deemed taxation rules under “Subpart F” of U.S. tax law applicable to CFCs7, and (2) they have established for book purposes that the funds are “permanently reinvested” abroad. Notwithstanding that the acquisition proceeds, and a foreign company ends up as the parent (of both the U.S. company/chain and the “acquiring” foreign chain), these two rules must continue to be met for U.S. tax and book consequences after the acquisition by the “U.S. chain” (the acquired U.S. company and its owned foreign subsidiaries), or there will be future adverse book and tax consequences in the U.S. despite the planning that went into the acquisition in the first place.

Third, there are residual U.S. tax obligations that almost never get publicized in the press – and sometimes are not appreciated by the actual players themselves. The amount of the “inversion gain” triggered in the 60% continuity of interest case constitutes a minimum amount of taxable income that must be reported by the expatriated U.S. entity and by any applicable “related persons” for each of the 10 taxable years or portions thereof following the acquisition. The amount of inversion gain is based on income or gain recognized by reason of the transfer of stock or other properties of the expatriated entity, AND income during the succeeding 10 years “by reason of a license or any property” by an expatriated entity which property was part of the acquisition or for a license after the acquisition if the “transfer or license is to a foreign related person.”

Fourth, certain measures have already been established to tighten exceptions to some inversion transactions. The “business activities” test, which is a key U.S. statutory exception to whether the inversion rules apply at all, has recently been tightened in temporary regulations. Now, there are four separate elements, the “25% requirements,” all of which must be met, in order for the exception to apply (and hence no inversion to occur):

1. The number of the employees in the acquiring company’s country of incorporation (“Country X”) must be at least 25% of the total number of the expanded group employees on the date the acquisition is completed;
2. The employee compensation of the employees in Country X must be at least 25% of total compensation of all the expanded group employees for the one year period prior to and ending on the date the acquisition was completed;
3. The value of the assets located in Country X must be at least 25% of the total value of all the expanded group assets on the date the acquisition is completed; and
4. The group’s income derived from Country X must be at least 25% of the total group’s income for the one year period prior to and ending on the date the acquisition is completed.8

Fifth, shareholders in the acquired U.S. company involved in the inversion transaction may have considerable personal tax exposure. What happens to the shareholders of the acquired U.S. corporation, the ones who end up with at least 60% (or 80%) of the acquiring foreign company? The reader may recall that the press releases relating to both the Pfizer/Astra Zeneca and Medtronic/Covidien transactions made veiled references to the fact that the proposed transactions were “taxable” to the shareholders. Those acquisitions/inversions would be taxable because they were, for U.S. tax purposes, considered taxable exchanges of stock (and perhaps cash) received from the acquiring company (or new foreign parent) in return for exchanging shares in the acquired U.S. company, or perhaps taxable because the outbound merger structure used

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6 It may well be, over time, that the acquired U.S. company per se has less U.S. taxable income to report in the future because, for example, the new foreign parent determines to utilize excess cash abroad in the “U.S. chain” to bolster the activities and expansion of the newly-affiliated foreign chain of companies, although for example interest income earned by a U.S. owned or controlled CFC lending subsidiary may well constitute “foreign personal holding company income” (FPHCI) reportable on a deemed taxation basis in the U.S. Alternatively, the cash held abroad in a foreign subsidiary of the acquired U.S. chain could be used to acquire new businesses or subsidiaries abroad, potentially even from the newly-affiliated foreign chain – subject to favorable tax consequences to the “seller” thereof. Also, the cash abroad might be used to acquire or develop new technology that the expanded group can use, even though the requirements to utilize an “arm’s length” purchase or licensing arrangement will apply (as will the potential to trigger FPHCI to the foreign licensor company unless the “active trade or business” exception applies). Lastly, the “excess cash” abroad could be used to loan funds from the affiliate foreign chain for use in the U.S. (as long as the tax consequences of IRC § 956 aren’t triggered).

7 IRC §§ 951-964. See also the PFIC rules in IRC §§ 1291-1298, for another type of foreign entity that may trigger deemed income to U.S. owners.

8 Temp. Treas. Reg. §1.7874-3T(b).
to affect the acquisition was not tax-free under U.S. tax law (such as pursuant to IRC § 367), and hence taxable to those U.S. persons nonetheless.

Further, the stock in the acquiring foreign corporation must be acquired by the former owners of the U.S. company “by reason of holding stock in the [acquired] domestic corporation.” IRC § 7874(a)(2)(B)(i). What if common investors hold stock in both the actual acquiring foreign corporation and the acquired U.S. corporation beforehand? Even more interesting, what if the ownership of each such entity was the same before and after the transaction? It should be recognized that the distinction referenced in the “by reason of…” language will not avail owners of the U.S. company in the situation where a new foreign group parent company is formed to technically acquire the two constituent “chains” of companies, one being the U.S. group and the other being the foreign group, since by definition no one owned any stock in the new parent company until that entity was formed and the inversion acquisition transaction thereafter closed. Calculating the 60% or 80% thresholds, therefore, can get tricky, though the continuity percentages cannot be diluted by issuing stock in a public offering “related to” the acquisition.  

A More Complex Decision and Much More Complicated Narrative

So, putting the primary points together, the shareholders of the acquired U.S. company have a significant taxable event themselves (hopefully receiving enough cash as part of their consideration to pay that tax). The acquired U.S. company (and any “related persons”) has to report a minimum amount of taxable income (equal to the “inversion gain”) for tax years starting with the year of the acquisition and extending as long as ten years thereafter if the 60% (but not the 80%) continuity threshold is met. And, the acquired U.S. company (and its chain of sub-

The announced justifications for these types of acquisitions by foreign companies is often for business fit, or expansion opportunities, or access to technology, etc., but the press reports all note that the combined entities will save taxes – U.S. taxes. While discussion of some of those opportunities is included here, suffice it to say that the present value of the assumed future tax savings (and additional net income) is presumably sufficiently greater than the present tax cost to the acquired company and its shareholders (as well as the additional administration and implementation costs) to justify the respective Boards of Directors urging shareholders to proceed with the acquisition (and to obtain their votes of approval).  

— Ken Levinson, Partner Faegre Baker Daniels, LLP

**Table 1: 2012 Real Per Capita Personal Income, by State**

<table>
<thead>
<tr>
<th>State</th>
<th>Amount</th>
<th>Rank</th>
<th>State</th>
<th>Amount</th>
<th>Rank</th>
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<td>Nebraska</td>
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<td>38,665</td>
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**A Look at Minnesota’s Real Personal Income Trends**

Newly available data from the U.S. Bureau of Economic Analysis offers a different perspective on state personal income – personal income adjusted for purchasing power. A look at Minnesota’s current status, recent trends, and why it matters.

Debates about policies to support economic growth inevitably include arguments about the best way to assess economic performance. There are a myriad of possible indicators to consider, but one on everyone’s list is “personal income”. A broad measure designed to capture income associated with both production activities and transfer payments, personal income includes cash income such as wages, salaries, and Social Security payments as well as non-cash income like employers’ contributions for insurance benefits and the value of government-sponsored medical benefits provided to individuals. As a result, it provides perspective on...
both overall economic activity as well as general household welfare.

Now for the first time, the U.S. Bureau of Economic Analysis (BEA) – the home of personal income statistics – is providing adjusted personal income data that accounts for price differences across the nation. Because this “real” personal income factors in cost-of-living differences, it essentially provides comparisons of purchasing power between states. BEA bases these new estimates on regional price parities (RPPs) and on its national Personal Consumption Expenditure (PCE) price index. RPPs measure geographic differences in the price levels of consumption goods and services relative to the national average, and the PCE price index measures national price changes over time. Using the RPPs in combination with the PCE price index allows for comparisons of the purchasing power of personal income across regions and over time.

### Some Things Remain the Same

Even before adjusting for price disparities, BEA’s personal income data confirms Minnesota’s well-deserved reputation as a high-income state; a reputation that has grown more deserving over the last twenty years. In 1993, Minnesota’s $21,770 in per capita personal income ranked 19th in the nation. As of 2013, that figure had risen to $47,856 placing us 11th nationally, trailing only a handful of east coast states and small population, energy development-intensive states like Alaska, North Dakota, and Wyoming. Minnesota’s per capita personal income growth of $26,086 is the 10th highest amount nationally over this twenty-year period.

At first glance, Minnesota continues to hold its own and then some when adjusting per capita incomes for purchasing power. As Table 1 highlights, Minnesota’s real per capita personal income of $45,494 for 2012 (the most current year) is 10th in the nation – 10.3% above the 50 state average. Other states, however, are impacted by the adjustment to a much greater degree. The pricey cost of living causes California to plummet from 12th in nominal per capita income in 2012 to 33rd in the nation when adjusting for purchasing power. Conversely, a little less income goes a lot farther among our neighbors to the south. Iowa leaptfrogs Minnesota going from 23rd to 7th on a real per capita income basis while Nebraska jumps from 19th to 6th nationally.

### Trend analysis

Trend analysis, however, communicates a slightly different story as real per capita personal income growth over the past several years places Minnesota as a middling performer. Table 2 presents the changes from 2008-2012 (all the years for which the BEA provides data) on both a dollar and percentage basis. With real personal income growth of $746 per capita (1.7%) over this period, Minnesota ranks a much more modest 27th in the nation, $100 below the 50 state median growth rate of $846 per capita (2.0%). Interestingly, Minnesota ranks lower than all bordering states. Oil saturated North Dakota led the nation with an astounding per capita income growth of $10,781 or 23.1% over this period.
MCFE Annual Meeting to Examine Minnesota Tax Competitiveness

What influences state tax competitiveness the most: tax system design or the level of tax burden? In the era of single sales apportionment, does the state corporate income tax still have significant competitiveness implications? Is individual income taxation an important competitiveness issue? What should Minnesota be pursuing with respect to income, sales, and property tax policy to improve its competitive standing?

Be sure to reserve Wednesday, October 8th on your calendar today to join us at the St. Paul River Centre for our 88th Annual Meeting of Members as we discuss these and many other questions surrounding the topic of state tax system competitiveness in the 21st century. We have assembled a true all-star lineup of national and state tax experts to discuss and debate this topic. We are especially pleased to have as our annual meeting luncheon speaker Richard Davis, President, Chairman, and CEO of U.S. Bancorp who will offer his distinguished and unique perspective on Minnesota competitiveness and our competitive challenges.

Immediately preceding our policy forum, our annual meeting will begin with a morning business session. Please join us for this session as well since it is an excellent opportunity to network with other members and to become more familiar with the activities, initiatives, accomplishments your membership support has made possible.

As always, individuals who are not members of the MCFE are more than welcome to join us and register for the policy portion of the conference and the conference luncheon. So bring a friend or colleague and introduce them to the MCFE.

Look for additional information from us on the event including registration details in the very near future. Annual meeting information will also be available on our website www.fiscalexcellence.org.

We hope to see you on October 8!

From The Director

Complexity versus simplicity is never a fair fight, and this was evident in a lot of the recent commentary surrounding Medtronic’s decision to purchase Covidien and locate the new combined entity in Ireland. In the battle for public opinion between the competing narratives of “it’s a complicated business decision demonstrating the continued relevance of taxation to the issue of business competitiveness, and the profound need for reform of corporate income taxation in this country” versus “greedy, self-interested corporate tax dodge” the latter will likely win every time.

Yet people across the political spectrum are acknowledging that the corporate income tax has become increasingly anachronistic in today’s global economy and is in serious trouble as a revenue source. A recent paper entitled, “Major Surgery Needed: A Call for Structural Reform of the U.S Corporate Income Tax” co-authored by senior tax scholars from the American Enterprise Institute and the Urban Institute takes a closer look at these realities. When representatives from these organizations can agree that a problem exists and needs attention, it deserves to be taken very seriously.

If anyone wants to go beyond political platitudes and clichés surrounding discussion of corporate taxation and understand what the problems really are, this paper is a valuable read. It examines the rationale for taxing corporate income in the first place; the current rules in place for doing so; the extraordinary challenges facing the tax; and, above all, the many reasons why different proposed unilateral “fixes” within the United States will likely fail to provide a real lasting solution. The essence: absent real international cooperation on establishing uniform and rational rules for defining corporate residence and income, major problems with the tax from both a competitiveness and revenue raising standpoint will persist.

Recent international developments suggest at least some progress is being made on these issues. However, past experience suggests a “believe it when you see it” attitude is warranted. Look at the United States’ own internal efforts on such issues as reining in economic development incentives and ending the economic war between the states, lumbering streamlined sales tax agreements, and related issues relevant to leveling playing fields in interstate commerce. As our own national evidence suggests, collective action and cooperation faces an uphill struggle in the “prisoner’s dilemma” world of economic development. This is why the authors also discuss and endorse a truly radical structural solution – replacing the corporate income tax with a shareholder level accrual-based tax in which shareholder dividends and capital gains – including unrealized gains – would be taxed at ordinary income rates. Of course, overcoming the design challenges and political obstacles of that approach is no less daunting.

In the meantime, we are likely to see a lot more headlines about similar corporate decisions in response to a tax whose conceptual difficulties are exceeded by its practical challenges. The authors note, “even before considering international implications, the corporate income tax is a problematic tax because it features multiple distortions that serves little coherent policy purpose.” Perhaps nothing captures the truth of that statement than the seeming intractability of attempting to fix it.

— M. H.
capita personal income growth of $10,781 (23.1%), with South Dakota and Iowa also in the national top ten in growth on a dollar basis. Wisconsin, our demographic doppelganger, ranks 21st with real personal income growth of $997 per capita.

Looking nationally, it’s difficult to discern any political or ideological rhyme or reason behind state performance over these five years. High tax peers have both outperformed us (Massachusetts) and drastically underperformed, too (New Jersey, California). Real personal income grew much faster in a state policymakers here routinely invoke as the antithesis of what we want to become (Mississippi) and in a state which has recently been encouraged in a report to mimic all our policies (Michigan). At the same time, some poster children for low tax environments (Florida and Utah) saw real personal income declines. Both the most progressive and most regressive tax system states placed 3 members among the nation’s ten worst performers.12

Is this trend cause for concern? That’s debatable because whatever influence state tax and fiscal policy may have had over five years – and especially over this five-year period – is likely swamped by bigger demographic and economic forces unique to individual states. Economists have found that certain states tend to lead and lag recessions and that the underlying industrial structure plays an especially important role. Minnesota’s recent performance may simply be a function of the fact that our more diverse and less volatile economy simply did not sink as low as other states. In fact, for the most recent year-on-year information available (2011-2012), Minnesota’s real per capita personal income growth ranked 14th and was basically equal to the national average change. It’s an example of how the popular argument of needing to emulate state policies based on simple measures of economic performance is fraught with potential complications.

So Why Care?

“For the first time, Americans looking to move or take a job anywhere in the country can compare inflation-adjusted incomes across states and metropolitan areas to better understand how their personal income may be affected by a job change or move. Businesses considering relocating or establishing new plants also now have a comprehensive and consistent measure of differences in the cost of living and the purchasing power of consumers nationwide.”

Nevertheless, as this quote from U.S. Secretary of Commerce Penny Pritzker accompanying the release of this data suggests, real personal income growth has economic and competitiveness implications. The metric is worth keeping a close eye for this reason: economic demographers have found some of the best economic growth and growth prospects lie in places that are relatively affordable. In such places, paychecks go further while at the same time businesses have access to a stronger consumer base and a better value proposition from the labor force. More personal income is good. More real personal income is better.

All this suggests that “affordability” should be at the top of the list of outcomes policymakers should strive for when deciding which economic and growth policies to emulate. Included in this focus should be the affordability of public services. BEA regional price disparities include the impact of sales taxes, fees, and property taxes associated with rental values but exclude other forms of taxation including income taxes and the goods and services supported by them. A place where personal income goes the furthest is positioned for economic success. A place where both personal income and tax dollars go the furthest is likely unbeatable.


12 2013 MN Department of Revenue Tax Incidence Study, p. 62