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Medtronic III – U.S. Tax Court attempts to "bridge the gap"?

October 2022

In light of the recent U.S. Tax Court deliberation in the Medtronic case, this contribution intends to discuss the facts, considerations and conclusions reached. Further, this contribution alongside with upcoming contributions intends to critically assess the conclusions reached by the U.S. Tax Court (as well as comparable court cases) and, the possibility of reaching a different conclusion considering another approach to the case based on the complexity provided by the parties involved.

The Medtronic dispute can be characterized (from the perceptive of Revenue Authorities) as "the classic case of a U.S. MNE taxpayer (Medtronic) shifting income from its highly profitable U.S. operations and intangibles to an offshore subsidiary operating in a tax haven (Medtronic Puerto Rico), by charging an artificially low rate for the intangibles". Medtronic's view of the case is that because its Puerto Rico subsidiary bears the lion's share of potential liability arising from any defectively manufactured products, it was entitled to a commensurate rate of return on its operations there.[1]

Background

Medtronic is a medical device company that produces and markets class III devices,[2] which include implantable cardiac pulse generators and neurological stimulators (devices), as well as other medical therapy devices (leads). Medtronic's parent company, Medtronic US, and its distributer, Medtronic USA, Inc. are located in the United States, and its class III device manufacturer, Medtronic Puerto Rico Operations Co. (MPROC), is located in Puerto Rico. Medtronic allocates the profit earned from its devices and leads between Medtronic US, Medtronic USA, and MPROC through its intercompany licensing agreements.[3]

Medtronic US and Medtronic USA (hereinafter collectively referred to as Medtronic US) primarily operates in the United States, developing and manufacturing (among other items) implantable pacemakers, brain pacemakers and leads.[4] Medtronic US has developed and owns approx. 1,800 patents.[5] MPROC manufactures implantable pacemakers and leads, using the Medtronic US patents, and for which it pays royalties to Medtronic US.[6] The internal agreements showed that MPROC bore risks related to product recall and defects.[7]

In 2002, Medtronic USA used the comparable uncontrolled transactions (CUT) transfer pricing method to determine the royalty rates paid. However, the Internal Revenue Service's (IRS) did not agree with such method and used instead the residual profit split transfer pricing method. In this regard, the IRS concluded that 90% of Medtronic's devices and leads profit should be allocated to the United States operations and 10% to the MPROC operations.[8]

To resolve the audit, Medtronic and the IRS entered into a Memorandum of Understanding (MOU) in which MPROC agreed to pay royalty rates of 44% for devices and 26% for leads on its intercompany sales, and it was agreed to apply the MOU in future years "as long as there [were] no significant changes in any underlying facts." Neither party considered the MOU's royalty rates to be an arm's length price, but rather as only a compromise in an effort to resolve the audit.[9]

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[1] Derived from the appeal of the IRS against Medtronic I, page 1 and 2, resulting in Medtronic II. Appeal from the United States Tax Court for the Eighth Circuit, No. 17-1866, Submitted: March 14, 2018.

[2] Medtronic III, page 6. "Class I medical devices are subject to the fewest regulatory controls, and class III medical devices are subject to the most stringent controls. Class III medical devices must comply with certain controls and go through a premarket approval (PMA) process. The PMA process is lengthy and can often take five to ten years. Class III medical devices are higher risk and more novel than are those of classes I and II."

[3] Appeal IRS Medtronic I, No. 17-1866, March 14, 2018, page 2, third paragraph (copied and edited).

[4] "A "lead" is a highly complex "wiring" system that transmits therapies from Medtronic's device to the heart via electrical signals and information about the heart's activity from the heart back to the device." Medtronic III, page 9.

[5] On 2022 Espacenet shows 20.011 patents on behalf of U.S. registered Medtronic companies: Medtronic Inc, Medtronic Navigation Inc, Medtronic Monitoring Inc, Medtronic Vascular Inc, Medtronic Xomed Inc, Medtronic Minimed Inc. By April 2006, Medtronic had a total of 1,800 patents. Medtronic III, page 12.

[6] Medtronic III, page 12.

[7] Medtronic III, page 14.

[8] Appeal IRS Medtronic I, No. 17-1866, March 14, 2018, page 2/3, fourth paragraph (copied and edited).

[9] Appeal IRS Medtronic I, No. 17-1866, March 14, 2018, page 3, First paragraph (copied and edited).

In tax years 2005 and 2006, Medtronic filed its tax return applying, initially the CUT method under which they determined royalty rates of 29% for intercompany sales of devices and 15% for intercompany sales of leads, which resulted in a total royalty payment of $1,191 million USD.[10] However, Medtronic later reported additional royalty income based on the MOU[11] which resulted in an increase of $581 million USD.[12]

Further, the IRS after completing an initial audit of Medtronic's transfer pricing method, determined that the comparable profits method (CPM[13])—not the CUT method—was the best way to determine an arm's length price for Medtronic's intercompany licensing agreements for those two years. Using the CPM to determine the royalty rates for intangibles under the intercompany licensing agreements, the IRS concluded that the rate paid by MPROC was too low, resulting in tax deficiencies for 2005 and 2006.

Approximately seven months later, the IRS (amending its initial notice[14]), using the CPM method determined deficiencies related to devices and leads of $548.1 and $810.3 million USD for 2005 and 2006,[15] respectively. Medtronic disagreed and filed suit in U.S. Tax Court, arguing that the CUT method, not the CPM, was the best method for determining an arm's length price for the intercompany licenses. This started the Medtronic I, II and III court cases.[16]

Medtronic III

On 18 August 2022, the U.S. Tax Court ('the Court') filed its opinion on Medtronic III.[17] The IRS argued that MPROC was the least complex party with respect to the controlled transactions, and as such, was the "tested party" in the transfer pricing analysis. They argued that the most appropriate method applicable to this case was the CPM.[18]

Further, the IRS argued that in terms of profit entitlement, MPROC should be rewarded with an operating margin based on to third-party comparable manufacturers, and Medtronic US should be rewarded with the residual profit. This meant that the majority of the $3.3 billion would be allocated to Medtronic US. The IRS maintained its position with adjustments of income reported by Medtronic US with $548 and $810 million for 2005 and 2006, respectively.[19]

Medtronic's representatives argued that the internal license agreements were at arm's length. They drafted a Comparable Uncontrolled Transaction analysis (CUT) comparing the internal license agreements with comparable external license agreements.[20] The Court proceedings went on for a few years, documented as Medtronic I,[21] Medtronic II[22] and, the most recent judgement, Medtronic III.[23]

(Intermediate) position after more than 180[24] pages of Medtronic I, II and III

In Medtronic III, the Court focused on examining the CPM and the CUT approaches. Medtronic's representatives took up the same position as in Medtronic I providing that the CUT should be applied, while the IRS argued that the CPM should be the applicable method. The Court, however, found that neither Medtronic US nor MPROC was an obvious candidate to serve as the tested party because neither Medtronic US nor MPROC has functional roles and risks that can be easily benchmarked.[25] MPROC performed non-routine functions such as ensuring product quality and assumed at least some part of the risk for product defects.[26] If MPROC were selected as the tested party, there would be no appropriate comparables.

[10] Initial royalty payments were of $478.8 and $712.7 million USD for 2005 and 2006, respectively.

[11] 44% intercompany sales of devices and 26% intercompany sales for leads.

[12] $663.4 and $1,109 million USD for years 2005 and 2006, respectively (total of $1,772 million USD).

[13] Comparable profits method is known, in countries outside the United States (EU) as the transactional net margin method (TNMM).

[14] Appeal IRS Medtronic I, No. 17-1866, March 14, 2018, page 4, second paragraph (copied and edited). "Initially, the IRS proposed an initial adjustment of $84 million based on his revised calculations under the MOU, this was contested by Medtronic arguing the CUT method should be instead used. Further, the IRS used the Comparable Profits Method (CPM), (similar to the TNMM) to calculate the arm's length royalty rates, the result of such analysis resulted in the IRS issueing a deficiency totaling $198.2 and $759.3 million USD for 2005 and 2006, respectively."

[15] Total of $1.358 million USD.

[16] Appeal IRS Medtronic I, No. 17-1866, March 14, 2018, page 4, second paragraph (copied and edited).

[17] Medtronic Inc. and Consolidated Subsidiaries v. Commissioner of Internal Revenue, T.C. Memo, 2022 Tax Ct. Aug. 18, 2022. "Medtronic III". (Medtronic III).

[18] Medtronic III, page 22.

[19] Medtronic III, page 3.

[20] Medtronic III, page 3.

[21] Medtronic Inc. v. Comm'r of Internal Revenue T.C. Memo 2016-112 (June 9, 2016). (Medtronic I).

[22] Medtronic Inc v. Comm'r., 900 F3d 610, 2018 US App LEXIS 22835 (Aug 16, 2018). (Medtronic II).

[23] Supra, no.1.

[24] 144 pages over the first decision of Medtronic II and the first 40 pages of Medtronic III.

[25] Medtronic III, page 39.

[26] Medtronic III, page 14 and 40.

With respect to the CUT analyses, the Court ruled that of the five general comparability factors, three showed comparability defects that affected the profitability outcome. The functions performed deviated, the economic conditions were different, and the license services provided showed material differences in IP rights.[27] Therefore, the 'comparable' agreement was not a CUT. As a result, the Court argued on page 40 of Medtronic III that, *"the Court's CUT in Medtronic I requires too many adjustments, and the CPM results in an unrealistic profit split and too high a royalty rate. Therefore, we conclude neither method is the best method"*.

The Court attempted to "bridge the gap"

As from page 48, the Court focuses on *"bridging the gap"*.[28] The term *"bridge the gap"* in the Oxford dictionary means *"to reduce or get rid of the differences that exist between two things or groups of people"*.[29] This is what the Court tried to do in the last 20+ pages of Medtronic III. The Court, thus, came up with a blended approach *(i)* amending the CPM with return on assets as PLI; *(ii)* amending the CUT; and *(iii)* finally, the Court implemented an 80/20 profit split.[30] Unfortunately, the Court did not clarify the 80/20 (residual) profit split in detail. It merely states that *"the resulting profit split reflects the importance of the patents as well as the role played by MPROC"*.[31] The method finally applied contains elements of the CPM, CUT and PSM, as depicted in the table below.[32]

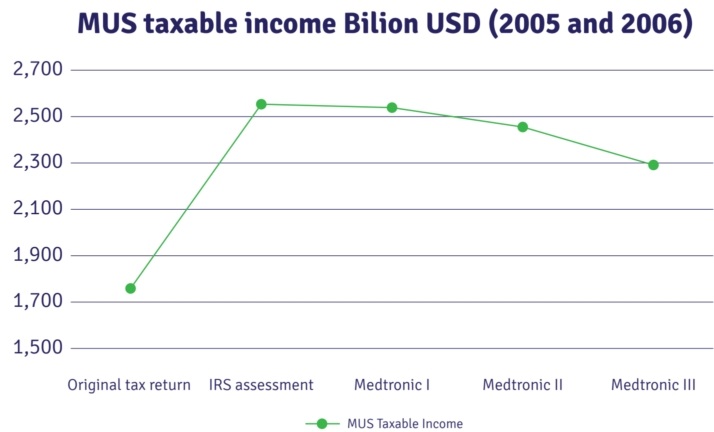
<table>
<tr><th colspan="2">Unspecified method with 80/20 residual allocation</th><th>Medtronic US profit for TY 2005–06</th><th>Med USA profit for TY 2005–06</th><th>MPROC profit for TY 2005–06</th></tr>
<tr><td colspan="2">Device and lead system profit to allocate</td><td colspan="3">$3,333,823,544</td></tr>
<tr><td colspan="2">Step 1: modified CUT + trademark license allocates returns to Medtronic US</td><td>$674,352,148</td><td>–</td><td>–</td></tr>
<tr><td colspan="2">Step 2(a): modified CPM allocates returns to MPROC</td><td>–</td><td>–</td><td>$1,344,326,942</td></tr>
<tr><td rowspan="2">Step 2(b): MPROC payments for components and distribution</td><td>Components</td><td>$138,805,027</td><td>–</td><td>138,805,027</td></tr>
<tr><td>Distribution</td><td>–</td><td>$425,697,389</td><td>425,697,389</td></tr>
<tr><td colspan="2">Step 3: allocate remaining profit based on evidence in the record with 80–20 allocation</td><td>$1,052,115,563</td><td>–</td><td>$263,028,891</td></tr>
<tr><td colspan="2">Total system profit allocated</td><td colspan="2">$2,290,970,127</td><td>$1,042,853,417</td></tr>
</table>

Observing the outcome, we question whether Medtronic representatives feel that the gap was bridged. Based on the numbers, it appears that the IRS has won. The blended approach results in an overall profit split of 68.72% to Medtronic US and 31.28% to MPROC and an R&D profit split of 62.34% to Medtronic US and 37.66% to MPROC.[33]

In this regard, below please find a table that comprises the changes in the overall profit split between MPROC and MUS in each of the corresponding instances. Additionally, find a chart with the outcome of the income allocated to MUS on each of the corresponding instances. Initially, Medtronic determined that the appropriate arm's-length royalty payments for devices and leads were $663.4 and $1,109 million USD in 2005 and 2006, respectively.[34] Further, the IRS challenged the company's determination and resolve for an increase of $1,358 million USD royalty for those years.[35] In Medtronic I the Court applying its CUT reduced the deficiency only in $14 million USD; however, in Medtronic II the Court decided over an increase of $1,246 million USD. Finally, in Medtronic III after the application of the aforementioned method decided over a royalty payment of $2,290 million USD.

[27] Medtronic III, page 30.
[28] The term 'bridge the gap' is used around 8 times starting on page 48.
[29] https://www.oxfordlearnersdictionaries.com/definition/english/bridge_2#bridge_idmg_1
[30] Medtronic III, page 66.
[31] Medtronic III, page 68.
[32] Medtronic III, page 67.
[33] Medtronic III, page 68. Medtronic determined that the appropriate arm's-length royalty payments for devices and leads were $478.8 million in 2005 and $712.7 million in 2006. Further, Medtronic applied increased royalty rates and the profit split methodology based on the Puerto Rico Memorandum of Understandings (MOU) previously agreed with the IRS (2002) and determined additional royalty income on its Schedules M-3 attached to its 2005 and 2006 tax returns of $663.4 and $1,109 million USD.
[34] Supra, no.7.
[35] The increase in the royalty payments was based upon the first return filed by Medtronic which considered a total payment of $1,191 million USD for years 2005 and 2006. Medtronic III, page 12.

Overall profit split		
Instance	MUS	MPROC
Original tax return	53,20%	46,80%
IRS assessment	76,48%	23,52%
Medtronic I	76,06%	23,94%
Medtronic II	73,12%	26,88%
Medtronic III	68,74%	31,26%



Observations

- The Court discussed the CUT method in great detail, but in the end decided that the method could not be applied reliably. The Court however stated that, *"there are enough similarities that the CUT can be used as a starting point for determining a proper royalty rate."*[36] Conceptually, we question the applicability of the CUT method.[37] The reasoning of the Court could, however, may have an impact on applying the CUT in other cases and/or arguments made by revenue authorities. In day-to-day transfer pricing, we may need to conduct a more detailed CUT analysis and clarify any comparability defects.

- In Medtronic I, II and, especially, in III, several transfer pricing methods were discussed. In the end, a blended approach was selected to *"bridge the gap"* between the methods proposed by the parties. This blended approach contains elements of the CUT, the CPM and the PSM, and looks like a trade-off between comparability defects of both, the CPM and the CUT, discounted in a residual PSM that serves as a sanity check of sorts.

  In day-to-day transfer pricing, we may need to dig deeper while selecting the most appropriate transfer pricing method and assess any comparability defects in more detail. Next to that a defect in comparability that affects profitability, at least conceptually observing Medtronic III, may be traded-off with a defect in another method and/or settled in a balancing PSM-adjustment (that serves as a sanity check).

- The IRS basically won Medtronic III but lost its CPM argument. The Court's analysis and ultimate rejection of the CPM proposed by the IRS may be valuable for many companies/taxpayers. The comparables presented by the IRS showed fundamentally different asset bases and involved different functions and risks. For instance, none of the comparable companies performed (only) the function of finished (so-called) class III device manufacturing. All companies performed some combination of the following functions: R&D, component manufacturing, finished medical device manufacturing and distribution.[38] Reference is also made to the Coca-Cola case for a valuable CPM analysis, and the routine activities therein discussed.[39]

- Finally, observing the (effective) win of the IRS, U.S. multinationals may be tempted to proceed with settlement agreements instead of long-term tax uncertainty and long drawn and costly audit/legal procedures.

The most intriguing part of the Medtronic I, II and III judgements is probably the statement of the Court on page 68 of the Medtronic III judgement that reads: *"the resulting profit split reflects the importance of the patents as well as the role played by MPROC".*[40] Apparently, these elements were not sufficiently captured in the CUT as well as the CPM studies produced. We can see in this sentence the struggle the Court was faced with to define and allocate value. It needed to consider unconventional (as in, non-nexus/substance) inputs.

[36] Medtronic III, page 35.
[37] Based on the comparability defects clarified by the Court on pages 52 -63 Medtronic III. The functions performed deviated, the economic conditions were different, and the license services provided showed material differences in IP rights.
[38] Medtronic III, page 43-44.
[39] Coca-Cola Co. & Subs. v. Commissioner, 155 T.C. 145, 210–13, 221–37 (2020).
[40] Medtronic III, page 68.

Based on the above and after analyzing the facts as presented in Medtronic I, II and III, we have decided on taking a deeper dive into the importance and positions of both, Medtronic US and MPROC, but also that of MSw. Among others the following topics will be discussed.

i. If and to which extent it is necessary to align of taxation with the 'value creation' concept[41] and the difficulties that this concept involves?
ii. Whether nexus/substance serves as an appropriate proxy for value and/or if this should be looked into from another perspective?
iii. If and to which extent it is possible to use profit (or excess sales) as a proxy for value and/or how to best capture the unique (strong) market (i.e. bargaining) positions of Medtronic.

We look forward to discussing our results in our upcoming contribution(s).

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[41] As provided by the OECD Transfer Pricing Guidelines and the UN Transfer Pricing Manual.