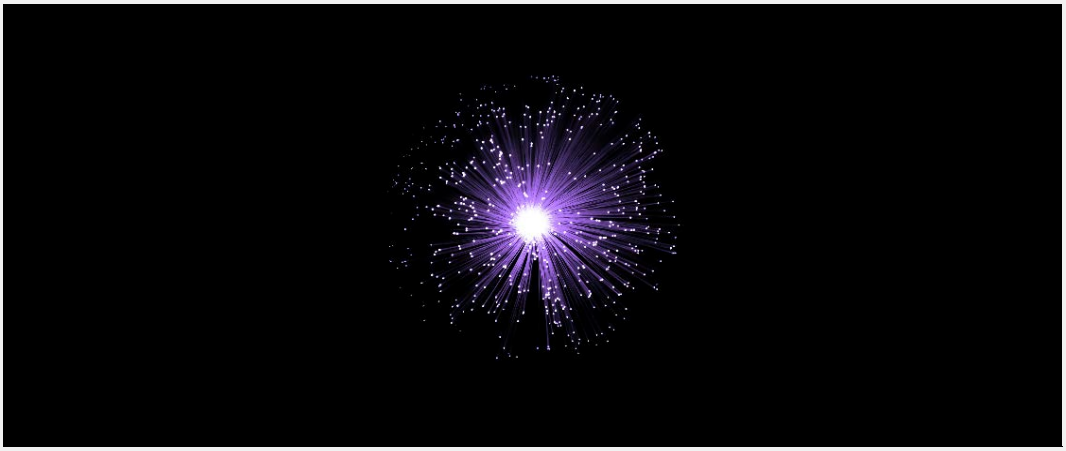

IRS files notice of appeal in *Medtronic* case

Global Transfer Pricing Alert 2017-015

The Internal Revenue Service (IRS) on 21 April filed a notice of appeal in *Medtronic Inc. v. Commissioner*, T.C. Memo 2016-112, to the Eighth Circuit Court of Appeals (Docket No. 006944-11). At issue is the appropriate royalty rate between Medtronic US and its Puerto Rican subsidiary, Medtronic Puerto Rico Operations Co. (MPROC) (the licensed manufacturer issue). The Eighth Circuit will decide whether the IRS's use of the aggregate comparable profits method (CPM) was appropriate to determine the royalty rate, or whether the comparable uncontrolled transaction (CUT) method, as adjusted to take into account differences between the controlled and uncontrolled transactions, is more reliable.

Also at issue are: (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 US 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).

Tax Court Decision

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

The US Tax Court on 9 June 2016 sided with the taxpayer on most of its positions. For a detailed summary of the Tax Court decision, see Global TP Alert 2016-20, dated June 14, 2016. A brief summary of the salient issues is provided below.

Licensed manufacturer issue

The licensed manufacturer issue involved two different types of agreements -- one for a trademark license and another for devices and leads licenses. 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.

With respect to the devices and leads licenses, the court disagreed with both the IRS's aggregate CPM position and with Medtronic US's proposed CUT method. Nevertheless, the court's disagreement with Medtronic US's proposed position was primarily on the basis that the taxpayer's proposed CUT 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 for the devices license due to certain factors such as exclusivity and know-how. The Tax Court found that, despite deficiencies in the taxpayer's analysis, this approach could be used as a starting point. The court then made additional comparability adjustments to increase the royalty for the devices license from 29 percent to 44 percent.

In contrast, 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.

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

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.

Procedural Posture on Appeal

The IRS is now appealing the US Tax Court decision, which was a memorandum opinion issued by a single 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.

On appeal, the Eighth Circuit will consider all the legal arguments, and it will not be bound by any of the Tax Court's legal determinations in the case.

Observations

The IRS's choice to appeal this decision is notable. In some ways, the *Medtronic* case could be interpreted as 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 *Medtronic*, the Tax Court, continuing its demonstrated preference for CUTs, even if inexact, rejected the IRS's aggregate CPM 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.

If the Eighth Circuit upholds the Tax Court's opinion, it would provide further support for this interpretation.

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