US TAX COURT APPLIES AN UNSPECIFIED METHOD TO INCREASE MEDTRONIC ROYALTY RATE

Recently the U.S. Tax Court issued its second opinion in the case of ***Medtronic, Inc. and Consolidated Subsidiaries v. Commissioner [T.C. Memo. 2022-84]*** (“Medtronic III”) for determining the arm's length rate for a licensing agreement (“Covered transaction”) between Medtronic Inc (“Medtronic US”) and its foreign subsidiary, Medtronic Puerto Rico (“Medtronic PR”) for the tax year 2005 and 2006 (“Covered years”).

This ruling comes after the Eighth Circuit Court of Appeal’s (“Circuit Court”) 2018 opinion (“Medtronic II”) annulled the Tax Court's first opinion in Medtronic, Inc. and Consolidated Subsidiaries vs. Commissioner [T.C. Memo. 2016-112] (“Medtronic I”) stating that the U.S. Tax Court's factual findings in Medtronic I were insufficient to evaluate the Tax Court's determination that the Siemens Pacesetter, Inc. (“Pacesetter agreement”) was an appropriate comparable uncontrolled transaction (“CUT”).

This article summarizes the recent U.S. Tax ruling and its relevance for businesses.

BACKGROUND OF THE CASE

Medtronic US is the consolidated group's parent entity, a leading medical technology company with operations and sales worldwide. Medtronic US entered into various license agreements (“Agreement”) with Medtronic PR to manufacture and sell devices and leads.

Effective September 30, 2001, the agreement granted Medtronic PR an exclusive license to use Medtronic US’s patents and portfolio of technology implantables to manufacture devices for sale to consumers in the United States and its territories and possessions, as well as leads for sale to customers globally. The agreement assigned all product liability risks for devices and leads to Medtronic PR and stated that Medtronic PR was *“liable for all costs and damages arising from recalls and product defects.”* Medtronic PR agreed to pay Medtronic US a wholesale royalty of 29% for devices and 15% for leads.

During the audit for the tax year 2002, the IRS argued that the CUT is not the best method to calculate the arm’s length of royalty payments by Medtronic PR to Medtronic US. To resolve the audit, Medtronic US and the IRS signed a memorandum of understanding (“MOU”) under which Medtronic PR agreed to pay a 44% royalty on devices and a 26% royalty on leads on its intercompany sales.

On May 22, 2007, Medtronic US and Medtronic PR amended and restated license agreements, effective May 1, 2005, to reflect agreements reached in an MOU between Medtronic US and the IRS. However, based on an analysis using the Comparable Profits Method (“CPM”), the IRS concluded that the royalties paid by Medtronic PR were not at arm's length and should be increased, limiting Medtronic PR’s earnings to 8.1% of profits in 2005 and 5.6% of the profits in 2006.

The U.S. TAX COURT’S RULING / MEDTRONICS I

Medtronic US challenged the IRS`s conclusions and filed a suit in the U.S. Tax Court, arguing that the CUT method was most appropriate for determining an arm's length price, as opposed to the CPM selected by the IRS.

The U.S. Tax Court rejected the IRS’s use of CPM as it did not give enough weight to Medtronic PR's role in quality control, among other reasons. The U.S. Tax Court used the Pacesetter Agreement as a base for its transfer pricing analysis using the CUT method and determined the arm’s length royalty rate for the devices and leads at 44% and 22% respectively, after making several adjustments.

THE EIGHT CIRCUIT COURT’S RULING / MEDTRONIC II

The Circuit Court held that the U.S. Tax Court’s factual findings from Medtronic I were insufficient to enable the Circuit Court to evaluate the Tax Court’s determination of the CUT as the best method. Further, the Circuit Court also held that *"The tax court did not address in sufficient detail whether the circumstances of the settlement between Pacesetter and Medtronic US were comparable to the licensing agreement between Medtronic and Medtronic Puerto Rico. The Pacesetter agreement resolved litigation between the parties, and the Tax Court did not decide whether it was one created in the ordinary course of business. Additionally, the Tax Court did not analyze the degree of comparability of the Pacesetter agreement's contractual terms and those of the Medtronic Puerto Rico licensing agreement."* Accordingly, the Circuit Court remanded the issue to the U.S. Tax Court for further consideration.

U.S. TAX COURT’S RULING ON REMAND / MEDTRONIC III

During the remanding proceedings, the IRS, using the CPM method, reduced the number of comparables from 14 to 5 and adjusted the product liability resulting in wholesale royalty rates of 59.6% for 2005 and 64% for 2006. This modified CPM resulted in Medtronic PR’s total system profits of 14% in 2005 and 12% in 2006. However, the U.S. Tax Court again rejected the IRS’s selection of CPM and concluded that *“the modified CPM is a minor change to the CPM. The modifications are not enough to overcome the flaws. The adjustment for product liability is inadequate. Therefore, the modified CPM is not the best method, and there is an abuse of discretion by the respondent due to the use of flawed comparables.”*

The U.S. Tax Court reexamined the facts of the case. It held that the Pacesetter agreement failed to meet three out of the five general comparability factors - functions, economic conditions, and property or services. Hence, the court rejected the Pacesetter agreement as an appropriate CUT selected by Medtronics US.

Further, the U.S. Tax Court also concluded that while the adjustments can be made to the Pacesetter agreement; however, too many adjustments result in the Pacesetter agreement as a CUT not being the best method pursuant to section 482 regulations.

After rejecting the CUT and CPM, the U.S. Tax Court requested the IRS and Medtronic US to propose an alternative method for determining the arm's length price for the covered transaction. While the IRS stood its ground, Medtronic US proposed an unspecified method that combined elements of the CUT and the CPM and provided two versions of this method, each consisting of three steps.

- The first step applies a modified version of Medtronic US's CUT method and the arm's length wholesale royalty rate of 8% for the trademark license to allocate profits to Medtronic US's R&D activities.

- The second step applies a modified version of the IRS's CPM to allocate profit to Medtronic PR's manufacturing activities. After completing the first two steps and allocating a portion of the profit for tax years 2005 and 2006, a part of the device and lead system profits remain unallocated.

- The third step allocates the remaining profit between Medtronic US and Medtronic PR using commercial and economic evidence (i.e., either 65:35 or 50:50 between Medtronic PR and Medtronic US)

The U.S. Tax Court ultimately applied the unspecified method proposed by Medtronic US to determine the arm's length rate of royalty payment by Medtronic PR to Medtronic US, except for step three. In step three, the U.S. Tax Court allocated the remaining profits between Medtronic PR and Medtronic US in the ratio of 20:80, respectively, instead of 65:35 or 50:50, as proposed by Medtronic US. This approach resulted in an overall system profit allocation of 68.72% to Medtronic U.S. affiliates and 31.28% to Medtronic PR, and a wholesale royalty rate of 48.8%

CONCLUDING REMARKS

The ruling highlights the importance of selecting the most appropriate transfer pricing method(s) for analyzing related-party transactions based on facts. The method selection must be rooted in credible evidence and by considering the facts and circumstances of each case.

It also indicates the possibility of heightened scrutiny by the IRS for transactions involving the use or transfer of intangible property, leading to increased litigation around this issue.

If your business is grappling with a similar issue(s), connect with our Global Transfer Pricing Experts to discuss the best dispute resolution strategies and the way forward.

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