

The Corporate Inversion of Medtronic Inc. and Covidien PLC

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Abstract

This case deals with the very topical subject of tax inversions. In the case, students are initially introduced to the concept of the tax inversion, the process by which a United States company reincorporates in another country, often as part of a corporate acquisition. Case participants (students) will learn one of the goals of such a corporate maneuver is to reduce the company's income tax burden. In the first section of the case, students are led through the actual structuring of the 2014 Medtronic/Covidien inversion. They will initially be challenged to explain the inversion process, its purported benefits, and the likely tax treatment of the companies and shareholders. The student objectives are threefold in section two of the case. First, the students are charged with calculating Medtronic's effective income tax rates before and after the inversion in an attempt to prove a benefit from a decrease in the effective tax rate. Second, case participants will be immersed in the non-GAAP measures the company uses to explain inversion tax benefits. Finally, students are tasked with preparing a pro-forma quantification of tax savings for the Medtronic/Covidien inversion and developing an argument as to whether it is actually beneficial and sustainable.

Case Description

This case is based upon Medtronic Inc.'s acquisition of Covidien PLC. This particular transaction shows case participants the mechanics of an acquisition structured as a corporate tax inversion. The case has two parts; the first part leads students through the structure of a corporate tax inversion and outlines the potential benefits of corporate tax inversions. The case also has participants research the current tax literature regarding corporate tax inversions. The second part of the case leads students through the calculation of one of the purported benefits of tax inversions: a decrease in the effective income tax rate of the surviving entity. The case also introduces students to corporate use of non-GAAP financial measures.

In part one, after answering general questions regarding corporate tax inversions students will be asked to analyze the transaction between Medtronic Inc. and Covidien PLC. Students will be expected to apply the information presented in the initial general conceptual review to the specifics of the Medtronic inversion. Finally, students will be required to ascertain the tax impact of the inversion on shareholders of Medtronic Inc. and Covidien PLC at the time of the transaction.

The solutions to the initial case questions can be accessed by students using the internet or a tax data source (e.g. RIA Checkpoint). Additionally, the research cited in the accompanying reference section of this paper is instructive. The articles referenced herein provide background information on the two companies, Medtronic Inc. and Covidien PLC, as well as inversion transactions.

This case is particularly relevant to accounting students and professionals given the recent changes to the tax regulations regarding corporate tax inversions. The United States Treasury Department under the Obama administration issued temporary regulations on April 4, 2016. These temporary regulations were accompanied by proposed regulations that specifically address earnings stripping, one of the potential benefits of corporate tax inversions. The federal government is attempting to make structuring corporate tax inversions more difficult in order to increase federal tax revenue. As the rules and regulations regarding corporate tax inversions change, this case will help students understand the motives for undergoing a corporate tax inversion, as well as why the federal government is trying to prevent companies from reincorporating in another country.

Case Synopsis

You are analyzing the potential tax benefits of a corporate tax inversion, specifically the acquisition of Covidien PLC by Medtronic Inc. You will first be asked to describe a corporate tax inversion and discuss the motives companies have for entering into such transactions. You will then be asked to research current tax literature regarding corporate tax inversions. After gathering this information, you will be asked to apply your knowledge to the specific transaction that resulted in the creation of Medtronic PLC.

The Case

Medtronic PLC is a global healthcare solutions company now headquartered in Dublin, Ireland. The company was founded in 1949 by Earl Bakken and Palmer Hermundslie as a medical equipment repair shop. In 1957 Bakken created a battery-powered heart pacemaker. Prior to his invention, pacemakers were bulky and required an electrical outlet to work properly. Bakken was inspired to develop a portable pacemaker after a power outage hit the University of Minnesota Hospitals, putting many patients at risk due to the inability to operate its pacemakers. The development of this product boosted the profits of Medtronic, allowing the company to expand its product line beyond pacemakers. However, a financial crisis in the 1960's slowed the company's growth. As a result, Medtronic sold stock to a local venture capital company while simultaneously developing the company's mission which is still followed today. This enabled the company to continue researching medical technology and ultimately expand its product line. Eventually the company went from solely producing pacemakers to providing therapies that treat more than 40 medical conditions. Medtronic is no stranger to international expansion; the company has had international offices since as early as 1967. However, Medtronic's prior international business activities are insignificant compared to the inversion with Covidien PLC (Medtronic, 2014).

Covidien PLC began as The Kendall Company in 1903. The Kendall Company, ran by Henry P. Kendall, produced cotton products. The company later expanded into health and hygienic products. The demands of two world wars bolstered the need for surgical dressings and cotton gauze, the primary products of the company. After the war, the company expanded its product line to include various other cotton products. These products helped the company sustain growth throughout the mid-twentieth century. In 1972, The Kendall Company was acquired by Colgate-Palmolive. This transaction led to significant growth both domestically and internationally. In 1988, Colgate-Palmolive sold its Kendall subsidiary to Clayton & Dubilier. In 1994, The Kendall Company was acquired by Tyco International, Ltd. and combined with Tyco's other medical companies. The Covidien name was adopted in 2007 when the company became an independent publicly traded company after Tyco spun off its medical businesses (Covidien, 2015).

Covidien PLC was acquired by Medtronic, Inc. on January 26, 2015. The acquisition, valued at \$49.9 billion, was announced on June 15, 2014. The transaction was partially financed by a \$16 billion note Medtronic issued specifically for the purpose of completing the inversion. External financing was used as opposed to internal financing due to a tax ruling from the U.S. Government that prevents a foreign subsidiary from granting loans to its related American company to finance inversion deals. In September of 2014, the U.S. Treasury Department announced new rules that change the tax treatment of loans between a foreign subsidiary and its U.S. parent company. Prior to these rules, the interest payments made by the parent company to the foreign subsidiary could be deducted for tax purposes. This lowers the amount of taxable income reported by the parent company and generates

an income stream in the home country of the foreign subsidiary. Now these loans will be treated as dividends, making them taxable in the United States (Gelles, 2014).

The inversion involved Medtronic, Inc., Covidien PLC, Kalani I Limited (“New Medtronic”), Makani II Limited (“IrSub”), Aviation Acquisition Co., Inc. and Aviation Merger Sub, LLC (“MergerSub”). Medtronic, Inc., Aviation Acquisition Co., Inc., and Aviation Merger Sub, LLC were all Minnesota based corporations prior to the transaction. Covidien, New Medtronic, and IrSub were all Ireland based entities before and after the inversion. New Medtronic and its wholly owned subsidiary IrSub acquired Covidien PLC. MergerSub merged with Medtronic, with Medtronic surviving the merger. Following this, both Medtronic and Covidien became indirect subsidiaries of New Medtronic (Securities and Exchange Commission [SEC], 2016). See the diagrams in Appendix 2 for a visual representation of the transaction.

The merged entity is the largest standalone medical technology development company in the world. It is composed of four business groups that develop and manufacture devices and therapies for various chronic diseases. These four groups are cardiac and vascular, restorative therapies, minimally invasive therapies, and diabetes. The company employs over 85,000 individuals in more than 155 countries (Medtronic, 2016).

Part 1: Questions

- 1) What is a tax inversion?
- 2) What are the potential benefits of an inversion?
- 3) Summarize the current U.S. income tax rules regarding corporate inversions. What three criteria must be met before the post-merger inverted corporate structure will be recognized for tax purposes?
- 4) Review the case handout which summarizes the acquisition of Covidien by Medtronic. What were the tax implications of the acquisition for the shareholders of Medtronic and Covidien?
- 5) What benefits does the transaction between Medtronic and Covidien provide to the new company, Medtronic PLC? How does the transaction impact the effective tax rates of Medtronic?

Part 2: Questions

- 6) What is meant by a corporation’s effective income tax rate? How is it calculated?
- 7) Access the income statements in the 2016 Medtronic form 10-K (filed June 26, 2016) for the pre-inversion year of 2014 and the post-inversion years of 2015 and 2016. Calculate the effective income tax rate for each year.
- 8) Is a decrease in the effective income tax rate from pre-acquisition 2014 to post-acquisition 2015 and 2016 observable? How does Medtronic explain the trend in the calculated effective income tax rate for the three years?
- 9) What is a non-GAAP financial measure? Access Regulation G via <https://www.law.cornell.edu/cfr/text/17/part-244> or equivalent source.
- 10) What are the general requirements related to non-GAAP disclosures by a company?
- 11) Access the financial statements in the 2016 Medtronic form 10-K (filed June 26, 2016) for the pre-inversion year of 2014 and the post inversion years of 2015 and 2016. What is the effective income tax rate calculated by Medtronic as a non-GAAP measure? Discuss the trend evidenced by the non-GAAP calculation of the effective income tax rate for the three year period 2014-2016.

- 12) Access the GAAP to Non-GAAP Reconciliation in the 2016 Medtronic form 10-K (filed June 26, 2016) for the pre-inversion year of 2014 and the post inversion years of 2015 and 2016. What is meant by the following company statement? “Exclude the impact of charges or gains that contribute to or reduce earnings and may affect financial trends but which include charges or benefits that result from transactions or events that management believes may or may not recur with similar materiality or impact to our operations in future periods.”
- 13) Are non-GAAP financial measures, which are presented in a form 10-K, audited by the company’s external auditors? Why or why not?
- 14) Using Medtronic’s 2014 non-GAAP effective income tax rate (19.2%) as a normalized pre-acquisition income tax rate, calculate the pro-forma non-GAAP income tax savings for post-acquisition Medtronic in 2016. Use Medtronic’s 2016 calculation of non-GAAP Income from Operations Before Income Taxes per 2016 Medtronic form 10-K (filed June 26, 2016) for the calculation.
- 15) Answer both of the following questions.
 - a) Today, your broker approached you with a “great” stock recommendation: buy Medtronic! She says the company is poised for success and (based on the calculation above) has a \$250 million ongoing cost (tax) advantage to its competition. Do you agree? Why or why not?
 - b) Today, your politically active cousin approached you with a “great” idea to help close the Federal deficit: ban tax inversions! He says companies like Medtronic are escaping paying its share of income taxes (to the tune of \$250 million)! The harm companies like this do to the U.S. economy far outstrips the value they provide. Do you agree? Why or why not?
- 16) Consider a scenario whereby the use of the corporate inversion expands as more countries outside the U.S. become “inversion-friendly”. Assuming more U.S. companies may now want to complete inversions, what will be the likely tax policy response of the U.S. and other countries?
- 17) What are some changes to the tax laws outlined in your response to question 3) above which could be enacted to discourage U.S. companies from entering inversions that move corporate headquarters to another country? Explain why your proposed tax law changes result in the best possible outcome for the U.S. economy.

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Instructor Notes

Case Objectives

This case deals with the very topical subject of tax inversions. In the case, students are initially introduced to the concept of the tax inversion, the process by which a United States company reincorporates in another country, often as part of a corporate acquisition. Case participants (students) will learn one of the goals of such a corporate maneuver is to reduce the company's income tax burden. In the first section of the case, students are led through the actual structuring of the 2014 Medtronic/Covidien inversion. They will initially be challenged to explain the inversion process, its purported benefits, and the likely tax treatment of the companies and shareholders. The student objectives are threefold in section two of the case. First, the students are charged with actually calculating Medtronic's effective income tax rates before and after the inversion in an attempt to prove a benefit from a decrease in the effective tax rate. Second, case participants will be immersed in the non-GAAP measures the company uses to explain inversion tax benefits. Finally, students are tasked with preparing a pro-forma quantification of tax savings for the Medtronic/Covidien inversion and developing an argument as to whether or not it is actually beneficial and sustainable. Extensive student feedback was obtained on the case and improvements included in the final case. General comments and student feedback is included in Appendix 1.

Case Learning Objectives

Learning Goal: Students will demonstrate problem solving skills in a global business setting. Meeting this goal will require students to:

Learning Objective #1: In a case setting, students will interpret corporate financial disclosure material to determine if a proposed transaction has a potential to yield financial benefits. (Blooms Taxonomy: Comprehension; assessed in question 8)

Learning Objective #2: In a case setting, students will extract relevant data and use analytical techniques to calculate ratios for multiple years using financial statement data. (Blooms Taxonomy: Analysis; assessed in question 7)

Learning Objective #3: In a case setting, students will use ratio analysis and/or student calculated quantifications of costs and benefits to provide decision quality input for senior management decisions. (Blooms Taxonomy: Synthesis; assessed in question 14)

Learning Objective #4: In a case setting, students will recommend, with justification, changes to income tax laws to achieve a business or societal goal. (Blooms Taxonomy: Evaluation and Creation; assessed in question 17)

Case Administration

This case can be presented to an advanced business taxation class taught at the graduate level. With supplemental coaching, it could be used in a graduate level (MBA) merger and acquisition class. The case is divided into two sections (Part 1 and Part 2) which are designed to be covered in two separate in-class guided sessions.

Part 1: The initial five questions are designed to familiarize the student with the concept of a tax inversion. A suggested method of guiding the class through Part 1 is to have the students access the articles listed in the reference section of the case either before or during completion of Part 1 of the case. Alternatively, the instructor may print out relevant sections of the articles and distribute them with the case. Written or oral responses to each question work well. Instructors should require students to answer these questions "in their own words". This obviates student tendencies to cut and paste from online sources. Regardless of the form of response, a thorough question by question discussion led by the instructor facilitates learning.

Part 2: The remaining ten questions are intended to guide students through calculations and disclosures corporations like Medtronic make when quantifying the key benefit of an inversion, the decrease in the effective income tax rate. Most of the required calculations require access to the Medtronic 2016 10-K. Given the voluminous nature of the 10-K and the need for students to use browser search functions, online access is recommended when students complete Part 2. Like Part 1 of the case, a thorough question by question discussion led by the instructor facilitates learning.

Part 1: Analysis of Questions

- 1) What is a tax inversion?

Tax inversions, often referred to as corporate inversions, are a method by which a U.S. business reincorporates in a foreign country, often as part of a corporate acquisition. As a result of the reincorporation, the company's tax residence changes to a foreign jurisdiction. Inversions can be accomplished by employing several structures such as: a stock inversion, an asset inversion, or a drop-down inversion which combines a stock and asset inversion. A stock inversion is completed when a foreign company purchases the stock of a U.S. company. An asset inversion occurs when a complete restructuring is done to make the foreign company the new parent company of the merged entity. A drop-down inversion uses the asset inversion structure but transfers assets to the foreign company for stock. Shareholders of the U.S. corporation usually become shareholders of the merged entity once the transaction is complete. In most tax inversions, the corporation's structure and physical location do not change (Lee, 2015).

- 2) What are the potential benefits of an inversion?

Research indicates there are at least three major potential benefits corporations can derive from a corporate inversion. The first of these is the most notable: decreasing corporate income taxes. The United States has one of the highest corporate income tax rates in the world. Additionally, the United States taxes a U.S. based corporation on its worldwide income. Worldwide income includes income earned both domestically and abroad. This can create a much larger tax liability for corporations located in the U.S. compared to corporations in countries using a territorial tax system. A territorial tax system only taxes income earned in the country imposing the tax. By reincorporating to a nation with lower income tax rates and a territorial tax system, companies can often reduce its tax liability (Scott, 2016).

The second potential benefit companies may realize by reincorporating through an inversion is earnings stripping. Earnings stripping is the process of a U.S. subsidiary paying interest to related third parties (such as a foreign corporate parent), thus lowering U.S. taxable income. In the case of an inversion, this is typically done when the foreign parent corporation issues debt (lends) to a U.S. subsidiary for operational expenses. The U.S. subsidiary then pays interest on the loan. These interest payments can be deducted from the subsidiary's taxable income, lowering the U.S. tax liability of the company (Schmidt, 2015).

The third key benefit derived from inversions is increased access to foreign earnings. U.S. corporations are only taxed on foreign earnings when they are repatriated to the United States. To avoid being taxed on these earnings, many companies leave the money in the foreign entities (off shore). However, reincorporating (as a non-U.S. corporation) via an inversion allows the corporation to use its foreign earnings without being subject to U.S. corporate income taxes (Scott, 2016).

- 3) Summarize the current U.S. income tax rules regarding corporate inversions. What three criteria must be met before the post-merger inverted corporate structure will be recognized for tax purposes?

The primary U.S. tax law related to corporate inversions is included in Section 7874 of the Internal Revenue Code. This section of code was enacted in 2004 and contains a provision that stipulates incorporation changes (such as inversions) will be ignored for federal income tax purposes unless specific criteria are met. Section 7874 applies when all three of its criteria are met. These criteria are an asset test,

an ownership test, and a business activities test. The asset test is met if the foreign entity is acquiring “substantially all” of the assets of the U.S. corporation. The ownership test stipulates the foreign reincorporation is ignored for United States income tax (and the U.S. will continue to tax the company as a U.S. corporation) if the shareholders of the domestic company own more than 80% of the stock of the foreign entity after the inversion. If the shareholders of the U.S. company own 60-80% of the foreign entity after the inversion, the transaction is treated as a foreign reincorporation with limited tax benefits. The business activities test requires the foreign entity to have substantial business activities in the country of reincorporation to avoid adverse tax consequences (Jackman, 2014).

In order to pass the business activity test, a corporation must satisfy three requirements. The first of these is the group employee requirement. This requires at least 25% of employees to be based in the new country of incorporation, post-acquisition. Additionally, one-fourth of the compensation paid to all employees must be paid to employees based in the country of incorporation. The second requirement concerns the assets of the newly merged corporation. At least one-fourth of the group assets of the company must be located in the foreign country on the date of the inversion. Group assets are tangible personal property or real property held for use in the active trade or business. These assets are only considered located in the relevant foreign country if they were present in the country at the end of the day the inversion occurred. The asset must also be physically located in the foreign country for the majority of the year-long testing period. The assets may be valued on a gross basis using fair values or adjusted tax bases. The third requirement of the business activity test pertains to the group income of the entity. At least 25% of the group income must come from the country of incorporation. This means one-fourth of the entity’s income must come from customers located in the relevant foreign country. This income is determined over a year-long testing period (Scott, 2016).

The Internal Revenue Service’s Notice 2014-52 adds new stipulations to the ownership test and restricts access to offshore earnings and cash of the U.S. company. If more than half of the total value of foreign group property is nonqualified property, a portion of the foreign acquirer’s stock will be ignored for purposes of the ownership test. Nonqualified property includes cash, cash equivalents, and certain other obligations. The notice also prevents “skinning” transactions which are part of a plan with a primary purpose of avoiding U.S. income tax by being considered an inversion (Jackman, 2014).

These new stipulations have already effectively stopped one large merger from being completed: the Pfizer-Allergan merger. The merging companies mutually terminated the transaction, citing “adverse changes in tax law” as the reason. Pfizer’s publicity team released a statement on April 6, 2016 to announce the termination. This announcement came just two days after the United States Department of Treasury announced plans to make further changes to the tax law regarding this type of merger (Pfizer, 2016).

- 4) Review the case handout which summarizes the acquisition of Covidien by Medtronic. What were the tax implications of the acquisition for the shareholders of Medtronic and Covidien?

The shareholders of Medtronic, Inc. received one ordinary Medtronic PLC share for each share of Medtronic, Inc. common stock they owned on the date of the inversion. Shareholders of Covidien PLC were required to exchange each ordinary share of Covidien PLC stock owned on the date of the inversion for .956 shares of new Medtronic PLC stock plus \$35.19 in cash. The inversion resulted in a taxable transaction for shareholders of Medtronic, Inc. and Covidien PLC since U.S. shareholders owned more than half of the stock of Medtronic PLC after the inversion (Schmidt, 2015). U.S. tax law imposes a capital gains tax on individual shareholders when an inversion transaction involves the acquiring company holding more than 50% of the shares of the purchased company. The shareholders could be subjected to a capital gains tax estimated to be as high as 33% when considering both federal and state taxes (Medtronic, 2015).

- 5) What benefits does the transaction between Medtronic and Covidien provide to the new company? How does the transaction impact the effective tax rates of Medtronic?

According to Medtronic, the transaction “should generate significant free cash flow” which “can be deployed with much greater flexibility.” However, the tax benefits typical of tax inversions are not as easily attainable as one might think. In the case of the Medtronic/Covidien inversion, the increased cash flow will initially come only from Covidien. This is because Medtronic’s international earnings are difficult to access without incurring a U.S. income tax liability. In order to avoid paying U.S. corporate income taxes, profits from the new foreign subsidiaries can be used to fund dividends and other cash outflows of the company. Additionally, Medtronic can move low profit assets to foreign subsidiaries that are U.S. tax exempt without paying a heavy tax burden. This is because the company will only be taxed on the fair values of those assets. Since the assets are not producing large profits for the company, Medtronic can argue the assets have no or low value, thus avoiding a large tax liability when the assets are moved. Eventually, the company can close down the foreign subsidiaries owned prior to the inversion without incurring a significant tax liability because these subsidiaries are now a lower percentage of the worldwide revenue. In summary, Medtronic sees an immediate benefit of Covidien’s cash flows but will have to engage in complex transactions to reap the majority of the tax benefits that can be derived from the inversion (Walker, 2014).

The company also cites a lower effective tax rate as a benefit of the inversion. A more complete explanation of this benefit follows in Part 2 of the case.

Part 2: Analysis of Questions

- 6) What is meant by a corporation’s effective income tax rate? How is it calculated?

A corporation’s effective income tax rate is the average income tax rate for the corporation for a given year. It is calculated by dividing total income tax expense as reported on the income statement by pretax income as reported on the income statement.

- 7) Access the income statements in the 2016 Medtronic form 10-K (filed June 26, 2016) for the pre-inversion year of 2014 and the post-inversion years of 2015 and 2016. Calculate the effective income tax rate for each year.

2014: $640 / 3705 = 17.3\%$

2015: $811 / 3486 = 23.3\%$

2016: $798 / 4336 = 18.4\%$

(Amounts above are in millions of dollars.)

- 8) Is a decrease in the effective income tax rate from pre-acquisition 2014 to post-acquisition 2015 and 2016 observable? How does Medtronic explain the trend in the calculated effective income tax rate for the three years?

No. Medtronic’s effective income tax rate actually increased in 2015 when compared to 2014. Medtronic’s effective income tax rate decreased in 2016, when compared to 2015, but the 2016 rate is still greater than the 2014 rate. No downward trend is detected when the analysis is based on GAAP figures. In addition to the effective tax rate calculated in accordance with GAAP, Medtronic provides a supplemental recalculation of the effective income tax rate calculated as a non-GAAP financial measure.

- 9) What is a non-GAAP financial measure? Access Regulation G via <https://www.law.cornell.edu/cfr/text/17/part-244> .

A non-GAAP financial measure is a numerical measure of a company’s historical or future financial performance, financial position or cash flows that:

- (i) Excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the most directly comparable measure calculated and presented in accordance with GAAP in the statement of income, balance sheet or statement of cash flows (or equivalent statements) of the issuer; or

(ii) Includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable measure so calculated and presented. (Regulation G, 2016)

- 10) What are the requirements related to non-GAAP disclosure by a company?

The company must accompany that non-GAAP financial measure with:

- (1) A presentation of the most directly comparable financial measure calculated and presented in accordance with Generally Accepted Accounting Principles (GAAP); and
- (2) A reconciliation (by schedule or other clearly understandable method), which shall be quantitative for historical non-GAAP measures presented, and quantitative, to the extent available without unreasonable efforts, for forward-looking information, of the differences between the non-GAAP financial measure disclosed or released with the most comparable financial measure or measures calculated and presented in accordance with GAAP.

The company shall not make public a non-GAAP financial measure that, taken together with the information accompanying that measure and any other accompanying discussion of that measure, contains an untrue statement of a material fact or omits to state a material fact necessary in order to make the presentation of the non-GAAP financial measure, in light of the circumstances under which it is presented, not misleading. (Regulation G, 2016)

- 11) Access the financial statements in the 2016 Medtronic form 10-K (filed June 26, 2016) for the pre-inversion year of 2014 and the post-inversion years of 2015 and 2016. What is the effective income tax rate calculated by Medtronic as a non-GAAP measure? Discuss the trend evidenced by the non-GAAP calculation of the effective income tax rate.

2014: 19.2%

2015: 18.2%

2016: 15.8%

Relying solely on these calculations, there is clearly a downward trend in the effective income tax rates post-acquisition. Medtronic attributes this decrease to the net tax impact of inventory step-up, debt tender premium, acquisition-related items, certain tax adjustments, amortization of intangible assets, the impact from the acquisition of Covidien, operational tax benefits described below, and year-over-year changes in operational results by jurisdiction. (Medtronic, 2016)

- 12) Access the GAAP to Non-GAAP Reconciliation in the 2016 Medtronic form 10-K (filed June 26, 2016) for the pre-inversion year of 2014 and the post-inversion years of 2015 and 2016. What is meant by the following company statement explaining the non-GAAP measures? “Exclude the impact of charges or gains that contribute to or reduce earnings and may affect financial trends but which include charges or benefits that result from transactions or events that management believes may or may not recur with similar materiality or impact to our operations in future periods.”

Medtronic has identified certain income and expense items in its GAAP results that have occurred in 2014, 2015, or 2016 that do not occur every year or if they do occur annually, they may involve a smaller amount in one year and a noticeably larger amount in another year(s). These items of income and expense have differing tax attributes (e.g. tax rates applied to them). Depending on the amount of these income and expense items and the related income tax expense, to leave them in the calculation of the effective income tax rate would have a noticeable effect on the effective rate. In response, Medtronic provides the non-GAAP calculations with these items removed. Medtronic believes the non-GAAP measures provide useful information to investors (Securities and Exchange Commission, 2016).

- 13) Are non-GAAP financial measures which are presented in a form 10-K audited by the company’s external auditors? Why or why not?

The external auditor's opinion does not cover non-GAAP measures. This is because non-GAAP measures are not considered to be part of the company financial statements. External auditors render an opinion only on the financial statements.

- 14) Using Medtronic's 2014 non-GAAP effective income tax rate (19.2%) as a normalized pre-acquisition income tax rate, calculate the pro-forma non-GAAP income tax savings for post-acquisition Medtronic in 2016. Use Medtronic's 2016 calculation of non-GAAP Income from Operations Before Income Taxes per 2016 Medtronic form 10-K (filed June 26, 2016) for the calculation.

2016 Non-GAAP Income from Operations Before Income Taxes X (2014 non-GAAP effective income tax rate - 2016 non-GAAP effective income tax rate) = 2016 Pro-forma income tax savings.
 $\$7,399,000,000 \times (19.2\% - 15.8\%) = \$251,566,000$

- 15) Answer both of the following questions.
- Today, your broker approached you with a "great" stock recommendation: buy Medtronic! She says the company is poised for success and (based on the calculation above) has a \$250 million ongoing cost (tax) advantage to its competition. Do you agree? Why or why not?
 - Today, your politically active cousin approached you with a "great" idea to help close the Federal deficit: ban tax inversions! He says companies like Medtronic are escaping paying its share of income taxes (to the tune of \$250 million)! The harm companies like this do to the U.S. economy far outstrips the value they provide. Do you agree? Why or why not?

Answers will vary. Some respondents to either question may choose to disagree and take issue with the calculation of the \$250 million amount. Arguments against the accuracy of the \$250 million amount may include:

- The amounts used in the calculations are not GAAP.
- The amounts are unaudited and are prepared by the company.
- The calculations involve applying 2014 data to 2016 data. 2014 is a pre-acquisition year reflecting Medtronic results and 2016 is a post-acquisition year and reflects Medtronic and Covidien results. The years may not be comparable.

Some respondents may take issue with the permanency of the \$250 million savings. Buying a stock or striking down a law based on a tax savings which may go away may not be prudent given the fluid nature of tax law.

Some respondents may choose to agree with the statements.

- 16) Consider a scenario whereby the use of the corporate inversion expands as more countries outside the U.S. become "inversion-friendly". Assuming more U.S. companies may now want to complete inversions, what will be the likely tax policy response of the U.S. and other countries?

Answers will vary. Student expectations of U.S. reactions will range from the passage of protectionist laws by Congress to restrain U.S. companies from taking advantage of inversion opportunities to Congressional action to reduce U.S. tax rates to retain American business headquarters and make the U.S. a country that foreign companies will want to invert into and headquarter in. Student expectations of the international response will likely involve some discussion of countries competing for corporate headquarters by lowering tax rates. However, informed students may also point out recent efforts in areas such as the European Union, to impose taxes on these companies who have completed inversions and established legal headquarters in Europe.

- 17) What are some changes to the tax laws outlined in your response to question 3) above which could be enacted to discourage U.S. companies from entering inversions that move corporate headquarters to another

country? Explain why your proposed tax law changes result in the best possible outcome for the U.S. economy.

Answers will vary. Some students may suggest ways to make it more difficult for U.S. companies to obtain inversion benefits through the relocation of a corporate headquarters overseas... This could involve tightening up the three criteria in Section 7874 (Question 3 above) so that the inversion is ignored for U.S. tax purposes. An equally logical student response is the very opposite. That is, a Congressional reduction of U.S. corporate tax rates, thereby reducing the need for inversions with companies going overseas to obtain tax benefits. Such a change also potentially attracts companies to come to the U.S.

Appendix 1 - General Comments and Student Feedback

General Comments:

The case was given to 18 students in a blended senior accounting/MAcc tax class in the fall of 2016. Seventeen of the students completed a feedback survey after completing the case. Survey questions queried difficulty, relevance, self-evaluation of learning, estimation of time needed to complete and asked for areas of improvement.

The following is a summary of the student feedback:

Average Difficulty (Scale of 1-10 with 10 being most difficult) 5.8;

Average Relevance: (Scale of 1-10 with 10 being very relevant) 7.6;

Average Self-evaluation of Learning (Scale of 1-10 with 10 being "I learned a lot.") 7.9.

Areas of suggested improvement from students varied with the most common response being "none". The second most common involved more assistance in finding data to complete calculations. The survey is included in the instructor notes and the actual student responses are included below.

The students struggled most in explaining in their own words what an inversion is. There was considerable "cutting and pasting" from sources which is to be discouraged. Additionally, designing a pretest proved to be a challenge as students had virtually no knowledge of inversions. However, a pretest was designed to evaluate students on proficiency as it relates to the three case learning objectives associated with the case. The three learning objectives are included in the revised instructor notes and the pretest is attached to the instructor notes.

Student Feedback:

Question 1: Students were asked to rate the case difficulty on a scale of 1 to 10. Students were then asked to explain why they rated the case as being difficult (or not difficult). These are the explanations for the score they gave.

- Student 1: The general definition questions were easy. The calculation problems didn't have a lot of explanation.
- Student 2: There were things we hadn't learned in class that were in the case and that made it difficult.
- Student 3: The most difficult part was the time. As for understanding the material, it was pretty straight forward, except for question 3.
- Student 4: A few questions were difficult near the end. Most of the case was qualitative and not quantitative. Also the effective tax rates and non-GAAP nominal tax rates were provided in the 10-K which made the case easier.
- Student 5: The necessary info was clear & accessible. Most of the difficulty came in navigating the 10-K until I just opened multiple copies.
- Student 6: Question #14 lacks clarity on what exactly you are wanting. Non-GAAP financial items are still difficult to understand even after the resource.
- Student 7: Some research questions were difficult to find but the questions were easy to understand.
- Student 8: There were certain questions that were challenging. However, there were some questions that took little research, and were quite easy to answer.
- Student 9: Difficult to find online info, easy to find 10K info.
- Student 10: It was not very difficult in general, but was somewhat time consuming.
- Student 11: It was not too difficult, but did present a challenge and an elevated amount of time and research to complete.
- Student 12: Compared to other classes it was similar to the amount of time and effort required to complete.
- Student 13: It definitely took some time to complete and a couple questions were hard to find.
- Student 14: Just time consuming and 14 was difficult.

- Student 15: The most difficult thing was to find what the current tax treatment was for inversions. The other research was pretty simple as well as the calculations.
- Student 16: Not too difficult however one questions I could not find the answer to.
- Student 17: Some of the questions were very obvious but others took an in depth form of thinking of what it was actually asking.

Question 2: Students were asked to rate the case relevance on a scale of 1 to 10. Students were then asked to explain why they rated the case as being relevant (or not relevant). These are the explanations for the score they gave.

- Student 1: Helpful in the sense of how to navigate the information.
- Student 2: It seemed like a standard business tax case.
- Student 3: Doesn't seem to be relevant for most tax jobs. Very informative though for understanding audit reporting language.
- Student 4: Tax inversions are a relevant and recent in the news. Many new provisions are being created to combat the inversions which is interesting to read.
- Student 5: The only reason I did not say 10 is because I believe during my career the U.S.T.C will change making inversions irrelevant/moot.
- Student 6: Inversions are happening constantly so it's good to know.
- Student 7: Tax inversions occur in the U.S. and the rules and implementation are always changing.
- Student 8: The case makes a point to show how companies try everything they can to reduce their taxes.
- Student 9: Tax inversion is of growing importance with global expansion.
- Student 10: Corporate inversions are a hot topic with new regulations and ways to stop them always in the media.
- Student 11: With the changing tax environment, any current application is useful.
- Student 12: It's something in the tax profession we have never discussed so it was nice to learn.
- Student 13: I'm not quite sure how much we will use tax inversion in real life situations, but it was good information to have.
- Student 14: Nice to do a real life problem and to learn about it in that manner.
- Student 15: A tax professional is likely to deal with tax inversions and non-GAAP measurements.
- Student 16: A tax professional's job is to find the best tax outcome for their client. Also good example in showing differences between non-GAAP accounting and GAAP.
- Student 17: I'm sure it will be relevant to know what's happening around you but right now it didn't mean much with all the other concepts I have to garner.

Question 3: Students were asked to rate their level of learning on a scale of 1 to 10. Students were then asked to explain how they arrived at their perceived level of learning. These are the explanations for the score they gave.

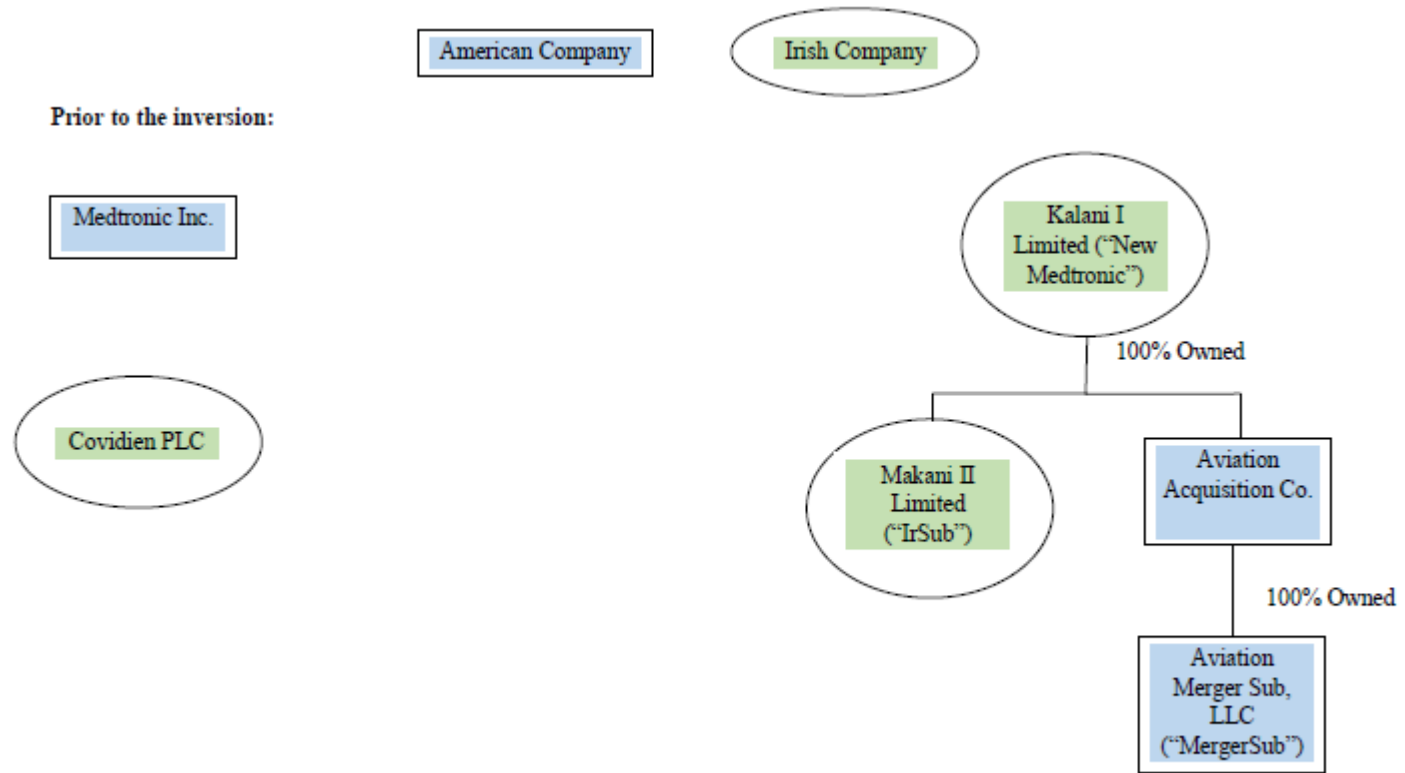
- Student 1: Learning about inversions was the main thing since I had no clue what they were beforehand.
- Student 2: I learned some but am still confused in some areas.
- Student 3: Everything for the most part was new for me, and informative.
- Student 4: I learned a lot about tax inversions, the benefits, and why Congress seeks to pass provisions to regulate inversions.
- Student 5: I was completely unaware of the concept of non-GAAP measurement items before this. I think the concept is both dangerous and also hogwash.
- Student 6: I knew nothing about non-GAAP financial items before. I still really know nothing about them but I learned that I must learn about them now.
- Student 7: Other than what the definition of a tax inversion, I didn't know the pros and cons to it and the different requirements.
- Student 8: I felt like I learned quite a bit about tax inversion and if it was successful for Medtronic.
- Student 9: Learned a little, felt more busy than anything.

- Student 10: I did not know the intricacies of inversions. Did not know how U.S. corp. tax rate compared to other countries, etc.
- Student 11: I did not know of inversions or Medtronic and now I do.
- Student 12: I had no idea what an inversion was or anything about GAAP to non-GAAP reconciliation.
- Student 13: I learned a lot about tax inversions. I'm not sure how much of it was correct.
- Student 14: Learned about inversions and how it is actually used in real life. Maybe didn't comprehend everything.
- Student 15: I know little about tax inversions and non-GAAP measurements.
- Student 16: Clear understanding of tax inversions.
- Student 17: It's a topic I never touched on before.

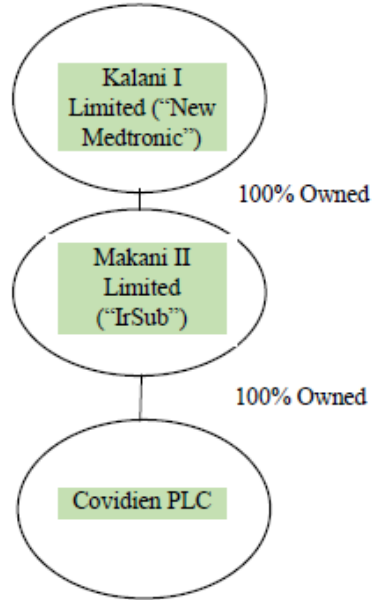
Question 4: Students were asked to make suggestions as to how the case could be improved.

- Student 1: More specific on where to find the numbers needed for calculations.
- Student 2: Give more resources to help look up definitions.
- Student 3: Ask questions that are more tax specific regarding the case.
- Student 4: Possibly provide more sources to obtain tax inversion info from. The book only had one paragraph. However, research was not too difficult.
- Student 5: More guidance as to where to find the effective tax rate calculations in the 10-k, as well as the non-GAAP adjustments. The "3 criteria" question should be clearer that it's not criteria, it's no recognition triggers.
- Student 6: Put it up on Washburn's D2L system so I can download the document to PDF for ease of editing. Make sure your questions are clear. Again #14 was challenging because I couldn't figure out what I was trying to solve.
- Student 7: Some questions seemed repetitive such as listing the advantages in one question and asking what the implications for shareholders in another.
- Student 8: Nothing of note.
- Student 9: None
- Student 10: Nothing
- Student 11: In a few years, maybe change the subject matter if relevancy is an issue.
- Student 12: More time looking at the non-GAAP problems.
- Student 13: Maybe exclude some of the more difficult questions to make it shorter.
- Student 14: Maybe a little shorter. Overall good though.
- Student 15: Look more into the tax consequences right after the inversion.
- Student 16: Possible more questions on the practice of tax inversions, when companies have used non-GAAP to hide income or losses.
- Student 17: Nothing comes to mind, maybe let them calculate the effective tax rate / don't since it blatantly lists it out in the 10-K.

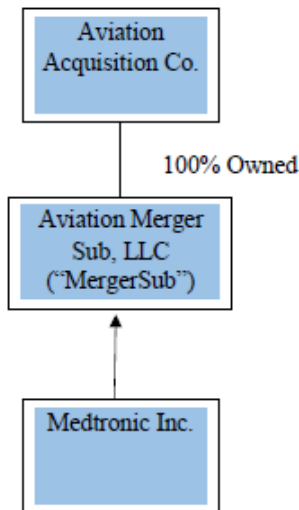
Appendix 2 - Visual Representation of Transaction



Covidien is acquired by "IrSub":



Medtronic merges with "Merger Sub" - Medtronic survives the merger:



The resulting company structure:

