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Transfer Pricing

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United States: Eighth Circuit vacates Tax Court's determination of transfer pricing method

The U.S. Court of Appeals for the Eighth Circuit today vacated an opinion of the U.S. Tax Court concerning the transfer pricing method for the determination of income from intercompany licenses for intangible property required to manufacture certain medical devices and leads. The Eighth Circuit remanded the case to the Tax Court for further development of the findings.

The case is: *Medtronic, Inc. v. Commissioner,* No. 17-1866 (8^{th} Cir. August 16, 2018). Read the Eighth Circuit's **decision** [PDF 285 KB] that includes a concurring opinion.

Summary

The taxpayer is a U.S. medical device company, with a device manufacturing subsidiary located in Puerto Rico. The taxpayer allocated the profits earned from its devices and leads through its intercompany licensing agreements.

The taxpayer's income tax return for 2002 used the comparable uncontrolled transactions (CUT) transfer pricing method to determine the royalties rate paid on its intercompany licenses. The IRS, on audit, determined that the taxpayer was shifting too much profit to Puerto Rico in an attempt to avoid taxation in the United States. The IRS applied the residual profit split method to conclude that 90% of the profit was to be allocated to the U.S. operations and 10% to the Puerto Rico operations. To resolve the audit, the taxpayer and IRS entered into a "memorandum of understanding" by which the Puerto Rico subsidiary agreed to pay royalty rates of 44% for devices and 26% for leads on its intercompany sales. The IRS in return agreed to apply these rates in future years (if there were no changes). Neither party considered these rates to be at an arm's length price, but only as a compromise to resolve the audit.

The IRS and taxpayer could not agree on how the memorandum applied to the royalty income for 2005 and 2006 tax years. After an initial audit of the taxpayer's transfer pricing method, the IRS determined that the comparable profits method—and not the CUT method—was the best way to determine the arm's length price for the intercompany licensing agreements for those two years. The IRS concluded that the rate paid by the Puerto Rico subsidiary was too low for 2005 and 2006, and proposed an initial adjustment of $84 million.

The taxpayer contested the IRS determinations, and asserted that the CUT method ought to be used to calculate an arm's length price. The taxpayer claimed it had overpaid its taxes based on its original royalty rates under the intercompany licenses. The IRS completed the audit and proposed to increase the royalty payments by $455 million—ultimately resulting in tax deficiencies of $548 million for 2005 and $810 million for 2006.

The taxpayer initiated an action in the U.S. Tax Court which, in June 2016, rejected both the taxpayer and IRS positions and "engaged in its own valuation analysis" to find that the CUT method was to be used to determine the arm's length royalty rate for the intercompany agreements—but with a number of adjustments. The Tax Court found the arm's length royalty rate for the device licenses was 44% and the rate for lead licenses was 22%. This resulted in an order that the taxpayer had an income tax deficiency of $26.7 million in 2005 and a tax overpayment of $12.4 million in 2006.

Today, the Eighth Circuit vacated and remanded the Tax Court's determination. The Eighth Circuit explained, in part:

> *In the absence of findings regarding the degree of comparability between the controlled and uncontrolled transactions, we cannot determine whether [a sample] agreement constituted an appropriate CUT.*
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> *The tax court also did not evaluate how the different treatment of intangibles affected the comparability of the … agreement and the … Puerto Rico licensing agreement.*
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> *Finally, the tax court did not decide the amount of risk and product liability expense that should be allocated between [the taxpayer] and [the subsidiary in] Puerto Rico. The Commissioner contends that [the subsidiary in] Puerto Rico bore only 11% of the devices and leads manufacturing costs, which included its share of the product liability expense, and that therefore [the subsidiary in] Puerto Rico's allocation of profits should be a similar percentage based on its economic contribution. The tax court rejected the Commissioner's 11% valuation, concluding that it was unreasonably low because it did not give enough weight to the risks that [the subsidiary in] Puerto Rico incurred in its effort to ensure quality product manufacturing. Accordingly, the tax court allocated almost 50% of the device profits to [the subsidiary in] Puerto Rico. In doing so, the tax court also rejected the Commissioner's comparable profits methods because it found that the comparable companies used by the Commissioner under this method did not incur the same*

amount of risk incurred by [the subsidiary in] Puerto Rico. Yet the tax court reached these conclusions without making a specific finding as to what amount of risk and product liability expense was properly attributable to [the subsidiary in] Puerto Rico. In the absence of such a finding, we lack sufficient information to determine whether the tax court's profit allocation was appropriate.

We deem such findings to be essential to our review of the tax court's determination that the … agreement was a CUT, as well as necessary to our determination whether the tax court applied the best transfer pricing method for calculating an arm's length result or whether it made proper adjustments under its chosen method.

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