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In *Medtronic*, U.S. Tax Court rules against IRS's use of CPM, applies CUT method

Global Transfer Pricing Alert 2016-020

The U.S. Tax Court on June 9 rejected the IRS's use of the aggregate comparable profits method (CPM) in *Medtronic Inc. v. Commissioner*, T.C. Memo 2016-112, to determine the appropriate royalty rate between Medtronic US and its Puerto Rican subsidiary, Medtronic Puerto Rico Operations Co. (MPROC) (the licensed manufacturer issue).

Also at issue were: (i) royalty payments made by Medtronic Europe, S.a.r.L. (Medtronic Europe) to Medtronic US for use in the manufacture of medical devices that were sold to another U.S. affiliate named Medtronic USA, Inc. (Med USA) pursuant to a supply agreement among Medtronic US, MPROC, and Medtronic Europe (the Swiss supply agreement issue); and (ii) whether Medtronic US, Med Rel, Inc., or Medtronic Puerto Rico, Inc.,[1] transferred intangible property compensable under Internal Revenue Code section 367(d) to MPROC when Medtronic US restructured its Puerto Rican operations in 2002 (the section 367(d) issue).

Licensed manufacturer issue

MPROC and Medtronic US entered into four separate intercompany agreements covering: (1) Medtronic US's sales of components to MPROC; (2) MPROC's sales of finished products to Med USA for distribution in the U.S.; (3) Medtronic US's grant of a trademark license to MPROC; and (4) Medtronic US's grant of technology and know-how licenses for devices and leads to MPROC. The taxpayer priced each of the four agreements separately, such that MPROC was treated as "a full-fledged entrepreneurial licensee responsible for its own success." In addition, Medtronic US argued that quality was the most important determinant of success in the medical device industry.

Upon review, the IRS treated MPROC not as a licensee but as a contract manufacturer, and performed a functional analysis that analyzed all four covered agreements together. Under this approach, MPROC was benchmarked against 14 companies in the medical device industry, and the remainder of the operating profits accrued to Medtronic US. The IRS also disagreed that quality was the most important determinant of success in this industry.

At trial, the IRS's expert concluded that the first two agreements were arm's length. As a result, the court did not examine them further. With respect to the other two agreements, Medtronic US had used the comparable uncontrolled transaction (CUT) method to benchmark each one. The court found that Medtronic US's proposed CUT method for the trademark license met the requirements of section 482 and therefore accepted that royalty as proposed.

In contrast, the court disagreed with the taxpayer's proposed CUT for the devices and leads licenses. At the same time, however, the court concluded that the IRS's aggregate CPM analysis was unreasonable too. In particular, the court quickly dismissed the IRS's attempt to aggregate the covered transactions, finding under the facts of the case that aggregation did not result in a reasonable allocation of system profits. In addition, the court dismissed the IRS's argument that its analysis met the commensurate with income standard under section 482 but that the taxpayer's proposed method did not.

Because of this, the court resorted to its own analysis, which involved using an adjusted CUT method that was based on Medtronic US's original position. As described in more

[1] Medtronic Puerto Rico, Inc. was the predecessor of MPROC.

detail below, the court's own analysis ended up with royalty rates similar to the IRS's position and to rates in a memorandum of understanding (MOU) that the taxpayer and IRS had entered into covering earlier years. The court stressed that the similarity between its conclusion and the MOU was purely coincidental.

The court agreed in large part with the criticism levelled at the IRS economist's report by Medtronic US's experts, and concluded that the IRS did not place enough emphasis on the importance of quality in the medical device industry. In particular, the court found that:

Product quality is the foundation for which implantable medical devices can be successful. A recall could make it very difficult for a company to continue to compete in the industry at the same level. A company can have a strong sales force and a creative marketing department, but these will not make a difference if the underlying product is unsafe and ineffective.

The court concluded that MPROC bore some of the risk involved in these transactions, and stated that MPROC contributed to the design process and had a role in product development. Finally, the court concluded that there was an ongoing relationship between Medtronic US and MPROC and that each party thereby benefitted from the other's know-how.

The court also disagreed with the IRS's proposed CPM comparables. More specifically, the court was concerned that the comparables manufactured different products at a smaller scale than MPROC, and that they engaged in additional functions such as sales and distribution. Furthermore, the IRS used the same set of comparables for what the court considered were two very different tested parties – Medtronic US's component manufacturing and MPROC's assembly of finished products.

Furthermore, the court took issue with the IRS's use of the return on assets (ROA) as the profit level indicator on the basis that "MPROC is more valuable than just buildings and equipment." The court concluded that the ROA was "misleading," because MPROC had "valuable intangible assets that were obtained through the devices and leads licenses … [which] are not recorded on petitioner's balance sheet."

As noted above, even though the court disagreed with the IRS's position, the court also took issue with Medtronic US's proposed CUT method, but mostly on the basis that such method did not make all the necessary comparability adjustments. Under Medtronic US's approach, a 7 percent royalty was adjusted to a 29 percent royalty due to certain factors such as exclusivity and know-how. The court disagreed with this for several reasons. First, the court rejected the taxpayer's assertion that market and product stage and development are proxies for profit potential. Second, the court noted that the controlled transactions included more intangibles than the adjusted internal CUT proposed by Medtronic US. Third, the court accepted the adjustments for exclusivity and know-how; however, the court concluded that the know-how adjustment was only for future technology. As noted above, the court found that there was an ongoing relationship between Medtronic US and MPROC, and that each entity shared with the other current know-how. The court concluded that such know-how was just as valuable as the exclusivity aspect of the agreement and warranted an upward adjustment.

Despite these deficiencies, the court did find that Medtronic US's approach could be used as a starting point. The court then made additional comparability adjustments to increase the royalty from 29 percent to 44 percent. As noted above, this final royalty rate is similar to the rate for leads used in the MOU that covered earlier years for this transaction. The 44 percent rate is also closer to the royalty rates proposed by the IRS using its aggregate CPM method (49.4 percent in 2005 and 58.9 percent in 2006) than Medtronic US's proposed royalty rate of 29 percent.

In contrast to the royalty for the licenses, the court found that an appropriate royalty for the leads was, as Medtronic US argued, half of the rate for the licenses. The court held, therefore, that the leads royalty should be 22 percent. This, too, was close to the 26 percent rate for the leads agreed to in the MOU.

Swiss supply agreement issue and section 367(d) issue

The court applied the same analysis to the Swiss supply agreement issue as to the devices licenses, and held that the royalty for the Swiss supply agreement issue should be 44 percent as well.

Finally, the court examined the section 367(d) issue, but rejected the IRS's assertions. The court concluded that the IRS did not identify what intangibles, as defined under section 936(h)(3)(B), had been transferred, or explain the specific value of any intangibles that should be covered by section 367(d). In addition, the court concluded that there was no section 367(d) transfer, because the intangibles used by MPROC were the subject of the devices and leads licenses.

Conclusion

It remains to be seen just how far-reaching this decision will be. Unlike the decision in *Altera Corp. v. Commissioner*, 145 T.C. No. 3 (July 27, 2015), which was decided by a panel of Tax Court judges 15-0, the *Medtronic* decision is a Tax Court memorandum opinion issued by one judge. Such an opinion is issued when the Tax Court considers that a case does not involve a novel legal issue and when the law is settled or factually driven.

In some ways, this decision might be interpreted as just an affirmation of the court's long-standing disagreement with the IRS in cases like *Bausch & Lomb, Inc. v. Commissioner*, 92 T.C. 525, 582 (1989), *aff'd*, 933 F.2d 1084 (2d Cir. 1991), where the IRS contended that an offshore manufacturing company should be analyzed simply as a contract manufacturer. In

this case, the court, continuing its demonstrated preference for CUTs, even if inexact, rejected the IRS's aggregate CPM value chain analysis. In doing so, the court focused for the most part on the strength of the taxpayer's functional analysis, which highlighted the importance of the licensee's contributions to maintaining product quality and assuming quality-related risks.

On the other hand, this decision may provide a level of comfort for taxpayers who are concerned about the possible changes that could be brought on by the OECD’s base erosion and profit shifting (BEPS) initiative, which some governments might interpret as advocating for an aggregate value chain analysis. In this case, the court squarely rejected that approach and instead opted for one that more carefully delineated each individual transaction.

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