



TaxNewsFlash

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U.S. Tax Court: Determination of transfer pricing method, on remand from Eighth Circuit

The U.S. Tax Court today issued an opinion 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 case is: *Medtronic, Inc. v. Commissioner*, T.C. Memo 2022-85 (August 18, 2022). Read the Tax Court's [opinion](#) [PDF 483 KB]

Background

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 completing its audit, the IRS 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.

The U.S. Court of Appeals for the Eighth Circuit, in August 2018, vacated and remanded the Tax Court's determination in *Medtronic, Inc. v. Commissioner (Medtronic II)*, 900 F.3d 610 (8th Cir. 2018). The Eighth Circuit found that the Tax Court's determination that an agreement between the taxpayer and a third party was an appropriate CUT was not sufficiently supported by factual findings. In particular, the Eighth Circuit concluded that the Tax Court did not provide:

- Sufficient detail as to whether the circumstances between the third party and the taxpayer were comparable to the licensing agreement between the taxpayer and its Puerto Rico subsidiary, and whether the third-party agreement was one created in the ordinary course of business
- An analysis of the degree of comparability of the third-party agreement's contractual terms and those of the Puerto Rico subsidiary licensing agreement
- An evaluation of how the different treatment of intangibles affected the comparability of the third-party agreement and the Puerto Rico subsidiary licensing agreement
- The amount of risk and product liability expense that should be allocated between the taxpayer and its Puerto Rico subsidiary

The Eighth Circuit deemed such findings essential to its review of the Tax Court's determination that the third-party agreement was a CUT, as well as necessary to its 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. Read [TaxNewsFlash](#)

Tax Court, on remand

The Tax Court scheduled further trial for expert testimony to address:

- Whether the third-party agreement is a CUT
- Whether the Tax Court made appropriate adjustments to the third-party agreement as a CUT
- Whether the circumstances between the third party and the taxpayer were comparable to the licensing agreement between the taxpayer and its Puerto Rico subsidiary and whether the third-party agreement was an agreement created in the ordinary course of business
- An analysis of the degree of comparability of the third-party agreement's contractual terms and those of the Puerto Rico subsidiary licensing agreement
- An evaluation of how the different intangibles affected the comparability of the third-party agreement and the Puerto Rico subsidiary licensing agreement
- An analysis that contrasts and compares the CUT method using the third-party agreement with or without adjustments and the comparable profits method (CPM), including which method is the best method

After the trial and analyzing those issues, the Tax Court concluded that the taxpayer did not meet its burden to show that its allocation under the CUT method and its proposed unspecified method satisfy the arm's length standard. The Tax Court further concluded that the IRS's modified CPM results in an abuse of discretion and that the wholesale royalty rate for both devices and leads is 48.8%.

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