US Tax Court issues new decision in *Medtronic* case

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In brief

The US Tax Court on August 18 issued its second decision in *Medtronic* (*Medtronic III*), applying an unspecified transfer pricing method that increased the allocation of income to Medtronic's US-based parent (Medtronic US) in certain intercompany transactions involving the license of intangible property to Medtronic US's Puerto Rican manufacturing subsidiary, MPROC. The decision comes after the US Court of Appeals for the Eighth Circuit had vacated and remanded the Tax Court's prior 2016 decision (*Medtronic I*), finding that the Tax Court did not have sufficient factual findings to conclude that the third-party agreement that was relied upon by the Tax Court (the Pacesetter agreement) was an appropriate comparable uncontrolled transaction (CUT).

In *Medtronic III*, the Tax Court concluded that neither Medtronic's CUT method nor the IRS's comparable profits method (CPM) — which treated MPROC as a contract manufacturer and shifted essentially all the residual income back to the United States — was the best method for determining the arm's length royalty owed under the intercompany license agreement. Instead, the Tax Court adjusted an unspecified method put forward by Medtronic that aimed to bridge the gap between the parties' proposed methods. The court's unspecified method resulted in a wholesale royalty rate of 48.8%, resulting in an overall profit split of 68.72% to Medtronic US (and US affiliates) and 31.28% to MPROC.

Takeaway: The *Medtronic III* decision represents a self-labeled unspecified method approach that the Tax Court believed would bridge the gap between Medtronic's CUT method and the IRS's CPM, both of which methods the court rejected based on comparability grounds. The court's pricing method relied on aspects of both parties' rejected methodologies and split the residual system profit on an 80/20 basis after providing profit to each party based on both a CPM and CUT basis. While called an "unspecified method," the heart of the court's method resembled a profit split method. The opinion also confirms that the CPM is not applicable to all foreign licensees, and risk allocations made by intercompany agreements can be respected in the presence of adequate economic substance. Finally, the opinion shows the potential importance of corroborating analyses. Overall, this case confirms that with the appropriate set of facts and risk allocation, migrating intangible property through a licensing arrangement where the system profit is high can remain an effective tool.

In detail

Factual background

Medtronic, Inc. (Medtronic US) develops, manufactures, markets, and sells regulated medical devices. During 2005 and 2006, the tax years at issue, Medtronic US operated through multiple business units; this case, however, involved only the Cardiac Rhythm Disease Management (CRDM) and Neurological (Neuro) business units. In 2002, Medtronic US contributed its Puerto Rican manufacturing operation to a new foreign subsidiary, MPROC. Conducting its operations under licenses from Medtronic US (the MPROC license), MPROC manufactures and sells CRDM and Neuro devices and leads, which are life-saving or life-sustaining Class III medical devices requiring FDA approval.

Under the MPROC license, MPROC obtained the right to use, develop, and enjoy the intangible property for manufacturing devices and leads. In addition, the MPROC license assigned all product liability risk for devices and leads to MPROC, stating that MPROC was "liable for all costs and damages arising from recalls and product defects." The MPROC license initially called for MPROC to pay Medtronic US wholesale royalties of 29% on MPROC's US net intercompany sales of devices and 15% on MPROC's net intercompany sales of leads. The license later was amended to provide for royalty rates of 44% and 26%, respectively, to reflect an earlier determination the IRS made regarding the arm's length royalties to be reported for US federal income tax purposes.

Procedural history

The Tax Court's second opinion in this case (*Medtronic III*) comes after the Eighth Circuit had vacated and remanded *Medtronic I*. In *Medtronic I*, the Tax Court found substantially in favor of Medtronic in its transfer pricing dispute with the IRS. Specifically, the Tax Court held that Medtronic's CUT method, with adjustments, was the best method for determining arm's length royalty rates, using a 1992 patent litigation settlement agreement between Medtronic and Pacesetter (Pacesetter agreement) as the CUT.

On appeal, the Eighth Circuit vacated and remanded the case for further consideration. The Eighth Circuit (in *Medtronic II*) stated: "The [T]ax [C]ourt determined that the Pacesetter agreement was an appropriate [CUT] because it involved similar intangible property and had similar circumstances regarding licensing. We conclude that the [T]ax [C]ourt's factual findings are insufficient to enable us to conduct an evaluation of that determination."

In *Medtronic III*, the Tax Court considered two key issues: (1) whether the CUT method is the best method for determining the arm's length royalty rate, and (2) what the proper royalty rates are for the devices and leads.

Positions of the parties

Medtronic

Medtronic continued to assert that the Pacesetter agreement, with appropriate adjustments, was a reliable CUT to establish the royalty rate for intangibles licensed to MPROC. Medtronic proposed two approaches with estimated high and low rates. One approach started with a 7% retail royalty rate, and after adjustments resulted in wholesale royalty rates of 22.3% and 33.4% for cardio and 17.9% and 27.5% for neuro. The second approach started with a 15% retail royalty rate, and after adjustments resulted in wholesale royalty rates of 29.4% and 33.8% for cardio and 25% and 27.9% for neuro.

In response to the court's questions at the conclusion of the *Medtronic III* trial, Medtronic also proposed two versions of an alternative unspecified method in its post-trial brief to "bridge the gap" with the IRS's proposed CPM approach. Medtronic's proposed unspecified method combined aspects of the CUT method with the Pacesetter agreement as a comparable and the CPM.

Medtronic's unspecified method involved the following three-step approach:

(1) Applied a modified version of Medtronic's CUT method and the arm's length royalty rate for the trademark license to allocate profits to Medtronic US's R&D activities.

(2) Applied a modified CPM to allocate profit to MPROC's finished device manufacturing activities and reduced the return to MPROC for profits allocated to Medtronic US (and its US affiliates, including Med USA) based on the arm's length prices for component manufacturing and distribution.

(3) Allocated the remaining system profit between Medtronic US and MPROC. These steps are summarized below.

Step One

The first step began with the Pacesetter agreement's 7.0% base retail royalty rate. All of Medtronic's expert's adjustments (accounting for portfolio access fee, cross licensing, know-how, and sub-licensing rights) were then made to the base royalty rate except for the profitability adjustment. These adjustments resulted in a modified CUT retail royalty rate of 17.3%. This royalty rate plus the established retail rate of 5.4% for the trademark license (wholesale royalty rate of 8%) resulted in an allocation of profits to Medtronic US for its R&D activities.

Step Two

The second step made modifications to the IRS's CPM to provide MPROC with a return on its operating assets (ROA). Specifically, Medtronic made an asset-intensity adjustment to address its concern that the book values used for MPROC's operating assets were too low as compared to the comparables.

After making the asset-intensity adjustment, the unspecified method allocated profits to MPROC based on a 41.3% ROA, the average of ROAs for the IRS's five-company comparables subset as applied to MPROC's adjusted asset base. In addition, MPROC must compensate Medtronic US for components and Med USA for distribution functions using the arm's length prices for those functions. Accordingly, the returns for those functions then were subtracted from MPROC's return and added to Medtronic US/Med USA's returns.

Step Three

The third step allocated the remaining system profit between Medtronic US and MPROC. Medtronic proposed two versions of its unspecified method. For both versions, steps one and two were the same.

Medtronic's *first version* allocated 65% of the remaining profit to MPROC and 35% to Medtronic US, resulting in 51% of the overall system profit being allocated to Medtronic US/Med USA and 49% to MPROC. Medtronic's *second version* was a 50-50 allocation of the remaining system profit between Medtronic US/Med USA and MPROC, allocating approximately 57% of the system profit to Medtronic US/Med USA and 43% to MPROC. Version one resulted in a wholesale royalty rate of 35.7%, whereas version two resulted in a wholesale royalty rate of 40%.

IRS

The IRS maintained its position that the CPM was the best method, and that the Pacesetter agreement was not a reliable CUT. The IRS's CPM kept MPROC as the tested party with the ROA as the profit level indicator. This approach assigned MPROC a routine manufacturing return based on a benchmarking of routine medical device manufacturers and allocated all the remaining profit to Medtronic US.

At the conclusion of the trial, the IRS altered its CPM by using a subset of five of the 14 comparables that manufactured implantables. In addition, the IRS made adjustments to its CPM to account for product liability. The IRS's revised CPM calculation resulted in wholesale royalty rates of 59.6% for 2005 and 64% for 2006 (the modified CPM). The modified CPM resulted in total system profit for MPROC of 14% in 2005 and 12% in 2006.

The IRS also rejected Medtronic's proposed unspecified method, arguing that it was based on the same flawed methodology used in Medtronic's CUT method.

Tax Court's Medtronic III analysis

The Pacesetter agreement is not a reliable CUT

Analyzing three of the five general comparability factors in Treas. Reg. sec. 1.482-1(d)(1), the Tax Court concluded that because three of the five comparability factors were not met, the Pacesetter agreement was not a CUT:

(1) Functional differences existed between MPROC's licensing arrangement and the Pacesetter agreement. As a licensor under the *MPROC agreement*, Medtronic US performed R&D and business management activities. In the *Pacesetter agreement*, Medtronic US as licensor did not perform R&D to develop Pacesetter products, nor did it perform any other activities to help Pacesetter market its products. Moreover, MPROC was engaged solely in finished device manufacturing, whereas Pacesetter also performed R&D, component manufacturing, and distribution.

(2) The economic conditions–specifically, the profit potential–of the Pacesetter agreement and that of the MPROC license were not similar.

(3) The intangible property licensed under the Pacesetter agreement compared to that licensed under the MPROC license was not comparable based on the greater number of patents and know-how provided by the MPROC license.

In addition, the Tax Court reviewed its adjustments in *Medtronic I* and concluded that "too many adjustments results in the Pacesetter agreement as a CUT not being the best method pursuant to the Section 482 regulations." Although the Tax Court concluded that the Pacesetter agreement was reached in the ordinary course of business and that there was a level of comparability in contractual terms between the Pacesetter agreement and the MPROC licenses, it was not enough to overcome the differences highlighted above.

Ultimately, the court concluded that the Pacesetter agreement required too many adjustments and therefore was not the best method for valuing Medtronic's intangible property.

Observations

The Tax Court's opinion reflects that when too many adjustments are made to a CUT, a point may be reached when the comparable ceases to be that and the CUT method no longer can be viewed as a reliable method. Taxpayers should expect increased scrutiny by the IRS and courts of the general comparability factors under Treas. Reg. sec. 1.482-1(d)(1) for transactional methods, like the CUT method. Moreover, taxpayers should analyze the profit potential of CUTs as this factor is critical in selecting and applying the CUT method. Corroborating analyses should also be strongly considered. In addition, the court's determination that the Pacesetter agreement was reached in the ordinary course of business reflects that comparables are not automatically to be precluded simply because they arose out of litigation. Rather, this is a factual determination, not a blanket rule.

The IRS's CPM is not the best method

With respect to the IRS's modified CPM, the Tax Court stated that the problems that *Medtronic I* addressed regarding the CPM remained the same. Despite reducing the set of comparables, the comparables still had fundamentally different asset bases and involved different functions and risks than those of MPROC. Unlike MPROC, which focused exclusively on manufacturing class III medical devices, all of the comparables performed functions in addition to manufacturing and manufactured class I and/or class II devices (in addition to class III devices), the court noted.

Moreover, pursuant to the MPROC license, all the product liability risk was allocated to, and borne by, MPROC. The court stated that MPROC's assumption of product liability risk was consistent with the economic substance because MPROC had the financial capacity to bear the burden. MPROC had managerial and operational control over the manufacturing operations for the finished devices and leads. The IRS's modified CPM made a $25 million adjustment to account for MPROC's product liability costs. The court, however, concluded that the adjustment for product liability was not adequate; IRS's modified CPM failed to give proper consideration to the fact that MPROC performed nonroutine functions such as ensuring product quality and assuming risk for product liability. Therefore, the Tax Court concluded that the IRS's modified CPM was not the best method and there was an abuse of discretion due to the use of flawed comparables.

Observations

Consistent with Treas. Reg. sec. 1.482-1(d)(3), taxpayers should seek to make their contractual allocations of risk consistent with the economic substance of the underlying transaction. The Tax Court found that under the MPROC license, all product liability risk was allocated to, and borne by, MPROC. This was viewed as consistent with the economic substance because (1) MPROC had the financial capacity to bear that risk and (2) MPROC had managerial and operational control over the manufacturing operations for the finished devices and leads. The court's emphasis on quality control and its role in the determination of the nonroutine nature of the manufacturing in this case appears to be fact and industry-specific. Finally, the opinion indicates that if the IRS had modified its CPM more substantially or had also offered a new method, the outcome possibly might have been different.

The Tax Court adopts an unspecified "bridge the gap" method as the best method

After concluding that neither Medtronic's CUT method nor the IRS's modified CPM constituted the best method, the Tax Court viewed its task as "bridg[ing] the gap" and finding "the right adjustments that make sense for this specific case." Medtronic put forth such a method (i.e., an unspecified method), while the IRS provided "no suggestion for realistically bridging the gap."

The court largely adopted Medtronic's unspecified method, except for the third step (the allocation of remaining system profit). The court adjusted the third step to allocate the remaining system profit 80% to Medtronic US/Med USA and 20% to MPROC. This adjustment was a way of "accounting for the imperfections of the CUT method" — i.e., differences of property licensed, profit potential, and having only one comparable — and "imperfections of the CPM" — i.e., unrealistic profit allocation to MPROC due to too high an adjustment to MPROC's return on assets and Medtronic's unsupported increase in asset intensity.

The court also concluded that there can be a single royalty rate for devices and leads and that the royalty rate is the same for both years at issue. Based on these changes, the court's unspecified method resulted in a wholesale royalty rate of 48.8%, which resulted in an overall profit split of 68.72% to Medtronic US/Med USA and 31.28% to MPROC. As a comparison, in *Medtronic I*, the blended wholesale royalty rate was 38%.

Observations

The Tax Court applied a self-labeled unspecified method to help "bridge the gap" between the parties' transfer pricing methodologies. Though called an "unspecified method," the mechanics of the court's methodology resembled a profit split method. Under this method, the elements that could be benchmarked were benchmarked and assigned returns, with the remaining system profit split on an 80/20 basis.

Let’s talk

For a deeper discussion of how the Tax Court’s second opinion in *Medtronic* may impact your business, please contact:

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